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Take Your Pick - Pay the Bank, Canada Revenue Agency or Neither

by David Chong Yen

As a sole proprietor, you have yet to take advantage of the incorporation concept. You also know there is a mortgage strategy you could use to pay off your personal mortgage faster and convert your personal mortgage interest as deductible business interest. This only meets your objective #2.

Some dentists are reluctant to incorporate because they think it is very expensive to remove money from their corporation. First, you pay taxes at the corporate level and then again at the personal level. With the two levels of tax, some dentists think they end up paying more than what they are paying now. Reality is...you actually save a few dollars with incorporation. In addition to the immediate tax saving, there are obviously other tax/non tax benefits to incorporate. The benefits may include: utilize the capital gains exemption of \$750,000, Health and Welfare Trust, Individual Pension Plan, Retirement Compensation Arrangement, pay non-deductible life insurance premiums and reduce probate fees.

Based on the most recent Federal and Ontario budget proposals, the 2008 corporate tax rate is now 16.50% (a decrease from 18.62%) for annual profits (i.e. revenue minus expenses including salary to the owner dentist) of up to \$400,000. The 2009 corporate tax rate will decrease even further to 16% (proposed); an additional incentive to incorporate.

For illustrative purposes, here is a personal/financial snap shot of a dentist:

- Married with two kids <18
- Spouse stays home and makes no income
- Practice worth \$750,000
- Annual profit of \$400,000 before any salary paid to dentist
- Assuming a salary to dentist of \$120,000 after incorporation, this allows the maximum allowable RRSP contribution
- Annual personal expenses (including bi-weekly mortgage payments) of \$120,000
- Home mortgage @4% with an outstanding balance of \$200,000
- Goal: to pay off balance of mortgage in two years

Chart 1

DDS	Incorporation
(sole proprietor)	

Profit	\$ 400,000	\$ 400,000
Less: salary to owner dentist		(120,000)
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Net Profit	400,000	280,000
Corporate taxes (@16.50%)	N/A	46,200
Personal taxes	171,000	38,000 (on salary)
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Profit net of taxes	\$ 229,000	\$ 315,800 (400,000 - 46,200-38,000)

Based on the example above, by incorporating, you have successfully deferred paying taxes to the Canada Revenue Agency by \$86,800 (\$315,800 - \$229,000) if you can live with an after tax salary of \$82,000 (\$120,000 - \$38,000). However, in this case, the dentist needs another \$38,000 to meet his annual cash requirement. How do we access the extra cash in a tax efficient manner?

Here is how we accomplish both of your objectives:

- Incorporate your practice with the help of legal and accounting professionals;
- Your spouse becomes a shareholder of your professional corporation;
- Pay a dividend to yourself of \$40,000 in each of the next two years; and
- Pay a dividend to your spouse of \$110,000 in each of the next two years.

In Summary,

Year 1	Dividend	Taxes	Net
DDS	\$ 40,000	\$ 12, 500	\$ 27,500
Spouse	\$ 136,000	\$ 25,300	\$ 110,700
Year 2			
DDS	\$ 40,000	\$ 12,500	\$ 27,500
Spouse	\$ 136,000	\$ 25,300	\$ 110,700
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Total	\$ 352,000	\$ 75,600	\$ 276,400

With the above strategy, you have successfully paid off your mortgage of \$200,000; maintained

your personal spending needs and also paid approximately \$98,000 [(\$171,000 – \$46,200 - \$38,000 - \$12,500 - \$25,300) x 2] less taxes over a two year period. Did I mention that you still have cash of \$115,600 in your PC which may be paid as a dividend to you or your spouse? The after tax dollars on this \$115,600 dividend (i.e. \$79,000) should be good enough to buy yourself a little car! This is all legit. How much mortgage interest have you saved over the 2 years? Would this be a win-win situation?

If you have parents/children who are 18 and older who make little or no income, your financial picture and tax savings is even better. Discuss with your professional adviser on your own financial situation. If you feel guilty for not paying your share of taxes, you can always donate money to your favourite charity.

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