Taxation of Lawyers

A sole proprietorship is the simplest entity for tax purposes; the time and expense needed to prepare the tax information for a sole proprietorship is generally less than for a partnership or professional corporation.

The income of a sole proprietorship is the revenue less allowable expenses and is reported on the sole proprietor's individual tax return.

CRA Form T2032 (available on the CRA website) can be used to calculate professional income instead of having an accountant prepare financial statements, although CRA may require you to file a balance sheet (even if you use the form, it is a good idea to have an accountant for your practice).

No deductions are withheld from the draws paid to a sole proprietor (see below re quarterly instalments).

All sole proprietors must have a calendar year end.

Space-sharers

Space-sharing associations are not taxable entities. Each member of a space-sharing association is treated as an individual business and can deduct its share of the common expenses in calculating its income.

Associates

The taxation of associates depends on whether they are employees, independent contractors or space-sharers.

If an associate is an employee, the employer must deduct IT, EI and CPP. The employer matches the employee's CPP contribution and pays 1.4 times the employee's EI deduction. Failure to withhold properly can be very costly, so it is important that an associate's status be determined correctly. The employer must isue a T4 to the employee on a calendar year basis.

For tax purposes, associates who are independent contractors are treated the same as sole proprietors.

Partnerships

A partnership is not a taxable entity. Partnership financial statements are prepared on a calendar year basis to determine the net partnership income, which is allocated among the partners pursuant to the partnership agreement.

The partnership claims Capital Cost Allowance (depreciation) on partnership assets.

A partner's share of the partnership net income is not necessarily equal to the partner's draws. Partners are taxed on the net income allocated to them by the partnership.

Partners can personally deduct expenses incurred for business purposes but not shown on partnership financial statements.

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For example, car expenses are often deducted by the individual partners because partners have different views on how much to spend on a vehicle.

No deductions for IT, EI or CPP are taken from draws paid to partners (see below re quarterly instalments).

From a tax perspective, there is no difference between a regular partnership and an LLP.

Professional Corporations (PCs)

All shareholders must be members of the Law Society of Alberta.

Revenue and expenses are accounted for at the corporate level.

The PC normally remunerates its shareholder(s) by way of salaries and bonuses, which are expensed by the PC. The PC may also pay dividends to shareholders.

The PC deducts IT and CPP from salary and bonuses paid to the lawyer, but not EI. An owner of a PC is not eligible for EI. The PC issues a T4 for salary and bonuses and a T5 for dividends.

A PC must have financial statements prepared each year and must file federal and provincial corporate tax returns and pay corporate income tax; some corporations are required to make monthly tax installment payments.

A PC that is a member of a partnership must have a calendar fiscal year, but a stand-alone PC can pick any fiscal year.

Small Business Deduction A Canadian Controlled Private Corporation ("CCPC") carrying on an active business in Canada is entitled to claim the Small Business Deduction (the "SBD"), which will give it an effective tax rate of under 17%. The Income Tax Act integrates the income of CCPC's and their Canadian resident shareholders, so the SBD provides a tax deferral and a small permanent tax savings for Alberta residents. You do not get any benefit from the lower tax rate unless you leave money in the corporation. It is usually not a good idea for someone who is just starting out to incorporate. However, every situation is different, so professional advice should be sought on this question.

Income splitting

You may be able to achieve some tax savings through income-splitting by employing family members in your sole proprietorship, partnership or professional corporation or by incorporating a management company to provide non-professional services to the law firm. Proceed with caution and get tax advice.

Deductions

Certain deductions get special tax treatment. The deduction of auto expenses is very complex; talk to your accountant. No deduction is allowed for club membership fees or dues where the main purpose of the club is providing recreation, dining or sporting facilities to its members. Only 50% of meals, drinks and entertainment may be deducted. You are only allowed to deduct two conventions in connection with your profession per year.

Golf club dues and green fees are not deductible, but meals at such facilities are subject to the normal 50% limitation.

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Reporting Taxable Income

A sole proprietor's net income, a partner's share of the partnership net income (less additional deductions), and a PC shareholder's salary, bonuses and dividends are reported on a calendar year basis and taxed with other personal income using the standard individual deductions, credits and graduated rates. A self-employed individual (sole proprietor, independent contractor associate or a partner) can extend the annual tax filing deadline from April 30 to June 15. The tax is still due April 30 and interest is charged from that date.

Quarterly Instalments

Sole proprietors, associates who are independent contractors, and partners must pay quarterly IT and CPP instalments, must pay both the employer and the employee CPP contributions, and are not eligible for Employment Insurance ("EI"). Penalties and interest for late or deficient instalments can be costly.

Buying/Selling a Practice

In the negotiation of the sale of a practice, it is in the purchaser's interests to allocate as little as possible to goodwill and as much as possible to "hard" assets, and in the interests of the seller to do the opposite.

Some of the assets of a sole proprietorship, an interest in a partnership, and shares of a professional corporation are capital properties, the disposition of which may trigger a capital gain or loss. Proceed with caution and get tax advice.

Special income tax elections are available to allow proprietorships to incorporate or to allow roll in or roll out of partnerships. These rules are complex, so get tax advice.

GST

Whatever type of operating entity you chose, the entity should register for GST and collect and remit as required.

GST may be payable on part or all of the purchase price of a practice.

GST is payable on amounts paid to associates who are independent contractors.

Additional Information in this document provided by: Leo R. Kelly, F.C.A., I.F.A Kelly & Creaghan Chartered Accountants

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