

Why you should reconsider incorporation

Manfred Purtzki

Dr Jim Smith (a fictitious doctor) keeps wondering why most of the doctors in his clinic have set up medical corporations, which they seem to be quite happy with, yet he has not. Every time he raises the subject of incorporation with his accountant during their annual consultation, he receives the same answers.

- There is no benefit in using the corporation to split income with his wife Lisa, who is earning \$80 000 a year as a pharmacist.
- Income splitting with his two children, aged 11 and 13, is also not possible due to the imposition of the “kiddie” tax in 2000, which removed the benefit of income splitting with minor children.
- Most of his \$250 000 of practice income is used, after the hefty personal income tax bill, to pay for personal and living expenses, in particular the accelerated payments on his \$400 000 house mortgage. As a result, Jim cannot take advantage of the low corporate tax rate, since funds are currently not retained in the corporation.

At first blush, the accountant’s advice seems to be correct. Because Lisa has a substantial income, the income splitting benefits are marginal at best. The kiddie tax imposes the top personal tax rate on dividends paid to minor children from the corporation, and therefore prevents access to the children’s low income tax brackets.

In Dr Smith’s case, the biggest benefit of incorporation is tax deferral. Corporate net income is taxed at only 17.62%, which means almost \$82 out of every \$100 of practice income that remains in the corporation can be used for investments or the repayment of practice-related debt. However, once Jim takes the money out, the tax deferral is lost because it must then be declared on his personal tax return.

So, would Jim be better off flowing his practice income through a corporation and receiving his personal funds in the form of dividends paid to him, or should he continue to report the net income from self-employment as a proprietor on his personal tax return?

Jim’s overall tax is basically the same whether he earns the income directly or channels it through a company. So if he cannot reap the rewards of incorporating and using the benefits of tax deferral and income splitting, what is the point of incorporating? Maybe his accountant’s advice is correct and he should postpone incorporation until the mortgage is paid off. However, in light of his significant tax payments, Jim has been falling short of his retirement savings goals. After many years of family practice, Jim has accumulated only \$200 000 in an investment portfolio outside his RRSP, so he is very interested in doing something to improve his financial situation.

While there is no obvious benefit for Jim to incorporate and draw a salary or a dividend, he should consider a third option that would provide

him with significant tax benefits. With practice income of \$250 000, he could draw corporate funds in the form of capital gains rather than dividends, thereby reducing his tax bill annually by about \$20 000. His current after-tax income of \$156 000 will jump to \$176 000.

Here is an outline of how Jim can use the capital gains method:

1. His medical corporation (“Medco”) pays Jim a dividend in the form of shares instead of cash. These types of shares are called *stock dividend* shares. They may have an issue price of \$.01 per share and a redemption value of \$100 per share. Since Jim receives shares instead of cash, only the issue price at a nominal value must be reported as a taxable dividend.
2. Jim then sells the stock dividend shares to Lisa at fair market value, which is equal to the redemption price of \$100 per share. Jim makes an election that the sale to his spouse is at fair market value, since a transfer of assets between spouses usually occurs at tax cost to avoid tax consequences.
3. Lisa issues a promissory note to Jim equal to the value of the shares received.
4. Lisa sells the stock dividend shares to a newly created holding company (“Holdco”) and in exchange,

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Holdco issues a promissory note to Lisa.

- 5. Medco redeems the stock dividend shares held by Holdco.
- 6. Holdco uses the redemption proceeds to pay off the promissory note owed to Lisa.
- 7. Lisa pays off the promissory note payable to Jim.

It sounds a bit complex, but it converts what would have been a dividend into a capital gain. Each year, Jim's lawyer will document the above transaction. Jim is happy because he puts an additional \$20 000 in his bank account to pay down the mortgage much faster.

Another perk: if Jim has any unused capital losses from previous years, he will be able to apply these losses against the capital gains, resulting in a tax refund from prior years.

Another option: to ease the burden of non-deductible house mortgage payments, Jim should also consider selling his \$200 000 investment portfolio to the corporation in exchange for a promissory note. His new corporation would take out a loan to pay off the \$200 000 promissory note, which Jim could then apply against the mortgage principal. As a result, the corporation uses the interest on its loan as a tax deduction, and Jim's mortgage principal is paid back with cheap after-tax corporate dollars.

Don't wait as long as Jim did. If you haven't yet incorporated your practice, even if the option seems less obviously attractive for you than it does for colleagues, revisit this issue with your advisor and reap the benefits of incorporation.

in memoriam

Dr Walter Burtnick 1928–2005

In memory of a colleague and friend

A sudden death. Unexpected. He always seemed so indestructible.

Born in Trail, he developed a love for the outdoors, particularly fishing and hunting.

He worked in logging camps and house construction before he responded to his true calling.

He was a family doctor in the real sense and for 45 years was involved in the lives of many people, from deliveries to terminal care and everything in between.

He was knowledgeable about many things and enjoyed teaching. He was a

wise counselor and a big man in every sense—strong, gentle, and comfortable to be around.

He was passionate about his work and could not contemplate retiring.

He was respected by his colleagues, loved by his patients, and at ease with his friends.

A strong family man, he leaves behind his wife, Irene; son, Julian (Shannon); daughter, Mary (Paul), and two grandchildren as well as his five sisters and a large extended family. Some 500 people came from far and near to pay their respects at the celebration of his life.

He is missed.

—Eric Paetkau, MD
Sechelt



Dr. Paul A. Farnan,
Clinical Coordinator

Helping Yourself or a Colleague

Physicians are feeling the strain in a changing health care world. We are not invincible and we need to take care of ourselves. Self care does not mean diagnosing and treating ourselves or our families. In an ideal situation, all BC physicians would have and regularly consult with their own family physician. Unfortunately, this is not always the case and one of the main obstacles seems to be concerns about privacy.

The Physician Health Program of British Columbia is a confidential resource for physicians, medical students, residents and their families. Common concerns dealt with by the program include, but are not limited to: personal and family emotional health issues, the inappropriate use of alcohol and/or drugs or coping with physical illness etc. The PHP is staffed by physicians who are keenly aware of the sensitive nature of these matters and who respect the privacy of those who contact the program. If you choose, you can call the program anonymously.

We should not be afraid to reach out for assistance if we need it. In addition, we have a responsibility to colleagues who might be experiencing difficulty. If you have concerns about yourself or someone close to you please don't hesitate...

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