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Should You Incorporate? Part 1

JEREMY ANDERSEN

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➔ **An oft-asked question from businessowners** of all stripes is whether or not to incorporate.

- Among the reasons cited is an expectation of tax savings due to lower corporate tax rates (currently 11% combined rate for Active Business Income earned by Canadian Controlled Private Corporations in British Columbia that are eligible for the Small Business Deduction).

While there are some limited instances where incorporating a business may yield slight tax savings, our tax system is structured to prevent such advantages—and changes in recent years have all but eliminated those advantages.

That is because our system of income taxation in Canada is based on a concept known as Integration.

The Basics

Fundamentally, Integration aims to make individual taxpayers indifferent as to whether they earn income as an employee (either of an arms-length corporation or one in which they are the controlling shareholder) or by distributing income by way of dividends from a company over which they are the controlling shareholder.

In either scenario the overall tax burden from the combined corporate and individual taxes should be the same. I say "should" because despite recent changes to the *Income Tax Act,* Integration is still imperfect and various factors can result in over- or under-integration—including the applicable marginal tax bracket.

That is best illustrated by examples.

1. Let's say you operate a business as a sole proprietor and your net income from operations is $250,000. At that income level, your income would be taxed at the highest combined (Federal and BC) marginal personal income tax rate, currently 53.5%. All else being equal, your tax liability would be $133,750, leaving you with net after-tax income of $116,250.

2. Let's assume instead that you incorporate that same business that pays you a salary equal to its net income of $250,000. Having paid out all its net income, the company would have no taxable income and thus no liability for tax. You, as the employee, would be taxed on $250,000 of personal income, resulting in the same outcome as the example above.

3. Now let's assume that rather than paying yourself a salary from the company, you pay yourself in dividends. All else being equal, the company's net income of $250,000 would remain in retained earnings. That income would be taxed at the corporate income tax rate of 11%, resulting in a tax liability of $27,500. After paying that tax bill, the company would have $222,500 available

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to pay dividends to you ($250,000 – $27,500). After accounting for the dividend gross-up and related dividend tax credit, the effective income tax rate on that $222,500 would be 48.89%, thereby resulting in your receiving net after-tax income of $113,720.

Those examples are summarized in the table below.

Income in corporation	250,000
Corporate tax	(27,500)
Available for dividend	222,500
Personal tax	(108,780)
Net after tax cash	113,720
Income earned directly	250,000
Personal tax	(133,750)
Net after tax cash	116,250
Tax deferral	106,250
Deferral of tax as %	42.5%
Cost of incorporation	(2,530)
Saving (-Cost) as %	-1.0%

- The $2,530 difference in after-tax income between the two scenarios is known as "under-integration." That is, the combined corporate and personal taxes are greater than the taxes that would have been paid if you had earned income directly. In other words, the cost in terms of taxes of incorporating under the Canadian taxation system for income-earners at the highest marginal tax rate is approximately 1%. That, of course, is in addition to the direct costs of creating and maintaining a corporation. So why bother to incorporate at all?

The answer is, although Integration may eliminate any immediate tax advantages, incorporating still provides some tax planning opportunities.

Tax Planning Opportunities

One such opportunity is through timing distributions of income. If you don't require all the income earned by your company, surplus income can be left in the corporation until it's needed. That income will initially be taxed only at the lower corporate tax rate for Active Business Income.

- In our example above, that strategy results in a 42.5% tax deferral.

Of course, that income will ultimately be taxed in the hands of the individual to whom it's distributed at their marginal tax rate. The discretion as to the timing of when that surplus income is distributed, however, lies in the hands of the businessowner who can spread that distribution over time rather than all at once, resulting in it being taxed at a lower marginal tax rate, thereby reducing the overall tax burden.

Note: I have referred to the lower corporate tax rates applying to active business income. While our income tax system is designed to favour small businesses, it is also designed to dissuade taxpayers from using corporate structures to earn investment income. Active Business Income refers to income earned by a corporation through the provision of its primary business activity.

That means if you provide professional services through a corporation,

It should be noted that dividends and salary are not mutually exclusive; sometimes a blend of the two is an advantageous strategy.

that income would be taxed as Active Business Income. If you invest the corporation's surplus cash, however, the income derived from those investment activities would not receive the same favourable tax treatment.

Another tax-planning opportunity is through an income-splitting strategy known as dividend "sprinkling." That strategy is often employed by spouses who are shareholders in a corporation that is operated by either one or both spouses.

- Rather than distributing 100% of the surplus to just one spouse to be taxed at a higher rate, the dividends can be split between the two shareholding spouses, resulting in that same amount being taxed in the hands of two individuals at lower marginal tax rates.
- That strategy can be further enhanced by issuing different classes of shares to each spouse, thereby allowing the corporation to pay 100% of the dividends to one spouse or to split them between spouses, depending on what is more advantageous, given the circumstances at the time.

A strong word of caution when employing such a strategy—the Tax On Split Income (TOSI) rules were enhanced in 2019, which at once expanded the applicability of the TOSI rules while also making them more complex. The implications of being offside with TOSI are severe. Therefore, it is wise to consult with a tax advisor who is familiar with your particular circumstances before contemplating such a strategy.

The Source of Income Matters

While Integration is intended to make individuals indifferent as to the source of their income, in terms of liability for tax, there are other factors to consider. For instance, dividends are not considered earned income and therefore do not apply to the income-test used for certain tax incentives.

- For example, RRSP contribution room is based on earned income, meaning employment income creates RRSP contribution room . . . dividends do not. Likewise, employment income is subject to CPP withholdings charged to both employers and employees, currently at a rate of 5.95% each. Those who are self-employed are responsible for both employer and employee portions, for a total of 11.9%.

It should be noted that dividends and salary are not mutually exclusive; sometimes a blend of the two is an advantageous strategy.

- For example, those who want the forced savings afforded by the CPP program may want to pay a salary to the CPP maximum applicable threshold. Or perhaps you would like to generate earned income to reduce the threshold for claiming the medical-expenses credit. Perhaps still you would like to declare a bonus to reduce your company's taxable income to a target level.

A Final Word

Those are generalized examples containing many simplifying assumptions that may not apply in every situation. Moreover, income tax rules are subject to ongoing changes; the assumptions used in the examples may not hold in the future. Readers are strongly encouraged to consult with a tax advisor before attempting to employ any of the strategies discussed in this article.

JEREMY ANDERSEN is a Courtenay Notary Public and CPA, CA, with 20 years' experience working in the public sector, private industry, and public practice.