The Journey to Incorporation, By Doug MacLeod, C.A.

The growth of a business brings about many important changes. Financial expansion, as with geographical expansion, must be carefully managed to ensure the business is operating as effectively as possible. Among the many factors to consider is the operating structure of your organization. A business can operate under any one of a number of different structures, including a sole proprietorship, a partnership, or a corporation. A new business most commonly begins as a sole proprietorship. As it grows, however, incorporating a business can lead to significant benefits. The following will outline some of the issues involved with incorporation and help you assess at what point you may want to adopt a corporate structure.

If you earn income through a corporation, the income will first be taxed at the corporate level. When the earnings are paid out of the corporation in the form of salary or dividends, the income is then taxed again at the personal level. In theory, the total corporate and personal income tax paid through a corporation should equal the personal tax that would be paid on the same income earned directly by an individual taxable at the top marginal rate. Although this is not always the case in practice, incorporation is generally not a good idea if you rely on all of your business profits to support your personal cash needs. Significant tax savings usually arise only if you are able to reinvest some earnings back into the business.

Under normal circumstances, an unprofitable business (such as one that is in the startup phase of operations) should not incorporate, since corporate losses can only be used to offset corporate income. A sole proprietor, on the other hand, can use business losses to offset other personal income.

Therefore, a corporate structure is most beneficial when a business becomes profitable and at least some the net earnings can be reinvested in the company. The following are some of the benefits of incorporation:

- Access to the small business deduction – a low tax rate of approximately 18% (which is scheduled to drop over the next few years) is available on the first $200,000 of business income.
- Limited liability – incorporation can limit your personal liability by keeping your personal and corporate assets separate. However, since banks often ask small business owners for personal guarantees on loans, incorporation may not protect you from all creditors.
- Income splitting – if your spouse and adult children are shareholders in the corporation, any dividends they receive will be taxed in their hands. The corporation can also employ family members of the owners as long as the amounts paid are reasonable for the work performed.
- Capital gains exemption – provided certain conditions are met, a $500,000 capital gains exemption is available when the shares of the corporation are eventually sold or transferred through a will.
- Rollover provisions - personal assets can be transferred to a corporation on a tax-deferred basis. This means capital gains tax does not have to be paid until the corporation disposes of the assets.
- Estate planning and continuity – it is easier and less costly to transfer shares in a corporation than it is to transfer individual assets of a business.

- Cash flow deferral – corporate tax provisions allow for the deferral of some cash outflows. For example, if you report a bonus paid to an employee for tax purposes, you do not have to pay out the cash until six months after the corporation's year end.
- Group insurance and retirement benefits – once you incorporate, you can create a registered pension plan and obtain tax-deductible group health and life insurance for yourself and your employees, including employed family members.

You should also be aware of some of the drawbacks of incorporation, most of which involve additional costs and effort. These disadvantages include:

- Incorporation costs – there are legal, accounting, and administration fees that must be paid when incorporating a business.
- Ongoing administration – more formal documentation, such as a complete set of financial statements, is required for a corporation. This usually means ongoing accounting and legal fees.
- Taxable benefits - benefits received by shareholders or employees, such as the use of a corporate-owned house or car, are taxable, unless reasonable amounts are paid for these benefits.
- Assets transferred tax free to a corporation cannot be subsequently withdrawn without triggering a potentially large tax liability.

Whether incorporation is beneficial depends very much on your personal circumstances. If you are considering incorporating your business, it is recommended that you seek advice from your tax and legal professionals.

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