Corporate restructuring

Business expansion usually entails a modification of your initial objectives with regards to ownership whether you presently operate as a sole proprietor or as a corporation. Change in ownership may encompass other shareholders such as family or key employees.

Sole proprietor to corporation

The conversion to corporate form may be based on tax or on non-tax reasons. Non-tax reasons may include limited liability which is not available to a sole proprietor or the possibility that other businesses will only do business with a corporation.

As a sole proprietor, your self-employment income is reported on your personal tax return, taxed on the basis of graduated tax rates. If your taxable income is over $132,406 but below the $500,000 taxable income level, your marginal rate is at 46.41%. Effective July 1, 2012, the top rate in Ontario has increased from 46.41% to 49.53% if your 2012 taxable income is over $500,000.

For corporations resident in Ontario, the first $500,000 of active business income is taxed at about 15.5% and excess is taxed at about 26.5%. If you retain the profits in the corporation, there is a tax deferral of about 30.91% if active business income is under $500K and you are personally at the top marginal rate. If the corporation annually pays out most of its corporate after-tax profits as salaries/dividends, there is no real tax benefit of incorporating because there is no tax deferral.

To incorporate you need to determine a name for your corporation and who will be the shareholders. Will they be entitled to voting rights? Will they participate in the growth of the company or just be entitled to discretionary dividends? In order to avoid adverse income tax implications, the issuance of shares has to be properly implemented.

You may be transferring your business assets including unrealized goodwill and liabilities to the corporation. In order to avoid adverse tax implications, it is suggested to have your lawyer prepare a purchase and sale agreement and you should timely file prescribed CRA election forms that will exempt the asset transfer from HST and from personal tax on any potential unrealized appreciation.

Income splitting opportunities

Structured properly, dividends may be paid on one class of shares at the exclusion of another class. If you are in the top marginal tax bracket and your adult child needs to pay $10,000 in tuition, you have to draw $18,700 in additional salary or about $14,800 in dividends to finance the tuition.

If you're adult child, held a non-voting class of special shares and had no other income, he or she may receive up to $37,000 in dividends without tax payable (all figures are approximate).

A discretionary family trust is often utilized where a parent wants to provide the benefits of stock ownership, but does not know who will ultimately control or manage the company. A corporate beneficiary named in the trust indenture, will provide a cost and tax effective way to transfer excess cash to a holding or sister corporation. There may also be benefits from a family law perspective in utilizing a discretionary family trust.

Retaining your QSBC status & creditor proofing

Corporations that accumulate excess cash or investments not needed for working capital requirements may not entitle common shareholders to utilize their capital gains exemption if 90% of the fair market value of the company's assets (including unrealized goodwill) are not used in an active business.

Owners should consider transferring non-business assets on a timely, tax-deferred basis to another corporation. This type of transaction may insulate these assets from the active business operations and from potential creditors.

Often, clients are in receipt of an offer from an unrelated party to sell their shares when the shares are not qualifying for the capital gains exemption. The tax-deferred transaction will generally not be effective if it is implemented within two years prior to the sale.

If you utilize a family trust as an ownership vehicle, each beneficiary of the trust may be entitled to their available capital gains exemption. Therefore by utilizing a trust, the combined available capital gains exemption (maximum $750K) is multiplied by the number of beneficiaries as opposed to one capital gains exemption if there was only one direct shareholder.

If structured properly, the trust may not have to own the shares for 24 months for a beneficiary to be eligible for the capital gains exemption

Shareholders' agreements

Shareholder agreements outline in detail the wishes of the controlling shareholder where there are other shareholders. In addition to provisions relating to the general operations of the business, the agreement will have key provisions with respect to triggering events including death, disability and the lifetime transfer of shares.

"A discretionary family trust is often utilized where a parent wants to provide the benefits of stock ownership, but does not know who will ultimately control or manage the company."

Without a properly drafted agreement, the door is open to potential shareholder disputes and unforeseen adverse income tax implications.

Key employees

The most popular method is to utilize a stock option agreement for the key employee to have the right to purchase common shares at a predetermined purchase price over a short period.

This is generally done where the employee can't afford a fair market value purchase price.

An alternative is to freeze the company and issue new shares for a nominal amount to the employee with the present shareholder holding both (i) fixed value shares equal to the value at the time of the freeze and (ii) controlling voting shares.

At some later date, the employee may acquire the funding to purchase the fixed value shares held by the controlling shareholder.

Structuring properly the acquisition of an employee buy-out is critical as a poor structure could cause significant adverse implications to the vendor. ■

Larry Stolberg CA, CPA,CFP

Disclaimer to readers: Contact your professional advisor prior to implementing any of the outlined strategies.