MACKENZIE Investments

CONFIDENCE IN A CHANGING WORLD

Tax & Estate Planning for Business Owners

Part I: Deciding On A Business Structure

Business owners have unique financial, investment, tax and estate planning needs. However, because most of their time, energy and resources are spent on the business, it is easy to give planning a lower priority.

That's why working with a financial advisor will not only help you put your unique plan in place, but will also result in an improved plan. The following material will help you get started in discussions with your advisor. This is Part I of a four part series, Tax and Estate Planning for Business Owners, which focuses on financial, investment, tax and estate planning strategies specific to business owners.

Many opportunities become available through incorporation of your business. For other business owners, a sole proprietorship may be the best structure. Part I compares the advantages and disadvantages of the various forms of business ownership, including incorporation. It also addresses the question of whether you should incorporate your business – a common question for business owners who seek to maximize protection of personal assets and/or minimize tax on business income.

Sole Proprietorship

A sole proprietorship is the simplest business structure to start and maintain. With a sole proprietorship, one person owns the business and its assets, and is solely responsible for all debts and obligations of the business. In exchange, the business owner can make all decisions and is entitled to all profits.

As sole proprietor, you are considered self-employed and would generally perform all functions required to successfully establish the business including securing capital, establishing and operating business processes and paying all taxes (which are calculated and reported on your personal tax return). Since a sole proprietorship is simply an extension of the business owner (and not a separate entity), any business losses can be used to reduce other income on your personal tax return including investment income, rental income and/or other income. On the other hand, should the business not have enough income and assets to fulfill its debt obligations, creditors would normally have access to your personal assets. This is known as unlimited liability.

Unlike many corporations, sole proprietorships tend to have more difficulty obtaining capital since it is not possible to issue shares in exchange for that capital. It may also be difficult to secure key employees as there are generally fewer resources and limited opportunities for career advancement. However, it is typically less costly to operate a sole proprietorship as government reporting requirements tend to be less onerous than the requirements for corporations.

Sole proprietorships are generally suggested for new businesses that do not carry the threat of personal liability. The following is a summary of the advantages and disadvantages of a sole proprietorship for your consideration.

Advantages	Disadvantages
Ability to make all decisions	Personally responsible for all debts – unlimited liability
Entitled to all profits	Limited ability to raise third party capital
Simple to establish and cost effective	Need to be a generalist; no partners with unique skills
Business losses reduce personal income tax	Attracting high caliber employees may be difficult

Partnership

A partnership is an arrangement in which two or more individuals combine resources with a view towards sharing expenses and profits. Generally, there are two types of partnerships – general partnerships and limited partnerships. In a general partnership, the partners share in the management of the business and each is personally liable for all debts and liabilities of the business. Limited partnerships limit the liability of each partner to the amount that partner has invested in the business. Limited partners are not personally liable for debts of the business, but are prohibited from participating in the day-to-day management of the business.

It tends to be less costly to establish a partnership than a corporation because there tends to be less government reporting requirements. Annual information returns are normally required for tax purposes, but income or losses of the partnership are typically reported on the personal tax returns of the partners.

One of the greatest advantages of a partnership is the ability to share in the unique skills of each partner and combine the financial resources of the partners. A significant disadvantage, however, in the case of general partnerships, is that each partner is personally liable not only for their own business debts, but for those of all partners in the partnership. A partnership can also be difficult to dissolve should disagreements arise between partners. Having said that, establishing a Partnership Agreement at the beginning of the relationship can set operating guidelines and address the process for resolving disagreements for the benefit of all partners.

The following is a summary of the advantages and disadvantages of partnerships.

Advantages	Disadvantages
Personal liability would not fall to one partner only – liability shared amongst general partners	Decision making is shared; potential for disputes
Can benefit from unique skills of partners	Unlimited personal liability; one partner's liability may detrimentally affect all general partners
Simple to establish; less costly than corporations	Limited ability to raise third party capital
Combined financial resources of partners	Finding suitable partners may be challenging
High caliber employees can be made partners	Can be legally bound by partners without knowing; difficult to dissolve partnership

Corporation

A corporation is another common business structure. Unlike proprietorships and partnerships, the law considers a corporation an entity that is separate from its owners, who are the shareholders. In fact, corporations file their own tax returns independent of shareholders, and corporate losses cannot be used to offset income on a shareholder's personal tax return.

Ownership in a corporation can be easily changed through the purchase and sale of shares of the corporation, without impacting the operations of the corporation's business. In regards to commercial activities, corporations have the same rights as individuals – they can sue, be sued and own and sell property.

Because of the ability to sell shares, it can be easier to raise capital for a corporation than for a sole proprietorship or partnership. Also, shareholders have limited liability – they are generally not personally liable for debts and obligations of the corporation.

You, as shareholder of your corporation also have some unique tax benefits including reduced tax rates for business income received by your corporation, a possible tax deferral, and an exemption from capital gains tax when certain types of shares are sold. Corporations also allow for sophisticated retirement planning including the use of Individual Pension Plans (IPPs), Retirement Compensation Arrangements (RCAs) and Estate Freezes.

The main disadvantage of the corporate structure is cost. Corporations are complex and thus tend to be expensive to set up and operate. Depending on where your corporation operates its business, additional federal and/or provincial incorporations or registrations may be required, with resulting legal and accounting fees. In addition, corporations are heavily regulated, and so require a number of reporting and disclosure requirements such as detailed financial statements and tax filings.

Corporations can be public (traded on a stock exchange) or private. They might also be classified as "professional corporations" if, as is the case with most doctors, dentists and lawyers in certain provinces and territories, the activities of the business are governed by a professional association.

Advantages	Disadvantages
Separate entity; rights similar to individuals	Costly to start and maintain (closely regulated by governments)
Shareholders not generally liable for business debts – limited liability	Possible conflict between shareholders and directors; can restrict decision making
Easier to raise third party capital through issuance of shares	Directors may be held responsible for corporate activities
Tax deferral on certain retained profits	Personal guarantees can undermine limited liability
Possible tax savings on sale or at death (eg. capital gains exemption, reduction of estate administration fees)	–

Should You Incorporate Your Business?

Many businesses start out as a sole proprietorship or partnership and later become incorporated as the business grows and becomes profitable. Whether or not your business should incorporate depends on many factors. If one or more of the following describe your situation, incorporating your business may be a suitable option. Speak with your financial advisor, lawyer and accountant to determine if incorporating is right for you.

I don't spend all of my income

If you do not require all the income your business earns for regular living expenses, then you may be able to take advantage of a tax deferral by earning your business income through a corporation. Generally, when income is earned through a corporation, it is taxed twice. Once at the corporate level, and again at the personal level when paid to shareholders as a dividend. When combined, the tax liability on business income earned through a corporation and distributed to shareholders is roughly equal to what it would be if earned through a sole proprietorship. This is known under the Income Tax Act as "integration". If you do not require all of your business income to fund daily living expenses, then the profits can remain in the corporation and be subject to the first layer of tax (corporate tax), which may be much lower than your personal tax rate. This effectively defers personal tax until such time as the profits are paid to you personally from the corporation. Note, this deferral opportunity applies only to business income. Investment income is taxed differently and does not offer such a deferral. The taxation of income in a corporation (including investment income) is discussed in more detail in Part II of this series, Earning Income In A Corporation.

The potential for liability is significant

If your business has the potential for significant liability, incorporating can help protect you and your assets. With a sole proprietorship or partnership, you are typically personally responsible for all debts and liabilities of the business. With a corporation, shareholder liability is usually limited to the amount you have invested in the company. Of course, shareholders who provide personal guarantees of corporate debt (possibly for the purpose of securing a loan for the corporation), would be personally liable for the guaranteed amount. Directors and officers of a corporation can also, in certain circumstances, be held personally liable for activities of the corporation.

My business is seeking capital

If your business needs to raise capital, incorporating can make it easier to do so. While corporations can borrow and incur debt like sole proprietorships, they can also sell shares to raise money that can be used in the business. This is a big advantage as equity capital does not have to be repaid and incurs no interest (although, your percentage of ownership in the company would decrease). Also, some lenders view corporations as being more stable than sole proprietorships, which can help to secure business loans.

I want flexibility with tax reporting

While sole proprietorships are generally required to use a calendar year-end for tax purposes (ie. December 31st), corporations can choose any date as their fiscal year-end as long as the year does not last longer than 53 weeks (Note: certain professional corporations are restricted to a calendar year-end). This allows corporations flexibility to choose a year-end that is most desirable for the business to help ensure that tax filing deadlines do not coincide with busy income earning periods. Also, certain corporate expenses can be claimed as a deduction prior to payment of the expense, resulting in a tax deferral. For example, bonuses can be paid to employees up to six months after being deducted by the corporation for tax purposes. This allows corporations with a late year fiscal year-end (i.e. July or later) to report and deduct the bonus on its current corporate tax return while deferring payment of the bonus (and taxation to employees) to the following calendar year.

I have a spouse, common-law partner and/or adult children

While sole proprietorships, partnerships and corporations all allow tax-deductible payments of reasonable salary to family members who work for the business, other payments to family members who are not actively involved in the business is permitted only if the business is incorporated. If your spouse, common-law partner or adult children are in a lower tax bracket than you, the payment of dividends to them as shareholders can result in tax savings for the family, even if they are not employees of your company. To be effective, the corporation must be a "small business corporation" (SBC) and not an investment corporation. Note that dividend payments to minor children would be subject to an additional tax that would eliminate the usefulness of this strategy.

I want to minimize tax on sale and at death

A lifetime capital gains exemption is available on the sale of "Qualified Small Business Corporation" (QSBC) shares. Because this exemption is available only on the sale of shares (not assets), it is not available to sole proprietorships or partnerships. To be eligible, the shares must satisfy certain conditions (for more information, see Part III, Retirement Planning for Business Owners). Also, estate administration fees (i.e. probate tax) is payable in some provinces on the death of a taxpayer. The fees are generally calculated based on the value of the deceased's estate, without a deduction for unsecured debt. On the death of a sole proprietor, the value of his/her business assets would be included in the probate calculation without reduction for unsecured debt. On the death of a corporate shareholder, the net value of the shares (with reduction for unsecured debt) is included in the calculation, meaning less tax payable at death. In some provinces, there might also be an opportunity to avoid probate fees on the value of corporate shares if a properly structured secondary will is established. Your lawyer can provide you with more information on this topic.

I need to preserve income-sensitive benefits

If you are receiving government benefits that depend on your level of income (e.g. Old Age Security), earning income through a corporation can preserve these benefits. Incorporated business owners can defer the payment of dividends (or reduce their salary), allowing corporate assets to remain in the corporation while minimizing the amount of taxable income to the business owner. Planning ahead to structure your income in the most tax-efficient manner can be done each year as your circumstances change so you can take best advantage of your cash flow and your income-sensitive benefits.

I'm thinking ahead to retirement

For business owners who are seeking advanced retirement planning strategies, an Individual Pension Plan (IPP) or Retirement Compensation Arrangement (RCA) can help. The establishment of these plans require corporate funding that is tax deductible. IPPs and RCAs are not available to sole proprietors or partners.

While there are many advantages to incorporating, there are also some disadvantages. Business owners should consider increased legal, accounting and administrative costs of setting up and maintaining a corporation. Also, once your business incorporates, you as business owner will no longer have the ability to deduct business losses from personal income (Note: corporate business losses can be used to offset income in the corporation for the previous three years or carried forward for twenty years). Because businesses often realize net losses in their first few years, many businesses begin as sole proprietorships or partnerships and convert to corporations as their business grows and becomes consistently profitable.

One should also be mindful of "Personal Services Business" (PSB) rules. These rules suggest that if, in the eyes of the Canada Revenue Agency (CRA), a business owner is considered an "employee" of the third-party entity to which he/she provides services, incorporating would deem the business owner to be an "incorporated employee" of that entity. Where this occurs, certain tax benefits typically available to corporations would not be available. To avoid the PSB rules and maximize tax benefits available when incorporating, the relationship between business owners and their clients should resemble a client-contractor situation and not an employer-employee situation.

Choosing an appropriate business structure that meets your needs is an important decision and will depend on the specifics of your situation. Professional financial, legal and accounting assistance is recommended.

GENERAL INQUIRIES

For all of your general inquiries and account information please call:

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