

# Accounting and Tax Issues for New Dentists



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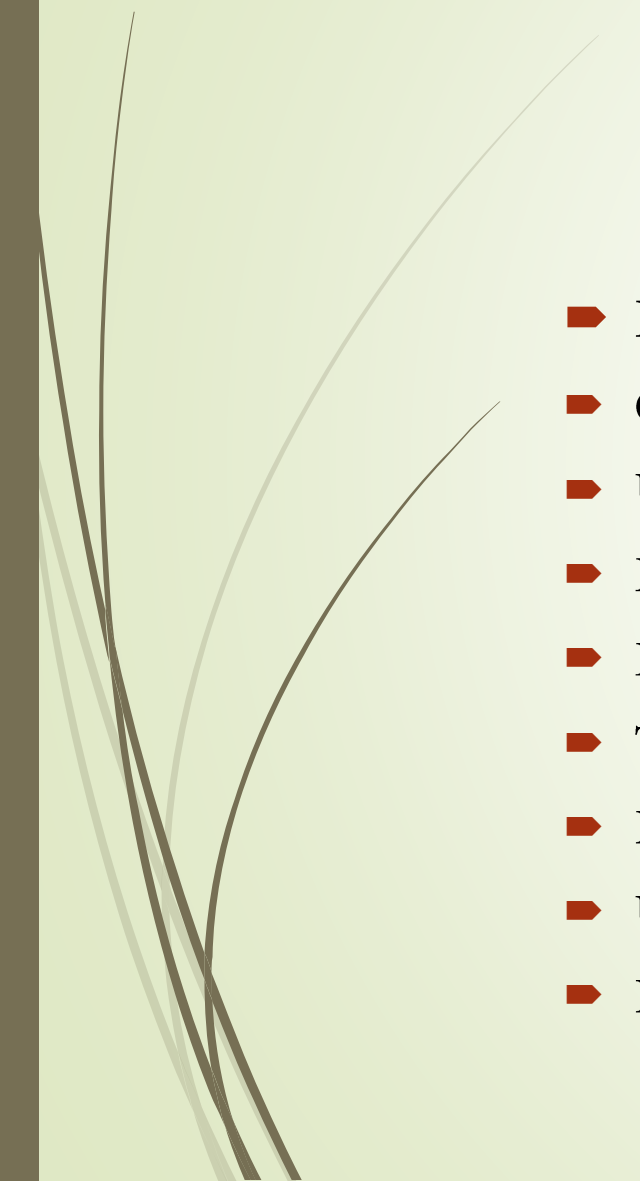
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# Accounting and Tax Issues for New Dentists

## Agenda - Topics

- Difference between employment income and business income
  - Calculating business income
  - Understanding individual tax rates and brackets
  - Deductible expenses
  - Due dates
  - Tax-planning strategies
  - Reasons to incorporate a dental practice
  - Understanding corporate tax rates
  - Investing through a dental corporation
- 



# What is the difference between employment income and business income?

- Generally, employment income (except....)
  - Income tax, CPP, EI and other deductions are withheld by the employer
  - Employee receives a “net” amount every pay period
- Employee receives a T4 every year
- Employee files a T1 tax return on or before April 30 of the following year
  - Calculate taxes owing
  - Receive credit for income taxes withheld throughout year
  - Difference payable or receivable from CRA
- Deductible expenses generally minimal under the *Income Tax Act*

# How do you calculate business income?

- ▶ Dentists working as sole proprietors (e.g. associates, independent contractors) or through a dental corporation need to determine business income:

	Gross Income
Less	<u>(Deductible Expenses) *</u>
	Net Income
Plus	<u>Other Income</u>
	<i>Taxable Income</i>
Multiplied by	<u>Marginal tax rates *</u>
	<i>Total taxes</i>
Less	<u>(Tax Credits) *</u>
	<u>\$ Taxes Owing</u>

# What are the combined income tax rates and brackets?


- Combined federal and Manitoba income tax rates and brackets for 2020:

<u>Taxable Income</u>	<u>Tax Rate</u>
First \$33,389	25.80%
\$33,390 - \$48,535	27.75%
\$48,536 - \$72,164	33.25%
\$72,165 - \$97,069	37.90%
\$97,070 - \$150,473	43.40%
\$150,474 - \$214,369	46.40%
Over \$210,371	50.40%



# What kind of expenses are deductible from business income?

- Generally speaking, the same principles apply to determining business income earned by either self-employed proprietors or professional dental corporations
- As a general rule, most expenses incurred are deductible if they are:
  - incurred to earn business income; and
  - are reasonable in the circumstances; and
  - are allowed by the *Income Tax Act*.




# What kind of expenses are deductible from business income?

The following are examples of common business expenses for physicians:

- Salaries and employee benefits
- Accounting and legal fees
- Advertising and promotion
- Dues & malpractice insurance
- Interest on office loans and lease payments
- Meals and entertainment (only 50% deductible)
- Convention expenses (2 per year)
- Travel expenses






# What kind of expenses are deductible from business income?

- Maintenance & repair of office + equipment
- Professional development (CME)
- Professional library
- Dental & office equipment + computer
- Cell & ISP charges
- Office expenses (e.g. medical supplies, postage, stationery, telephone, answering service, etc.)
- Utilities such as heat, power, electricity, natural gas and water
- Other insurance (office, practice overhead)





# What kind of expenses are deductible from business income?

- For auto expenses, need to determine business portion vs. personal
- **Keep a travel log**
  - Travel to and from work is *not* deductible!
- Automobile deduction limits apply:
  - purchased or leased
- Automobile operating expenses include:
  - fuel and oil, maintenance and repairs
  - insurance, license fees
  - interest on car loans or lease payment



# What kind of expenses are deductible from business income?

- Only deduct 50% of meals/entertainment
- Specific prohibition for...
  - recreation facilities
  - certain club dues
- Record client names on receipts
- Be reasonable
  - Avoid being “red flagged” by CRA
- Onus of proof – business purpose



# What kind of expenses are deductible from business income?

- To claim home office, need to meet one of two tests:
  1. principal place of business; OR
  2. used exclusively for your business + used on a regular basis to meet patients
- Proper records and receipts must be kept
- Need to determine appropriate % of rent , taxes, utilities, etc.




# When are tax returns due and taxes payable?

- Individual taxpayer
  - Personal T1 tax return and any taxes owing must be filed by April 30 of year following respective taxation year (e.g. 2020 taxes owing are due April 30, 2021)
- Individual sole-proprietor
  - T1 tax return is due June 15 of year following respective taxation year
  - However, taxes owing must be paid by April 30 to avoid interest and penalties (Note: prudent to file tax return and pay taxes owing by April 30)



# When are tax returns due and taxes payable?

- ▶ If an individual proprietor owes > \$3,000 in taxes on April 30, 2020, and in either 2019 or 2018, the CRA requires the taxpayer to make quarterly installments.
- ▶ Proprietors remit tax owing by paying quarterly installments which are due on:
  - ▶ March 15
  - ▶ June 15
  - ▶ September 15
  - ▶ December 15



# When are tax returns due and taxes payable?

- **First Year:** No installments required – due April 30 of second year
- **Second Year:**
  - April 30 – Taxes due from first year
  - September 15 – 50% tax instalment for second year based on first year
  - December 15 – 50% tax instalment for second year based on first year
- **Third Year:**
  - March 15 – 25% tax instalment for third year
  - April 30 – balance of taxes (if any) for second year
  - June 15 – 25% tax instalment for third year
  - September 15 – 25% tax instalment for third year
  - December 15 – 25% tax instalment for third year



# When are tax returns due and taxes payable?

- Failing to proactively set money aside for future tax installments is a critical mistake!
  - Interest and penalties on insufficient or missed payments can be onerous
- Don't spend “tax money” that isn't yours
- Consider some short-term liquid investments





# What are some basic tax planning strategies?

- Goal of income splitting:
  - To reduce a household's overall taxes payable by having the higher-earning family member (e.g. dentist) shift a part of their income to the “hands” of a lower-earning family member (e.g. spouse, partner or child) so that this income is taxed in a lower tax bracket
- Some examples of income splitting:
  - Higher-taxed spouse or partner (e.g. dentist) pays all household bills and expenses, while lower-taxed spouse invests his or her income in non-registered investments



# What are some basic tax planning strategies?

- Some examples of income splitting:
  - Employ or engage services of spouse or child in dental practice and pay a reasonable salary:
    - Work must actually be performed
    - Amount must be paid
    - Money must actually be transferred to the spouse or child
  - Dividend-sprinkling: issue shares of a dental corporation to a lower-taxed family member(s) in order to pay dividends to such member(s) and have these dividends taxed in their “hands”
    - However, see the new “TOSI” rules...



# When to incorporate a dental practice?

- Should I incorporate my dental practice? As we'll see, this depends largely on your personal obligations and cash needs...
- Incorporating a business (e.g. dental practice) requires filing Articles of Incorporation to create a new “person” or legal entity called a “corporation”
- For a professional corporation, generally need consent to incorporate
- In Canada, a corporation has the same rights as a natural person:
  - it can own property, enter into contracts, obtain loans, sue or be sued, and even be found guilty of committing a crime
- Two most common reasons to incorporate in non-professional context:
  1. Creditor protection purposes
  2. Tax planning purposes



# When to incorporate a dental practice?

- Generally, shareholders and directors are not responsible for the corporation's debts and obligations (subject to some exceptions, including personal guarantees and “statutory liability” of directors)
- If a corporation goes bankrupt, shareholders and directors are generally protected from the corporation’s liabilities (i.e. shareholders should not lose more than their investment in the corporation)
- However, dental incorporation laws in Canada provide that liability of a dentist to a person receiving dental services is not affected by the fact that these services are provided on behalf of a dental corporation
- An incorporated dentist is “jointly and severally liable” with the dental corporation for all professional liability claims
- Incorporating a dental practice gives limited creditor protection...



# When to incorporate a dental practice?

- Tax planning purposes that may motivate incorporating a dental practice include:
  - a) Dividend-sprinkling
  - b) Tax deferral (i.e. pay corporate tax but defer dividend tax)
- Until recently, dividend-sprinkling through private corporations was a common tax planning technique
- For professional corporations, it was already somewhat limited because of laws limiting who can be shareholders of a professional corporation (e.g. in Manitoba, limited to spouse or CL partner and children)
- For 2018, new “tax on split income” or “TOSI” rules were introduced to severely curtail dividend-sprinkling through private corporations



# When to incorporate a dental practice?

- If TOSI rules apply to a dividend received by a related individual, the dividend will be automatically taxed at the highest marginal tax rate
- TOSI rules apply to minor children (already a “kiddie tax” since 2000) and related individuals unless an exception applies, such as:
  - Dividend received by adult family member who is engaged on a “regular, continuous and substantial basis” in the business (e.g. dental practice) in either the tax year in question or in any five (5) prior tax years
    - met if family member works on average 20 hours per week during year
  - Dividend received by adult family member who is at least 25 years if dividend is a “reasonable return” based on the work performed, the property contributed, the risks assumed, etc.
  - Dividend received by spouse if professional is at least 65 years
- TOSI rules do not apply to salary received by a related individual

# When to incorporate a dental practice?

- Primary reason dentists incorporate is “tax deferral”
  - Earn more than their personal cash needs (e.g. debt obligations, household expenses, lifestyle expenses) and want to *defer* paying tax on the “excess cash” earned by their dental practice
- “Theory of integration” – tax paid by a corporation on its profit *plus* tax paid by its shareholders on dividends received out of after-tax profit of the corporation should be *equal to* tax paid by individual had same profit been earned directly as a sole proprietor
- “Tax deferral” is the tax benefit that results from leaving some “excess” profit in corporation and not paying it out as dividends to its shareholders so as to delay paying personal taxes on such excess
  - Deferral comes to an end when dividends are paid out of corporation and taxed in the “hands” of one or more of its shareholders





# How is a corporation taxed?

- A “Canadian-controlled private corporation” or “CCPC” that earns “active business income” is taxed at reduced federal rate of only 9% on the first \$500,000 of profit
  - Need to add provincial or territorial tax rate (3.2% in ON, 2.0% in BC and NIL in MB)
  - In MB, left with \$0.91 cents for every dollar of profit up to \$500,000
- Any “active business income” in excess of “small business limit” of \$500,000 is taxed at general federal rate of 15%
  - Need to add provincial or territorial tax rate (11.5% in ON, 12.0% in BC and 12.0% in MB)
  - In MB, left with \$0.73 cents for every dollar of profit in excess of \$500,000



# How is a corporation taxed?

- If two or more dentists own shares of a dental corporation that operates a dental clinic, they benefit from only one “small business limit” of \$500,000
- If two or more dentists incorporate separately-owned dental corporations and form a “partnership” to operate a dental corporation, they still benefit from only one “small business limit” of \$500,000
- If two or more dentists own shares of a dental corporation that operates a dental clinic, and incorporate separately-owned dental corporations to provide services to the incorporated dental clinic, they still benefit from only one “small business limit” of \$500,000
  - Perhaps consider a cost-sharing arrangement (≠ partnership)



# How is a corporation taxed?

- If two or more CCPCs are “associated” with one another (rules are complicated), the “small business limit” must be shared among them
  - If one spouse carries on dental practice and another spouse carries on separate business, perhaps consider separately-owned corporations (no cross shareholdings) instead of commonly-owned corporations
- In 2018, amendments to tax rules introduced to limit the \$500,000 small business limit where a CCPC earns investment income in excess of \$50,000
  - For every \$1 of investment income over \$50,000, the SBL is reduced by \$5
  - Investment income is calculated for associated corporations
  - ON and NB do not parallel federal tax legislation



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# Are there limits to investing in dental corporation?

- Provincial legislation generally limits the business and activities of a dental corporation to the *practice of dentistry* and the provision of services related to it (i.e. cannot carry on any other business), but do not prohibit a dental corporation from investing its surplus funds
- In MB, a dental corporation may invest its funds in real property, other than for development purposes, or in stocks, mutual funds, debt obligations, insurance, term deposits or similar investments
  - Can invest in real property (e.g. a rental property or apartment) for purpose of earning rental income, but cannot invest in real property for purpose of buying and selling real property
  - If investing in real property, consider separate real estate holding corporation





# What are pros and cons of incorporating?

➤ Some pros:

- Tax deferral
  - Pay less taxes now and invest more now for the future
  - *It's not what you earn, it's what you keep!*
- Increased flexibility in deciding how much to pay oneself and how to pay it
  - Can pay be paid either through salary or dividends, or combination of both
  - Ineligible versus eligible dividends
  - Currently, dividends are taxed at a lower rate than salary
- Limited tax planning opportunities for income splitting
- Very limited creditor protection

# What are pros and cons of incorporating?

## ➤ Some cons:

- Increased costs:
  - Start-up costs to incorporate, organize and obtain corporate dental practice permit (e.g. legal costs, accounting costs, filing fees)
  - Annual costs to maintain corporation
    - separate set of financial statements and T2 tax returns
    - annual resolutions and Annual Returns with provincial companies office
    - corporate dental practice permit needs to be renewed annually
- Increased amount of administration – “hassle factor”:
  - Need to open separate bank account (maybe also investment account)
  - Need to maintain separate set of books and records
  - Additional installments required for the Corporation – both federal and provincial



# Are professional advisors necessary?

- Dentists are generally in the top 10% of earners in Canada
- Expert accounting and tax advice can help reduce overall tax burden to increase after-tax cash for family unit and increase wealth accumulation
  - Largest expense in a dental practice is income taxes
  - Primary goal of incorporating is tax deferral
- Expert accounting and legal advice recommended before signing any professional or other contract, setting up dental clinic, incorporating, etc.
- Accounting and bookkeeping, and tax and estate planning, ought to be evaluated and customized to personal needs
- Financial advisor or wealth planner recommended for prudent investments
- *Just as patients seek to establish long-term trusting relationship with dentists, dentists should seek to establish long-term trusting relationship with qualified professional advisors (accountant, lawyer and financial advisor)*

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*Thank you!*



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