

Should I Incorporate?

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Many of you know that there are three common legal structures of business: sole proprietorship, partnership and incorporation. Many entrepreneurs start as sole proprietorship or when there is more than one owner, as a partnership. Why? Because it is less costly to set up and have greater freedom from regulations. However, some entrepreneurs should consider incorporating their business. A corporation generally allows more tax planning flexibilities and thus opens doors to more tax savings.

Tax benefits

The main two income tax advantages for incorporation are the lower tax rate offered by the small business deduction and the capital gains deduction.

- Lower tax rate: A corporation may be able to enjoy the lower corporate tax rate available for qualified small business. For non-corporations, money earned from self-employed business is reported on your personal tax return. You may need to pay significant amount of taxes when the income is taxed at a high marginal personal tax rate. For example the top marginal personal tax rate is about 44%. The income tax paid on such income may generally be reduced or deferred by using a corporation. The B.C. small business rate for 2005 is about 17% for the first \$300,000 profit.
- Capital gains deduction: When you sell the shares of a qualified small business corporation; the first \$500,000 capital gain is tax free.

When to consider incorporation

However, in order to realize substantial tax savings, the profits of the corporation must be able to accumulate within the corporation. If the entire profits are paid out as annual salary to you to sustain your personal living expenses, you are likely not going to get the advantage of the lower tax rate of incorporation. Here are simple examples that show this concept, based on 2005 B.C. tax rates and assuming no other personal income:

<u>Corporate profit</u>	<u>Salary draw</u>	<u>Corporate tax</u>	<u>Personal tax</u>	<u>Tax paid</u>
\$300,000	-	\$53,000	-	\$ 53,000
\$300,000	\$300,000	-	\$115,000	\$115,000
\$100,000	-	\$17,000	-	\$17,000
\$100,000	\$100,000	-	\$28,000	\$28,000
\$40,000	-	\$ 7,000	-	\$ 7,000
\$40,000	\$40,000	-	\$7,100	\$ 7,100
\$30,000	-	\$ 5,300	-	\$ 5,300
\$30,000	\$30,000	-	\$4,500	\$ 4,500

Let's take a look at the corporation that made \$300,000 profit. If it leaves that \$300,000 in the company, the corporate tax paid is \$53,000. But if the owner takes the \$300,000 as salary, the personal tax paid is \$115,000.

These examples show what I called the Forty-thousand-rule. At \$40,000, you start to get some tax savings from incorporation. The higher you go above \$40,000, the more significant the tax savings. On the other hand, when you go below \$40,000, you pay less tax when you are unincorporated.

Should I / Can I Incorporate

When deciding whether to incorporate, tax is not the only factor you consider. You need to consider other factors that can affect your business, such as legal liabilities, company image, and financing issues.

Some companies need to incorporate because of the high risk in legal claims. Incorporation usually can protect the owner's personal assets from company creditors since creditors can sue a corporation for funds, but cannot go after the owner directly. However, this may not be true for certain professionals, such as professional accountants. Professional corporation does not allow the accounting professional to escape unlimited professional liability.

You may also want to review the provincial laws governing your profession because, in certain provinces, carrying on a profession through corporation is not permitted. As a professional, you should consult with your professional association to ensure that the bylaws allow you to practice your operation through a corporation.

Incorporation may also be more costly and involved more paperwork. Once incorporated, you no longer report your business income on your personal income tax return. You need to file two tax returns, one corporation tax return to report your business income and one personal income tax return to report your personal income.

How to incorporate

With the new B.C. Business Corporations Act, the government has made the incorporation procedure easier than ever. Nonetheless, you should consult your lawyer and your accountant before incorporating. They can help you draw up the corporate documents that include information such as value, type and number of shares, and help you set up your business in a more tax effective structure. An effective start up could give you substantial savings in the long run.