Professional Incorporation of Advisors or Directed Commissions: Is there a difference and should you care?

Canadian Securities Institute
A Moody's Analytics Company

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Our agenda for today

1. Introduction
2. Current options for registrants
3. Should you incorporate or “direct commissions”?
4. Current state of affairs
5. What happens next?

Introduction

Introduction

- The “incorporated professional” is not a new concept

- Exists in most jurisdictions for traditional professions
  - Physicians, lawyers, engineers, architects, social workers, land surveyors, etc.
  - Jurisdictionally sensitive as the regulation of professionals is a provincial matter constitutionally speaking

- Must be permitted under governing legislation for the profession in question and provided explicitly under such legislation

Introduction

- A function of historical (taxation) case law which prevented duly licensed professionals from having income paid to a personal corporation as the corporation itself was not permitted to hold a license (in that case, a physician)

- The solution was to license or extend a "permit to practice" to a corporation which would be provided for under that profession's legislation

- As a result, the professional corporation in question "practices" through professionals authorized to practice under legislation

Introduction

- The legislation will dictate other requirements or conditions in order for corporation to be granted a permit
  - Who can be a shareholder, voting or otherwise (For example, can non-professionals or family members hold shares? What about a family trust?)
  - Who can be an officer or director
  - Restrictions on voting agreements (like USAs) which are typically void if such agreements are used to circumvent above restrictions
  - "Obligations to clients/patients not diminished"/"Liability of professionals"
  - Joint and several liability with the professional and his or her professional corporation
- Structure completely customizable to equate "the professional" to "the incorporated professional"

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Current options for registrants

How can I structure my business currently?

- For IIROC registrants:
  - Employer/Employee
  - Principal/Agent
  - Neither professional incorporation nor directed commissions/income redirection permitted

How can I structure my business currently?

- For MFDA registrants:
  - Employer/Employee
  - Principal/Agent
  - Principal/Agent with directed commissions/income redirection (not applicable to clients in Alberta)

How can I structure my business currently?

- For MFDA registrants that choose directed commissions, the target corporation must adhere to MFDA guidelines
- As noted above, structure-wise, in a professional incorporation model certain prohibitions/requirements are baked into structure (e.g. who can be a shareholder). These are typically very prescriptive in nature
- MFDA R 2.4.1(b) (and MSN-0072) prescribe a particular form of agreement between the approved person and the Member and the "payee" in order for income redirection to be permitted
- Conditions include continued requirements to comply with rules, appropriate supervision, access to books and records, constraints as to ownership, etc.

How can I structure my business currently?

- For insurance registrants:
  - Employer/Employee
  - Incorporation permitted (meaning the personal corporation of the insurance registrant holds an insurance license)

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Should you incorporate or “direct commissions”?

Incorporation vs. Directed Commission Structure

- What is the difference between professional incorporation and directing my commissions?

- Professional incorporation
  - Corporation is registered and licensed and income is earned directly by corporation
  - Professional is also licensed

- Directed commissions
  - Salesperson is registered and licensed and income is earned by that person and "redirected" to the corporation (which is not licensed) which acts as a conduit to receive such income

Legal and tax considerations of using a corporation

A word to the wise – always speak with your professional advisors first!

- Tax considerations
  - Access to the small business deduction/tax deferral
  - Capital gains exemption opportunities (qualified small business corporation)
  - Directed commissions tax status is unclear
- Legal considerations
  - Limited liability (**but** this does not extend to professional negligence or regulatory misconduct)
  - Start up and ongoing costs
  - Ownership structure must comply with requirements as stipulated in governing legislation
  - Does not in any way alter who owns or controls your book of business

Practice Management Considerations

- The need – to run your practice like a business
  - Operate like a business owner
  - Benefits primarily align to those who are growing their practice / earnings

- Aligns to sound financial planning advice that advisors provide to current business owner clients
  - Financial benefits of incorporation. i.e. qualified small business capital gains deduction, SBD, dividend vs salary etc.

- Enables the desire / requirement to scale and to grow

Practice Management Considerations

- More flexibility regarding team structure(s) and arrangements
  - Team members typically are employees of the corp vs of the firm

- Opportunity for '3 way agreements' between the advisor, the firm, and the corp
  - i.e. who can be shareholders, % ownership requirements etc.

- Succession and Advisor Retirement Planning
  - Creates a degree of consistency for the client
  - Consistency of brand

Industry considerations?

Another word to the wise, speak with your firm first!

- Who owns the clients? [This is a bit of a trick question…]
- Competitive advantages between firm registrants/platforms
  - If permitted by the new SRO (somehow), where does that leave ARs?
- Do the rules still apply to me?
- Levelling the playing field

4 Current state of affairs

What is the current state of Affairs?

Right now

- IIROC registrants
  - Limited to the options noted above
  - In other words, cannot incorporate
  - Some very limited work-arounds but are cumbersome and lack the elegance of the incorporated professional

- MFDA registrants
  - Directed commissions/income redirection have been permitted for many years (R 2.4.1)
  - Historically has been accompanied by income tax uncertainty (hence the importance of professional advice)
  - Again consider ongoing taxation authority initiatives

What is the current state of Affairs?

On deck - SRO consolidation

- SRO consolidation
  - By December 31, 2022, the MFDA and IIROC will amalgamate to form a consolidated SRO
  - Among other things, “directed commissions” is noted as an ongoing consideration for the newly formed SRO
  - Given the disparity of approaches to this issue between the MFDA and IIIROC this would seem to be an obvious problem to overcome

What is the current state of Affairs?

SRO consolidation

- According to 25-404, this is the issue:

g) Harmonizing Directed Commissions

Introduction

A directed commission arrangement generally refers to an arrangement whereby a dealing representative or other registered individual requests their sponsoring firm to pay part or all of the commissions or fees earned by the individual to a personal corporation owned by the individual and / or the individual's family members. This is different from an incorporated salesperson model, which is the ability of an individual to carry on registrable activities through a corporation that itself is registered under securities legislation.

As noted in the Consultation Paper, the MFDA and IIROC currently take different approaches to directed commissions arrangements. In short, the MFDA rules permit these arrangements except in Alberta. IIROC rules do not permit these arrangements. Directed commission arrangements are generally not permitted for other registrant categories, such as exempt market dealers, except in Manitoba and Saskatchewan. However, CSA staff continue to see directed commission arrangements being used by other registrant categories in the context of compliance reviews. Registered individuals generally seek to adopt directed commission arrangements to enable a more tax-efficient structure to manage business flow and disbursements.

What is the current state of Affairs?

SRO consolidation

- And just to be sure we are all on the same page…

The tax status of individual registrants who use a directed commission arrangement is unclear. A corporation that does not carry on the business for which commissions are paid, and merely acts as a conduit to receive commissions, may not be able to achieve the desired outcome for tax purposes.

An incorporated salesperson model allows a registered individual to carry on registrable activities through a corporation that itself is registered under securities legislation. As a registrant, the corporation would be subject to registration requirements. Because the corporation itself would be registered and, therefore, able to engage in the registerable activities that would *earn* the commissions, this model would not seem problematic from a tax perspective. This model has been adopted and utilized by other professionals, such as physicians, lawyers and accountants. Although this model would likely alleviate the issue of tax uncertainty, it would require legislative amendments, which would take considerable time to implement. Legislative amendments that would allow for incorporated salespersons have been made to the securities legislation of Alberta and Saskatchewan, but they have not been proclaimed.

5 What happens next?

What happens next?

- New SRO to be operating January 1, 2023
- Expectation is for MFDA registrants to enjoy status quo pending outcome of learnings and guidance from Directed Commissions working group
- Income tax uncertainty will be (should be?) an iron fist for registrants
- Check with your firm to determine what they will permit but expect this to be a competitive issue

Thank you