

Wealth retention strategies for today's professional

Your fair share—it's what you've earned.

A Grant Thornton white paper for professional services firms

It's long been assumed—for the most part accurately—that Canadian professionals are bound to pay higher taxes than traditional incorporated businesses. It's been expected and accepted, by both the Canada Revenue Agency (CRA) and professionals themselves. However, an increasing desire on the part of professionals to preserve wealth and maximize after-tax dollars has made this assumption more of a “long gone” than a foregone conclusion. From individual practitioners to members of partnerships of all sizes, they're actively looking for ways to reduce their annual tax burden and retain more of their money during their careers, so they can retire sooner, or simply have more money when they do retire. Whether you're a partner at a major Canadian law firm or a doctor who



practices as a proprietor, the best ways to reduce your tax burden and preserve hard-earned wealth for your family's future are to defer current income tax, achieve income splitting with family members, and put robust estate planning in place through the implementation of trusts. While these options are available to both individual professionals and members of professional partnerships, it's sometimes more complex for the latter. There are, however, specific strategies that can effectively combine these planning objectives, allowing after-tax dollars to be truly maximized.

Tax deferral strategies

Professional corporation (individual practice)

The first tax planning objective is to reduce or defer current income taxes payable on professional income. It's likely that most professionals with an individual practice—doctors, lawyers, accountants—have been made aware by their tax adviser of some of the best ways to reduce the amount of tax they pay. In many cases, the most effective approach is the creation of a professional corporation where practice assets are transferred to the corporation and the professional essentially becomes a shareholder and an employee rather than a proprietor.

Incorporation of a professional practice can provide an opportunity for a professional to take advantage of the Small Business Deduction (SBD), which allows for a reduced tax rate on professional income earned by the professional corporation (and not withdrawn as salary) up to a specific yearly limit. Professional corporations that qualify for the SBD generally have corporate income tax rates that are substantially lower than the personal income tax rates traditionally paid by individuals, which provides a tax

deferral for the professional. The professional corporation, or a holding company, can in turn invest the cash retained from the tax deferral back into the practice or in other investments rather than pay it out now to the CRA.

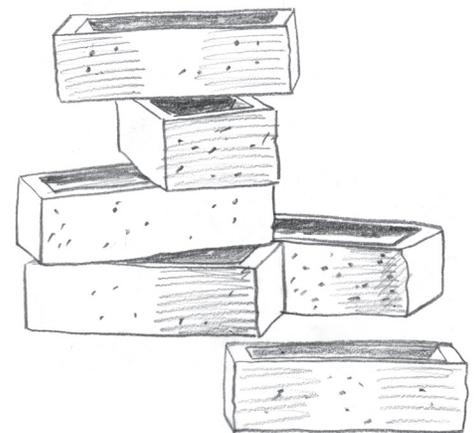
Not all circumstances necessarily favour this solution. If the amount of income retained in the corporation is too low or if there are no income splitting opportunities, the tax savings may not justify the creation and maintenance of a professional corporation. Professional incorporation is an excellent option, however, for individual professionals who do not currently need all or most of the money generated by their practice to fund their lifestyle or for professionals who have the ability to split income with other family members who are taxed at lower personal income tax rates.

Professional corporation (partnerships)

Now what about professionals who are partners, whether with one other person or as a member of a large firm? These professionals work hard for their money and often feel that their tax burden is disproportionately large. The traditional structures available to professionals holding interests in their partnerships have not been very efficient with regard to maximizing family wealth, and those partners generally cannot access the same tax benefits available to individuals who incorporate their proprietorships as professional corporations. This is primarily because, unlike a professional who incorporates a proprietorship, a professional corporation within a partnership must share the SBD annual limit with all the other partners of the partnership. For example, assume there is a partnership with 10 partners that share income equally. Any partner in this partnership, that is a professional corporation, would have access to only 10% of the SBD annual limit.

Not surprisingly, members of professional partnerships are looking for ways to mitigate the high tax burden they have traditionally been expected to bear. The fact is, the tax planning option available to individual professionals—professional incorporation to fully benefit from the SBD—is also generally available to partners, of both large and small partnerships, although in a more complex and planning-intensive structure. Any number of partners within the partnership can choose to participate in this tax planning and various options are available depending on a number of factors specific to the professional and the partnership (i.e., province of jurisdiction, terms of the partnership agreement, etc.).

The introduction of a multiple professional corporation structure in a partnership can have a number of non-tax benefits, including making it easier for the firm to attract and retain high performing professionals, increased flexibility for retirement and increased liability protection provided by the introduction of a limited liability company.



Tax savings strategies

Income splitting with family members

When combined with the right income tax deferral strategies, income splitting with family members, who are 18 years or older, with lower marginal tax rates, can be one of the best ways for professionals to achieve permanent income tax savings. Most professionals in Canada are allowed to have family members as shareholders of a professional corporation, either directly or indirectly through a family trust, which facilitates income splitting with family members in the form of dividends.

Professionals in individual practices and partners in professional partnerships, who carry on their practice through a professional corporation, are generally able to take advantage of this option.

Management services limited partnership

Another strategy partners in an existing partnership can use to increase tax savings through income splitting is the creation of a management services limited partnership (MSLP). The MSLP can provide administrative and support services to a professional partnership in lieu of services currently provided internally. Family members of partners—such as spouses or family trusts—will subscribe as limited partners. Income earned by the MSLP can then be paid to the limited partners, meaning it will ultimately be taxed in the hands of family members, normally at lower tax rates.

Although any existing partnership could benefit from the implementation of an MSLP structure, it's best suited to larger professional partnerships where the transferrable administrative and support services can generate income sufficient for splitting with family members, thereby justifying the cost of establishing and maintaining the MSLP.

Family trust

The introduction of a family trust in either a professional corporation or an MSLP structure is an excellent way to achieve income splitting with adult family members who have a lower marginal income tax rate. The family trust will hold shares in the professional corporation or partnership units of the MSLP, and family members will be beneficiaries of the family trust. The use of a family trust provides the flexibility to allocate income to beneficiaries on a discretionary basis to maximize income splitting opportunities each year.

There are many ways for individual Canadian professionals to structure a professional practice. Under the right circumstances, both tax deferral and tax savings can be achieved, meaning more money to invest now and more money to enjoy in the long run.

Estate planning strategies

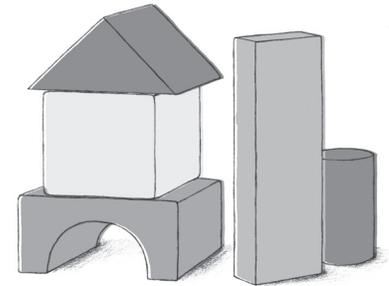
Maximizing your family's wealth after your own passing is normally a real priority for professionals. Achieving that objective requires you to plan differently than you do for your own future, but the tax objectives remain the same—defer tax and split income to achieve permanent income tax savings.

Testamentary trusts—trusts established as a result of the death of an individual—offer several highly effective ways to help establish and maintain long-term financial well-being for your family.

Testamentary spouse trust

A testamentary spouse trust can be established by the terms of a person's will to hold assets for the benefit of a surviving spouse. Property can be

transferred to a testamentary spouse trust on a tax deferred basis which achieves the tax deferral strategy. Also, a testamentary spouse trust can generally access marginal income tax rates, which can help achieve a tax savings strategy.



Testamentary family trust

In some situations a discretionary family trust can be used to hold assets for the benefit of surviving family members for a long period of time. This trust can help achieve a tax savings strategy as well as provide income splitting opportunities. However, unlike the testamentary spouse trust, there is no deferral of income taxes available on any property transferred into this trust.

Testamentary life insurance trusts

A testamentary life insurance trust can, in certain circumstances, receive the same income tax benefits as other testamentary trusts. In this case, the assets are contributed from the proceeds of a life insurance policy.

In order to achieve optimal tax deferral and tax savings, professionals should consider providing for the implementation of multiple testamentary trusts in their estate planning.

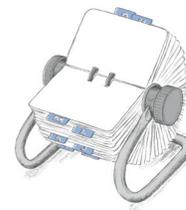
In addition to achieving income tax deferral and savings strategies, the use of multiple testamentary trusts in estate planning has a number of potential non-tax benefits for professionals and their families. These include the ability to hold funds for minor beneficiaries, protection of the funds from potential creditors of beneficiaries of the estate, and maintaining flexibility in allocating income and capital to beneficiaries.

Conclusion

Professionals looking to preserve more wealth, for themselves and their families, have a number of tax planning opportunities available to them that they may not have considered. Also, professional firms should be aware of all tax planning strategies available to their partners. The benefits of these strategies may not be readily apparent to professional firms because they are not necessarily triggered by the size or circumstances of the partnership, but rather by each individual professional's lifestyle, family situation and cash flow requirements. Does the professional make much more income than is needed for personal cash flow each year? Are there family members with low incomes? Does an impending retirement present a serious cash concern? Firms who are ahead of the planning curve and make members aware of the full range of wealth retention strategies—and make them easy to understand and access—will naturally

create a partner retention advantage, as well as making the firm an appealing choice for potential future partners.

Each professional, of course, needs to fully understand the risks and benefits of any new tax scenario in relation to their individual needs and goals. But all professionals, whether practicing in proprietorships or professional partnerships, should be implementing tax strategies that will allow them to defer and save the maximum amount of tax now, look comfortably to a secure future and generally enjoy the wealth they've earned.



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