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Planning for the Incorporation of Dentists in Ontario

by David Chong Yen (Ontario Dentist Magazine, April 2001)

The May 2, 2000 Ontario Budget proposed that regulated professionals, including dentists, should be given the option to incorporate. In short, this means dentists will be permitted to incorporate their dental practice, which would then be referred to as a professional corporation. The legislation also states that non-dentists, including spouses, children and parents, will not be permitted to own shares of the corporation.

The Ontario government is expected to provide more specifics in due course. At the time of this article's writing, legislation permitting the incorporation of dental practices had been given Royal Assent, but it still needs to be proclaimed as law before coming into effect. In the meantime, the following tax planning issues should be considered, in anticipation of the approved legislation allowing dentists to incorporate. But before you take any action, consult a tax professional to determine if you can, in fact, save and defer taxes by incorporating your particular dental practice. Also, consult your lawyer to determine the legal ramifications.

Selling a Professional Business to a Corporation

A valuation may need to be done of the dental practice, since the dentist would sell their dental practice to the newly-formed corporation. Consider an independent appraiser of dental practices for this task. The valuation is just one of several steps needed determine the price at which the dental practice will be sold to the corporation. It is generally possible to defer any taxes arising on the sale of the dental practice to the corporation by consulting a tax professional.

Dividend / Salary Mix

Salaries are paid to employees of the corporation for services they have rendered. Employees of the corporation include the dentist, but dividends are only paid to shareholders of the corporation. In light of this, paying the optimum amount of dividends and salaries is important in order to minimize overall taxes. Factors surrounding the optimal mix of salaries and dividends are as follows:

1. Tax rates applicable to dividends are different from those that apply to salaries. The top tax rate for salaries is higher than the top tax rate for dividends;
2. Salaries are considered "earned" income, and as such, increase your RRSP contribution limit. Dividends are not considered earned income and so do not count towards your RRSP contribution limit;
3. RRSP contributions are currently limited to 18 per cent of earned income, to a maximum of \$13,500 per year;
4. Salaries represent tax-deductible expenses to the professional corporation;
5. Dividends are not considered a tax-deductible expense to the professional corporation, and;
6. The professional corporation, if it derives virtually all of its income from dentistry, will be considered an active business, with the first \$200,000 of its income taxed at a low rate, approximately 20 per cent. The professional corporation may also derive some of its income from investments. However, this investment income will be taxed at a rate of approximately 50 per cent.

Other Issue to Consider

The dentist, who owns shares of the corporation or company, is entitled to dividends, provided the corporation has retained earnings (in other words, profits from the current or previous years, which have not been paid out to share-holders). These dividends do not count towards income on which RRSP contribution limits are based, since earned income is a requirement for the RRSP limit calculation.

Because of the above factors, a salary of \$75,000 should be paid in order to maximize your RRSP contribution, provided your corporation is profitable enough to do so. Consider leaving any money not required for personal expenses in the corporation. If you follow that advice, a tax deferral will be achieved, as the company would pay only a 20 per cent tax rate, versus a higher rate if the dentist receives the income directly. The corporation can then invest the surplus money, although such investment income will likely be taxed at a higher tax rate of approximately 50 per cent.

In general, the corporation's tax rate will likely be 20 per cent on the first \$200,000 of income subject to taxes. Furthermore, the dentist who incorporates will likely be entitled to a \$500,000 capital gains exemption with respect to shares of the professional corporation (in other words, the first \$500,000 capital gains, which arise when the corporation shares are sold, will be tax free, subject to certain restrictions).

Many dentists are currently independent contractors. Where dentists are permitted to incorporate, they will become employees (and not independent contractors) of the corporation they own. Furthermore, where the dentist owns more than 40 per cent of the professional corporation, no employment insurance is payable on the salaries paid to the dentist. However, where this test is not met, then employment insurance will be payable on the salaries paid to the dentist.

Are Hygiene, Technical Service Corporations Still Needed?

Hygiene or technical service corporations were created to operate the hygiene or technical service component of a dental practice. A non-dentist, including a family trust, may own either corporation. It bears repeating that a dentist's spouse or children who are not members of the regulated profession would not be allowed to own shares of the newly-formed professional corporation.

Therefore, if there are individuals with whom income splitting can be achieved, and these individuals are not dentists, then a hygiene or technical service corporation will still continue to yield tax savings. In such cases, non-professionals will directly or indirectly own the non-professional (hygiene) portion of the business. The dentist will own shares of the dental corporation, which in turn, owns the dental business. Therefore, depending on the circumstances, a hygiene or technical service corporation may be used in combination with a professional corporation.

Impact on Stub Period Income

Many dentists are paying additional taxes as a result of reporting a non-December year-end as at December 31, 1995. Since then, the government has taxed dentists on the income deferred over a 10-year period, from 1995 onward. Where the professional sells the business to the corporation, he or she will be deemed to cease operating this business. Instead, the corporation (a separate legal body from the dentist) would then take over.

When a dentist ceases to operate his or her business, the remaining reserve (in other words, the untaxed portion of the income deferred) will be recognized as income. However, with proper planning some of this can be deferred to the year following incorporation. This could create a larger tax bill than anticipated in the initial year. Seek a tax professional before incorporating.

Use of a Holding Company

A holding company is created to own shares of another company. This is often done to protect one company's assets from creditors, or to separate the operating asset of one company from the investment assets - including cash - of another company. Generally speaking, it is permissible to pay dividends from

one company to another on a tax-free basis. Unfortunately, it is unlikely that the new legislation will permit the use of holding companies to own professional corporations.

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This article is intended to present tax saving and tax planning ideas and is not intended to replace professional advice.