# THE ENLIGHTENED ENTREPRENEUR:

## achieving your financial goals through your corporation

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# Introduction

We know that 2020 has been a year of uncertainty for all, and especially for entrepreneurs, doctors and anyone else who owns their own business or practice.

As a business owner, you undoubtedly continue to face these challenges. We hope that this white paper will provide you with a helpful opportunity as you navigate these challenges, while still working to grow your business, realize your goals, and seek financial security during these times.

By incorporating your business or practice, you will find some money-saving strategies that can be leveraged. These strategies are important to consider now more than ever, if you are in the position to do so.

Throughout this white paper, you will find answers to the following questions:

- Why should I incorporate my business?
- When should I incorporate my business?

In addition, we will explore some of the advantages of incorporating, such as:

- Growing your investments
- Taking money out of your corporation
- Selling your business tax-free ... or close to it

We hope that you will find the contents of this white paper useful. If you still have some questions, or are looking for more information, please do not hesitate to contact me at matthew.lekushoff@raymondjames.ca or (416) 777-6368.

I will be more than happy to sit down and discuss incorporating your business in more detail.

# Operating Co. vs. Holding Co., What's The Difference?

Throughout this paper, as we discuss the advantages of incorporating your business, it's important to note that we are referring to the benefits of incorporating both an operating company and a holding company.

So what's the difference between the two? Simply put, an operating company "does the things", while a holding company "owns the things".

You can think of an operating company as the company that runs the day-to-day operations of your business, such as selling goods or services, receiving revenue, paying costs and hiring employees. A holding company, on the other hand, might own shares of your operating company, real estate, equipment that is used by your operating company, and/or investment assets such as stocks and bonds.

# Why Should I Incorporate My Business?

Incorporating your business simply means that you are creating a new legal entity, a corporation. In Canada, a corporation has the same legal rights as an individual - it can own property, receive loans, enter into contracts, and sue or be sued.

Incorporating your business can mean:

- **Limited Liability**
  When forming a corporation, the business owners become shareholders. They transfer money, property, or services to the corporation in exchange for shares, and limited liability - they are not personally responsible for the corporation's debts. If the corporation goes bankrupt, the shareholders will not lose more than their investment into the corporation, meaning their personal assets are not at risk.

- **Lower Tax Rates**
  Generally corporations are taxed on active business income at rates lower than income tax rates for individuals. In addition, there are various tax-saving strategies that can be leveraged through a corporation. We will be exploring these strategies further throughout this paper.

However, incorporating can also be expensive, depending on the complexity of your business. While the initial government fee is approximately $200, legal and accounting services can range between $750 and $3,500, in addition to recurring costs associated with filing annual reports and corporate tax returns.

# When Should I Incorporate My Business?

Timing is crucial! In life, and, even more so, in business.

Deciding when to incorporate your business is no different. It's likely time to incorporate if the following is true:

- Your business has approximately $100,000 in gross earnings and it's expected to continue to grow
- You are in a high income tax bracket
- Your spouse is also an employee of the business, meaning you can income split
- You expect savings of at least $40,000 per year and are looking for a tax-preferred investment strategy
- In addition to the above, you would like an alternative to RRSPs to fund your retirement

# Lowering your personal income tax

Since corporate tax rates are lower than personal income tax rates (12.2 per cent for the first $500,000 in 2020), if you're earning more than you need to live on, incorporating will work to your advantage.

Once incorporated, you can pay yourself either through salary (income) or dividends - the differing factor being how much tax you'll pay. Through salary, the full income you pay yourself is subject to your marginal income tax rate. As a shareholder, you can also pay yourself in dividends as a way of distributing the corporation's after-tax profits.

Dividends are taxed more favourably than income, and if you have no or few alternative sources of income, up to $40,000 can be paid out without incurring personal income taxes when done so through eligible dividends.

In addition to controlling how and how much you are paid, incorporating also allows you to deduct all business expenses from your taxes. These can include a variety of items, such as advertising, accounting, and insurance, as long as the primary use of these items is for your business.

If you primarily work from home (more than 50 per cent of the time), you are also eligible to apply for home office deductions, including a range of expenses, such as a portion of home insurance, Internet services, property taxes and mortgage costs, utilities, and repairs and maintenance. Capital costs or fixed assets - buildings, vehicles, equipment, and computers - are partially deductible, meaning that you can write off a portion of these costs each year.

Personal medical expenses can also be deducted by using pre-tax corporate earnings through the Health and Welfare Trust (HAWT) program.

# Income-splitting with your spouse

Another reason for incorporating your business or practice is if your spouse or another family member is an employee of the business. If this is the case, incorporating will enable you to income-split with your family member.

If you hire a spouse or child, your corporation deducts their salary as an expense and the family member pays taxes on their own personal income tax rate, which would be substantially lower than your own. You can also add a family member as a shareholder and pay them dividends, which are taxed at a reduced rate.

# Funding your dream retirement

Although RRSPs and TFSAs are more commonly used to save for, and fund, retirement, they aren't always the most tax-efficient methods. Any withdrawal from your RRSP increases your declared "income" and consequently the amount of taxes you pay. Once you turn 71, you will be legally required to transfer the funds in your RRSP to an RRIF or an annuity, from which you will have to withdraw a minimum amount each year, thereafter. The result can push you into a higher tax bracket.

Investing in TFSAs, on the other hand, occurs after your income tax has already been deducted, meaning you are left with less to invest. There are also limitations imposed by the government specifying how much you can invest, per year and cumulatively. These limitations often mean most people are not able to meet their retirement goals solely through a TFSA.

The advantage of saving through your corporation is that you can withdraw the funds at a very low (potentially zero) tax rate with more flexibility. It can be a powerful saving and investing tool either used in addition to RRSPs and TFSAs, or used on its own, to fund your ideal retirement.

Another option available to incorporated individuals is an Individual Pension Plan (IPP). While it can be expensive to set-up and administer, the fees are tax-deductible and any contributions to the plan or costs associated with administering are not subject to income tax. The contribution room is also often higher than that of an RRSP. Lastly, IPPs can be used as an effective estate-planning tool - assets held within the IPP can be transferred to family members of a deceased plan holder without triggering taxes. It should be noted that this is only achievable if the family members are also included in the IPP as plan members.

# Growing Your Investments

Once you've chosen to incorporate your business or practice, the funds held within your corporation can be invested and grown similar to any other investment accounts. If you take out less in salary and dividends, you can keep funds in your holding company and invest these funds into everything from stocks, bonds, ETFs, mutual funds, and several other securities.

You will, of course, have to pay taxes on the growth of your investments within your corporation. To maximize tax savings, investments that are growth-oriented and pay little to no income would be preferred in order to take advantage of the small business tax rate (which allows you to earn up to $50,000 of passive investment income at the preferential rate of 12.2 per cent vs. 20.5 per cent).

# Taking Money Out of Your Corporation

We discussed the benefits of maintaining profits inside your corporation and investing those savings for further growth. But, the reality is that you will eventually need to withdraw from your corporation to fund your goals - the primary objective of all your hard work, after all!

Money can be taken out of your corporation in three ways, whether it be to fund current lifestyle needs while you continue to work, your retirement, a sabbatical or more:

**Paying Yourself a Salary**
This is the most straightforward strategy, but also the least advantageous in most instances. The salary you pay yourself is treated as earned "income" and is subject to personal income tax in the year you take it. This is often used to supplement lifestyle expenses or smooth out income should your business have a slow year. Paying yourself a salary will also help create RRSP contribution room if you wish to contribute.

**Taking Out Dividends**
Dividends are generally taxed at a lower rate than salary (the exact rate depends on a number of factors). Keep in mind that if you choose to take all of your compensation as dividends, it can diminish the amount of CPP you are eligible to receive.

**Paying Shareholders**
If you've set up a holding company to own shares of your operating company, you can have multiple shareholders own shares of the holding company. These shareholders could include yourself, your spouse, and your children, provided they are engaged in the business. Paying shareholders in dividends allows them to take advantage of a preferential tax rate.

Chances are that you will use a combination of these strategies to withdraw from your corporation for the result that benefits you most.

# How to Sell Your Business Tax-free ... or Close to It

As an entrepreneur, Michael Gerber's *The E-Myth* provided me with one of the most impactful pearls of wisdom. In it, Gerber suggests that a key reason to start a business should be to sell it.

Many of the doctors and entrepreneurs I meet usually haven't thought about selling their business. They're usually so busy running their companies that they haven't given much consideration to their exit strategy until they are ready to put it into action. The problem is that many of the tax-saving strategies surrounding the sale of a business or practice require planning in advance.

When you make a profit on the sale of an investment in Canada - whether it be a stock, bond, piece of real estate, or, in this case, a business - the profit is subject to capital gains tax. It means that if you make a $600,000 profit on the sale, half of it is subject to the same type of tax you'd pay on income.

For example, if you earned a $75,000 salary, $300,000 would be added to your income for the year you made the sale. If you are living in Ontario in 2020, your taxes would then increase from $14,999 to $162,118. In other words, selling your business would result in $147,119 of additional taxes paid that year.

Fortunately, in Canada, the first $883,384 of profit from selling your business is tax-free (for 2020), which is referred to as the lifetime capital gains exemption.

However, in some cases, it is possible to sell your business for over this amount and still not pay taxes. If you use holding companies and family trusts strategically, family members can be linked together to use their lifetime capital gains exemptions and reduce the overall tax impact from the sale.

For example, a husband, wife, and two children (of any age) could set up a family trust to own the company that is being sold. In doing so, in 2020, they would have a combined $3,533,536 lifetime capital gains exemption to use against the sale of a business. If the business were to sell for a $3,000,000-profit, they would not have to pay any capital gains taxes on the sale - depending on other variables, such as each individual's personal tax rate.

It is important to note that in order for a business to qualify for the lifetime capital gains exemption, the shares of the business must be qualified as small business corporation shares. That is, you must have owned the shares for the two years before you sell them and, at the time of the sale, substantially all of the business's assets (90 per cent or more of the value) must be used for carrying on an active business in Canada.

This is why you must plan early! Research how to structure your operating and holding companies and consult with your accountant and financial advisor well in advance of the actual sale date.

# Conclusion

As with most things in business, making the decision to incorporate involves many moving parts. It's important to know all of your options and take into consideration your personal and business situation before making a decision.

If you're interested in incorporating your business, or have already done so and would like to take advantage of these strategies let us know and we'd be happy to discuss your situation.