

Top 10 reasons to incorporate business



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Recently I was teaching a course on executive compensation, and the topic was the importance of linking compensation with an overall corporate strategy.

At the end of the class a student asked me to discuss the main differences between a financial planner and a business executive benefit consultant. I explained that traditionally a financial planner/investment advisor/insurance agent focuses exclusively on a client's personal balance sheets.

This could include a client's personally-owned RRSP, investment and real estate portfolios, life insurance, disability insurance, critical illness insurance and long-term care insurance.

In essence the traditional financial planner assists with a business owner's personal financial affairs, separate from the source that created the client's wealth – the client's business.

On the other hand a business executive benefit consultant creates solutions that deal with the business side of a client's balance sheet and assists their clients in achieving five outcomes.

These outcomes are wealth preservation, tax minimization, creditor proofing, wealth accumulation and wealth distribution.

Successful business people want their financial advisors to show them ways to keep their wealth. In essence, successful people want their financial advisors to provide them with financial, tax, succession, and estate planning solutions.

Business owners are different from the rest of Canadians. If for no other reason, the Income Tax Act favours people who work for themselves.

There are numerous advantages available to those who own their own business, who take the risk and have the creativity and fortitude to do something on their own. These people are compensated for it.

In the future when you speak with your clients about the value of incorporating their businesses to minimize taxes, here are 10 reasons to support that course of action.

Tax Deferral Opportunities

For every \$1,000 retained in an incorporated business your client gets to keep an additional \$260 over what they would have had to pay in income taxes had they declared it personally.

Income Splitting

Pay a reasonable salary and bonus to family members, including spouse and children for services they rendered to your client's business. Prepare a job description for the services they each render, and pay a dividend to family members. While the payment of a family salary must meet the 'reasonableness' test, this does not apply to dividends, which means your client can pay a \$100,000 dividend to a shareholder who does not provide any services to the company.

Tax Advantage of Capital Gains Exemption

In Canada, we still have a wonderful tax break to reward successful entrepreneurship, the \$500,000 lifetime capital gains exemption. It allows an incorporated business owner a tax-free capital gain, provided an individual holds the stock in a private company for at least two years.

Paying Capital Gains Instead of Salary

Clients who own incorporated business can structure their cash withdrawals as capital gains rather than salary or dividends. Capital gains are only taxed on half the income earned. So an individual who has used up his or her lifetime capital gains exemption, who pays himself \$300,000 in capital gains, who has an Ontario personal marginal tax rate of 46 per cent, will pay \$69,000 in tax as compared to taking the same amount out as regular income. That would require paying the Canada Revenue Agency \$138,000 in personal taxes.

Individual Retirement Arrangements

If your client is a business owner over the age of 50, and employed by an incorporated business, your client should consider creating a 'super-sized RRSP' – that is, an individual pension plan (IPP) or a retirement compensation arrangement (RCA).

Contributions to these two vehicles will exceed maximum allowable registered retirement savings plan (RRSP) limits, meaning your client can save a great deal more money for his or her retirement in a tax-efficient way.

Both are fully deductible by the sponsoring company and are non-taxable benefits for the individual. Increases in the total value of the assets held are tax-deferred until withdrawn.

Universal Life Insurance

Universal life insurance allows tax-sheltered growth within your client's policy. A corporate-owned life insurance contract can tax shelter much of your client's retained earnings in the cash-value portion of the policy, provided the premiums are not deducted. As incorporated business owner, your client can access these funds for

business or personal use by collateralizing the policy through loans from a bank. For example, your client might borrow funds annually in order to increase his retirement cash flow.

Make sure your client has the appropriate documentation and guarantee fees in place to avoid a personal benefit (which forces your client to pay a lot of unnecessary personal tax).

Any related bank loan would be repaid automatically upon your client's death from a portion of the policy proceeds. At the same time, a credit to the corporate capital dividend account (CDA) would be created equal to the full policy proceeds.

Employee Profit Sharing Plan

An employee profit sharing plan (EPSP) is a special purpose trust that allows the beneficiaries of the plan to share in the profits of a company. The allocation to an EPSP is taxable in the hands of an employee, and a deductible expense for an employer. An EPSP is a non-registered savings plan in which the employer contributions are computed by reference to a company's profit.

Advantages of an EPSP are:

- They attract neither employer/employee Canada Pension Plan or EI contributions;
- They allow for more control over retirement assets;
- They are treated as pension and/or RRSP eligible earnings;
- Source deductions and withholdings are not required by the EPSP trustee or employer;

• They allow for income splitting opportunities;

- All amounts paid from an EPSP to an employee are not subject to a reasonableness test, unlike salaries;
- The 'kiddie tax' rules should not apply to income received by minor children from an allocation from an EPSP, if they are bona fide employees of the business; and
- Contributions to the EPSP can be made up to 120 days after a corporate year end.

Health Spending Accounts

A health spending account (HSA) is a corporate bank account with deposits available exclusively for health care expenses. Having an HSA allows you to convert health care expenses into 100 per cent business deductions equal to the annual deposits into the HSA. Payments of these expenses are treated as a non-taxable benefit to you.

You'll determine the contribution amount each year and also how to spend the benefit dollars. Unlike traditional medical and dental plans, if the deposits are not spent in the current year, the funds remain in the account, available for future use.

Loan Money for Education and Succession

The basic principle behind the loan arrangement is to shift the income needed to pay for education from the parent to the low-income child. The child reports the loan as income when in the low tax bracket, and receives a deduction when in a high tax bracket.

Suppose your client's corpora-

tion lends \$60,000 to his daughter, including \$40,000 for law school tuition. The daughter pays \$7,000 tax. When the lawyer-daughter takes over the business from your client and repays the \$60,000, she can deduct the payments from the earnings, generating a total net saving of \$24,000.

Writing Off Your Mortgage

If your client has a mortgage on his home and capital in his corporation, consider having the client write a cheque from the business to themselves, depleting this capital balance.

After using this money to reduce or eliminate their home mortgage your client can then go to the bank for a personal investment/business loan and invest the money back into his or her corporation. This strategy converts the non-tax deductible interest you pay for your mortgage into a tax deductible investment loan, plus it can also creditor-proof your money.

There are many more benefits to incorporating a business. The best professional to help determine whether it is time to incorporate a business is a trusted advisor.

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