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Practicing Through Professional Corporations

TAX LETTER

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CRACKDOWN ON PERSONALSERVICES BUSINESSES

If you set up a corporation to provide your employment services, the *Income Tax Act* imposes severe restrictions on the corporation.

These rules, called the **personal services business** (PSB) rules, apply only where your corporation provides your services to a third party, and, but for the corporation, you would reasonably be regarded as an *employee* of the third party. (The rules do not apply if you are an independent contractor — i.e., already carrying on business, not working as an employee — and you incorporate that business.)
For this purpose, "your corporation" would be any corporation in which you, or a family member, own 10% or more of the shares of any class.

Where a corporation carries on a PSB, the following restrictions apply:

- The corporation **cannot claim the small business deduction**. All of the corporation's business income will be taxed at the top corporate rate rather than the "small business" rate that normally applies to the first $500,000 of active business income.
- The corporation **cannot deduct any expenses other than salary** and benefits actually paid to you as the "incorporated employee", and certain other expenses that you would be allowed anyway as an employee.
  No deductions for amounts paid to other employees of the corporation. No deductions for business expenses (after all, as an employee you would not be able to claim such deductions). And no deductions for bonuses accrued but not paid out to you.

For the past 30 years, conventional tax planning wisdom has been that one should avoid setting up a PSB, because of the above restrictions.

However, as we noted in our June 2010 issue, under the heading "Personal Services Business May Be Useful Again", PSBs became useful again with recent reductions in tax rates. The "high" corporate tax rate, when the small business deduction does not apply, is going down to about 25% (depending on the province), which is much lower than the top tax rate on employment income (about 45% depending on the province). As well, dividends paid out from such income (so-called "eligible dividends") receive an enhanced dividend tax credit, so that they are taxed at a significantly lower rate than regular income. Indeed, for a person with no other income, up to about $60,000 of dividends can be received before any tax has to be paid.

We noted in June 2010: "If you have a spouse and/or adult children with little or no income, it may now be worthwhile to incorporate your employment relationship, by creating a corporation of which they are shareholders.

Despite the relatively "high" tax rate on the income ineligible for the small business deduction, you may be able to pay out dividends on that income to your spouse and children at low

tax cost, with a net savings over you earning the income directly."

The federal government has now cracked down on this planning idea. On October 31, 2011, the Department of Finance released 100 pages of draft technical amendments to the *Income Tax Act.* Buried in these technical changes, without any public announcement, is a **13-percentage-point increase in the taxation of personal services businesses**. Such income will no longer be eligible for the "general tax reduction" in section 123.4 of the *Income Tax Act*, which as of 2012 reduces the general corporate tax rate for most corporations from 38% to 25% (where the small business deduction is not available).

The new change will apply to corporations' taxation years that begin November 1, 2011 or later.

And that will be the end of creative planning with personal services businesses!

THE LEAP YEAR BITES — WATCH THOSE DEADLINES!

Because 2012 is a leap year, some deadlines fall earlier this coming year than normal.

If you will be filing a T3 **trust tax return**, the deadline (assuming a calendar year-end for the trust) is 90 days after the end of the year. Normally that is March 31. This year, because February has 29 days, the 90-day period expires on Friday, **March 30**.

The CRA extends a Saturday deadline to the following Monday, so if you thought the deadline was Saturday March 31, you might think you had until Monday April 2. But a return filed on April 2 will be late. If the return contains any election or designation being made that has to be filed by the return's due date, and the return is not filed by March 30, the election or designation will not be considered to have been properly made!

If you are making **RRSP contributions**, any investment that gives you a **labour-sponsored funds tax credit**, or various other investments that can be completed up to 60 days after the end of the year and still be claimed on your 2011 return, note that this year, the 60th day is **Wednesday, February 29, 2012**, not March 1 as usual.

THE 10-YEAR LIMITATION ON WAIVER OF INTEREST

The rules have changed for applications for waiver of interest and penalty.

The CRA has a policy of "Taxpayer Relief" (formerly called "Fairness"), under which it may waive interest and penalty in extraordinary circumstances, such as where a taxpayer was affected by illness, where the CRA provided wrong information, where there have been unreasonable delays on the CRA's part, and various other circumstances. This waiver is authorized under subsection 220(3.1) of the *Income Tax Act*.

In 2004, subsection 220(3.1) was changed to prohibit the CRA from providing such interest waiver unless application for relief was made to the CRA **within 10 years after the end of the taxation year**.

The interpretation of this rule was uncertain. The CRA and some early court decisions said that the "taxation year" was the original year in which the debt arose. The contrary view, put forward by some tax commentators, was that it referred to the years during which the interest accrued.

To take a simple example: Suppose you invested in a tax shelter in 2000, and the CRA reassessed you in 2002 to deny the shelter benefits. After many delays on the CRA's part, you lose an appeal in the Courts in 2011. Assume the delays were sufficient to qualify for Taxpayer Relief interest waiver.

The CRA would say that if you didn't apply for interest waiver by the end of 2010, they had no legal authority to waive the interest that accrued on your 2000 taxation year from 2001 on, even though you would otherwise qualify for relief.

As we noted in "Around the Courts" in our October issue, the Federal Court of Appeal has now ruled otherwise. In *Bozzer v. The Queen*, the Court ruled that the 10-year rule refers to the years during which the interest accrued. Thus, in this example, if you apply for relief during 2011, the CRA would have authority to waive all of the interest that accrued from 2001 forward. (Of course, you still have to qualify under the CRA's Taxpayer Relief guidelines.)

The deadline for the CRA to seek leave to appeal the *Bozzer* decision to the Supreme Court of Canada has now passed, so the decision is final. The CRA now accepts the *Bozzer* rule and will reconsider applications that were turned down.

If you applied for interest waiver in the past and were turned down because of the 10-year rule, you should reactivate your request with the CRA and ask them to reconsider it. The CRA has not yet announced a new policy publicly, but it is now forced to comply with the *Bozzer* decision and will no longer refuse Taxpayer Relief on the grounds that your application for waiver of interest was filed too late.

MAKE MONEY VOLUNTEERING FOR A CHARITY

If you volunteer for a charity, you may be able to make a little money at no cost to the charity.

The charity cannot give you a donation receipt for the services you provide for free. A valid donation receipt for tax purposes can only be issued for a donation of property or money.

However, suppose the charity **pays you for your services and you donate the money back**?

If you are not in the top tax bracket, this will pay off. Donations over $200 per year provide you a tax credit at the **top marginal rate**, which applies only to taxable income (after all deductions) exceeding about $130,000 per year. If you are in a lower bracket, the income you report from the charity will be taxed at a lower rate than the credit you receive. The lower your tax bracket, the higher the differential and thus the more profitable it will be to have the charity pay you.

If you are in **Alberta**, the benefit is even larger. Alberta provides a special 21% tax credit for charitable donations over $200 that makes the total federal/provincial credit worth 50%, even though the top marginal rate of tax is only 39% (and of course is lower if your taxable income is below about $130,000).

Of course, the amount the charity pays you for your services must be reasonable, or the charity can run into problems if it is audited by the CRA. Also, if you are a director of the charity (or related to a director), you might not be permitted to be paid by the charity for your services. There are numerous rules, both federal and provincial, that govern charities and their activities.

WATCH OUT FOR SHORT TAXATION YEARS

A corporation can be **deemed to have a year-end for tax purposes**, in the middle of its fiscal year, for a number of reasons.

One common reason is a **change in control** of the corporation. If the corporation is sold to new owners, it will be deemed to have a year-end and start a new taxation year. (Losses from previous years will then generally not be claimable unless the corporation continues to carry on the same or a similar business.)

Another trigger for a year-end is if the corporation becomes or ceases to be a Canadian-controlled private corporation. Thus, for example, if the majority shareholder becomes non-resident, the corporation will be deemed to start a new taxation year.

There are several other such triggers, including becoming or ceasing to be exempt from tax, and becoming or ceasing to be a "financial institution".

What happens when the corporation has a new taxation year and a resulting "short" year (or two)? Many things change, and there can be numerous negative side effects. For example:

- A **corporate tax return must be filed** for the "short" year, within 6 months of the deemed year-end.
- The due date for the current year's tax balance is moved earlier (two or three months after the deemed year-end).
- A **loss carryforward year will usually vanish** due to the extra taxation year, as can other carryforward years such as for foreign tax credits, investment tax credits and certain reserves. This means that the carryforwards will expire sooner than they otherwise would. (Most business losses can now be carried forward for 20 years, but many other carryforwards are much shorter.)
- A **loan to a shareholder** may have to be repaid sooner to avoid being included in the shareholder's income.
- Certain accrued amounts that were deducted but have not been paid out may be reincluded in income sooner than would otherwise be required.

As well, certain calculations that are based on the presumption that a taxation year has 365 days will now be different. For example, a corporation's **monthly instalment requirements** are based on the previous year's tax payable, but prorated based on the length of that taxation year. Suppose a corporation has $100,000 of tax payable for the year but all of it was earned in the first three months of the year, and the corporation was sold after 3 months. The "instalment base" for the next year will be $100,000 but prorated to a 12-month year, so the corporation might have to remit instalments of $400,000 the next year (though it can pay lower instalments if it knows that its tax will be lower).

Similarly, most **capital cost allowance** claims will be prorated to the short taxation year, as will various other claims including those for cumulative eligible capital, the small business deduction, and limitations on investment tax credits for small corporations.

Any change to a taxation year-end must be very carefully analyzed for all the unexpected fallout.

DO YOU MAKE DONATIONS TO U.S. CHARITIES?

Do you make donations to charities located in the United States? They may be eligible for a tax credit on your Canadian tax return in one of several ways.

First, donations to many foreign **universities** qualify as charitable donations in Canada. The institution must be listed in Schedule VIII of the *Income Tax Regulations*, which lists universities that are known to have significant numbers of Canadian students and that have applied to be on the list. Schedule VIII lists over 500 institutions, of which over 400 are in the United States. The list runs alphabetically from Abilene Christian University (Abilene, Texas) to Yeshiva University (New York, NY), and includes virtually every important U.S. university and college. You can find Schedule VIII at the end of the *Income Tax Regulations* on www.CanLii.org (which is a handy source of all Canadian laws, regulations and reported Court cases).

(Note that starting 2012, the Canada Revenue Agency will have a measure of control over foreign universities for purposes of Canadian donations. Under a measure introduced in the 2011 federal Budget and expected to be enacted in December 2011, if the CRA determines that a foreign university is not complying with the requirements as to how the funds should be used, the CRA can "de-register" the university and it will no longer qualify for donations. Thus, for example, if a U.S. university is involved in a scheme to issue donation receipts for "donations" that are really payments for tuition, are paid back to the donor, or are routed to causes that are not part of

the university's normal function, it could be de-registered and no longer qualify for Canadian donations. Foreign universities may also be required to issue receipts that comply with Canadian tax receipt requirements.)

Second, a donation to any other U.S. charity will generally qualify for Canadian credit **if you have U.S.-source income**. This rule is found in Article XXI, paragraph 7 of the Canada-U.S. tax treaty. The charity must be one that "could qualify in Canada as a registered charity if it were a resident of Canada". Donations can be claimed for up to 3/4 of your "income arising in the United States". This would include business income from U.S. clients, or investment income arising in the U.S. such as from the purchase of U.S. stocks or bonds within your Canadian brokerage account.

The Canada Revenue Agency has stated that any organization that qualifies under section 501(c)(3) of the U.S. Internal Revenue Code will qualify for this relief. If you want to know whether a particular organization you are donating to qualifies under section 501(c)(3), you can search for it on www.guidestar.org.

Third, some foreign charities have a "**Canadian Friends of...**" or similarly-named organization in Canada, which is registered as a Canadian charity. The "Canadian Friends" can receive donations and use them to benefit the foreign charity, and will issue you a Canadian tax receipt which you can use on your Canadian tax return like any other Canadian charitable donation. If you are considering a donation to a U.S. charity and cannot obtain Canadian tax relief under either of the first two ways, ask the charity if it has a parallel Canadian charity that can accept donations for it, or check the CRA web site at cra.gc.ca/charities.

AROUND THE COURTS

Reporting income as partners made the wife liable to third parties

Tax return reporting can have unexpected consequences!

In *Prince Albert Co-operative Association Ltd. v. Paul Rybka and Tina Rybka*, Paul Rybka was a farmer. He and his wife Tina had been married for about 25 years. For many years, they **reported farming income as partners on their income tax returns**. This was done for income-splitting purposes, as is commonly done by couples. The farming income was taxed at a lower rate because it was split between them.

The income-splitting may have been justifiable, because Tina did work for the business, such as handling its books and paying the bills. However, Paul owned all the farm machinery, leased the lands on which the farming was done and did the actual farming. The grain permit books for the lands, and all cash advances for grain, were solely in Paul's name.
Paul incurred debts of some $50,000 to the Prince Albert Co-op in the course of his farming business, and the Co-op sued him in the Saskatchewan courts. During the proceedings, the Co-op found out that Paul and Tina had reported their income as partners on their tax returns. The Co-op therefore sued Tina as well.

Although the Saskatchewan Court of Queen's Bench ruled that there was no partnership, the Saskatchewan Court of Appeal reversed that decision and reached the opposite conclusion. As the Court of Appeal put it:

> "The parties' decision to take the advice of their accountant in 1998 to show the farming operation as a partnership cannot be viewed as merely a tax election in an attempt to save money. It was a representation and a certification to the Canada Revenue Agency that a certain state of affairs with respect to the farm, i.e. a partnership, existed. That representation spanned eight tax years. It was done on the basis of professional advice."

As a result, the Court found that a partnership existed, and Tina was jointly liable to the Co-op for the $50,000 debt.

This is a cautionary tale for those who report income as partners in order to split income. If Paul had paid Tina for her services in handling the books and paperwork for the business, rather than treating her as a partner, this problem would not have arisen. Partners are normally jointly liable for the debts of the partnership.

US Deferred Income Plan treated as RRSP

In the *Natarajan* case, the taxpayer lived in Windsor, Ontario but worked for a US employer across the border in Detroit. She contributed to the company's Deferred Income Plan.

For US tax purposes, Ms Natarajan was not taxable on the funds she contributed to the Deferred Income Plan. This was similar to what happens in Canada with an RRSP or registered pension plan: the funds are not taxable when earned, but are taxed when they are eventually received out of the plan.

For Canadian tax purposes, Ms Natarajan did not report her US income that was paid into the Deferred Income Plan, because she had not received it. The Canada Revenue Agency thought differently, and assessed her for this income.

In the course of Ms Natarajan's appeal to the Tax Court of Canada, the CRA agreed that the contributions in question were not taxable because this income had not been "received". Effectively, the CRA's concession turned the US plan into an RRSP or registered pension plan for Canadian tax purposes!

It remains to be seen how broadly this concept might be applied in future cases.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.