

Incorporating law firms offers tax advantages

BY IAN HARVEY
For Law Times

Lawyers seeking tax relief should consider incorporating their businesses, says Clifford M. Goldlist, a senior tax partner at Lerner LLP in Toronto, who finds himself spending more of his time guiding fellow members of the bar through the process.

“Until 2001 Ontario professionals were prohibited from incorporating,” he says. “Even after the Ontario Business Corporations Act was amended that year, it was several years before the Law Society Act was amended to make it permissible for lawyers to incorporate.”

Since the path has been cleared to incorporate, lawyers have begun to do so and while it hasn't exactly been a stampede, Goldlist says that the pace is picking up of late.

“Certainly their accountants are pushing them this way,” he says. “And there's been much discussion of the subject of late at professional conferences. By the time they get to my office and sit down, they have a good idea and want to know if the tax benefits are really worth the effort.”

He says there are several clear advantages, especially in the area of tax savings and deferral.

There are a couple of wrinkles around incorporating, he says, one is that to qualify under the rules the practitioner must first get a certificate from the Law Society of Upper Canada and the other is that all shareholders of the company must be lawyers. No non-lawyers may be shareholders, which means spouses, children, and other administrative staff or managers cannot hold an equity position. Also, the only business the corporation is permitted to carry on is the practice of law.

On the non-tax front, though incorporation does not offer any additional shield from professional liability claims, it does afford liability protection for non-professional

claims such as from landlords and suppliers. The big advantage is the significantly lower marginal corporate tax rate and tax-planning opportunities to reduce and defer tax.

“The small business deduction is available only to Canadian-controlled private corporations,” says Goldlist. “Income which qualifies for the small business deduction (generally, active business income net of expenses not exceeding the annual business limit — \$400,000 federally and \$500,000 in Ontario) is taxed at a combined federal and Ontario rate of 16.5 per cent in 2008 and 2009. That's about 30 per cent less than the combined federal-Ontario top personal marginal tax rate of 46.41 per cent which most practising lawyers in Ontario are paying.”

Leaving the money in the corporation to shoulder the overhead and other business expenses, including a salary to the practitioner, will immediately cut the tax rate as long as the professional does not need the remaining money to live on. Also, leaving the money in the corporation, including the 30 per cent annual tax savings creates a greater source of capital to finance the practice or invest in other things, he says.

“You can reinvest with 83.5-cent after-tax dollars rather than with 53.5-cent after-tax dollars,” Goldlist points out. “It's not rocket science to see that this alternative can be very attractive to a mature lawyer earning good money with adult children and who does not need to spend everything he or she earns.”

While the rules don't allow for “income splitting” in the traditional sense, they do open the door to channel funds to spouses and adult children in other ways.

First, he says, lawyers whose spouses are lawyers but not practising can also benefit from the professional corporation because they are allowed under the law society's rules to be shareholders.



Clifford Goldlist says there are several clear advantages to incorporating, especially in the area of tax savings and deferral.

“That both spouses are lawyers happens more often than you might think,” he says. “Many lawyers' spouses maintain their professional qualification but don't practise for a variety of reasons.”

There's also an option to set up a management corporation owned by a trust to benefit the practitioner's spouse and adult children, which can be administered by the practitioner as trustee.

The management corporation can provide leased premises, staffing, administrative, and other support services, such as computer, photocopier, and other equipment leasing arrangements, IT services, bookkeeping, and the like to the professional corporation on a cost-plus-15 per cent basis. The income earned by the management corporation will generally qualify for the small business deduction. If the spouse and adult children have no other income they can receive up to \$32,000 a year each in tax-free dividends from the management corporation. They can also be paid a reasonable salary by the management corporation if they are employed to provide services to the practice.

Goldlist says that alternative is generally not as effective for tax-planning purposes where the practitioner has a professional corporation because associated corporations must share the annual small business limit. In those cases where the management corporation does not provide any added benefit, a degree of income splitting can still be achieved by having the professional corporation employ the spouse and adult children and pay them a reasonable salary.

Another potential advantage, he says, is the corporation can pay for certain non-deductible expenses, such as corporate-owned term life insurance premiums and the non-deductible portion of corporately leased automobile costs, and meal and entertainment expenses (including golf club membership, and social and sports club dues and fees), where they are business development related and there's scope for the professional corporation to set up and administer an individual pension plan for the practitioner.

For those already practising in partnership, including a limited liability partnership, a professional corporation can also offer significant tax advantages.

The latter needs careful planning to reorganize the firm so the professional services of the partners are rendered to the partnership through their own independent professional corporations.

The central management and administration functions of the firm are still provided by the partnership. The lawyers' professional corporations invoice the partnership for their services while the partnership in turn invoices the clients as before.

As a result, the practitioners earn most of their income not as members of the partnership, but through the billings of their professional corporations to the partnership. Those billings will thus reduce the income of the partnership accordingly.

There are, however, a myriad of rules and some pitfalls, including stickhandling around the requirement that the small business deduction must be shared amongst partners, ensuring the operation is not deemed a “personal services business” and thus not qualified for small business deduction.

Avoiding the “general anti-avoidance rule” as such means an advance income tax ruling should be sought first, but Goldlist says there are several instances over the last few years where favourable rulings have been obtained.

Though the dual structure can overcome these adverse income tax rules, it is not entirely without some issues of its own. One is the CRA apparently will not consent if the lawyers' professional corporations are not free to solicit work for themselves free of any responsibility not to compete with the partnership.

“That stipulation can certainly cause problems at the partnership level,” he says.

On the downside there are some compliance costs and added accounting costs, including income tax returns and GST registration and remittances on behalf of the professional corporations, he says. And there can also be issues around allocating profits derived from associates which will continue to be generated at the partnership level.

“The last carrot dangled out there, but I'm not sure how realistic it is, is the potential \$750,000 lifetime capital gains exemption in the event of a sale of the practice or on the death of the lawyer,” says Goldlist.

In a sale, the buyer must agree to buy the shares of the professional corporation which must also be “qualified small business corporation shares.” However, he says, if the professional corporation is successful, as is hoped, it will have significant retained earnings in the form of investments which likely will render it unable to qualify. **LT**