

An Endangered Species: The Personal Services Business

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Individuals often want to be treated as self-employed independent contractors (“SEICs”) rather than as employees in order to deduct more expenses. Businesses that normally hire contractors are generally reluctant to hire such SEICs because they remain at risk for source deductions in the event that Canada Revenue Agency (“CRA”) successfully challenges the status of these taxpayers. When the risk is too high, a compromising solution used to be for the individual to incorporate a company and operate as an incorporated employee, otherwise known as a personal services business (“PSB”). In light of recent changes to the legislation, this may no longer be advisable.

Previously, the legislation governing PSBs permitted access to a reduced corporate tax rate of 25% (in Alberta) through the General Rate Reduction mechanism. Thus, to the extent that a shareholder of a PSB left funds in the company, they would enjoy a deferral of income tax of 14%. Recent changes proposed to the Income Tax Act of Canada announced on October 31, 2011, by the Department of Finance state that PSBs would no longer qualify for the rate reduction to 25% (in Alberta).

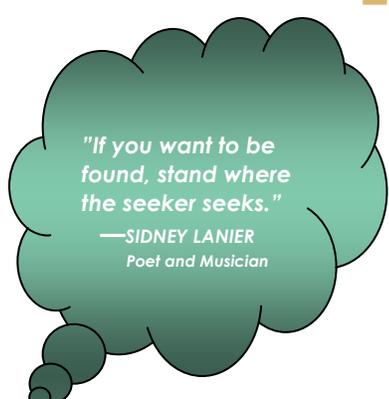
The change results in the elimination of the tax deferral opportunity due to the higher corporate tax rate. After taking into consideration the General Rate Income Pool rates, having a PSB now results in a significant tax disadvantage of 11% (in Alberta) when dividends are paid from the PSB to a shareholder. The combined flow-through personal and corporate tax rate on a dividend paid by PSB is 50% (in Alberta) versus the top marginal tax rate of 39% for earning the same income as an individual.

For taxation years beginning after October 31, 2011, it is best to pay all future PSB earnings as a salary to the incorporated employee to avoid the additional tax consequences inherent with receiving dividends. In addition, it may be worth considering winding up the PSB and have the earnings paid directly to the incorporated employee if it is reasonable to do so.

This article has been written for general information purposes; the author recommends that the reader discusses the contents of this article with his or her professional advisors should they have any concern about the risk that being assessed as a personal services business might pose to their specific circumstances.

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"If you want to be found, stand where the seeker seeks."

—SIDNEY LANIER
Poet and Musician

Special points of interest:

- **New 30% Ontario Tuition Grant Announced. Deadline is March 31st.**
- **Maximum contributions:**

	2011	2012
RRSP	\$22,450.00	\$22,970.00
CPP	\$ 2,217.60	\$ 2,306.70
EI	\$ 786.76	\$ 839.97
- **See our "Special Leap Year Reminder" on page 4.**
- **Personal tax instalments:**
 - March 15, 2012
 - June 15, 2012
 - September 15, 2012
 - December 15, 2012

Changes to the Canada Pension Plan

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As of January 1, 2012, the Canada Pension Plan (CPP) changed to better reflect how Canadians choose to live, work and retire. These changes provide more options so that Canadians can make the decisions that are right for them as they make the transition from working life to retirement.

Changes for Workers between the Ages of 60 to 65

If you are under age of 65 and work while receiving your CPP retirement pension, both you and your employer will be required to make mandatory CPP contributions towards the new Post-Retirement Benefit (PRB). This additional benefit will be added to your current retirement benefit, gradually increasing the eventual retirement income. Further information regarding the PRB and details on obtaining an estimated calculation of this additional benefit can be found by visiting the Service Canada website at www.servicecanada.gc.ca/eng/isp/cpp/prb/index.shtml.

Those electing to receive CPP benefits before the age of 65 will have a larger reduction than was applicable prior to 2012. The change is a phased-in reduction that will increase the early CPP reduction to 0.6% for each month before the age of 65. As such, if the CPP is received five years early, it will be reduced by up to 36% (previously up to 30%).

The current requirement that Canadians between the ages of 60 and 65 must stop working for two months before applying to receive CPP no longer applies.

Changes for Workers between the Ages of 65 to 70

If you are 65 to 70-years-old and are receiving a CPP retirement pension, you will be required to contribute to CPP unless you have elected to stop CPP contributions on Form CPT30, "Election to Stop Contributing to the Canada Pension Plan, or Revocation of a Prior Election". This election must be filed before the contributions cease and changes to this can only be done once per year.

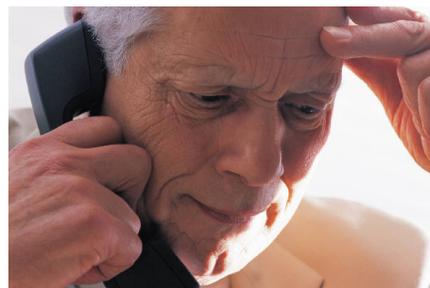
Should you decide to continue to make CPP contributions, your employer will also be required to make CPP contributions. The contributions made by both you and your employer will go towards your PRB and will not make you eligible for other CPP benefits, nor will it increase their amount.

Self-employed individuals in between the ages of 65 to 70 who receive CPP benefits can complete the applicable section of Schedule 8 "CPP Contributions on Self-employment and Other Earnings" for 2012. This should be filed with the 2012 income tax return.

Those who delay receiving CPP benefits until after the age of 65 will receive a larger increase than was available prior to 2012. From 2011 to 2013, the CPP will be increased to 0.7% per month (from the current 0.5%) after the age of 65. By 2013, for those who start receiving their CPP pension at the age of 70, the pension amount will be 42% (previously 30%) more than if CPP benefits had been received starting at age of 65.

As of 2012, the percentage of low earnings that were automatically dropped from the calculation of average earnings will increase to 7 ½ years (from the current standard of seven years), which will likely increase the benefit amount.

The changes to CPP may affect your retirement planning, including when to decide to apply for the CPP retirement pension. In making your decision, you will need to consider your current age, work history and when you plan to retire in order to make the decision that is best for you.



RRSP Prohibited Investments

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Overview

In the 2011 federal budget, the Department of Finance Canada introduced new anti-avoidance rules for Registered Retirement Savings Plans (RRSPs). These rules are intended to prevent individuals from holding certain types of investments in their RRSPs and from using these accounts in tax planning arrangements that would be considered unacceptable by the Government of Canada.

Generally, the new rules prohibit the following from being held in an RRSP:

- ◆ Investments in entities in which you alone or together with non-arm's length persons have a significant interest (generally 10% or more).
- ◆ Investments in entities with which you (or any entity in which you have a significant interest) do not deal at arm's length.

Impact on Holding Private Company Shares inside your RRSP

Prior to the new rules, individuals could hold shares in a private company where they had 10% or more interest in provided neither they nor their relatives were in control of the company; the cost of the shares also needed to be less than \$25,000. Under the new regime, the \$25,000 rule no longer exists and private company shares in an RRSP could be a prohibited investment subject to harsh penalty taxes.

Impact on Mortgage Investment Corporation Shares

Under the old rules, you could hold up to 25% of the Mortgage Investment Corporation (MIC) and the investment would qualify for RRSP investment purposes; however, with the regulation changes in 2011, ownership maximums are effectively reduced from 25% to fewer than 10% of any class of MIC share. In addition, the definition of a "related party" for the purposes of the maximum ownership calculation is broadened from a spouse and minor children to any blood, marital or adoptive relative.

Summary of Penalty Taxes

Prohibited Investment Penalty Tax

The new regulations will apply a special tax equal to 50% of the fair market value of a "prohibited investment". However, transitional relief provides that

this 50% tax will not apply if the prohibited investment was acquired on or before March 22, 2011, and is disposed of before the year 2022.

RRSP Tax Advantage

Current RRSP rules provide that income attributed to "prohibited investments" is considered an advantage and is generally subject to a tax equal to 100%. So, although there is transitional relief available for the investment principal amount, the taxpayer will likely want to dispose of their prohibited investment as soon as possible to avoid the advantage tax.

The advantage tax applies as of March 23, 2011. Under transitional rules, the advantage tax will be taxed at the annuitant's marginal income tax rate (rather than 100%) provided the following holds true:

- ◆ The income or gain is withdrawn and paid to the RRSP holder within 90 days after the end of the year.
- ◆ An election is made prior to July 2012 to have the transitional rules apply.

This distribution will be taxable in the year the distribution is made. For example, a "transitional prohibited investment benefit" calculated from March 23, 2011 to December 31, 2011 and withdrawn on February 15, 2012, will be taxable on the individual's 2012 personal tax return.

Removing Prohibited Investments

Generally, when you withdraw an investment from your RRSP, the fair value of the proceeds is included in your income in the year of the withdrawal and is subject to tax at your marginal rate. The Department of Finance has recognized this is a costly process to remove newly prohibited investments and they have provided some transitional relief. Prohibited investments can be swapped out of your RRSP in exchange for cash or other property of the same value. Swap transactions involving the shares of a private company must be supported by an appropriate valuation.

New rules announced in the 2011 federal budget prohibit some investments from being held in an RRSP.

Important Tax Dates to Remember

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It's that time of year again...

It comes around every year, so you may as well prepare for it! Tax time usually draws many sighs, in between several cups of coffee, but tally up we must.

Here are a few important dates to mark on your calendar to make sure you meet your deadlines:

- ◆ T4 and T5 filings are due February 29th, 2012.
- ◆ In order to avoid interest, corporations with a December 31st, 2011, year end must make their tax payments by:
 - March 31st, 2012, if they have an active operating business, OR
 - February 28th, 2012, for other companies, such as holding companies.

Corporations should also continue to make their respective monthly or quarterly instalments to CRA if required to do so.

- ◆ Personal tax returns may not be due until April 30th, 2012, but don't forget to keep making your instalments to CRA if you are scheduled to do so. The next instalment date is March 15th, 2012.

Special Leap Year Reminder!

- ◆ Trust Returns (T3) with a calendar year end are due on March 30th, 2012 - NOT March 31st, 2012.
- ◆ RRSP contributions must be made by February 29th, 2012 - NOT March 1st, 2012.

