Common pitfalls & best practices for starting and leaving practice

The following are highlights from an article prepared by Margaret Dickie of Deloitte & Touche to help guide lawyers through the critical tax and income planning steps they need to take when going into and leaving private practice. For the full text of the article, please go to www.practicepro.ca/financesbooklet

Starting a practice

Registering your practice

From Canada Customs and Revenue Agency (CCRA – formerly known as Revenue Canada), you will need to obtain:

- a business number;
- a GST number (which must appear on all invoices issued to clients); and
- a payroll number, if you are going to have any employees. You will also need to register with Ontario so that you can make Employer Health Tax remittances.

Planning for required filings

Partnership returns:

- Partnership returns (for partnerships of six or more lawyers) are due by March 31.
- Returns include financial statements, T5013 slips (a partner's equivalent of a T4) plus some additional information.
- Partnerships of less than 6 lawyers: each partner files a copy of the partnership financial statements with their personal returns. A partner receiving a T5013 only needs to file that form.

Tax instalments:

- As a self-employed lawyer not subject to employee payroll deductions, you have to pay income tax in quarterly instalments, due March 15, June 15, September 15 and December 15 annually.
- CCRA charges penalty interest if instalments are seriously deficient; current rates are 3.5% to the extent instalments paid are less than 75% of the required amount.
- The contra interest rule lets you avoid interest charges as follows: if you pay your June 15 instalment on June 30, i.e. 15 days late, you can avoid an interest charge by paying your September 15 instalment on August 31, i.e. 15 days early.
- Taxes must be paid in full by April 30 even though the filing deadline for self-employed individuals is June 15.
- As a rule of thumb, set aside 40 to 45 per cent of your income for taxes: Set in place procedures to keep yourself disciplined and not use tax monies for personal use.

Banking arrangements

- Set up a separate bank account for the business: Make sure all business receipts and expenses flow through this account.
- Maintain appropriate records and reports if you draw funds from the business or pay business expenses personally and then reimburse yourself.

Borrowing

- When you borrow to invest in a business, the interest expense is deductible for tax purposes. Interest expense on funds used to acquire personal assets is not.
- Use available cash to fund the personal acquisitions; use borrowed funds to put into your practice.
- Keep a clear paper trail showing the borrowed funds going into the business in case you are challenged by the CCRA.
- Pay down your personal debt first with your income from the practice. If the practice needs more capital don't leave your income in the practice. Take it out to pay the personal debt and get another loan to put in the business.

Leaving Practice

- Plan ahead for the possible tax implications of leaving practice.
- Because partnerships can defer tax to a future period, this can mean partners are allocated deferred income – and required to pay tax – in a year after that income has actually been received and spent. Partners who do not plan for this can be caught short of cash when the deferral ends.
- Lawyers carrying a 1995 reserve who leave law practice may lose their entitlement to claim the reserve. The balance of the reserve is then included in income earlier than expected, requiring taxes to be paid on income for which there is no current cash distribution.
- Partners who leave a practice will at some point be deemed to have a disposition of their partnership interest, triggering either a capital gain or a capital loss. If the partnership did not engage in any unusual tax transactions, it will likely be a capital loss. The leaving partner should ensure that he knows what this loss is as it can be used to offset capital gains in either the year of disposition or any future year. Many partners are not aware that this disposition even takes place.