Tax Planning for Lawyers

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TAX PLANNING FOR LAWYERS

INTRODUCTION

The purpose of this paper is to explore the different ways that a professional corporation can benefit a lawyer. In particular, the impact of recent changes to the professional corporation legislation in Alberta will be examined specific to the context of practicing law. Issues that will be covered include tax deferral, income splitting, appropriate methods for adding family shareholders and the appropriate use of a family trust with a professional corporation. Also covered is the decision to pay salaries or dividends, a strategy for removing assets from a professional corporation without paying tax, a strategy for structuring a professional partnership and the issue of whether a professional corporation could be a personal services business.

REASONS FOR INCORPORATING

In order to understand the reasons for incorporating a professional corporation ("PC"), it is first necessary to understand the reasons for incorporating a business in general. Once those reasons are understood, the same ideas can be applied to a PC to see if there are advantages available to the professional.

There are a number of tax and non-tax reasons for incorporating a business. The first, and most obvious reason to incorporate is the availability of limited liability for the business owner, which is something all lawyers understand. Other reasons include tax deferral, income splitting, using the $800,000 capital gains exemption ("CGE") on the sale of the business[1], and multiplying the capital gains exemption, as well as creditor-proofing the business with a holding corporation.

Tax Deferral

A major tax advantage of a corporation is the ability to defer income tax. Tax deferral is possible because corporations generally have a lower tax rate on business income than an individual. Personal tax rates for Alberta resident individuals are graduated depending on how much income is earned as follows:

[1] The capital gains exemption is presently $750,000 but is rising to $800,000 on January 1, 2014 and will continue to rise automatically each year thereafter depending on the rate of inflation.

Up to $43,561	25%[2]
$43,562-$87,123	32%
$87,124 - $135,054	36%
$135,055 and over	39%

Corporate tax rates on business income[3] in Alberta are at two levels. Where the corporation is a Canadian-controlled private corporation[4] ("CCPC"), the tax rate on the first $500,000 of net business income after all expenses and salaries including owner salaries and bonuses have been deducted is 14% in Alberta. This very low tax rate is often referred to as the small business deduction ("SBD") rate. Net business income over $500,000 of CCPCs and all net business income of non-CCPCs is taxed at the general corporate tax rate of 25%.

Salaries and bonuses drawn out of a corporation are taxed as full rate income to the shareholder and are deductible to the corporation whereas dividends are paid out of after tax corporate income and not deductible to the corporation. In theory[5], the same amount of tax should be paid on net business income earned directly by an individual and net business income earned first by a corporation that then paid out as a dividend to the shareholder. The result of this taxation regime is that the tax rate on dividends received by individuals should be much lower than the tax rate on salaries and bonuses. The lower dividend tax rate is to take into account the fact that the corporation has already paid an amount of tax on that income. [6] Dividends that are paid to individuals out of corporate income that has been taxed at the SBD rate of 14% are taxed in the individual's hands at graduated rates of up to 27.71 in Alberta[7]. Dividends that are paid out of corporate income that has been taxed at the general rate of 25% are called "eligible dividends" and are taxed at graduated rates of up to 19.29% in Alberta.

The ability to defer tax through a corporation arises out of the fact that if the shareholder does not need or want the corporate income, the income does not have to be paid out to the shareholder as a

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[2] Personal tax credits are deducted from the tax payable and do not reduce taxable income. Therefore, while tax is payable at 25% on the first $43.,561 of income the personal tax credits reduce that tax payable thus reducing the effective tax rate on very low amounts of incomes until the personal tax credits are exhausted.
[3] Corporate tax on investment income is calculated very differently from business income and is beyond the scope of this paper.
[4] Simply put, a CCPC is a Canadian corporation that is not a public corporation and is not controlled by one or more non-residents or one or more public corporations.
[5] This theory is often called the "Theory of Integration"
[6] The mechanism for achieving the lower tax rate on dividends received by an individual is a three -step process. First, the dividend is increased, or grossed up, by a factor which takes into account the corporate income that was earned. Second, the grossed up income is subject to the individual's personal tax rate. Third, a dividend tax credit, which is a personal tax credit, is applied which reduces the personal tax on the dividend. The end result of the gross-up and dividend tax credit is a much lower tax rate on the dividend that should result in perfect integration.
[7] Rising to 29.87% in 2014 to make integration more perfect.