Corporate Payoff

Until recently, if your business wasn't incorporated, you probably were paying too much tax. But for many, the 1999 federal budget altered the equation, by making It much tougher to reap the tax benefits after money is taken out of the corporation. What's more, dramatic reductions in corporate tax rates are now kicking in - so dramatic that they will reshape tax planning, making incorporation an even more lucrative strategy than it was before.

So it's time for an update on forming a company - when does it make sense and when doesn't it? But before I get to this, here's a short primer on the tax benefits of forming a company.

How it works. Even with recent changes, it's possible to save up to $50,000 a year in taxes by incorporating your business - that's like earning an extra six figures a year before taxes. How so? To begin with, corporate tax rates on business income are the better part of half a dozen points lower than top personal brackets in most provinces. But tackled onto this is the enormously lucrative " Small Business Deduction" - a federal tax reduction of a further 16%. It applies to qualifying active business income which, since 2003, has encompassed a much wider field, The annual qualifying income rose from $225,000 in 2003 to $250,000 in 2004. In lieu of another $25,000 rise in 2005, the latest federal budget proposed the $300,000 figure take effect in 2005 rather than a year later. Plus there are additional tax incentives tacked on in most provinces (in Ontario, for example, it's an extra 5.5%).

What's more, there is a dramatic change in the way rates are assessed. In addition to "investment rates" and "small business rates" there are now "business rates", Federal and provincial tax changes mean that rates applicable to business rather than investment income are slated to drop towards the 20% 'I range in most provinces. The ability to incorporate and obtain business rates could mean an across-the-board reduction of one-third or more from the top bracket if you incorporate.

It's possible to set up a company on short notice - sometimes in hours, for $1,000 or so. There may be some extra professional fees for tax planning, but they're modest. You won't lose control of Your business, and you can use your company's profits for virtually any business or investment activity - even if it has nothing to do with your regular business.

When to consider incorporating. Here are four key guidelines as to when you should seriously consider incorporating a business:

Healthy profits. The business profits, when added to other sources of taxable income, should take you well out of the lowest tax bracket. Translated, this means that your annual taxable income, including from your business, should be well in excess of the $35,000 threshold where the lowest tax bracket kicks in.

No losses expected. You are not expecting tax losses from your business in the near future. Because a corporation is separate from you, if you incorporate your business, tax losses are deductible only to the corporation - not you. So don't incorporate until you have achieved profitability.

Low-bracket family members. You have explored the possibility of taking advantage of low-tax-bracket family members. Very often, when business income is fairly modest, you can obtain tax benefits similar to incorporation by making sure you have taken advantage of low-income family members, because this could reduce your taxable income towards the $35,000 level. By putting family members on the payroll, salaries you pay them can be deductible from your business income as long as they are not unreasonably large, given the services performed.

Use of your company's profits. You can leave at least some of your business profits in the company or you may be able to make tax-effective use of low-income family members as shareholders. I will have more to say on the latter shortly, because that's where the federal budget comes in.

Once you start to draw out your company's income, the tax benefits start to erode, because you must then pay additional tax on salaries or dividends that you take out of your company. This will be necessary to the extent that you are looking to the company's earnings to fund your day-to-day personal/living expenses.

To put it another way, incorporation makes sense if you don't need all of your business income to live on, or, for business reasons, you intend to reinvest at least some of your profit in the company - I this can be in the business itself, or in other investments (for example, the stock market or mutual funds, treasury bills, etc.). When you distribute your corporation's profits out of the company, there will usually be additional tax to pay, because you will "pay yourself' in the form of salary or dividends.

Dividend splitting. Until recently, it was often possible to fend off this tax problem by making low-bracket family members shareholders of an incorporated family business. If properly structured, dividends paid to them could be taxable at very low rates, often tax free - a process that tax drones call "dividend splitting." This lucrative manoeuvre could help ensure the continuation of substantial tax benefits even after the profits were distributed out of the company: a taxpayer with no other income can receive nearly $24,000 of dividends each year without having to pay federal tax.

Enter the 1999 federal budget, which put the kibosh on some key strategies in this area. A special "dividend-splitting" tax - at the highest tax rate - now applies to those 17 or under for dividends from private companies, including those received through a trust or partnership. This pretty well kills off "dividend splitting" with minors (although surtaxes may not apply). In a nutshell, this means that if kids 17 or under are the only low-tax-bracket family members in sight, you'll miss the major benefits of incorporation unless you can leave a good shot of its profits in the company.

Happily, though, there is still an opportunity to split dividends if you have kids 18 or over or a spouse who is in a low tax bracket. There are a number of hidden tax traps when it comes to this manoeuvre - but with the help of a tax adviser, it's often possible to steer clear of these obstacles. For example, one of the largest traps (which tax drones call the "corporate attribution rules") usually doesn't apply in situations where substantially all of the value of the corporation's assets is used in Canadian active business activities. Other dividend-splitting opportunities for a spouse or adult kids may be available, for example, if the business is in a start-up mode or has a nominal value. But remember: You'll need qualified professional advice.

The bottom line. With corporate tax rates dropping fast, there's probably never been a better time to incorporate. When you combine the Small Business Deduction with the lower rates, you can save a bundle. This is provided either that you leave at least some of your profits in your company for reinvestment, or if you do need your company's profits to live on, that you have a spouse, parent, or adult child in a low tax bracket.