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Incorporation for Physicians

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Incorporation is a term that most physicians and medical residents are familiar with, but may not fully understand.

The purpose of these notes is to provide an introduction to incorporation and to answer the following questions:

- What?
- Why?
- When?
- How?
- What next?

What is Incorporation?

Incorporation is the creation of a separate legal entity, the corporation, to earn the medical practice income.

A company can enter into contracts, own property and investments, earn income and pay taxes.

It can distribute its earnings to its shareholders through salary or dividends.

Why Incorporate?

There are a number of benefits of incorporation, mainly a result of the favourable tax rates in BC on active businesses in comparison to personal income tax rates.

Lower Income Tax Rates

The corporate tax rate on active business income in BC is 13.5% on the first $500,000 of earnings, and 25% on earnings in excess of $500,000.

The highest personal income tax rate is 43.7% (on income in excess of $132,000).

This difference in tax rates gives the corporation an advantage in paying for items that are not deductible for tax purposes, such as life insurance, club dues, debt principal payments and investments.

To pay for these items, the company must first earn income and pay associated tax. The amount left over can be used to pay for these expenses.

Consider a $10,000 annual life insurance premium (life insurance premiums are not generally deductible for tax purposes):

- A person in the highest tax bracket must earn $17,760 before taxes to pay the premium.

  $10,000 / (100% - 43.7%)

- A company only needs to earn $11,560 to pay the premium, an advantage of $6,200.

  $10,000 / (100% - 13.5%)

Income Tax Deferral

Income from an active business is taxed in a corporation at 13.5%, compared to the highest personal tax rate of 43.7%, a difference of over 30%.

Income that isn't needed to fund personal expenses can be left in the corporation and be taxed at only 13.5%. More after tax funds are available for investing purposes than when all of the income is earned personally.

This is only a deferral of income tax. Personal tax is still paid on the income when finally taken from the company as dividends or salary. However, with planning some of this deferral can be permanent.

If dividends are paid from the company when the shareholder has lower personal income (retirement), the shareholder will not be in the highest tax bracket and some of the tax deferral will never be paid.

A person with no other sources of income can earn $30,000 of dividends without paying personal income tax.

Note: Dividends are taxed at a lower rate to take into account the income tax already paid by the corporation.

Income Splitting

Income splitting is paying another person income so that two or more sets of lower income tax rates can be used.

Individuals are taxed personally at marginal tax rates – the higher the income, the higher the tax rate.

Personal income tax rates for 2012 in BC are as follows:

Taxable Income	Regular Income	Capital Gains	Regular Dividends	Eligible Dividends
First $37,013	20.06%	10.03%	4.16%	-6.84%
$37,013 - $42,707	22.70%	11.35%	7.46%	-3.20%
$42,707 - $74,028	29.70%	14.85%	16.21%	6.46%
$74,028 - $84,993	32.50%	16.25%	19.71%	10.32%
$84,993 - $85,414	34.29%	17.15%	21.95%	12.79%
$85,414 - $103,205	38.29%	19.15%	26.95%	18.31%
$103,205 - $132,406	40.70%	20.35%	29.96%	21.64%
Over $132,406	43.70%	21.85%	33.71%	25.78%

The tax on one person reporting $120,000 in income is a lot more than the tax on 3 people each reporting $40,000 in income (difference is over $15,000).

An unincorporated physician can only split income by paying wages to family members. However, the deductibility of wages is subject to a reasonability test. If the wage isn't reasonable, there is the possibility of double taxation – the physician will be denied the tax deduction, but the family member will still have to pay tax on the income.

The amount of salary that is considered reasonable is a judgement call, but it is very unlikely that a salary of $60,000 paid to an adult child or spouse that is not active in the practice will be considered reasonable.

When the medical practice is incorporated, dividends can be paid to shareholders. There is no reasonability limitation on dividends.

Shareholders of a medical corporation can be a spouse, children, parents, siblings, or other relatives. A shareholder with no other sources of income can receive up to $30,000 in dividends without paying personal tax.

Children under the age of 18 can be shareholders, but should not be paid dividends until they turn 18. Dividends to minor children are subject to the “Kiddie Tax” which effectively taxes the dividend at the highest personal tax rate.

Income Smoothing

A corporation can be used to smooth an individual’s income over a period of low earnings and take advantage of the individual’s lower marginal tax rates over 2 or more years.

Income can be used to assist with maternity leave, education leave or a sabbatical.

Consider a physician who earns $200,000 in 2012, and who will have no earnings in 2013 while on sabbatical.

If the income is earned personally, the full $200,000 is taxed in 2012 and no income tax will be paid in 2013.

If earned corporately, the corporation will pay tax in 2012, and then can pay dividends or salary out to the physician in 2012 and 2013.

By spreading out the $200,000 over 2 years, tax of about $17,500 is saved.

Capital Gains Deduction

Each Canadian is entitled to earn $750,000 in tax free gains on the sale of shares in a qualified small business corporation (QSBC).

To be considered a QSBC, 90% of the assets of the company must be used in an active business at the time of the sale, and 50% of the assets must be used in an active business over the 2 years prior to the sale.

The capital gains deduction is not usually a consideration for physicians as most medical practices have a very low resale value. However, where the company owns the real estate that the practice operates from, the capital gains deduction can be used.

Tax planning is required a few years prior to any sale to ensure that the shares of the company will qualify for the capital gains deduction.

Limited Liability

Limited liability is often mentioned as one of the main reasons to incorporate a business. A shareholder's liability for actions / problems of the company is limited to their investment in the company.

However, physicians are still personally liable for any malpractice, even if operating through a corporation.

In addition, banks will usually require personal guarantees of the shareholders for debt of the corporation.

Flexibility

Using a corporation provides great flexibility and a number of choices for remuneration, including:

- Salary vs. dividends
- Personal Health Services Plan (PHSP)
- Individual Pension Plan (IPP)
- Employee Profit Sharing Plan (EPSP)
- Retiring Allowance

A detailed description of these options is beyond the scope of these notes.

Why Not Incorporate?

Incorporation is not without drawbacks, including:

- Legal and accounting costs for set-up ($2,000 – $3,000)
- Annual legal and accounting costs ($2,000 - $4,000)
- Increased complexity
- Increased compliance – preparation and filing of T4 and T5 slips, corporation income tax return and financial statements, preparation and filing of annual legal resolutions and annual report to the registrar of companies

In most cases, the advantages of incorporation greatly outweigh the disadvantages.

When to Incorporate?

Incorporation is not cost effective for everyone. A physician who spends everything he earns and has no family members to split income with is not ready for incorporation. Incorporation in this situation provides no tax savings; only additional costs and complexity.

Consideration should be given to incorporating when:

- Funds can be set aside for saving/investing; or
- There are family members with lower income that can be used for income splitting purposes; or
- The practice will be incurring large capital costs and debt (equipment, building).

How to Incorporate?

The ability of physicians to incorporate is governed by the *Health Professions Act (British Columbia)* and requires the approval of the College of Physicians and Surgeons of BC. Consultation with your lawyer and accountant are essential when planning to incorporate to ensure that the proper structure is put in place. Canada Revenue Agency (CRA) only allows physicians to earn income through a medical corporation if the company has the correct structure and permissions. If a corporation does not comply with the rules, the income can be attributed back to the physician personally.

Some of the steps in the incorporation process are:

- Articles of Incorporation – governing document for the corporation listing what it can and cannot do, rights and restrictions of shareholders, etc...
- Application to the College of Physicians and Surgeons
- Application to the BC Registrar of Companies
- Opening of bank account, payment for shares
- Registration with CRA for income tax and payroll
- Registration with Worksafe BC
- Obtaining MSP billing number for corporation
- Notification to CMPA and disability insurance providers
- Notification to BCMA regarding payment of benefits (CMPA rebate, CME benefit)

What Next?

If you have any questions or would like assistance with the incorporation process or any other financial planning issues, please contact me:

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