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Should I Incorporate My Business?

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Every business owner will likely be faced with the decision of whether or not they should incorporate their business. There may be major tax advantages, as well as commercial advantages to incorporating, depending on the type of business, level of income generated by the business and your personal cash flow needs.

Some of the main advantages of incorporating are as follows:

1. Tax Reduction due to the Imperfections in the Integration System

Theoretically, the total amount of taxes paid at the corporation level plus the amount of taxes paid at the personal level when the corporation distributes its after-tax profits should be the same as if the individual had earned the business income directly as an individual proprietor. However, this is not always the case, depending on the type of business, type of income earned and the individual's marginal tax rate. Therefore, it may be possible to use a corporation to take advantage of the imperfections of the integrated tax system.

2. Tax Deferral and the Small Business Tax Deduction

If your corporation qualifies for the small business deduction, you will be able to take advantage of the special low rate (federal tax rate of 11%) for the first $ 500,000 of active business income in 2011. Note that active business income generally does not include investment income or rental income, which are taxed at a higher corporate tax rate.

Generally, a corporation provides tax deferral when you do not require all available income for personal needs and the funds are retained and reinvested in the corporation, thereby deferring the taxes payable when corporate earnings are paid to the individual (usually by the way of dividends).

3. Limited Liability

When a business is incorporated, the liability of the shareholders is usually limited to the assets owned by the corporation. However, for many smaller corporations, personal guarantees of the shareholders are generally required to secure financing from the bank, thereby eliminating part of this advantage.

4. Lifetime Capital Gains Exemption

If your corporation is a qualifying small business corporation, you will be able to claim the $750,000 lifetime capital gains exemption to shelter the gains when you sell your business.

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5. Flexibility

There is more flexibility in determining when you personally receive income and in what form (salary versus dividends) when you have a corporation. Also, a corporation can choose its fiscal year-end whereas an unincorporated business income is reported on a calendar year basis in your personal return. You may therefore choose a corporation fiscal year-end that works best for your business cycle and personal schedule. As bonuses accrued in a corporation may be paid out up to 179 days after the fiscal year-end, depending on your corporation's fiscal year-end date, you may be able to defer reporting the bonus at the personal level by one calendar year.

6. Income Splitting

Corporations provide the opportunity of income splitting with your spouse and/or adult children by having them become shareholders of the corporation. The dividends they receive will be taxed in their hands and this gives you the opportunity to redistribute income to family members who are taxed at a lower rate. Note that income splitting cannot be achieved with minor children as the dividends they receive will be taxed at the highest personal marginal tax rate ("kiddie tax").

7. Estate planning

There is more flexibility in terms of estate planning with a corporation. Strategies include reorganizations, estate freezes, and various tax-deferred rollovers whereby you can transfer the growth of the business to other family members.

There are, however, some potential disadvantages that should be considered in operating a business through a corporation, such as the legal and administrative costs associated with maintaining a corporation (e.g. cost of maintaining separate books and annual filing of corporate tax returns).

When a business is incorporated, any operating loss from the business can only be deducted against past or future corporate income (carried back for 3 years and carried forward for 20 years). The loss cannot be applied against other income sources whereas an unincorporated individual can deduct their business loss against any other source of income, such as rental and investment income. Therefore, it may not be advantageous for start-up businesses to incorporate as they often may incur losses in the first few years.

As each individual's situation is different, please consult with your personal tax adviser to help with your decision on whether or not you should incorporate your business and when would be a beneficial time to do so.