



QUARTERLY NEWS LETTER  
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## Incorporation - Is It For You?

It's a hot topic, and rightfully so. It could be financially beneficial to many of you. Sometimes, the benefits of incorporating are oversimplified to make it sound as though it is the pot of gold at the end of the rainbow.

The reality is, incorporating is not for everyone, and it has nothing to do with whether you historically spend all of the profits of the practice. The truth is, even if you are accustomed to spending all of the practice's profits, by incorporating you can still save in the area of 2% on personal taxes, which leaves you (personally) with more after tax dollars. The problem with respect to incorporating is timing.

This article is broken down into two sections. The first outlines the benefits of incorporating (this may be a review for some of you, as we have already broached the subject one on one). The second outlines what the timing issues are.

### *Benefits of Incorporating*

Among others, there are three major benefits to incorporating:

1. Personal Tax Savings;
2. Higher After Tax Dollars for the Corporation to pay down loan principal, purchase capital, and other non-deductible expenditures;
3. Possible Tax-Free Proceeds on the sale of the shares of your practice due to the \$500,000 Lifetime Capital Gains Exemption on the sale of small business corporation shares.

In order to truly understand these benefits, we must understand how cash flows through your practice. At the risk of insulting some of you, we are about to embark on a crash course in Business Affairs (pun intended) 101 - Financial Statement Analysis.

The Income Statement measures financial performance over a period of time, usually 1 year. It looks at production and other sources of revenue and deducts expenses from total revenues to give us Net Income.

Your practice Net Income determines the size of your tax bill. Your Net Income is also supposed to pay the following items:

1. Your draw (which is made up of any money paid to you or for you in the form of take home pay, personal expenses or personal taxes);
2. The practice loan principal (business loan principal is not an expense, only the interest on the loan is expensed);
3. And, capital expenditures (any furniture or equipment purchased throughout the year).

Therefore it is not uncommon to see \$200,000 of Net Income distributed in the following manner:

Net Income	\$200,000
Less: Draw-Take Home (including Personal Expenses paid out of practice account)	\$90,000
Less: Draw-Personal Taxes (37.5% Rate)	\$75,000
Less: Loan Principal Paid	\$20,000
Less: Capital Expenditures	\$10,000
<b>CASH SURPLUS</b>	<b>\$5,000</b>

To be fair, this calculation has been simplified. In actuality there are other variables that affect how much cash is available to pay draw, principal and capital. Those variables however, are not typically huge in dollar amounts, and except for depreciation, are difficult to forecast. Therefore, for the purposes of our discussion the above calculation is more than relevant.

The Balance Sheet will be discussed in the section below that looks at the timing issues of incorporation.

So, we can use the numbers above to validate our first two benefits.

**Benefit number 1** stated that there is a personal tax savings for the owner if the practice incorporates. This is so because the owner no longer takes a draw from Net Income, but rather becomes an employee of the corporation and is paid just as all the other employees are paid, with source deductions taken off his/her cheque at

every pay period. Therefore, you are only taxed on what you take out of the corporation.

	Sole Proprietor	Incorporation
Take Home Draw/Net Pay	\$90,000	\$90,000
Taxes Paid (37.5% Rate)	\$75,000	\$54,000
<b>Personal Tax Savings</b>	<b>\$21,000</b>	

As a sole proprietor (or partnership) you pay taxes on the practice's total net income, regardless of your draw. As an employee of a corporation you are taxed on only what you take out of the corporation in the form of salary or dividends. As an employee in order to take home \$90,000, your gross pay would have to be \$144,000. Therefore, you only pay \$54,000 in taxes.

Even if a sole proprietor draws out all of the profits of the practice, he/she can still save on taxes by blending the compensation package between salary and dividends (Dividends carry a significant lower tax rate than regular income).

**Benefit number 2** stated higher after tax dollars to pay down loan principal and acquire non-deductible assets.

Again using the same numbers outlined above the benefit is illustrated in the table below:

	Sole Proprietor	Corporation
Net Income	\$200,000	\$56,000
Draw (Including Personal Taxes)	\$165,000	
Corporate Taxes (20%)		\$11,200
Cash Available	\$35,000	\$44,800
<b>Excess Cash Savings</b>	<b>\$9,800</b>	

You may have noticed that the Corporation's Net Income is significantly lower than the Sole

Using the numbers above, with the goal of having a \$90,000 in net pay, the tax savings are as follows:

Proprietorship's. The reason for this is the owner's salary of \$144,000 becomes an expense to the Corporation, thereby reducing the original Net Income from \$200,000 to \$56,000.

**Benefit number 3** refers to the \$500,000 Lifetime Capital Gains Exemption (LCGE). What this means to the owner, or shareholder of the practice, is when he/she sells the practice the first \$500,000 of Capital Gains is tax free. It goes right into their pocket. The reason for this, is when incorporated you no longer sell the assets of your practice. Rather, you sell the shares of your corporation to the incoming professional. The LCGE applies to the sale of small business corporation shares, such as the ones in your professional corporation.

As a sole proprietor, if you sell your practice (or assets) and you had a Capital Gain of \$500,000, then you would pay taxes on \$250,000 of that gain.

Given, the benefits outlined, some of you are probably saying, "what the heck are we waiting for, let's incorporate". This brings us to section 2 of the article, timing.

#### *Timing Issues of Incorporation*

There are three factors affecting the timing of incorporation:

1. Equity Position;
2. 1995 Reserve Income;
3. And, CNIL (Cumulative Net Investment Loss).

**Timing Issue number 1** is Equity position, which makes this an appropriate time to discuss the Balance Sheet portion of the Financial Statements.

The Income Statement measures financial performance over a given period. The Balance Sheet is the exact opposite. It takes a snap shot of your financial position on one particular day. It

measures your worth on one particular day if you had to cash out your business without goodwill.

The formula looks like this...Assets - Liabilities = Equity.

Assets represent cash and anything that can be turned into cash (i.e. bank account, accounts receivable, inventory, equipment, building).

Liabilities represent money you owe (accounts payable, loan principal, etc.). When you convert your assets to cash and pay out all of your liabilities, what you have left is Equity.

If you have positive Equity, you have passed the first timing issue and are in a good position to incorporate. If you have negative Equity, then the situation becomes more complicated.

If you have negative Equity it means that over the years you have drawn more than the practice net income. Also, since you are taxed based on Net Income, negative Equity represents dollars you have taken out of the practice, but have not paid taxes on. Therefore, in the year you incorporate, if you have negative Equity, it must be claimed as income on that year's tax return. If the negative Equity is significant, it can be a significant one time tax hit (**note:** partnerships can be an exception).

Therefore, we must determine the best way to deal with the negative Equity prior to incorporating.

**Timing Issue number 2** is the 1995 Reserve Income. For those of you who have Reserve Income stemming from the 1995 year end changes, the remaining Reserves (which are supposed to end in 2005) would have to be claimed on your income tax return in the year you incorporate.

Therefore, a cost benefit analysis would have to be conducted in order to determine how your reserves affect the overall financial benefits to incorporating.

**Timing Issue number 3** is CNIL, or Cumulative Net Investment Loss. If you have CNIL that means over the years your investment expenses (fees, commissions, tax shelter losses, etc.) were greater than your investment income (interest, dividends, capital gains on investments). CNIL affects your Lifetime Capital Gains Exemption.

Therefore, an analysis of the overall affect of the CNIL would have to be conducted.

## Conclusion

There are significant benefits to incorporating. However, timing significantly impacts the benefits. We at Business Affairs will be contacting clients who are in a good position to incorporate in December. If you would like to know sooner, whether or not incorporation is right for your current situation, please contact Norma Jean or myself (Frank).

## Benchmarks

As we had mentioned in our last newsletter, we are reprinting key cost ratios for your practice. These are the ratios that can easily affect your net income.

<b>Veterinary Bench Marks</b>	<b>Cost Ratio</b>
<i>Drugs and Supplies</i>	18-21%
<i>Lab Fees-External</i>	2-4%
<i>Lab Fees-Internal</i>	1-2%
<i>Wages - Support Staff*</i>	16-20%
<i>Associate Fees</i>	25-30%**
<b>*Exclusive of arms-length employees</b>	
<b>**Percent of own production</b>	
<i>Ideal Expense Net Income Ratio</i>	65/35

## Survey

Many thanks to all who took the time to respond to our service questionnaire. We sent out 200 questionnaires and had a 35% response rate.

Look for the results of the survey in our next newsletter in January of 2003.

## Tax, Tips and Traps (T,T and T)

We have included two packages of T,T and T with this newsletter. They are the final two installments for the 2002 tax year. The next T,T and T will be available with our 2003 newsletters.