TAB 7

Getting the Right Fit
Limited Liability Partnerships

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Limited Liability Partnerships
Professional Development & Competence
The Law Society of Upper Canada

Professional Corporations – What are they exactly?
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Limited Liability Partnerships

The Governance Scheme

Amendments to the *Partnerships Act* in force in July 1998 permit professions to practice in the form of limited liability partnerships. Unlike a general partnership, where the partners are liable for debts and liabilities arising from the negligent acts of all partners, the partners in a limited liability partnership are not personally liable for the negligent acts of another partner or an employee who is directly supervised by another partner. However, the partnership assets continue to be at risk for the negligence of the partners and employees.

The *Partnerships Act* establishes the following requirements for professions wishing to practice as LLPs:
* the act governing the profession must expressly permit practice as an LLP;
* the partnership must register its firm name under the *Business Names Act*; and
* the professional governing body must establish minimum liability insurance requirements for the LLP.
The *Partnerships Statute Law Amendment Act, 1998* (Bill 6) which amends the *Partnerships Act* respecting LLPs may be found at The Legislative Assembly of Ontario website at www.ontla.on.ca.

The Law Society Act permits lawyers to practice as limited liability partnerships. The registration of the business name of the firm as "LLP" is a requirement of the *Partnerships Act*. The final requirement of the minimum level of insurance for LLPs is in By-Law 26. By-Law 26 also requires lawyers to disclose to the clients of the LLP the nature of the limitation on the liability of the partners. The text of By-law 26 appears below, with relevant commentary.

BY-LAW 26

LIMITED LIABILITY PARTNERSHIPS

PROFESSIONAL LIABILITY INSURANCE

Insurance requirements

1. A limited liability partnership shall maintain professional liability insurance coverage for each partner in accordance with By-Law 16.

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- **Specialist Certification**
- **Spot Audit**
- **Unclaimed Trust Fund**
- **Trustee Services**

This section of the by-law establishes the minimum insurance required by a law firm practising as an LLP to be the coverage now maintained individually by each member who is a partner of the firm. This is currently in the amount of $1,000,000 per member. Accordingly, the requirements in s. 44.2(b) of the *Partnerships Act* would be met by requiring the LLP to maintain the coverage that members who are partners maintain pursuant to By-Law 16 on Professional Liability Levies. Section 1 of the by-law focuses on the fact that the partners are essentially the partnership and that it is the partnership's obligation, in the language of the *Partnerships Act*, to ensure that the insurance at the member level is maintained for each partner to satisfy the requirement. The reference to By-Law 16, which requires all members practising law to pay the insurance levy for professional liability coverage, effectively links the scheme to the level of insurance currently carried by members individually. This provision, notwithstanding that for LLPs it is the partnership that is required to maintain the coverage for the partners, in no way operates to derogate from the obligation of members individually to comply with the requirements of By-Law 16 to pay the insurance levy.

DISCLOSURE

Partnership continued as limited liability partnership

2. (1) When a partnership is continued as a limited liability partnership, as soon as is reasonably practical after the continuance of the partnership as a limited liability partnership, the limited liability partnership shall disclose to each person who was a client immediately before the continuance and who remains a client after the continuance the liability of the partners of the limited liability partnership under the *Partnerships Act*.

(2) A limited liability partnership satisfies the disclosure requirement under subsection (1) if it publishes in a local newspaper notice of the matters set out in subsection (1).

(3) In subsection (2), "local newspaper" means any newspaper distributed in the area in which the limited liability partnership carries on business.

While disclosure of the fact that a firm is an LLP and the effect of the limitation of partners' liability is not a legislative requirement that must be enacted by a profession, the Law Society believes it is appropriate as a matter of professional responsibility that at a minimum, clients be told of the nature of the limited liability of the partners resulting from the new practice structure. Although *public* notice is effectively accomplished through the registration as an LLP under the *Business Names Act*, clients, within the general public, maintain unique relationships with law firms. Accordingly the by-law obliges lawyers to make the appropriate disclosure to clients at the time a firm continues as a LLP.

If a written form of notice to clients is to be sent, law firms are encouraged to design their own communications respecting the disclosure requirement and customize them as they see fit for their particular clients. To the extent that lawyers may find it useful, a sample letter, appearing below, may be considered an example of a communication on disclosure.

Sample Disclosure Letter for LLPs

Dear Client:

Effective (date), the firm of ---- has become a limited liability partnership, as permitted by amendments to the *Partnerships Act* and the *Law Society Act*. The firm is now know as ----- LLP.

As the name suggests, the partnership carries on the practice of law with a degree of limited liability. The partners in a limited liability partnership are not personally liable for the negligent acts of another partner or an employee who is directly supervised by another partner. Each partner is personally liable for his or her own actions and for the actions of those he or she directly supervises and controls. The partnership continues to be liable for the negligence of its partners, associates and employees, and accordingly there is no reduction or limitation on the liability of the partnership. All of the firm's assets remain at risk.

Liability insurance protection for the members of the partnership continues, and minimum insurance requirements, as required by the *Partnerships Act*, have been established for LLPs by the Law Society. The Law Society has determined that the liability insurance coverage for an LLP is that maintained individually by the partners.

The limitation on liability is the only change to the partnership resulting from the legislative amendments and this change will not affect our firm's relationship with you as a client. We would be happy to answer any questions you have about our limited liability partnership.

Firms may also choose to publish a notice in a local newspaper as provided in subsection 2(2) of the by-law. Such notices should be complete and clear enough for clients to understand the nature of the limitation on the liability of the firm.

Taxation Issues

Law firms should consult with their tax advisors with respect to any tax consequences that may flow from continuance of a general partnership as an LLP, or any other matters that may impact on the firm because of the new practice structure.

***Professional Corporations* – What are they exactly?**

January 29, 2002
Law Society of Upper Canada
Breakfast Seminar
Osgoode Hall

GOWLINGS

Incorporating the practice of SMITH LYONS

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1. *OVERVIEW*

It was nearly a decade ago that the NDP Government in Ontario promised, as part of the OHIP fee negotiations, that it would allow physicians to incorporate their professional practices. However, the Health Professions Regulatory Advisory Council, an independent advisory board (the "**Advisory Council**"), advised at the time that such a change would be inequitable and would be against the interests of the public.[1] Given the public pressure, the NDP Government re-examined its commitment to physicians and abandoned the idea of permitting professionals to incorporate.

However, on May 2, 2000, through a small and unexpected pronouncement in the *2000 Ontario Budget*, the Minister of Finance re-introduced the idea of professional corporations. The Honourable Mr. Ernie Eves announced that the Government of Ontario intended to extend the right to incorporate to specified regulated professionals. The Budget Paper read as follows:

> To level the playing field with other self-employed individuals who can choose to operate their business through a corporation, our Government proposes that the right to incorporate be extended to all regulated professionals.
>
> Professionals would be able to enjoy many of the same tax and non-tax advantages of incorporation; however, their professional liability would not be limited in any way by practicing within a professional corporation, nor would non-members of professional associations be permitted to own shares in a professional corporation.
>
> The Government will consult with stakeholders and develop legislation that would ensure that the protection of the pubic interest is paramount.[2]

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[1] See Porter, Posluns & Harris, *Incorporation of Professional Practices Receives a Setback*, (1994) Doc. No. 2011205 [Q.L.]. On June 16, 1994, the Advisory Council concluded that the government should not proceed with permitting the privilege of incorporation by any regulated health profession as it was not in the public interest on a number of grounds. The concerns included the fundamental ethical question of permitting tax advantages to some of the most advantaged members of society and the entrenchment of the fee-for-service model that could discourage the reform of health care.

[2] See Ontario Ministry of Finance, *2000 Ontario Budget – Balanced Budgets - Brighter Futures*, Budget Papers by The Honourable Ernie Eves, Q.C., (Toronto, Ontario: Queen's Printer, 2000).

The draft provisions allowing regulated professionals to incorporate were included in Bill 152 - *Balanced Budgets for Brighter Futures Act* of that year and received royal assent on December 21, 2000. Technical amendments to the provisions were made through Bill 45 - *Responsible Choices for Growth and Accountability Act*, and on the November 1, 2001 the legislation was proclaimed and the creation of professional corporations in the Province of Ontario fell in line with the Province of British Columbia, Alberta and New Brunswick.

In the following pages, we will review the legislative provisions incorporated within the *Business Corporations Act* (Ontario)[3] and the Law Society Act (the '**LSA**")[4] through Bills 152 and 45. We will subsequently examine the tax advantages and disadvantages of incorporating professional corporations and finally conclude with some general remarks regarding their usefulness.

2. *THE BUSINESS CORPORA TIONS ACT (ONTARIO)*

Prior to the enactment of subsections 3.1 to 3.4 of the OBCA, the OBCA provided that where the practice of a profession was governed by an Act, a corporation could only practice the profession if the Act specifically permitted it.[5] Sections 3.1 to 3.4 of the OBCA have changed that and now govern the incorporation and administration of professional corporations. Subsection 3.1(2) of the OBCA now specifically provides that a professional corporation may practice a profession that was governed by an Act, provided only if that Act expressly permits the practice of the profession by a corporation or if the profession is governed by:

(1) an Act named in Schedule 1 of the *Regulated Health Professions Act, 1991*;

(2) the *Certified General Accountants Association of Ontario Act*, *1983*;

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[3] R.S.O. 1990, c. B.16, as amended (the "**OBCA**").

[4] R.S.O. 1990 c. L.8.

[5] Subsection 3(1) has been repealed and has been replaced with sections 3.1 to 3.4 of the OBCA.

(3) the *Chartered Accountants Act, 1956*;

(4) the *Law Society Act*;

(5) the *Social Work and Social Service Work Act, 1998*; and

(6) the *Veterinarians Act*.

To date it appears that only lawyers, accountants, doctors (including dentists), veterinarians and social workers will eventually have the ability to practice through a professional corporation under the OBCA. However, this may change over time as the OBCA permits the Province to prescribe additional Acts.[6]

A. Definition

It is generally understood that a "professional corporation" is a corporation that carries on a profession. However, subsection 3(1) of the OBCA specifically defines the term to mean "a corporation incorporated or continued under the OBCA that holds a valid certificate of authorization or other authorizing document issued under an Act governing a profession". Accordingly, the first step in establishing a professional corporation is to ensure that the corporation is incorporated under or continued under the OBCA from a jurisdiction other than Ontario.[7] Second, the corporation must obtain a valid certificate of authorization or other authorizing document issued under an Act governing a given profession.

Although there are several professions that may be able to incorporate under the OBCA, we will, for purposes of this paper, limit the analysis to lawyers and the provisions provided under the LSA. In this respect, it is noted that a certificate of authorization is defined under the LSA as

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[6] Subsection 3.1(3) provides that the Lieutenant Governor in Council may make any regulations prescribing additional Acts.

[7] Section 180 of the OBCA sets-out the requirements that are to be met in order to continue a corporation under the OBCA.

meaning a certificate of authorization issued under the LSA authorizing the professional corporation named in it to practice law. The specific authorization is provided at subsection 61.0.1. Unless that certificate is issued to that corporation, a corporation cannot act as a barrister or practice as a solicitor.[8] Moreover, a corporation cannot represent or hold itself out expressly or by implication to be a professional corporation unless it holds a valid certificate.

B. Requirements

Before a corporation can be treated as a professional corporation under the OBCA, its incorporators must ensure that the five following conditions are respected.[9]

(1) Share ownership

All of the issued and outstanding shares of the professional corporation must be legally and beneficially owned, directly or indirectly, by one or more members[10] of the same profession.[11] Thus, only members of the same profession may participate in a given professional corporation. As a result, the professional corporations as provided for under the OBCA cannot be used to establish multidisciplinary practices. They also cannot be used to split income between a spouse and children as only professionals can be shareholders.

Furthermore, even if at first glance, the language adopted in the provision appears to be broad by referring to "*directly or indirectly*" and may have been designed to allow a holding corporation to be interposed between the member and the professional corporation, it is arguable that the term "*directly or indirectly*" contemplates situations where the shares may be held by a trust or

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[8] Once established and once it has received its certificate, a professional corporation under the LSA is required to notify the Secretary of the Law Society of Upper Canada within the times prescribed of a change in the shareholders of the corporation.

[9] These requirements are all provided at subsection 3.2(2) of the OBCA.

[10] A member is defined under subsection 3(1) of the OBCA to mean a member of a profession governed by an Act that permits the profession to be practiced through a professional corporation.

[11] See paragraph 3.2(2)1 of the OBCA.

an agent of a professional given the use of the word "beneficially owned" in the provision.[12] Because of this uncertainty, it would be prudent to limit the shareholders of a professional corporation to shareholders that are professionals.

(2) Directors and Officers

All of the officers and directors of a professional corporation must be shareholders of the Corporation. Thus, the directors and officers must, hold directly or indirectly, the shares of the professional corporation.

(3) Corporate Name

The name of the professional corporation must include the words "Professional Corporation" or "Société professionnelle". The name must also comply with the rules respecting the names of professional corporations set out in the regulations and the rules respecting names set out in the regulations or by-laws made under the Act governing the profession.

(4) Numbered Corporation

A professional corporation is precluded from having a numbered name.[13]

(5) Articles of Incorporation

Finally, paragraph 3.2(2)5. of the OBCA provides that the articles of incorporation of the professional corporation must provide that the corporation may not carry on a business other than the practice of the profession. However, paragraph 3.2(2)5. also provides that the paragraph shall not be construed to prevent a professional corporation from carrying on activities that are

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[12] The word "beneficially owned" generally contemplates the real owner of the property even though it is in someone else's name. It is generally viewed as an interest in the property, capable of leading to the acquisition of legal title. See for example, *Csak v. Aumon* (1990), 69 D.L.R. 567 at 570 and *277287 Alberta Ltd.* v. *R.*, [1997] 3 C.T.C. 2380 at 2385.

[13] See paragraph 3.2(4)4. of the OBCA.

ancillary to the practice of the profession, including the *temporary investment of surplus funds earned by the corporation.*

C. Other Provisions

In addition to the above restrictions imposed on a professional corporation, subsection 3.2(4) of the OBCA provides that an agreement or proxy that vests in a person, other than a shareholder of a professional corporation, the right to vote the rights attached to a share is void.[14] Subsection 3.2(5) of the OBCA also provides that a unanimous shareholders agreement in respect of a professional corporation is void unless each shareholder of the corporation is a member of the professional corporation.

It is also noted that unlike partnerships, a corporation will not cease to be a professional corporation despite:

- the death of a shareholder;
- the divorce of a shareholder;
- the bankruptcy or insolvency of the professional corporation; or
- the occurrence of such other event or existence of such other circumstance as may be prescribed.[15]

Nevertheless, a professional corporation will cease to be a professional corporation on the revocation of its certificate. If such an event does occur, the corporation will also be required to change its name to remove from it the word “Professional” or “Professionnelle”.[16]

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[14] See subsection 3.1(4) of the OBCA.

[15] See subsection 3.3(1) of the OBCA.

[16] See subsection 3.3(2) of the OBCA.

3. *ADVANTAGES AND DISADVANTAGES*

There are several advantages to converting a professional practice or partnership into a professional corporation. The two most significant advantages are limited commercial liability and potential tax savings.

A. Commercial Liability

A principal advantage in establishing a professional corporation is that liability of the professional may be limited. It is generally accepted that an individual who carries on an activity is personally liable for his or her torts and breaches of contracts in the course of carrying on the activity, as well as those of his or her employees. As most are aware, this inevitably exposes to seizure, by a successful litigant, all of the assets owned by that professional notwithstanding that the assets may not be connected in any way to the activities carried on by that professional.

In order to limit this exposure, many individuals establish a corporation or a distinct legal entity to carry on the business activity. The ability to limit exposure through a corporation was clearly established in the leading case of *Salomon v. Salomon & Co.* where Lord Halsbury stated:

> I will for the sake of argument assume the proposition that the Court of Appeal lays down that the formation of the company was a mere scheme to enable Aron Salomon to carry on business in the name of the company. I am wholly unable to follow the proposition that this was contrary to the true intent and meaning of the *Companies Act*. I can only find the true intent and meaning of the Act from the Act itself; and the Act appears to me to give a company a legal existence with, as I have said, rights and liabilities of its own, whatever may have been the ideas or schemes of those who brought it into existence.[17]

This principle is now enshrined in subsection 92(1) of the OBCA. In particular, subsection 92(1) of the OBCA provides that, "The shareholders of a corporation are not, as shareholders, liable for any act, default, obligation or liability of the corporation....[18]"

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[17] [1897] AC 22 (HL) at 30-31.

[18] There are numerous exceptions under various statutes.

As one of the fundamental reasons for establishing a corporation is to limit the liability to the corporation, it must be noted that a professional corporation, for its part, is not a pure corporation. Although most of the commercial liabilities of carrying on a business will be limited to the assets of the professional corporation, liability relating to negligence or professional misconduct will not be limited.

The amendments to the OBCA as enacted under section 3.4 specifically provide that subsection 92(1) of the OBCA shall not be construed as limiting the professional liability of a shareholder of a professional corporation for the acts of the shareholder or acts of employees or agents of the professional corporation. The OBCA also provides that for purposes of professional liability, the acts of a professional corporation will be deemed to be the acts of the shareholders, employees or agents of the corporation, as the case may be.[19] This exposure to liability is further confirmed under subsection 3.4(3) of the OBCA which provides that the liability of a member for a professional liability claim will not be affected by the fact that the member is practising the profession through a professional corporation.

The liability of a lawyer is further confirmed by the provisions of the LSA. The LSA, its regulations, by-laws and its rules of practice and procedure apply to a member, a student member and all other persons practicing law regardless of the existence of a corporation.[20] In addition, subsection 61.0.5(1) of the LSA provides that the professional, fiduciary and ethical obligations of a member, a student member or other persons practicing law on whose behalf they are practicing law:

(a) are not diminished by the fact that they are practicing law through a professional corporation; and

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[19] See subsection 3.4(2) of the OBCA.

[20] See subsection 61.0.4(1) of the LSA.

(b) apply equally to the corporation and to its directors, officers, shareholders, agents and employees.

As a result of these provisions, all shareholders of a professional corporation will continue to bear the responsibility of his or her professional liability, as well as that of the other shareholders of the professional corporation and those of his or her employees and agents.

In addition to those liabilities, subsection 3.4(4) of the OBCA also provides that a shareholder is jointly and severally liable with a professional corporation for all professional liability claims made against the corporation in respect of errors and omissions that were made or occurred while the shareholder was a shareholder of the corporation.[21] Unlike a limited liability partnership, the professional liabilities of a shareholder will not be limited to his or her negligent acts and acts of individuals under that professional's direct supervision or control.[22]

Nevertheless, it is interesting to note that subsection 3.4(6) of the OBCA provides that if a professional corporation is a partner in a partnership or a limited liability partnership, the shareholders of the corporation have the same liability in respect of the partnership or the limited liability partnership as they would have if the shareholders themselves were partners.[23]

This option, however, does not appear to be available to lawyers in Ontario as section 61.1 of the LSA specifically provides that only two or more members may form a limited liability

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[21] This liability may be limited by subsection 3.4(5) which states that the liability of a member under subsection 3.4(4) cannot be greater than his or her liability would be if he or she were not practicing through a professional corporation.

[22] Subsections 10(2) and 10(3) of the *Partnership Act*, R.S.O. 1990, c. P.5 (as amended), state that a partner in a limited liability partnership is not liable, by means of indemnification, contribution, assessment, or otherwise, for the debts, obligations and liabilities of the partnership or any other partner arising from negligent acts or omissions that another partner or an employee, agent or representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership. Nevertheless, a partner of a limited liability partnership will continue to be liable for the partner's own negligence or the negligence of a person under the partner's direct supervision or control.

[23] Subsections 3.4(5) and (6) were not included in the original draft of the legislation, but were subsequently included in Bill 45.

partnership or continue a partnership as a limited liability partnership. The term "member" is, in general terms, defined under the LSA to mean individuals and, therefore, does not include corporations.[24] Accordingly, there is some doubt as to whether an existing limited liability partnership may derive any benefit from incorporation. It would appear that until the LSA is amended to align itself with the OBCA, there may be no real benefit to partners in a limited liability partnership to incorporate a professional corporation.

B. Tax Advantages and Disadvantages

(1) General Overview

In addition to the definitions of "professional corporation" provided in the OBCA and the LSA, subsection 248(1) of the *Income Tax Act* (Canada)[25] provides that a professional corporation means a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor. Interestingly, no mention of social workers is made within the ITA.

The Canada Customs and Revenue Agency (the "**CCRA**") in *Interpretation Bulletin* IT-189R2, *Corporations used by practicing members of a profession*, dated May 24, 1991 ("**IT-189R2**") set out certain general guidelines applicable to professional corporations. More particularly, paragraph 1 of IT-189R2 states that the CCRA will recognize a corporation as carrying on a professional corporation provided that: (1) the applicable legislation does not limit the practice of the profession to individuals; and (2) the activities of the corporation and its relationship to its employees and clients are similar to those ordinarily associated with a corporation carrying on business. In the CCRA's view, these activities would include owning and renting the premises of the business, owning and renting the office furniture, fixtures and equipment, purchasing necessary supplies, providing clerical services in its own name, billing clients in its own name,

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24 The term "member" is defined at subsection 1(1) of the LSA to mean member of the Law Society of Upper Canada and includes life members which are generally individuals that complete the Bar Admission Course and are called to the bar.

25 R.S.C. 1985, c. 1 (5th Supp.) as amended (the "**ITA**").

depositing collections in its bank, paying salaries and making clients aware that they are dealing with a professional corporation. In other words, as long as the corporation looks and feels like a corporation carrying on business, it will be treated as a corporation carrying on business. If the corporation is merely established to take advantage of some of the benefits without actually carrying on any real corporate activity, the CCRA has indicated that it will attempt to tax the income as though it has been earned by the professional and not the corporation.[26]

Assuming that a professional corporation is recognized by the CCRA, there are tax planning opportunities that may be utilized by these corporations. These advantages include, for example, the ability to claim the small business deduction and the $500,000 capital gains exemption provided for "qualified small business corporation share", just to name a few. These advantages and others will be examined in some detail below and should shed some light on the ways these corporations may be used to maximize tax saving opportunities.

(2) Small Business Deduction

The fact that the ITA is not only used as a means of generating income for the Federal Government, but that it is also used as a political and social instrument is exemplified by the preferential treatment accorded to Canadian Controlled Private Corporations ("**CCPC**")[27] through the small business deduction provided at subsection 125(1) of the Act. In general terms, the small business deduction enables a CCPC that earns "active business income" from a business carried on in Canada to claim a deduction from the taxes otherwise payable by it equal to 16% of the CCPC's active business income.[28] Because this small business deduction is not available to a sole proprietorship nor a partnership, it is one of the more important tax factors that

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[26] See paragraph 5 of IT-189R2.

[27] A Canadian-controlled private corporation is defined in subsection 125(7) as a private corporation that is a Canadian corporation, other than a corporation that lists its shares on a prescribed stock exchange or a corporation that is controlled, directly or indirectly, in any manner whatever, by one or more non-resident persons, by one or more corporations that lists its shares on a prescribed stock exchange, or by any combination thereof.

[28] The term "active business" is defined in subsection 248(1) and subsection 125(7). In general terms, an active business means any business carried on by the corporation other than a "specified investment business" or "a personal services business", and includes an adventure or concern in the nature of trade.

may influence a professional in incorporating his or her practice. Using the tax rates for 2002, the deductions results in a tax rate of approximately 20% for the CCPC. This is compared to the general tax rate on Ontario corporations of approximately 38% and the current top marginal rate for individuals resident in Ontario of approximately 46%.

The small business deduction is, however, generally limited to the first $200,000 of active business income of a CCPC. Note that where two or more CCPCs are associated[29] with each other, the aggregate claim of the associated group will be restricted to $200,000.[30]

In addition to the "associated corporation" rule, subsection 125(6) of the ITA also provides a specific anti-avoidance rule aimed at corporations participating in a partnership to ensure that the small business deduction limit is not abusively multiplied. The rule is designed to ensure that only a maximum aggregate amount of $200,000 of active business income earned by a partnership is considered when determining the total small business deduction available to each of the partners.[31]

In general terms, a corporation that participates in a partnership will be required to include in its income its share of the active business income of a partnership of which it is a member. The corporation will accomplish this by including in its income its "specified partnership income". The specified partnership income of a corporation is generally defined in subsection 125(7) to mean the lesser of: (a) the corporation's share of a partnership's income from active businesses carried on in Canada less amounts deducted by the corporation in respect of that income; and (b) that proportion of $200,000 that is the corporation's share of partnership income from an active business carried on in Canada.

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[29] See section 256 of the ITA. Corporations are generally associated if they are subject to common control and common ownership of shares by a person or a related group of persons. The central element underlying "association" is control whether it be *de facto* or *de jure*.

[30] See subsection 125(3) of the ITA.

[31] There are also specific rules under subsection 125(6.1) for groups of partnerships.

For example, if a partnership was composed of four equal corporate partners and the partnership's income from an active business carried on in Canada was $100,000, each corporate partner would include $25,000 as specified partnership income of the corporation for the year for the purpose of calculating the small corporation's business deduction. If such income was in excess of $200,000, then the amount to be included as specified partnership income by each partner would be equal to one-quarter of $200,000 or $50,000. The excess income would not be eligible for the small business deduction.

In light of the restrictions imposed under the Act in respect of the sharing of the small business deduction, it is evident that only a sole practitioner or members of a small partnership will benefit significantly from the small business deduction advantages accorded to a CCPC. Furthermore, in order to maximize the benefits arising from the small business deduction, these professionals should, as a general rule, ensure that the active business income earned within the professional corporation be limited to $200,000 as any taxes paid on income earned above that amount will be effectively taxed twice. It will first be taxed within the professional corporation at the higher rate of approximately 38% and then once distributed to the shareholder it will then be taxed in the hands of that shareholder at the rate of approximately 30% if distributed by way of dividends.

It is also imperative that the corporation not be viewed as a "personal services business" nor a "specified investment business",[32] as the small business deduction is not available to such corporations. Moreover, the deduction of expenses by a "personal services business" is restricted to the narrow range of items described in paragraph 18(1)(p) of the ITA. In general terms, paragraph 18(1)(p) of the ITA limits the deductions of expenses by a corporation in computing its income by disallowing all expenses except: (i) salary, wages or other remuneration paid to an incorporated employee of the corporation; (ii) selling, negotiating and similar

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[32] A "specified investment business" is defined under subsection 125(7) of the ITA to be, in general terms, a business the principal purpose of which is to derive income from property. Such income would include interest, dividends, rents and royalties. However, it is noted that the rules would not apply if the corporation employs six or more full-time employees.

expenses that would have been deductible in computing that employment income if that person had been employed and had been required by a contract of employment to pay them; and (iii) legal expenses incurred in collecting amounts owing for services rendered.

(3) Holding Surpluses

The most significant tax saving that arises with the use of professional corporations does not reside in the fact that it will be entitled to the small business deduction described above (as the small business deduction effectively enables a complete harmonization between having an individual earn income through a corporation and earning it directly), but in the fact that the professional corporation may be able to defer the recognition of income that is recognized by the shareholder. More particularly, if a professional can leave the first $200,000 of income earned in the professional corporation and reinvest that money, the tax savings that arise from the deferral of income recognition is significant given the time value of money.[33]

That being said, there is some doubt as to whether a professional corporation may be able to reinvest its profits for a prolonged period of time under the OBCA. As discussed above, paragraph 3.2(2)5. of the OBCA provides that professional corporation must limit its activities to carrying on the business of the practice of the profession and that it may only deviate from that purpose to invest its surplus funds temporarily. The provision reads as follows:

> The articles of incorporation of a professional corporation shall provide that the corporation may not carry on business other than the practice of the profession but this paragraph shall not be construed to prevent the corporation from carrying on activities that are related to or ancillary to the practice of the profession *including the temporary investment of surplus funds earned by the corporation.*

[33] For a detailed analysis of the tax advantages of deferral, see Vern Krishna, "*Professional Corporations*" (April 2001), 11, Canadian Current Tax No. 7, at 71.

It is unclear whether the reference to "temporary investment" requires a professional corporation to limit its investments. In reviewing the provision in greater detail, it is arguable that the provision should be interpreted broadly as it is carving out an exception to the restriction.

In addition, it is noted that the term "temporary" is defined in *Black's Law Dictionary* to mean:

> Lasting for a time only; existing or continuing for a limited time; transitory.[34]

The Manitoba Court of Queen's Bench has also held in *Patus v. Zurich Insurance Co*, that the adjective "temporary" is the opposite of permanent.[35] It is, therefore, arguable that provided there is some time limit to the re-investment of the surplus funds and that time limit is identifiable and not permanent, the re-investment of these surplus funds should not be viewed as offending the requirement of paragraph 3.2(2)5. This view also seems to be supported by Vern Krishna, where in his article, *Professional Corporations*, he states:

> The difference between the corporate and non-corporate forms of business is that the incorporated professional can defer further taxes by leaving the income in the corporation.[36]

This view, however, is not shared by everyone[37] and as with most ambiguous legislation it will be for the courts to decided exactly what was intended when the legislature included the word "temporary" within paragraph 3.2(2)5. of the OBCA.

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[34] B. A. Garner, *Black's Law Dictionary*, 7th ed. (West Group: Minn., 1999) at 1476.

[35] (1993), C.C.L.I. (2d) 1.

[36] Vern Krisha, "*Professional Corporations*" (April 27, 2001) The Lawyers Weekly, 6.

[37] See Bruce Ball, "*Incorporation of law firms moves a step closer*" (March 9, 2001), The Lawyers Weekly, 13 where the author claims that it appears that the legislation prohibits the long-term investments of the surplus funds of the professional corporation.

(4) Qualified Small Business Corpor ation Share

Another advantage in establishing a professional corporation is the possibility of claiming the capital gains exemption on qualifying small business corporation shares ("**QSBC Shares**").[38] The exemption entitles a shareholder to a $500,000 exemption on the capital gains that arise on the disposition of his or her shares in a professional corporation provided the shares of the professional corporation qualify as QSBC Shares. In general terms, there are three requirements that must be satisfied in order to qualify as QSBC Shares under the ITA.

First, the professional corporation must be a "small business corporation" at the time of disposition.[39] Second, each of the shares held by the shareholder must not have been held by anyone other than the shareholder or a person related to him or her throughout the 24-month period preceding the time of disposition. Third, throughout the required holding period, more than 50% of the fair market value of the assets of the professional corporation must have been used principally in an active business carried on primarily in Canada by the corporation.

(a) Small Business Corporation Test

As indicated, the professional corporation must be a "small business corporation" ("**SBC**") at the time the shares are disposed of by the shareholder. An SBC is defined under the ITA as a corporation that is a CCPC "all or substantially all of the fair market value of the assets of which are used principally in an active business carried on primarily in Canada".

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[38] See the definition of "qualified small business corporation share" as provided at subsection 110.6(1) of the ITA.

[39] The term "small business corporation" is defined at subsection 248(1) of the Act.

(b) CCPC

As noted above, a CCPC generally means a private corporation that is a "Canadian corporation" other than a corporation controlled directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations or by any combination thereof.

(c) All or substantially all of the fair market value of the assets of the corporation are used principally in an active business carried on primarily in Canada

All or substantially all of the fair market value of the corporation's assets must be attributable to assets that were used principally in an active business carried on primarily in Canada. The CCRA has administratively accepted that "all or substantially all" means 90% or more, and that "principally or primarily" means 50% or more. It is commonly accepted that assets used in an active business generally include trade receivables, inventory, fixed assets such as real property, machinery and equipment. However, advances to shareholders, excess cash, prepaid expenses, insurance proceeds and deposits do not qualify as assets used in an active business.

(d) The 24-Month Holding Period Test

The second component of the definition of QSBC Shares requires that the shares of the shareholder not be owned by a person unrelated to the shareholder throughout the period of 24 months preceding the time the shares are disposed of. This test is formulated in the negative and, therefore, shares which are owned by a shareholder for less than 24 months are not automatically disqualified unless the shares were acquired from an unrelated party or were issued by the corporation within this 24-month period. There are very limited exceptions to this 24-month rule and they should be explored in the event that the shares that are to be disposed of do not satisfy the 24-month holding period test as they may apply.[40]

(e) The 50% Active Business Test

The third component of the definition of QSBC Shares requires that throughout the 24-month holding period prior to the sale of the shares, such shares were shares of a CCPC where more than 50% of the fair market value of the assets of the corporation was attributable to assets used principally in an active business carried on primarily in Canada. From a practical point of view, this test requires that the corporation be a small business corporation throughout the 24 months prior to the disposition of the shares as discussed above with the exception that the 90% threshold is reduced to 50%. This requirement is continuous and, therefore, the corporation must not fail to satisfy the above test at any time during the 24 months prior to the determination time.

(5) Fiscal Year-end of the Professional Corporation

The 1995 Federal Budget determined the fiscal periods of professionals and professional partnerships such that subsection 249.1(1) of the ITA now provides that a fiscal period of such a professional or partnership cannot end after the calendar year in which the fiscal period began. Moreover, paragraph 249.1(1)(b) of the ITA now specifically requires professional corporations that are members of a partnership to have fiscal periods that coincide with the calendar year.[41] The result is that the fiscal year-end of a professional corporation that is a member of a partnership will be December 31.

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[40] See paragraph 110.6(14)(f) of the ITA.

[41] Note that section 249.1 does not affect the calendar year of a professional corporation that is not a member of a partnership as it is able pursuant to paragraph 249.1(1)(a) to select any fiscal period that is 53 weeks or less in duration.

(6) Work -in-Progress

A corporation that is carrying on the practice of a profession as a professional corporation will be required to determine its income on an accrual basis.[42] Therefore, it will generally be required to include in the calculation of its income any work-in-progress.

However, a professional corporation as defined within the ITA may qualify to make an election under section 34 of the Act so as not to be required to include in its income any amount in respect of work-in-progress at the end of the year. As a result, consideration should be given to making the election. However, these rules are detailed and should be reviewed carefully.

4. *CONCLUSION*

In light of the foregoing, it is clear that the application of the rules under the OBCA, the LSA and the ITA as they relate to professional corporations will be different every time a new factual situation is presented. Accordingly, professionals should speak to an advisor and make sure that incorporation is the right thing for them.

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[42] See paragraph 3 of IT-189R2.

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Professional Corporations

Overview

Lawyers may now practise law through a professional corporation. The Schedule to Bill 152, *Balanced Budgets for Brighter Futures Act*, 2000, came into force on November 1, 2001, amending the *Law Society Act* to permit lawyers to carry on the practice of law through a corporation.

The legislation provides that:

- all of the issued and outstanding shares of the corporation shall be legally and beneficially owned, directly or indirectly, by one or more members of the same profession,
- all officers and directors of the corporation shall be shareholders of the corporation,
- the name of the corporation shall include the words "Professional Corporation" and no professional corporation shall have a number name, and
- the articles of incorporation of a professional corporation shall provide that the corporation may not carry on a business other than the practice of the profession.

A professional corporation may have more than one shareholder but multi-disciplinary professional corporations are not permitted.

By-law 34 - Professional Corporations, created by the Law Society in response to this new provincial legislation, covers, among other things, the name, structure and registration requirements for a professional corporation.

For more information:

- Application-related questions may be directed to (416) 947-3315 (Administrative Compliance Processes), or lsforms@lsuc.on.ca
- If you have other questions about professional corporations, contact the Law Society's Practice Advisory at (416) 947-3315, toll-free at 1-800-668-7380, ext.3315, or by e-mail at advisory@lsuc.on.ca.
- To find information about this or other legislation, check out the Great Library's resources

Thursday, Jur

Profession Corp

Overview
Q & As
By-law 34

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The Law Society of Upper Canada | Barreau du Haut-Canada

Professional Development & Competence

Affiliations

Fact Scenario

Kim is a sole practitioner who regularly works with an accountant. Kim and the accountant have engaged in joint marketing efforts and regularly join together so that Kim provides legal services and the accountant provides accounting services to the same clients. Kim has heard that there is a new regulatory scheme for affiliations but believes that it just applies to large firms which operate under comprehensive arrangements with affiliates for joint delivery of services, but not to such informal arrangements like those he has with the accountant. Is Kim right?

Kim is wrong. This arrangement falls into the definition of "affiliation" in By-Law 32 and rule 1.02 of the *Rules of Professional Conduct* (the *"Rules"*) and Kim must comply with the new regulatory scheme.

Synopsis

The Law Society has implemented a new regulatory scheme for affiliations. The scheme addresses regulatory issues arising from affiliations between lawyers and non-lawyers. It is important to note that the definition of affiliation is very broad and will capture arrangements that can be arrayed on a continuum from very informal arrangements to the structured and comprehensive arrangements of a law firm with a professional services firm.

The most obvious risk of affiliations is to the independence of legal advice, unfettered by conflicting interests. Toward that end, the new scheme for affiliations aims for transparency. The affiliated firm's arrangements with the non-lawyer firm must be transparent to the Society and, as needed, to clients.

Textual Sources

The scheme comprises new By-Law 32 and various provisions of the *Rules of Professional Conduct*[1]. Generally, an affiliation (which is defined in rule 1.02 of the *Rules* and s. 1. of the By-Law) is the joining by a lawyer or group of lawyers on a regular basis with an affiliated entity in the delivery, or promotion and delivery, of the legal services of the lawyer or group and

[1] Rule 1.02-definitions; subrules 2.04(10.1), (10.2), and (10.3)-conflicts of interest; commentary to subrule 2.08(9)-fee-splitting; clause 3.03(1)(l)-letterhead; subrule 3.04(3) and commentary thereto-advertising; and, subrule 5.01(6)-supervision and delegation.

the non-legal services of the affiliated entity. An "affiliated entity" is defined as "any person or group of persons other than a person or group of persons authorized to practice law in or outside Ontario".

Key Characteristics

The key characteristics of the regulatory scheme for affiliations are as follows.

Compliance is Mandatory

Where a lawyer or group of lawyers meet(s) the test of an affiliation in the By-Law, she, he or they must comply with the new regulatory regime.

No Fee-Splitting with Non-Lawyers

While an affiliation might be viewed as a type of multi-disciplinary practice, it is important to remember that it has key differences. One of the most important differences is that lawyers may not split fees with non-lawyers in an affiliation. While there is an exception to the prohibition against fee-splitting with non-lawyers in subrule 2.08(9) for multi-disciplinary partnerships, there is no exception for affiliations.

Lawyers Must Own and Control

Unless a practice is a properly constituted multi-disciplinary partnership, the practice through which lawyers deliver legal services to the public must be owned by lawyers. Lawyers must also maintain control over the practice. (By-Law 32, paragraphs 2(a) and (b).)

Separate Premises

To facilitate work on client matters, lawyers and non-lawyers may provide their joint services at the premises of the affiliated entity or the law firm. However, the practice of law must be carried out at an office separate from that of the affiliated entity. The By-Law provides that the lawyer or lawyers must carry on the practice through which she, he, or they deliver(s)

> *legal services to the public, other than those that are delivered jointly with the non-legal services of the affiliated entity, from premises that are not used by the affiliated entity for the delivery of its non-legal services, other than those that are delivered by the affiliated entity jointly with the legal services of the [lawyer(s)].* *(*By-Law, paragraph 2(c)).

Reporting Requirements

Lawyers who affiliate with non-lawyers must immediately give to the Law Society notice in prescribed form (Form 32A). The essence of the notice requirements is disclosure of the financial arrangements, ownership, control and management of the law practice, and the lawyers' compliance with regulatory requirements related to confidentiality and conflicts of interest. In addition, there is an annual filing requirement (in Form 32B). Unlike the scheme for MDPs in By-Law 25, the Society does not approve or license the affiliation.

Avoiding Conflicts of Interest

A lawyer practising in an affiliation is required to address conflicts as if the lawyer's practice and that of the affiliated entity were one, where services are provided jointly to a client by the law firm and the affiliated entity. (*Rules*, subrule 2.04(10.3) and commentary thereto.) The ordinary conflicts rules, applicable to lawyers and law firms, apply equally to affiliations. Where there is an affiliation, before accepting a retainer to provide joint services, a lawyer must disclose to the client: any risk to solicitor and client privilege, the lawyer's role in providing the various services, and any arrangements or agreements between the lawyer and the affiliated entity that may affect the independence of the lawyer's representation of the client. (*Rules*, subrule 2.04(10.1).) After making such disclosure, the lawyer must obtain the client's consent to act. (*Rules*, subrule 2.04(10.2).)

While the requirement for conflicts searches may seem to be onerous for affiliations that are less formal, the Task Force concluded that it was necessary for the regulatory scheme to apply to all types of affiliations as they are defined in order to ensure that clients receive legal services consistently with the profession's core values. Moreover, the *Rules* essentially permit law firms to design their own conflicts-checking systems and to make the necessary disclosure to clients. This flexibility allows lawyers to design systems to meet their own needs.

Supervision and Delegation

Without first obtaining the client's informed consent, a lawyer is not permitted to delegate to staff of the affiliated entity any tasks in connection with the provision of legal services. (*Rules*, subrule 5.01(6).) It is important to remember that under the *Rules*, consent must be reduced to, or recorded in, writing.

OPENING YOUR LAW PRACTICE
TAXATION ISSUES

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Revised May, 2004

PURCHASE OF EQUIPMENT

Equipment and Furniture

- Equipment is depreciated for income tax purposes using the capital cost allowance ("CCA") system. The CCA ("depreciation") claimed on each type of equipment or furniture is prescribed by regulations in the Income Tax Act.

- The following is a list of the capital cost allowance rates for the type of equipment a new practitioner would purchase:

1. Computer Hardware	-30% declining balance (45% after March 23, 2004)
2. Computer Software	-100% declining balance
3. Office Furniture	-20% declining balance
4. Telephone System	-20% declining balance
5. Automobile	-30% declining balance (subject to limitations)
6. Office Equipment	-20% declining balance

- In the year of acquisition only one-half of the maximum allowable CCA is allowed as a deduction.

- Where the fiscal period of a business is less than twelve months, CCA is restricted to the maximum claim, times the proportion that the number of days in the fiscal period is of 365.

- A CCA claim is discretionary, i.e. you can defer claiming CCA to a more profitable year.

LEASE VS. PURCHASE

Lease

- The following are characteristics of a lease:
  - No down payment (possibly).
  - First and last month lease payments (possibly).
  - Buy out clauses to consider (open vs. closed leases).
  - Guaranteed residual value.
  - Payment is deductible when incurred.
  - Lower monthly payments.

Purchase

- Money is required for a down payment.
- May require bank loan to purchase equipment.
- Interest is payable on monthly outstanding loan balance.
- Usually resale value exists.
- Capital cost allowance may be claimed on depreciable assets over a number of years.

LEASE VS. PURCHASE

Lease vs Purchase Considerations

- The following questions must be considered when deciding whether to lease or purchase equipment:

    1. Do you have the cash available to purchase the asset?
    2. How much room do you have available on your line of credit?
    3. What is the implicit rate of interest on the lease as compared to the borrowing interest rate?
    4. What is the implicit purchase price in the lease as compared to an outright purchase?
    5. What are the income tax consequences of leasing as compared to purchasing the equipment?
    6. What are your overall cash flow consequences?
    7. How long do you anticipate keeping the equipment?

AUTOMOBILES EXPENSES

Purchase Considerations

- The maximum capital cost on which capital cost allowance may be claimed is limited to $30,000 plus the GST and PST payable on $30,000.

Lease Considerations

- Lease payments are restricted to the lesser of:

  1. $800 per month plus the PST and the GST payable on $800.
  2. Lease charges for the year * ($30,000 plus PST + GST on $30,000) / 85% of the greater of 100/85 * $30,000 plus PST + GST on $30,000 and the MLSP.

Interest Costs

- Interest on money borrowed to purchase an automobile is limited to $300 per every 30-day period.

Operating Costs

- Operating costs such as gas, repairs and maintenance, licenses etc. are deductible.

Personal Use

- All the above expenses are deductible only to the extent the automobile is used for business purposes.

OFFICE IN A HOME

Home Office Expenses

- In order to claim home office expenses, a taxpayer must meet one of two tests:

  a) The workspace is the taxpayer's principal place of business

  OR

  b) The workspace is used exclusively for the purpose of earning income from a business and is used on a regular and continuous basis for meeting the taxpayer's clients.

- Most expenses are deductible, including property taxes and mortgage interest attributable to the percentage space the office is of your house.

PROMOTION

Business Meals and Entertainment

- Only 50% of business meals and entertainment expenses are deductible for income tax purposes. This rule also applies to GST.

- Examples of expenses subject to the 50% limitation schedule include:

  a) Business meals.

  b) Tickets for sporting and cultural events.

  c) Accommodation at resorts.

- The 50% limitation does not apply if a lawyer takes a client to lunch and includes the lunch tab on a subsequent bill to the client.

- The 50% limitation also does not apply where food and entertainment are available to all employees (i.e.: a Christmas party).

INTEREST DEDUCTIBILITY

Financing Start-up Costs

- The following questions must be considered when deciding how to finance start-up costs:

  1. Do you have the cash available to finance the start-up costs?
  2. If you have the cash, do you have any non-deductible debt outstanding?

- If a practitioner has cash available to fund the start-up costs, the practitioner should ensure they have no non-deductible debt that can be repaid before injecting the funds into the practice. Non-deductible debt should be repaid first since in most cases any borrowings made to earn business income will be deductible. Thus, for example if a practitioner borrowed $25,000 at 10% to start their practice, $2,500 in interest would be deductible, whereas none of the $2,500 would be deductible on personal debt.

- If the start-up costs are borrowed, the practitioner should then ensure they always repay any non-deductible debt before repaying the start-up loan.

Line of Credit

- The same rule as discussed above should also be applied for repayment of a practitioner's line of credit. When repaying the line of credit, the practitioner should always ensure they repay loans on which interest is non-deductible before repaying the line of credit.

Income Tax Act

- In general, the Income Tax Act permits the deduction of interest on indebtedness used for the purpose of earning income from a taxpayer's business.

- To be deductible interest must be paid or payable in respect of the year pursuant to a legal obligation to pay interest thereon.

REGISTERED RETIREMENT SAVINGS PLANS

RRSP Considerations

- Self-employed individuals are afforded limited opportunities to save for retirement other than through an RRSP. It is thus important that the practitioner makes the yearly contributions to their RRSP. The practitioner should strive to make the maximum RRSP contribution; especially once the practice begins to generate sufficient income.

- The practitioner's net income from the previous year will be the major component of earned income, which is calculated for the purpose of determining an individual's RRSP limit for a given year.

- An individual's RRSP contribution is determined by multiplying 18% times the individual's earned income for the preceding year.

- The maximum RRSP contributions for future years are as follows:

2004	$15,500
2005	$16,500
2006	$18,000

- Where individuals are unable to make the maximum RRSP contribution in a year, they can carryforward the unused contribution room indefinitely. Thus, if we assume a practitioner has sufficient earned income each year to make the maximum RRSP contribution, and their cash flow precludes making an RRSP deduction in 2004 and 2005, the practitioner could make a RRSP contribution of $32,000 in 2006, if they had sufficient funds. The practitioner could also make a contribution less than $32,000 and carry the unused contribution room forward.

INCOME SPLITTING

Salaries to Spouse and Children

- Salaries paid to a practitioner's spouse and/or children will be deductible to the extent the wages are reasonable in relation to the work performed.

- The receipt of salaries may be received tax-free in cases where a spouse has no other income sources and/or there are childcare expenses to be deducted. In other cases where these deductions are not available, or the practitioner's spouse has other income sources, the payment of salaries will still be beneficial where the practitioner's marginal tax rate is higher than that of their spouses and children.

- Salaries paid to spouses and/or children will enable them to have earned income for the purposes of making RRSP contributions.

REGISTRATION AND FILING REQUIREMENTS

Employer Payroll Deductions

- Practitioners are required to withhold income tax, Canada Pension Plan ("CPP") and Employment Insurance ("E.I.") from their employees' wages and remit these amounts, in most cases, on a monthly basis.

- In addition, the practitioner must match the CPP deducted from the employee's paycheque and pay 1.4 times the E.I. deducted.

- In order to remit payroll deductions, the practitioner must open an employer source deduction account. This is done by completing Form PD20. Upon processing this form, Canada Customs and Revenue Agency will issue the practitioner an account number and send the practitioner form PD7AR to be used for the payroll remittance.

Employer Health Tax

- The practitioner is also required to pay the Employer Health Tax ("EHT"), which is a tax based on salaries and remuneration paid to employees. The rate of tax varies from .98% to 1.95%.

- The first $400,000 of Ontario Payroll is exempt from EHT.

REGISTRATION AND FILING REQUIREMENT

Goods and Services Tax

- Practitioners are required to register for goods and Services Tax ("GST").

- Practitioners will receive input tax credits for GST paid on goods and services purchased and collect GST on services the practitioner provides. The practitioner will then remit/claim the difference of GST collected/paid on a quarterly basis, in most cases.

- Practitioners must ensure that they properly account for the GST on their invoices. A standard method of presentation seems to have evolved, whereby disbursements subject to GST (i.e.: courier, photocopies, telephone etc.) are segregated on the bill from the disbursements not subject to GST (i.e.: land transfer tax and registration fees).

- It is very important that practitioners set-up their accounting records in order to ensure that they correctly record the GST.

Worker's Compensation

- Practitioners that have employees are required to register for Worker's Compensation and report their payrolls and pay tax based on Worker's Safety and Insurance Board assessment rates.

Proprietor/Partnership Registration

- All partnerships are required to register their names under the Business Names Act with the Ministry of Consumer and Commercial Relations. Sole practitioners do not have to register their name unless they use a name other than their own name.

LEGAL STRUCTURE OF PRACTICE

Proprietorship

- A proprietorship is the simplest tax structure to practice law.
- Income earned from the practice of law, less expenses applicable to earning the income is taxed as professional income on the practitioner's personal income tax return.
- Net professional income is taxed at personal marginal tax rates.
- The following are the marginal income tax rates for 2004:

Under $35,000	-	21.6%
$35,001 - $70,000	-	30.8%
$70,001 - $113,804	-	37.1%
> $113,804	-	46.4%

- A proprietorship should be utilized until the practitioner does not require all the income earned in their proprietorship to meet their daily living requirements.
- A proprietor may transfer their law practice into a corporation using the tax-free rollover provisions of the Income Tax Act.

LEGAL STRUCTURE OF PRACTICE

Partnership

- A partnership is taxed in a similar manner to a proprietorship. Each partner's income is subject to the same marginal tax rate as a proprietor.
- Deductions such as capital cost allowance are taken at the partnership level.
- The income that flows through to each partner retains its original character or source.
- A partnership is very difficult to dissolve from both a business and income tax perspective.
- A partnership may be transferred tax-free into a corporation utilizing the provisions of the Income Tax Act.
- Partnerships of six or more partners must file T5013 Partnership Information Returns with Canada Customs and Revenue Agency.

LEGAL STRUCTURE OF PRACTICE

ADVANTAGES OF INCORPORATION

Benefit of the Small Business Deduction

- The primary tax objective of using a professional corporation will be to generate an income tax deferral (i.e. where the small business deduction ("SBD") is available).
- A Canadian controlled private corporation calculates its tax liability by:
  1. First applying the standard corporate rate to its total taxable income.
  2. After the basic tax amount is determined, a deduction for the SBD is allowed.
- Current combined Federal and Ontario tax rate applicable to a professional corporation is 18.62%.
  - Currently an individual resident in Ontario subject to the top marginal tax rate is taxed at 46.41%.
  - This results in an income tax deferral of 27.79%.
- The small business deduction is available on the first $225,000 of taxable income earned by the corporation in any given year (Increasing to $300,000 by 2006).
- The corporation also provides for an absolute income tax savings of 2.28%.
  - Where the corporation pays its corporate tax and
  - Distributes the remaining income as a dividend

Example 1 - Tax Deferral

			Tax Rate
Corporation			
Taxable income	$ 225,000		
Combined Federal and Ontario Corporate Tax	41,895		18.62% A
After-tax funds	183,105	1	
Individual			
Taxable income	225,000		
Total tax if earned as sole proprietor or partner	104,422		46.41% B
After-tax funds	120,578	2	
Tax deferral with corporation.	$ 62,527	[1-2]	27.79% [B-A]

Example 2 - Absolute Tax Savings

Net cash available for distribution to shareholder	$ 183,105	1
Tax to shareholder is distributed as dividend – 31.34%	57,385	
After-tax proceeds to shareholder	125,720	
After-tax proceeds if earned personally	(120,578)	2
Absolute savings with corporation	$ 5,142	2.28%

LEGAL STRUCTURE OF PRACTICE

ADVANTAGES OF INCORPORATION

Year-end of the Professional Corporation

- Income Tax Act does not legislate a December 31 year-end for a professional corporation, unless the professional corporation is a member of a partnership.
- Non-calendar year-end may provide for income tax planning in the first year of incorporation.
- Bonuses accrued are deductible if paid within 179 days of corporation's year-end.
- Potential access to $500,000 capital gains exemption

Miscellaneous Issues

- Flexibility of remuneration.
- Dividends paid to eliminate CNIL account. A CNIL account will impair a professional's ability to fully utilize the capital gains exemption.
- No employment insurance if professional owns more than 40% of the shares (which they have to).
- No income tax installments required during the first fiscal period.
- $10,000 tax free "death benefit"

Disadvantages of Incorporation

- Overview
    - Loss of year-end reserves
    - Association with others
    - Loss of certain benefits and deductions
    - Cost and expense establishing and maintaining the professional corporation.

PURCHASE OF A LAW PRACTICE

Considerations

- The following are some of the many consideration that are important in determining what to pay and whether to purchase a law practice.

  1. Nature of clients – Is the client base expanding or stagnant?
  2. Client Needs – Can the clients needs be satisfied?
  3. Practice Personnel – is the existing staff qualified?
  4. Office Technology – Is the office technology advanced?
  5. Competition – What is the strength of your competition?
  6. Lease – What are the terms of the existing lease?
  7. Vendor Assistance – Is the seller willing to help the transition?
  8. Payout period – What are the purchase terms?
  9. Allocation of purchase price – Important for Tax purposes?
  10. Retention Clause.
  11. Valuation.

PURCHASE OF A LAW PRACTICE

Income Tax Considerations

- The allocation of the purchase price allocated to goodwill, the covenant not to compete, seller's services, work-in-progress and the fixed assets are very important for income tax purposes.

- In general, a purchaser will want the purchase price to be allocated in the following order:

  1. To pre-paid expenses and other items that will be fully deductible in the following year.

  2. To equipment and furniture that can be depreciated at a fairly high rate.

  3. Goodwill and other eligible capital properties that would provide a deduction of 7% of ¾ of the purchase price.

  4. Capital properties such as securities or a partnership interest that would be non-deductible expenses to the purchaser.

- Since the vendor would in most cases want the allocation of the purchase price to be allocated in the reverse order, negotiations usually result in a compromise of the allocations of the assets.

- With the advent of incorporation, the vendor may now wish to sell shares to access their $500,000 capital gains exemption.