



●●● **Focus: Law firms miss advantage of professional corporations**

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Since 2001, incorporation for law firms has been a possibility. Despite its advantages, only a relatively small proportion of law firms that could benefit from incorporation have in fact done so.

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“It’s hardly new,” says David Rotfleisch of Rotfleisch & Samulovitch Professional Corporation in Toronto.

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“Lawyers have always been notorious for their lack of tax planning.”

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There are both tax and non-tax reasons for lawyers to consider incorporation, Rotfleisch points out.

The main benefit is creating a tax deferral by retaining earnings in the professional corporation. A PC can also take advantage of the \$800,000 capital gains exemption available for the sale of a small business, which can only be claimed on the sale of shares of a qualifying corporation and not for the sale of a sole legal proprietorship or a legal partnership. It also allows for the creation of individual pension plans funded by

corporate assets.

On the other hand, PCs are subject to strict rules governing the taxation of shareholder benefits such as shareholder loans or the use of company cars.

A PC incorporated in Canada by lawyers who are Canadian residents will most likely qualify as a “Canadian-controlled private corporation.” Such entities can claim the small business deduction.

“The small business deduction features a reduction of the normal corporate income tax rate on the first \$500,000 of a corporation’s annual taxable income earned from carrying on an active business in Canada,” Rotfleisch explains.

The upshot is that a PC will pay tax at between 11 and 16 per cent (depending on the province of residence) on its first \$500,000 of taxable income. The remaining tax is deferred, paid by the PC’s shareholders only when they receive dividends, and then at a rate between 19 and 40 per cent.

“The deferral is significant, especially for a taxpayer in the top marginal tax bracket, and means that approximately twice the funds are available for investment, since in effect tax money is being retained in the corporation and invested,” Rotfleisch says.

Paul Pape of Pape Barristers Professional Corporation agrees. “If you’re prepared to leave some money in your practice, you can defer roughly 15 per cent of your income,” he says.

However, Pape adds that it’s much easier to do that in a sole proprietorship or small law firm.

“Once you have five or 10 partners, everybody’s interests tend to be different, so what you tend to see is that some lawyers are getting the deferral by creating their own personal corporation to whom their income is distributed,” he says. “The truth of the matter is that I see very few PC letterheads.”

As well, in a partnership structure, individual partners may have to share the small business deduction benefit among themselves. Finally, there are certain restrictions on PCs, the most important being that the corporation’s shareholders must all be lawyers who are members of the same provincial or territorial law society.

As for non-tax benefits, the main non-tax benefit to incorporation in general is liability protection. But a PC does not provide the same protection.

“It actually provides no additional limitation on liability for professional negligence claims,” Rotfleisch says. “But it can provide some protection from creditors from whom the corporation has borrowed money.”

There are other non-tax benefits, however, such as the possibility of making it easier to formulate relationships with associates by making them independent contractors. Incorporation could also allow for greater flexibility in setting up profit-sharing plans and in other employee compensation discussions.

But lawyers contemplating incorporation should consider the increased costs and administration involved in doing so. And because shareholders must be lawyers, the creation of a PC restricts a professional’s ability to income split immediately (as opposed to obtaining a deferral) by paying dividends to family members.

So there are advantages and disadvantages to incorporation. The question that remains, however, is whether those who could take advantage have done so.

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