



The Pros and Cons of Incorporating Your Small Business

The decision to incorporate your small business is significant. Incorporation offers a variety of tax benefits but also comes with its own set of challenges. This newsletter aims to provide a balanced view of the tax advantages and disadvantages of incorporating your small business.

Advantages of Incorporating a Business

1. Lower Corporate Income Tax Rates

One of the primary tax benefits of incorporating is access to lower corporate tax rates. Small businesses can take advantage of the small business deduction, which significantly reduces the corporate tax rate on the first \$500,000 of active business income. This can result in substantial tax savings compared to personal income tax rates.

2. Tax Deferral Opportunities

These lower tax rates provide an opportunity for tax deferral. Corporate profits that are not immediately needed for personal use can be left in the corporation and taxed at a lower corporate tax rate. This deferral can allow for more funds to be reinvested into the business or into portfolio investments compared to having earned the business income personally as an unincorporated business.

3. Capital Gains Exemption

When you sell shares of a Canadian-controlled private corporation (CCPC), you may be eligible for the Lifetime Capital Gains Exemption (LCGE). This exemption can shield a significant portion of the capital gains from tax, providing substantial tax relief upon the sale of your business.

4. Limited Liability Protection

Although it's not a tax advantage, we cannot ignore that one of the foremost benefits of incorporating your business is the limited liability protection it offers. As a corporation, the business exists as a separate legal entity from its owners. This separation means that the personal assets of the shareholders are protected from the business's debts and legal liabilities. Creditors and litigants can only pursue the assets owned by the corporation. This protection provides a significant safety net for business owners, allowing them to take on business risks without the fear of losing their personal wealth in case of financial difficulties or legal issues within the business. However, it is important to note that creditor protection may be of limited use if a bank or other lender requires a personal guarantee for a loan.

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Disadvantages of Incorporating

1. Double Taxation

One of the most significant tax-related drawbacks of incorporating is the potential for double taxation on death. However, having an estate plan to deal with this can mitigate this problem.

2. Increased Tax Compliance Cost & Administration

Incorporating a business involves compliance with tax regulations, which can increase costs. While many of these same issues arise if a business is not incorporated, there are two levels of tax filing required if you are incorporated. There is an increased administrative burden because the business owner needs to manage personal as well as corporate cashflow and needs to learn to segregate personal and corporate expenses.

3. Complexity in Income Withdrawal

Withdrawing income from a corporation can be more complex than just earning income as a sole proprietor. You need to decide between paying yourself a salary or dividends, each with different tax implications. Proper planning is essential to optimize tax efficiency, which requires professional advice.

4. Trapped Corporate Losses

Another potential disadvantage is the issue of trapped corporate losses. If your incorporated business incurs losses, those losses are trapped within the corporation and cannot be used to offset personal income. This can be a significant drawback, particularly in the early years of a business when losses are more common. As a sole proprietor, you can apply business losses against other personal income to reduce your overall tax burden, but this benefit is lost when you incorporate.

Conclusion

Incorporating your small business can offer substantial tax benefits, including lower corporate tax rates and tax deferral opportunities. However, it is essential to carefully weigh all the factors and consider your business's unique needs and goals before deciding.

