

A taxing question: The tax implications of different firm structures

Sole proprietorship and lawyers in association

This is the one type of business structure that has not changed significantly in recent years. From a tax perspective, working alone or in association may be an excellent option for those just starting out in practice, perhaps working part-time or out of their home. Your net professional income, essentially fees billed less practice expenses, is included in your income for tax purposes. If you operate your business from your home, you can deduct a reasonable proportion of your home office expenses. You must calculate your professional income on a calendar year basis. As well, you have the option of realizing additional tax benefits from incorporating as a professional law corporation, as discussed later in this article.

If you decide to work with a group of other professionals (either in association with other lawyers, or with non-lawyers as an MDP) sharing office, secretarial and other costs, you can still operate as a sole practitioner, for tax purposes. However, once the arrangement moves to one in which you share profits rather than costs, you will need to consider one of the other two structures described below.

Limited liability and other partnerships

Since 1999, when changes to the *Law Society Act* and By-Law 26 came into effect, lawyers have been able to carry on professional practice through a limited liability partnership (LLP). Prior to that, professionals could carry on practice only through a general partnership (GP) which brought with it all the problems of joint and several liability. Most professional law partnerships in Ontario have now converted into LLPs which, from a tax perspective is the preferred method of carrying on practice¹. Carrying on business through a partnership, whether a GP, an LLP or MDP, has a number of tax implications:

- Partnerships are not considered separate legal entities and are therefore not subject to tax. Profits are calculated at the partnership level, applying the normal tax rules, and are then allocated proportionately among the partners, who each pay their own tax.
- Provided the partnership files the appropriate election with CCRA, there is no need to place a value on work in progress in the calculation of income. This means that, for tax purposes, income is recognized when a fee is billed and not when the time is docketed or recorded.
- A partnership must adopt the calendar year as its fiscal period.
- For tax purposes, a partner's interest in a partnership is treated as an asset separate and distinct from the underlying assets of the partnership. As with any other asset, an interest in a partnership has a cost base for tax purposes which must be tracked. The cost base is increased by contributions of capital to the partnership plus the partner's share of income computed on a tax basis, and reduced by drawings on account of income or capital. When a partner disposes of his or her interest in the partnership upon resignation or retirement, a capital gain or loss may result because of differences in the calculation of income for book and tax purposes.
- A partnership offers maximum flexibility in structuring the ownership interests of the individual partners. Interests can be changed to reflect changes in the profit contributions of individual partners. It is also possible to have income interests in different proportions to capital interests.
- Special rules in the tax legislation permit partnerships to allocate profits to former partners, which eases the transition when partners retire or withdraw from the partnership.
- The one major tax disadvantage of a partnership is that all profits are taxed currently in the hands of the partners and

¹ LawPRO statistics indicate that 2003 LLPs represented 49% of all law firms in Ontario. © 2003 Lawyers Professional Indemnity Company. This article originally appeared in LAWPRO Magazine "Helping Your Practice Soar", Summer 2003. It is available at www.lawpro.ca/magazinearchives

there is no opportunity to reduce or defer tax, as there is with a corporation (see below). However, profits of the partnership taxed in the hands of the partners are considered to be earned income for the purposes of calculating an individual's ability to contribute to an RRSP, provided the partner is "actively engaged in the business".

- As far as the individual partners are concerned, they are treated as being self-employed for tax purposes, which means that they contribute to the Canada Pension Plan but they do not have to pay Employment Insurance (EI) contributions nor, in Ontario, the Employer Health Tax (EHT).
- The partnership, and not the partners, must obtain a business number from CCRA, for GST and payroll withholding purposes. The partnership must also file an annual information return on form T5013 with CCRA and issue each partner an information slip showing the amount of income to be reported on the partner's individual income tax return.

Professional corporations

Since 2001, lawyers and certain other professionals in Ontario have been able to carry on practice through a professional corporation (PC). While a PC does not provide any additional liability protection in respect of professional risk, it offers a wholly different set of tax planning opportunities.

The Canadian tax regime has always provided a favourable tax environment for a small business corporation, technically known as a "Canadian-Controlled Private Corporation" or CCPC, by providing a significantly reduced tax rate on the first \$200,000 of annual income. Until recently the setting up of a corporation was denied to most professionals. Not only did the law change to allow the setting up of PCs but the tax benefits were also enhanced, for all CCPCs, by a reduction in the tax rate and a raising of the threshold to which the reduced tax rate applied.

Currently, in Ontario a tax rate of 18.6 per cent applies to the first \$225,000 of annual income and, by 2006, the rate will be reduced to 17.1 per cent on the first \$300,000 of annual income. How does this impact your professional practice?

Corporations are taxed quite differently when compared to partnerships and their partners:

- A corporation is a separate legal entity and taxed independently from its shareholders.
- If a practitioner wishes to withdraw funds from his PC, he can either receive the money on a pre-tax basis as a salary or bonus, or on an after-tax basis as a dividend. The difference is that a salary or bonus reduces the taxable income of the corporation and creates an equal amount of taxable income in the hands of the recipient, while a dividend is paid out of the after-tax income of the corporation. Although a dividend is taxable in the hands of the shareholder, the shareholder is given credit for part or all of the tax paid at the corporate level. The following illustrates the tax impact of paying a salary or dividend out of a PC to its owner/shareholder.

		Salary	Dividend
PC	Revenue	1,000	1,000
	Salary paid	(1,000)	-
	Taxable income	-	1,000
	Corporate tax	-	(186)
	After-tax income	-	814
Individual	Salary/dividend received	1,000	814
	Dividend gross-up	-	203
	Taxable income	1,000	1,017
	Federal & Ontario tax	464	255
	After-tax income	\$536	\$559

There are two interesting points to note from this example. First, of the \$1,000 profit earned in the PC, \$186 goes in taxes

and \$814 can be reinvested in the business. Second, even when profits are withdrawn from the business, the combined effective tax rate is 2.3 percentage points lower than it would have been had the income been withdrawn as a salary, and the shareholder receives an additional \$23.

- If you are a sole practitioner, you can set up a PC to carry on the practice and enjoy the full benefit of the small business rate. If you are in practice with one or more other professionals, you can still use a PC to carry on the practice, but you have to share the benefits of the small business rate, and the more practitioners you have, the smaller each person's share of the tax reduction.
 - Once the PC's income exceeds the amount eligible for the small business rate, the combined tax rate in the corporation increases to about 36.6 per cent (reducing to 31.6 per cent in 2005). It then becomes tax inefficient to pay tax in the PC and distribute the after tax income as a dividend. At this point it is more tax efficient to pay a salary or bonus to the practitioner to reduce the PC's income down to the level of the small business rate.
 - Most practitioners should ensure that they have sufficient income to maximize their RRSP contribution. This requires approximately \$80,500 of earned income to generate an RRSP contribution of \$14,500 (the maximum in 2003). Salary or bonus constitutes earned income, a dividend does not. A salary or bonus at this level will also cause maximum CPP contributions to be made.
 - While EI contributions are not required on a salary you receive from a corporation you control, if total salary and bonuses paid by the PC exceed \$400,000 the PC will be liable to EHT up to an amount not exceeding 1.95 per cent of its payroll.
- Unlike other corporations, a PC is required to use a December 31 year end for tax purposes.
 - If the PC is in the position of reducing its taxable income by paying a bonus, a small measure of tax deferral can be achieved by accruing the bonus as an expense in the corporation in one year and paying it to the practitioner in the following year. Provided the bonus is paid within 179 days of the end of the corporation's tax year, the bonus is deductible in the year that it is accrued by the PC even though it is only paid, and taxed in the hands of the recipient, in the following year.
 - PCs tend not to be used in larger professional practices. If you have ten professionals practising together, spreading the benefits of the small business tax rate among ten individuals does not produce large individual tax savings. If the ten practitioners each set up their own PC to carry on business in partnership, the tax rules require that the benefits of one small business rate be spread among all ten PCs.

With the introduction of PCs, practitioners now have the same choice of business entities to organize their practices as other Canadian business people, and each have their particular advantages and disadvantages.

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