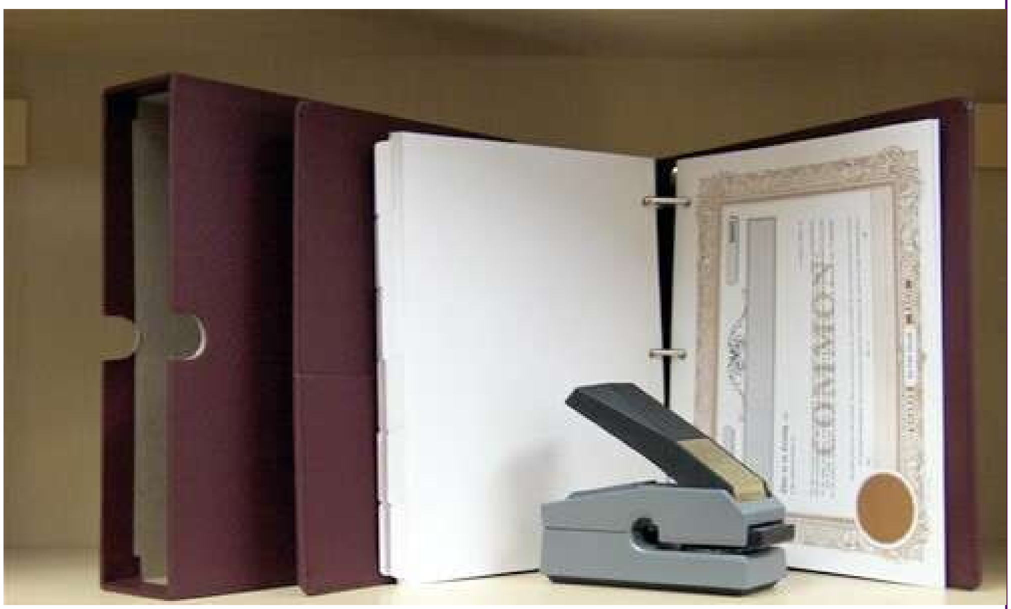
The Client Advisor

To Incorporate or Not to Incorporate

by Randy Northey



At one time or another, most small business owners will consider the question of whether or not to incorporate. While there are numerous considerations, the decision is usually made on the basis of one or more of a few primary considerations: tax advantages, protection from personal liability and cost.

Taxation Advantages

A significant tax advantage for small businesses is the low combined corporate tax rate of 16%. This allows businesses to make capital purchases, repay the principal of debt or accumulate cash with dollars that have been taxed at only 16%, as opposed to the personal tax rate of up to 46%. In addition, share ownership can be structured to distribute corporate profits among a number of shareholders, including spouses and children over the age of 18, thus spreading income to lower rate taxpayers. As well, corporations have the ability to establish various health, pension and insurance plans for owner/managers and their families, using funds taxed only at the low small business rate.

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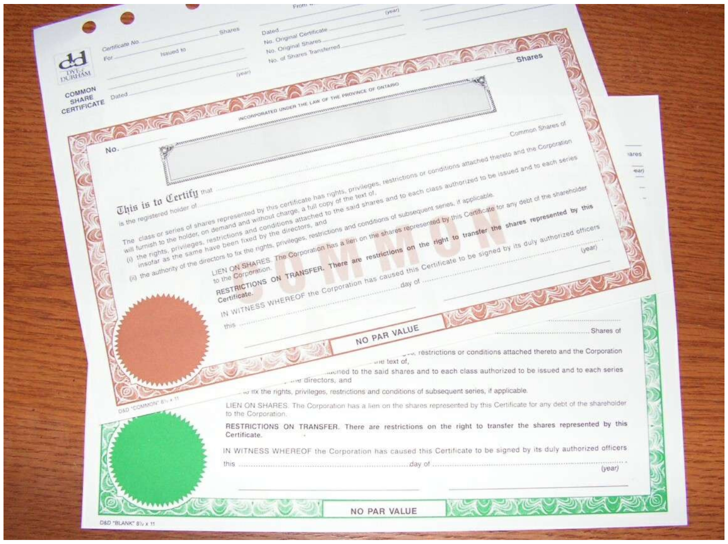

The tax advantages diminish in corporations with few capital requirements, little debt or a requirement to immediately withdraw all profits to cover living expenses. The combination of the small business tax rate applied to the profits of the company and the tax on the dividend when the profits are withdrawn results in tax that approximates the tax that would have been paid had the income been earned outside a corporate structure.

In general, there is little advantage in setting up a corporation to hold investments, such as stock portfolios or rental property investments, as investment income is taxed differently. If the capital to make the investment is profit from a small business that is a corporation, however, there is a tax-saving opportunity by virtue of the ability to invest funds that have been taxed only at the small business rate prior to being invested. If access to the capital gains exemption is a concern for the business owner, care must be taken to ensure that the investment income earned in the corporation does not disqualify the corporation from access to the exemption.

A sole proprietor's business assets can usually be transferred to a corporation on a tax free basis. This allows businesses to choose the opportune time to incorporate. It can also result in a tax benefit in the year of incorporation, through the choice of year-end for the corporation.

Liability Issues

A corporation is a recognized legal entity separate from its shareholders. As a result, liabilities of the corporation are not liabilities of the shareholders, directors or officers. An unincorporated business exposed to possible financial losses exposes the owner's personal assets to liabilities of the business. Generally, this is not so with a corporation.

Of course there are numerous exceptions. Small business owners often are required by their lenders to provide personal guarantees for indebtedness. Even so, incorporation will still protect these business owners' personal assets from trade creditors and customers. There are also numerous statutes which impose personal liability on directors and officers for such things as employee tax withholdings, GST, PST, WSIB, environmental matters and health and safety matters. Directors, officers and shareholders who commit crimes or act fraudulently are similarly not protected. In addition, a corporation needs to comply with corporate law and maintain proper books and records in order to afford liability protection.

Cost of Incorporation

The added costs of incorporation generally arise from accounting and legal fees relating to the initial set-up (which can be simple or complex), the costs of preparing an annual set of corporate financial statements and tax returns, and the costs of keeping the corporation in compliance with corporate laws.

If you are considering incorporation, it is important to obtain the advice of your financial and legal advisors before making the decision.

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