REALTOR® Inc. – Tax benefits of Personal Real Estate Corporations

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On October 1, 2020, Ontario joined the majority of provinces that permit a licensed REALTOR®[1] to conduct certain aspects of a real estate sales business through a corporation.[2] Let's look at some of the tax advantages, benefits and opportunities that may be available with a personal real estate corporation ("PREC")[3], which may help you to decide whether to establish a PREC and how you may use a PREC for tax planning opportunities.

PREC requirements

A PREC must be established under provincial laws. In some provinces, the PREC also needs to be licensed with the provincial real estate authority, so both the PREC and REALTOR® may need to pay licensing fees.

As a REALTOR®, you must hold a minimum percentage of the shares of the corporation.[4] Most provinces require that you hold more than 50% of the voting shares, so that you are the controlling shareholder, and in some provinces you must own all of the voting shares. Non-voting shares (if any) may generally be owned by you or certain family members (typically your spouse/partner, children, and parents, and sometimes a corporation owned by them or a trust of which they are beneficiaries.) Most provinces also have rules governing other matters, such as the permitted name of the PREC, who can be officers and directors of the corporation, and what types of advertising activities may be undertaken.

Permitted activities will depend on provincial legislation and the objects of the corporation.

In turn, you can receive remuneration from your PREC. You may also be able to continue to receive remuneration directly from the brokerage for services you provide to it, depending on the provincial rules. A written agreement generally governs the relationship between your PREC, the brokerage and you.

While corporations may sometimes provide limited liability for their shareholders, in most, if not all provinces, you, as the REALTOR®, will remain liable for the realty services that you provide and will continue to be held accountable for professional misconduct.

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1 The term "REALTOR®" is controlled by the Canadian Real Estate Association ("CREA") and identifies real estate professionals who are members of CREA.

2 As of Dec. 1, 2020 this is also permitted in Alberta, B.C., Manitoba, Nova Scotia, Quebec and Saskatchewan.

3 The term PREC (personal real estate corporation) is being used generically to refer to a corporation set up to receive a REALTOR®'s real estate commissions. The actual term varies by province.

4 In some provinces, you must hold the shares directly while others you may hold the shares indirectly, such as through a trust or another corporation.

Reasons to incorporate

There are various tax reasons why it may be beneficial to incorporate, such as the potential for tax savings or deferral, to ultimately take advantage of the lifetime capital gains exemption on the sale of the business or, in limited circumstances, income splitting opportunities with a spouse/partner or adult children. Let's examine each of these opportunities in more detail.

Tax savings

It may be possible for an absolute tax savings to be realized if non-deductible (or even partly deductible) expenses can be paid by the PREC, as opposed to personally. To illustrate this, suppose that Mari is a REALTOR® who has a life insurance policy to provide for her family in the case of untimely death. Her annual premiums total $1,000. Let's assume:

- Mari lives in Ontario in 2020 and pays tax at a marginal rate of 53.5% on ordinary income.
- The PREC can take advantage of the small business deduction on its first $500,000 of active business income and pays tax at a rate of 12.2% on this income.

If Mari's business is not incorporated, she would have to earn income of about $2,150 ($1,000 divided by (1 minus 53.5%)) to be able to pay the $1,000 insurance premium.

Now, assume Mari's realty business was incorporated and the $1,000 non-deductible[5] insurance premium was paid by her PREC.[6] The corporation would only have to earn $1,140 ($1,000 dividend by (1 minus 12.2%) to be able to pay the $1,000 insurance premium.

This tax saving would also apply to other non-deductible business expenses, such as golfing fees, or partially deductible expenses, such as meals and entertainment which are 50% deductible when incurred for business purposes. Note, however, that personal expenses must never be paid from your PREC!

Tax deferral

Earning income through a corporation has often been heralded as a great tax deferral mechanism, provided you do not need all the cash and can afford to leave some money in your corporation for investment purposes. The reason this works is that the corporation initially pays tax at a lower rate than you would pay on the income, leaving more funds in the corporation available to be invested.

Income that is eligible for the small business deduction (SBD)

A lower, small business tax rate (the "SBD Rate") applies to active business income up to the SBD Limit, which in 2020 is $500,000 federally and in all provinces and territories (other than Saskatchewan where it is $600,000.) The SBD Rate is substantially lower than the top marginal personal tax rate that would be paid on the income, so there can be a significant tax deferral by leaving after-tax corporate income inside a corporation as opposed to receiving the income personally.

Example of the earning $100,000 of income in Ontario in a PREC vs. personally

Suppose you're employed at a brokerage and earn $100,000 of revenue from trading in real estate in 2020. Assuming that you pay tax at the top Ontario marginal rate[7], Figure 1 shows that you would have about $46,500 of after-tax cash if you earned the revenue personally.

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[5] Note that life insurance premiums are generally not tax deductible unless a bank or other lender required the insurance policy as collateral for a loan.

[6] In this case, to avoid a shareholder benefit issue, the PREC would be both the owner and corporate beneficiary of the policy. Upon Mari's death, the death benefit, less the adjusted cost basis of the policy, would be credited to the PREC's notional "capital dividend account" and could then generally be paid out as a tax-free dividend to the estate.

[7] Results may differ if you do not pay tax at the highest marginal tax rate.

Figure 1: Revenue earned personally

Description	Amount (rounded to nearest $100)
Revenue	$100,000
Personal tax (at 53.5%)	(53,500)
After-tax cash	**$46,500**

Alternatively, suppose the $100,000 of revenue was paid by the brokerage to your PREC. Figure 2 shows there would be corporate tax of 12.2% and the after-tax amount of $87,800 could be distributed it to you as non-eligible dividends (in the current year or a future year). You would pay tax of $41,900 (47.7% x $87,800) on the dividends and would be left with after-tax cash of $45,900.

Figure 2: Revenue paid to your PREC and distributed to you as dividends

Description	Amount (rounded to nearest $100)
Revenue	$100,000
Corporate tax (at 12.2%)	(12,200)
Amount available for distribution to you as a dividend	$87,800
Personal tax (at 47.7%)	(41,900)
After-tax cash	**$45,900**

There is a tax cost of $600 (0.6% on $100,000 of revenue), meaning that you would have $600 ($45,900 minus $46,500) less cash if you earn the revenue through your PREC, rather than earning the revenue personally; however, there is still an advantage of earning the revenue inside your PREC because of a timing difference as to when the personal tax is paid.

If you earn the $100,000 of revenue personally, you will pay tax of $53,500 for the year when you earn the income. If your PREC earns $100,000 of revenue, corporate tax would be only $12,200 for the year when the income is earned. The $41,900 of personal tax on the dividend is not payable until the $87,800 dividend is paid to you. If you don't need the money immediately, you can leave it inside the PREC for investment and personal tax can be deferred until the amount is paid to you as a dividend in the future. Thus, there is tax deferral of $41,300 ($53,500 of personal tax minus $12,200 of corporate tax), or 41.3% of the original $100,000 of revenue.

The advantage is not really in the tax deferral itself but, rather, what may be done with the deferred amount. The PREC would have $41,300 more cash to invest than you would have personally.

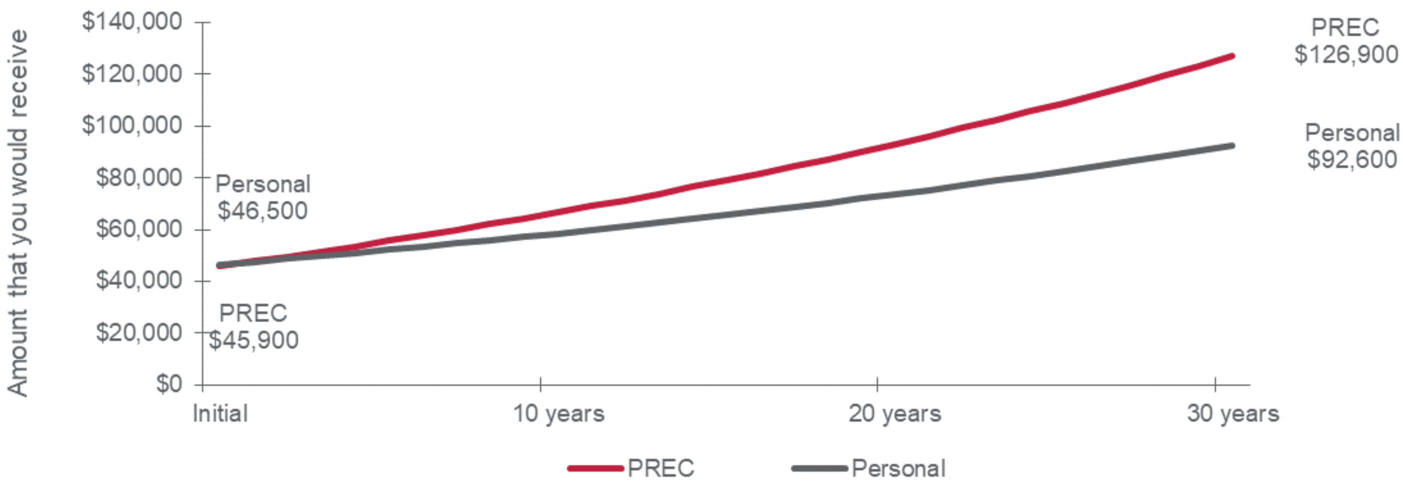
You could defer withdrawing this after-tax income to a tax year in which you have a lower marginal tax rate. For instance, you may anticipate taking a parental leave which will result in less income for a particular future year(s). You also may anticipate that your income in retirement will drop, resulting in a lower marginal tax rate.

Furthermore, if you invest the extra cash, this could also mean additional investment income earned within the PREC than if you earned the income personally.

Example of the benefit of investing the tax-deferred amount over time

Let's assume that $100,000 of revenue from trading in real estate was earned in 2020. With a PREC, your corporation would have $87,800 (after tax) to invest. If you earned the revenue personally, you would have $46,500 (after tax) to invest. Suppose investments earned 5% fully-taxable income and, in the future, the investments were cashed in and all proceeds (after tax) were distributed to you. Figure 3 shows the amount of after-tax cash that you would receive over 30 years with investments in your PREC vs. personal investments.

Figure 3: Amount that you would receive after taxes over 30 years if $100,000 of revenue from trading in real estate was earned in 2020 in a PREC or personally and after-tax income was invested, with 5% fully-taxable investment income



After 30 years, you would receive $34,300 more after-tax cash with a PREC (which yields $126,900) rather than with personal investments (which yields $92,600).

Income that is not eligible for the SBD

What about income above $500,000, which is not eligible for the SBD? Historically, the traditional advice was that you should not retain more than $500,000 of income inside a corporation in a year since it would be taxed at a higher general rate (which is 26.5% in Ontario in 2020, rather than the 12.2% SBD Rate). Instead, it was often recommended that the corporation "bonus down" by distributing income above the $500,000 level to shareholders as a bonus.

This rule of thumb, however, may not be valid given there is an enhanced dividend tax credit on eligible dividends, which are paid from income that is taxed at a corporation's higher general rate. For example, due to the enhanced dividend tax credit, which compensates for the higher corporate tax, in Ontario in 2020 the top marginal tax rate on eligible dividends is reduced to 39.3% (rather than 47.7% for non-eligible dividends.) The net result is that, even though general income is taxed inside a corporation at the higher tax rate of 26.5%, there is still a tax deferral of 27.0% (53.5% personal tax rate minus 26.5% corporate tax rate on general income) when after-tax general income is left in a corporation. With $100,000 of revenue, there would be about $27,000 more cash to invest in your PREC than you would have personally.

While there is a lower amount of deferred tax available for investment in a PREC when the SBD is not available, you could still have significantly more cash available with corporate investing. For details for all the provinces and territories, please see our report Bye-bye bonus! Why business owners may prefer dividends over a bonus.[8]

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8 The report "Bye-bye bonus! Why business owners may prefer dividends over a bonus" is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/jg-dividends-bonus-en.pdf,

Effect of passive income on the SBD

Access to the SBD Rate is limited in certain circumstances. The federal SBD Limit, which is normally $500,000, is reduced for corporations that have over $50,000 of certain types of passive investment income in the previous year, and reaches zero once $150,000 of this investment income is earned in the previous year.[9] This means that a portion (or all) of the corporation's revenue that would normally be eligible for the lower federal SBD Rate will be taxed at the higher general rate instead. As Ontario does not follow this federal measure, the Ontario SBD Limit (and tax rate on revenue from trading in real estate) is not reduced with passive income,[10] which can lead to a very different result. For further information see the report CCPC tax planning for passive income.[11]

The Lifetime Capital Gains Exemption (LCGE)

While, in most cases, it's unlikely that a realtor would be able to sell his or PREC in the future, if there was an opportunity to sell the shares, and if the corporation is a qualified small business corporation (QSBC), a shareholder may be able to claim the lifetime capital gains exemption (LCGE) to shelter up to $883,384 of capital gains on sale of the shares from tax. This could result in tax savings of up to about $238,000 for each shareholder.

To qualify as a QSBC, all or substantially all (interpreted to mean 90% or more) of the value of the PREC's assets must be used in an active business in Canada at the date of sale or transfer of the shares. The shareholder or someone related to the shareholder must have owned the shares for at least two years prior to their disposition. Also, during that entire two-year period, more than 50% of the PREC's assets must have been used in an active business in Canada. It is, therefore, critical to ensure that any investments made through your PREC do not inadvertently disqualify you (and your family members) from ultimately claiming the LCGE upon sale or, ultimately, upon death.

Additional information is available in the report Business Transition Planning: Unleashing the tax opportunities![12]

Income splitting

With income splitting, income is transferred from an individual who pays tax at a high tax rate to a family member who pays tax at a lower tax rate, which may reduce the overall tax paid by the family. Income splitting may sometimes be achieved with a corporation by including family members as shareholders.

When your family members are shareholders of your PREC, they may be able to use the basic personal amount and dividend tax credit to shelter dividends they receive from the PREC from tax. Due to the Tax on Split Income (TOSI), however, it will generally only be possible to split dividend income with family members who are sufficiently involved in the PREC, or if you are at least 65 years of age. Further information is available in the report The CCPC tax rules.[13]

Corporate-owned life insurance

Once the PREC has been established, it may be possible to consider additional tax planning opportunities, such as corporate-owned life insurance solutions. This would require the input and advice from both a qualified life insurance advisor and a tax advisor.

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9 The provinces (other than Ontario and New Brunswick) and territories have also implemented this measure.

10 New Brunswick also does not follow the federal measure, but PRECs are not permitted in New Brunswick.

11 The report "CCPC Tax Planning for Passive Income" is available online at cibc.com/content/dam/small_business/day_to_day_banking/advice_centre/pdfs/business_reports/ccpc-passive-income-en.pdf.

12 The report "Business Transition Planning: Unleashing the tax opportunities!" is available online at cibc.com/content/dam/small_business/transition-planning-en.pdf.

13 The report "The CCPC tax rules" is available online at cibc.com/content/dam/small_business/day_to_day_banking/advice_centre/pdfs/business_reports/private-corporation-tax-changes-en.pdf.

Registered Retirement Savings Plans (RRSPs)

Another consideration when deciding whether to use a PREC is that you must have personal "earned income" to be able to make RRSP contributions. For example, you would need at least $154,611 of earned income in 2020 to claim the maximum $27,830 RRSP deduction for 2021. When you personally receive remuneration for the services (trading in real estate) that you provide to the brokerage, this is "earned income", as would be salary received from the PREC; however, dividends that you receive from your PREC are not "earned income" and do not build RRSP contribution room. Of course, whether it makes sense to contribute to an RRSP, rather than investing in a corporation, is altogether another matter and is discussed in the report RRSPs: A Smart Choice for Business Owners.[14]

Establishing and maintaining a corporation

A corporation is a separate legal entity and must adhere to legal and tax and regulatory requirements, which can be time-consuming. You may find that you need assistance from legal, tax, accounting or other professional services, or need to pay regulatory costs (such as for licensing.) Make sure to consider the all the time and expenses that may be involved in setting up and maintaining a corporation when determining if a PREC makes sense for you.

Getting the right advice

More information about corporations is available from your provincial real estate regulatory body. Setting up and maintaining a professional corporation requires knowledgeable legal and accounting advice. The tax benefits may be worth the cost and detail. You should consult with your legal and tax advisors prior to incorporation.

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14 The report "RRSPs: A smart choice for business owners" is available online at cibc.com/content/dam/small_business/advice_centre/business-reports/RRSPs-for-business-owners-en.pdf.