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Is Incorporation right for your business?

My personal view as an accountant is that virtually every "active"[1] business except the smallest of service businesses should be incorporated. Incorporation can "creditor-proof" personal finances and provide a variety of immediate and long term tax benefits. It also provides prestige and a sense of permanence to suppliers, bankers and customers. But incorporation may not be right for your business. There are no simple answers. The following article discusses some of the basics about creditor-proofing and possible tax savings.

Overview

If you are operating an unincorporated business as a single owner or in partnership, you and any partners are the business. You pay taxes annually based on your business income for the calendar year and if the business is in financial difficulty you can be held personally liable for its debts.

A corporation, however, has a life of its own. It is a taxpayer in its own right and the company's debts are separate from those of the owners.

Creditor proofing

Although incorporation can limit your liability because of the separation of the owner from the business, there are limitations. Banks and large suppliers often require personal guarantees from the company's shareholders before they will loan funds. Regardless of the need for personal guarantees, financial institutions seem to prefer to lend to incorporated businesses because the separation of personal and business finances can provide lenders with an additional level of security and a more formal structure into which to lend.

The shareholders of a small company are usually its directors and may be personally liable for company debts in many situations. Under law, directors are responsible for debts relating to employee wages, income taxes, GST, employee deductions and Worker's Compensation. The directors may also be liable under statute for certain specified acts relating to share or dividend transactions or under common law where the actions of the company were illegal or represented gross negligence.

Tax advantages

The question of whether to incorporate to save taxes is relatively black and white subject to two qualifications:

"Will the business make money?"

> A corporation is a taxpayer in its own right and files its own tax returns. If a sole proprietorship or partnership is losing money and the owner(s) have other personal income then the loss from the business can be deducted from the owner's other income. A company or incorporated business can only deduct losses against prior years' or future income earned within the company. That is, business losses are trapped in the corporation until the company becomes profitable.

"Will you need to take all of the income of the company out to meet personal expenses?"

> All of the cash in an unincorporated business is always the owners, but the monies of a corporation belong to the company. The rules are complex, but in simple terms, under the Income Tax Act (ITA), you cannot

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[1] In this context an active business is one that provides goods or services, e.g., a retailer, manufacturer, distributor, computer repair shop, real estate broker, etc. It excludes small rental operations and investment companies with fewer than six employees, which are generally considered to earn "passive" income, i.e., income that is earned more as a function of ownership and time rather than the proactive work of the owners and employees.

borrow money from your company and if you need all of the company's income to live on, the company will need to pay you a salary, bonus or dividend such that there is little or no tax advantage to incorporation.

But, if a company is already established or you believe your operation will be immediately profitable there can be large tax advantages to incorporation. In Ontario, personal tax rates start at 22% and rise to more than 46% at $113,000 while the first $300,000 in income for a qualifying small business company[2] is taxed at only 18.6%.

The primary advantage of this lower corporate tax rate is that you have more money left after taxes to build your business and pay down its debts. Assuming that you have $200,000 in business income and that you need $50,000 after tax to live on. The differences in total taxes paid and cash available are:

	Unincorporated	Incorporated		
		Company	Personal	Total
Total income	$ 200,000	$ 200,000		
Salary paid		(70,000)	70,000	
Net taxable income	$ 200,000	$ 130,000	$ 70,000	$ 200,000
Taxes payable	(74,000)	(23,100)	(16,000)	(44,100)
Net cash available after taxes	$ 126,000	$ 106,900	$ 54,000	$ 160,900
Less: Living expenses	(50,000)			(50,000)
Cash remaining	$ 76,000			$ 110,900

In the above example, if you are incorporated and leave any income in excess of your personal requirements in the business, you will save $34,900[3] in current taxes and have that much more money in the company for expansion or to pay off the company's debts.

There are other tax advantages to incorporation such as the ability to defer taxes using bonuses that are not payable until six months after the year end and the opportunity to split income by making family members shareholders.

Finally, a corporate structure may allow enhanced tax deferral or reduction strategies for the sale of your business, or succession and estate planning purposes. The most basic of these opportunities is that a shareholder of a qualifying small business corporation may be eligible for a capital gains exemption of up to $500,000 when the shares of the business are sold or passed on to his or her children.

Conclusion

There are many issues to the question of whether you should incorporate your business and the preceding discusses only a few of them in very general terms. If you are considering incorporation, you should talk to an accountant or tax adviser to ensure that forming a company is the right decision and to ensure that the company is set up to maximize the tax benefits. A lawyer or other legal professional should always be used to make certain the corporation is properly formed, provides adequate creditor protection and meets any future needs.

This report is presented as a source of general information only and has been prepared based on information from various sources. Every effort has been made to ensure the accuracy of the information but this article is not intended as a substitute for competent professional advice tailored to the individual reader's particular circumstance.

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[2] This lower tax rate is only available for a Canadian Controlled Private Corporation (CCPC) on Active Business Income (ABI). If a company is not eligible for the Small Business Deduction (SBD), corporate tax rates may be higher than corresponding personal rates.

[3] The tax savings are a deferral that may be short or long term, depending on when the retained income is distributed to the shareholders as dividends.