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The Tax Benefits of Technical & Hygiene Service Corporations

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

Overview

A Technical Service Corporation / Hygiene Service Corporation (THSC) are an entity that operates the hygiene or technical service component of a dental or specialty practice; for example orthodontic. Such corporations are separate businesses from one's dental or specialty practice; hence, the THSC employs its own hygienist and pays its fair share of rent, dental supplies, telephone, receptionist and other business expenditures. The Royal College of Dentists and Surgeons of Ontario (RCDSO) recently issued their position on the subject of TSC's in the form of a Practice Advisory.

The THSC is taxed at approximately 20 per cent, compared to the top personal tax rate of 44 per cent. Unlike a management company, this type of corporation does not charge GST. It is my recommendation that the dentist should not own the THSC, and typically, it is in fact owned by a discretionary family trust. The beneficiaries of the trust usually include spouses, children, parents, etc. As a trustee of this trust, the dentist can exercise control over the THSC without owning it. The beneficiaries receive money via the trust at the discretion of the trustee.

Planning

Prior to implementing a THSC, determine the amount of hygiene or technical service income generated by your practice. Your accountant will use this figure to perform a cost/benefit analysis. Also, determine if you have individuals with whom you can split income. For this, you will need to answer the following questions: Do you need all the income generated by a THSC to pay your personal expenses? Of equal importance is whether you have children attending university and/or parents requiring financial support.

Next, obtain a valuation of your hygiene or technical service business, then obtain legal and tax advice before implementing. Lastly, refer to the RCDSO May 2000 Practice Advisory on technical service corporations.

Benefits of hygiene and technical service corporations

1. Tax savings and deferral

The THSC will save taxes, since it is taxed at 20 per cent, compared with the top personal tax rate of 44 per cent. Profits remaining in the THSC can be paid out as dividends to individuals.

A tax deferral means that instead of paying taxes now, taxes are paid in a later year. This benefits the taxpayer, since they can invest this money until such time as the tax bill becomes due. A THSC facilitates tax deferral in two different ways:

a) With a non-calendar year-end, the THSC can declare bonuses and realize a tax deduction in the current year, yet the recipients of these bonuses will be paid and taxed in a subsequent tax period.

b) Profits can be left in the THSC and used to buy dental equipment and/or the building in which the dentist practices. Note, however, that profits represent the amounts remaining after expenses have been deducted from revenues, and therefore are taxed at a 20 per cent rate.

2. Income splitting

The THSC facilitates income splitting, as shareholders of the THSC may include non-dentists such

as spouses, children, parents, etc., who may be in a lower tax bracket. Income splitting is the process by which income is deflected from the higher income taxpayer into the hands of the lower income taxpayer. Hence, tax savings can be achieved because individuals 18 years or older may receive up to \$23,000 in dividends tax-free, assuming they do not have any other income.

3. Capital gains exemption

Shares of a THSC qualify for the \$500,000 capital gains exemption, meaning a dentist will save taxes when he or she sells shares of their THSC, as the first \$500,000 of gains on these shares will be tax-free.

4. Creditor-proofing

The THSC provides protection from the dentist's creditors, since the dentist will no longer own the technical/hygiene components of the dental office.

5. Estate planning and probate fees

With a trust as shareholder of the THSC, estate planning is facilitated and probate fees can be saved. A trust enables the dentist to exercise control over the THSC, although he or she does not own it.

Pitfalls and Constraints

From the government's perspective, there are acceptable and unacceptable ways of splitting income. Attribution rules are restrictions implemented by the government to define the unacceptable ways of splitting income. If these rules apply to your income-splitting transactions, then in most cases the income, which was split and paid to the recipients, will be taxed in the provider's higher tax rate, instead of the recipient's hand and at a lower tax rate. Your tax advisor should be aware of these attribution rules and should be able to navigate you around such pitfalls, such that income is taxed in the recipients' hands, and therefore, in a lower tax bracket.

The government also frowns upon the payment of dividends to individuals under 18 years of age, and any dividends received by them will be assessed at the top tax rate, also known as the "kiddie tax" rate. As a result of this disincentive, it is suggested that individuals under 18 years should not receive dividends from the THSC.

Personal service business rules should be avoided, as they essentially levy taxes at the 44 per cent personal tax rate, compared with the 20 per cent THSC tax rate. Generally speaking, personal service business rules may apply if the THSC employs family members, which would result in higher taxes for the THSC. For this reason, where family members work at the dental office, the dentist should employ them. This is beneficial since the dentist is taxed a higher rate. Therefore, any expenses charged to the dentist, including family salaries, will yield a larger savings.

General Anti-Avoidance Rules have been designed to provide taxation authorities with the ammunition to challenge a tax strategy designed solely to save taxes. However, as previously outlined, the THSC also facilitates estate-planning objectives.

Your lawyer should address conflict of interest guidelines and legal issues, such as professional services. This area was discussed in a June 1999 RCDSO document "Guidelines Respecting Conflict of Interest." Professional income should not be diverted away from the dentist and into the THSC, although technical or hygiene income - which is separate and distinct from professional income - may be funneled into the THSC.

THSC vs. Incorporation of a dentist

An introductory discussion of the incorporation of professionals was discussed in the April 2001 issue of Ontario Dentist. Once the incorporation legislation has been proclaimed, a THSC will be compatible with a

professional corporation and may be used in combination with one. However, it is important to remember that they are separate and distinct entities.

While a THSC has the potential to save a dentist significant taxes, a cost/benefit analysis should be done before implementation, including seeking the opinion and direction of both a lawyer and accountant specializing in this area.

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