Tax Notes
UPDATE: Non-Professionals as Shareholders of Ontario Professional Corporations

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Recently, the Ontario Medical Association ("OMA") reached an agreement with the Province of Ontario ("Province") regarding provision of medical services by Ontario physicians ("Physicians").

From an income tax perspective, likely the most interesting development arising from the agreement is the potential income splitting advantages that may arise as a consequence of the proposal ("Proposal") to permit immediate family members (i.e., spouses and children) of Physicians to be non-voting shareholders of medical professional corporations. Outside the area of income tax, permitting immediate family members to be shareholders of DPCs may provide Physicians with improved asset protection opportunities as well as potential pitfalls.

Apparently, the Ontario Liberals have a bit of a sweet tooth, as the May 11, 2005 Ontario budget proposes to extend the Proposal to apply to Ontario dentists (in this article, Ontario dentists and Physicians are collectively referred to as "Doctors" and their professional corporations are referred to as "DPCs").

Unfortunately, unlike legislation enacted in respect of many British Columbia professionals,**[1]** it does not appear that the Proposal is intended to permit family trusts settled for the benefit of the Doctor and/or the Doctor's family or family owned holding corporations to own non-voting shares of DPCs. As will be discussed below, assuming these shortcomings are found in the final legislation that is to be enacted in connection with the Proposal, which is to be in place by January 1, 2006, many Doctors may want to think twice before reorganizing their share capital to make family members shareholders of their DPCs.

The Good: Income Splitting and Asset Protection

Subject to general limitations on income splitting with minor children**[2]** and the potential application of the many attribution provisions in the Act,**[3]** this Proposal appears to be intended to permit Doctors to directly use their DPCs to income split with other members of their families in a manner that has not been available previously to Doctors or, for that matter, to any other professionals in Ontario. For example, Doctors who do not pay adult children or spouses with low incomes a salary because the Doctor's family members are not involved in the practice, could instead pay dividends to them as shareholders of the professional corporation, which could result in significant net family tax savings.

In this regard, it should be noted that at this point in time, we understand that the legislation will apply to Doctors only and will make them the sole professional groups in Ontario entitled to income split in this manner. On the other hand, many professionals in Ontario, including Doctors, are able to set up management corporations to gain income splitting benefits without restriction on shareholdings.

It will be interesting to see proposed legislation in respect of the Proposal. In particular, it will be interesting to see whether the liability of non-Doctor shareholders of DPCs will be limited in the manner of other share capital corporations or whether it will be unlimited in respect of professional negligence matters. Assuming the liability of non-Doctor shareholders is strictly limited, then it well may be that an even greater advantage than income splitting for Doctors would be the ability to use DPCs to gain a measure of asset protection from any professional liability claims against Doctors.**[4]**

The Not-so-Good: Flexibility - Tax and Asset Protection

While the foregoing appears to be a radical change from the existing rules in Ontario, it is rather common-place in other jurisdictions in Canada such as Manitoba and British Columbia, among many different types of professionals – not just physicians and dentists. Moreover, in British Columbia, physicians, dentists, engineers, lawyers and accountants are able to issue non-voting shares of their professional corporations to immediate family members, holding corporations and even trusts where the only beneficiaries are the professional and his or her immediate family members.

The key to most good tax and asset protection planning is not just the tax savings and asset protection benefits but the flexibility provided by such planning. Unfortunately, if trusts and holding corporations are not able to be shareholders of DPCs, the ability for Doctors to incorporate future planning may be quite limited. Some examples of how these restrictions will impact on DPCs are discussed below.

It appears that at the outset of setting up the DPC structure the Doctor would be required to set the entitlements of his or her family members and the Doctor's ability to force those family members to accept future changes to such entitlements would likely be much more difficult than if the shares were held in a discretionary family trust.**[5]** For example, if the Doctor wants to take shares away from a child (assuming the child is agreeable) at a time when the shares have increased in value, the transfer would be taxable to the child.**[6]**

To maximize income splitting opportunities it will also be necessary to be able to "sprinkle" dividends to the shareholders who can best use income.**[7]** However, unlike in a situation involving indirect shareholdings of family members through a discretionary trust, the DPC would need to have a complex share structure involving multiple non-voting classes of shares that permit dividends to be paid on one class of shares without having to pay dividends on other classes of shares. Presumably the legislation will permit such shareholdings – though time will tell.

Another area that may be a cause for concern for Doctors is the impact of creditors of family members on DPCs. In this regard, since only family members can be shareholders it is not clear what rights creditors of a family member would have to enforce their rights against shares of a DPC – or for that matter what value a non-voting minority share of an DPC would have. In any event, a properly structured discretionary trust will often be able to provide significant asset protection against the creditors of beneficiaries of the trust.

In a divorce situation the issuance of shares of a DPC to a Doctor's spouse could become a very serious issue – one that might otherwise be limited to some degree if the shares are held by a discretionary trust.**[8]** It will be interesting to see if the legislation provides for what is to happen to shares of a DPC held by a former spouse or for that matter shares inherited from a shareholder of the DPC who is not an immediate family member. For example, the legislation might require that the spouse or non-family member transfer the DPC shares back to the Doctor or it could provide that the spouse or legatee would still be considered a family member eligible to hold shares of the DPC.

The inability to insert holding corporations between the DPC and its shareholders will continue to cause logistical problems for Doctors (and other Ontario professionals) that are not faced by shareholders of ordinary corporations. This prohibition will continue to force Doctors to have to make a choice between building-up non-business assets in the DPC, which could vitiate the tax benefits of the DPC**[9]** and expose those assets to creditors of the DPC, and potentially distributing such assets to the Doctor or family members, which might not be desirable in all situations.

Conclusion

While the Proposal is a start (and the OMA should get kudos for having persuaded the government of Ontario to put the Proposal forward), additional pressure needs to be brought on the government of Ontario to permit closely held trusts and holding corporations to hold shares in DPCs. Unfortunately, until such changes are made, taxation professionals will need to give careful consideration before recommending that family members subscribe for shares of DPCs.**[10]**

Michael Goldberg is a tax partner at Minden Gross LLP. Thanks to David Louis, also of Minden Gross LLP, and Peter Wong, of Boughton Law Corporation, which is a Vancouver affiliate of Minden Gross through Meritas Law Firms Worldwide, for their helpful comments on earlier versions of this article. Any errors or omissions are strictly my own.

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[1] See discussion below.

[2] See section 120.4 of the *Income Tax Act* (Canada) ("Act"). Unless otherwise stated all statutory references are to the Act.

[3] For example, depending on how family members acquire shares, any one or more of the attribution rules in sections 74.1, 74.2 and 74.4 and possibly other provisions in the Act could be applicable.

[4] We understand that the Canadian Medical Protection Association provides all Canadian physicians with an almost unlimited defense fund. Consequently, most Canadian physicians (the fund may not cover physicians in certain situations) may not have the same concerns for their personal assets as other Canadian professionals. As such, vis-à-vis Physicians this benefit might be of less interest than it would be to Dentists and other professionals.

[5] It is possible that a well drafted shareholders' agreement could ameliorate this shortcoming and some of the others discussed below.

[6] Based on anecdotal discussions with some physicians that I know it seems that the prospect of selling a Physician's practice or DPC is viewed as remote by most Physicians. The same is not true for Dentists.

[7] See *Newman v. The Queen*, 98 DTC 6297 (SCC). Again, care must be taken to ensure that the various attribution rules in the Act will not be violated either at the time the structure is put in place or afterwards. Furthermore, even if the attributions rules are not applicable, where minor children are the non-professional shareholders or are beneficiaries of a family trust, the so-called "kiddy tax" rules in section 120.1 will considerably limit the benefits of splitting income.

[8] The discussion of family law issues is beyond the scope of this article.

[9] For example, the build-up of such non-business assets could make it difficult for Doctors and their families to use their capital gains exemptions if the DPC is ever sold. In addition, if it is intended to pay dividends to persons defined in subsection 74.4(5) to be "designated persons" (i.e., spouses, common-law partners and/or minor non-arm's length persons – if dividends were paid to minors the "kiddy tax" rules would also need to be considered), even a relatively small build-up of such assets could result in the Doctor being subject to the deemed interest attribution rules in section 74.4.

[10] It is hoped that the political motivations that led to permitting non-Doctors to hold shares of DPCs will signal a change in approach by the Ontario government generally, such that in the near future the Ontario government will extend the Proposal to benefit all Ontario professionals.