The Institute™
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COMMENT

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Compliments of: Raymond Matt, CFP, CLU, TEP, CHS
Tel: 705-526-2807 Cell: 416-452-2334
www.csiplan.ca

PERSONAL SERVICES BUSINESS CHANGES

The term "personal services business" is defined in the Income Tax Act. In general terms, a personal services business exists where the relationship between a purchaser of services and an individual would be one of employment but for the existence of a corporation. In essence, it is when an executive incorporates and provides services to his or her (former) employer through a company. An exception to the personal services business rules applies when the company employs more than five full-time employees.

New federal personal services business rules have been proposed, effective for taxation years beginning after October 31, 2011. These changes will effectively eliminate the tax advantages such a business previously enjoyed.

Prior to the proposed legislative changes released last October, a personal services business was taxed at the top corporate rate because it did not qualify for the small business deduction. This rate has been decreasing steadily over the last few years because of the planned schedule of lower federal corporate tax rates — 16.5% in 2011 and 15% in 2012. Taking into consideration the provincial tax rates of between 10% and 16%, this meant that the corporate tax rate for a personal services business would have been in the range of 25% to 31% in 2012, providing a significant tax deferral not otherwise afforded to individuals.

An individual may decide to operate his or her affairs through a personal services business for any number of reasons. The biggest hurdle to clear is that of ensuring the arrangement is not re-characterized as an employment scenario. Some of the criteria in the determination include the level of control the employer has over the worker's activities, who purchases work-related equipment, the degree of financial risk undertaken by the worker, and the intentions of the contracting parties.

Another important aspect of a personal services business is that the tax-deductible expenses are restricted. The allowable deductions match those allowed to employees, such as salaries and benefits paid to the incorporated employee, and expenses incurred in connection with selling property or negotiating contracts if the expenses would have been deductible by an employee.

It should be noted that because the personal services business did not qualify for the small business deduction, the income was included in the "general rate pool", and as a result the company would have been able to pay eligible dividends.

The legislative changes proposed last fall will increase the tax rates applicable to personal services businesses. The proposal is that a personal services business will not be eligible for the general corporate rate reduction of 11.5% in 2011 and 13% in 2012. This means that the federal tax rate will be 28% which, when added to the provincial tax rate, will produce a corporate tax rate in the range of 38% to 44%.

In addition, there is a significant loss of integration, which makes a personal services business unattractive. Integration measures the tax efficiency of earning income directly at a personal level, or indirectly through a corporation and ultimately to the individual. The dividend gross-up and federal dividend tax credit on eligible dividends is designed based on federal tax rates of about 15%, not 28%.

The impact of the proposed change could be summarized as follows:

	Current Situation	Proposed Changes
Corporate taxable income	$100,00	$100,000
Corporate tax rate (July 2012, Ontario)	26%	39%
Corporate taxes	26,000	39,000
Potential dividend to shareholder	74,000	61,000
Top effective tax rate on eligible dividends	28.19%	28.19%
After-tax cash position of shareholder	53,139	43,804
Combined effective tax rate	46.9%	56.2%

Under the previous rules, the taxpayer just about broke even on full integration. The advantage was deferral of tax: only about half of the taxes were paid immediately by the corporation when the income was earned, and the taxpayer only paid tax upon receipt of the dividend from the corporation.

Under the new rules, the taxpayer loses almost all of the deferral advantages and will actually pay more in taxes over the long term as compared to earning the same amount of profit directly as an employee.

Planning strategies to deal with the situation would include bonusing down corporate profits or income splitting by paying dividends to individuals in much lower tax brackets.

Where an individual already has a personal services business, he or she will have to re-evaluate and perhaps restructure depending on the circumstances.

I/R 2101.07

MAXIMIZING OLD AGE SECURITY

At this time of year many income tax returns have just been filed, and seniors will have found out how much of their Old Age Security (OAS) they got to keep.

Old Age Security payments are "clawed back" at a rate of 15% when net income exceeds a certain threshold ($67,668 in 2011). This means that when an individual's net income is less than $67,668, he or she will be eligible for the full amount of the OAS annual benefit — $6,368.25, in 2011. For each dollar of net income over the $67,668 threshold, an individual's OAS benefit amount is clawed back by $0.15. The full amount of OAS benefit is clawed back when an individual reaches $110,123 of net income [$67,668 + (6,368.25/15%)]. A senior who earns $80,000 of net income will be entitled to $4,518.45 of OAS benefits, and will have to pay back the difference between what was received ($6,368.25 – 4,518.45 = 1,849.80), unless an amount was withheld at source.

So how does a senior plan his or her affairs to keep more of the OAS benefit?

Review the type of investment income

After consideration of the individual's investment risk profile, many non-registered investment portfolios are set up to be "tax efficient". Tax efficiency can be achieved by taking into account the different tax treatment afforded to different types of investment income when designing an investment portfolio. Some types of income — capital gains and dividend income, for example — are taxed at a preferred rate when compared with regular income. Only 50% of a capital gain is included in income. Dividends are subject to a gross-up, but the taxpayer is entitled to a dividend tax credit. Interest income is not eligible for any special treatment and is taxed at the individual's regular rate of tax.

The structure for taxing dividend income works against seniors with respect to the Old Age Security clawback because dividends are grossed-up for the calculation of net income while the offsetting dividend tax credit is integrated at a later point in the tax return.

For example, eligible dividends (generally, dividends from public companies) are grossed up by 41% to arrive at the income amount, so that the taxpayer reports 141% of the actual dividend received as income. Eligible dividends generate a federal dividend tax credit of 16.44% of the grossed-up amount, which ultimately reduces the tax associated with the dividend. However, because the OAS clawback is based on the individual's net income amount, the formula for taxing dividends creates an artificially high net income amount that results in a higher clawback than would be triggered if the income was from another type of investment.

Ineligible dividends (private company dividends taxed at the low rate) are subject to a 25% gross-up and generate a federal dividend tax credit of 13.33% of the taxable amount; thus, they have less impact on the OAS clawback (but a higher net tax rate).

While eligible and ineligible dividends are tax-preferred types of income and result in less overall income tax than interest income, the impact on an individual's eligibility for OAS is more subtle. From a planning point of view, seniors should understand this interplay when assessing investment decisions.

Divide, Defer and/or Deduct

The three "D's" of tax planning are: Divide, Defer and Deduct. These rules create the stage for numerous planning strategies that seniors can employ to lower their net income and therefore retain more of the OAS benefit.

Divide

- Spouses can divide pension income under the pension income splitting rules.
- Spouses can sometimes share non-registered investment income by utilizing carefully structured loan strategies between them or perhaps other family members.
- Canada/Quebec Pension Plan payments are eligible for sharing between spouses, upon application to the government.
- Income earned in a Tax Free Savings Account (TFSA) is not taxable, so it is important to maximize any opportunity where using a TFSA might help lower net taxable income.
- There may be times where a senior wants to distribute some of his or her capital to intended (adult) beneficiaries early, which would remove the associated investment income.

Defer

- Where other income provides adequately, seniors could defer the receipt of RRIF payments as long as possible. Then, by the time he or she is required to begin minimum RRIF payments, there may be fewer non-registered assets to generate taxable investment income, so the impact on the net income may be lower.
- Spend non-registered money first, and maximize any deferral opportunities associated with a RRIF or RRSP.

Deduct

- Deduct eligible interest expense on any borrowed funds used to invest, and eligible investment management fees.

Incorporate

Seniors may want to consider moving their investment portfolio inside a holding company. This would move the associated investment income from the taxpayer's personal income tax return to the corporation's income tax return. By removing the investment income from the personal tax returns, the taxpayer's net income could be reduced by an amount that would allow the retention of some or all of the Old Age Security payments.

Income could be drawn from the holding company by paying down the shareholder loan created when the investment portfolio was transferred into the holding company or by strategically paying dividends, bearing in mind the impact on the Old Age Security claw back formula.

The strategy of incorporation will depend on the amount of OAS benefit involved, the client's desire to retain the OAS payment, and other broader planning undertakings being taken within the family. This type of strategy is typically more sophisticated and is better utilized for larger investment portfolios, but keep in mind that the costs of incorporation and bookkeeping/tax filing could approach or exceed the amount of OAS otherwise clawed back. Additionally, there may be tax consequences of the transfer of assets into the corporation, and eventually of winding up the corporation if it gets too small to be worth the added fees and costs.

Planning to retain more of the OAS benefit could also assist in the retention of the federal age credit and provincial tax credits. It is always important to ensure the benefits derived exceed the cost.

I/R 3201.03

CHARITABLE GIVING

The charitable sector of the Canadian economy relies on the generosity of individuals and corporations in order to fund its activities. Many people give because they believe in the cause and feel a passion to share.

In a sense, the federal and provincial governments have created a partial matching system by allowing tax credits for charitable donations, which lowers the net cost to the individual. This better aligns resources to those charitable activities that the population wants to support. Over the past several years, the federal government has made a significant effort to enhance the tax system with respect to charitable giving. While the following comments apply to the federal income tax returns, the provinces generally apply the same rules (except that the rates of the provincial tax credits mirror the provincial tax rates).

The total amount of charitable donations has increased steadily over the years. Statistics Canada released the following data with respect to the 2010 tax year, based on the personal income tax returns filed that year.

$8,253,210,000	Total amount of donations reported by individuals in 2010
24,494,940	Total number of tax returns filed
5,742,000	Number of tax returns reporting a charitable donation
23%	Percentage of taxpayers reporting a charitable donation
$1,437.34	Average donation amount
$260.00	Median donation amount

The median donation is that amount where half of those reporting a charitable donation gave more and half gave less. The region with the highest median donation was Abbotsford-Mission, British Columbia, with $620 — a position that they have held for nine consecutive years.

The actual number of taxpayers who make a charitable donation is likely higher than the above chart shows. First, couples generally group their charitable donation claims together on one of their returns (as explained further below). Additionally, the numbers in the chart are based on donations claimed on tax returns, which will have some leakage because receipts can get lost and some donors do not file returns. As well, there are many charitable donations made in smaller amounts, where receipts are never issued but the quantum of the donations can add up significantly across the total Canadian population.

Charitable donations of up to 75% of net income are eligible for a tax credit in the year. The federal charitable tax credit is 15% on the first $200 per year, and 29% on amounts in excess of $200. This means that a charitable donation of $1,000 would attract a $262 (15% of $200 plus 29% of $800) federal tax credit. For certain gifts in-kind of depreciable and/or other capital property, special rules allow the 75% of net income limit to be increased by 25% of the income generated because of the disposition triggered by the gift in-kind.

Charitable donations can be claimed in the year they are made or carried forward and claimed in any of the next five years. This is advantageous because the federal tax credit does not generate a refund, so any unused or underutilized tax credits can be claimed in a subsequent year when they can be fully used.

Charitable donations made in the year of death, or pursuant to a bequest in a will, can be claimed up to 100% of net income on the deceased's terminal tax return. Any charitable donations that cannot be used on that terminal return can be carried back one year and claimed on the prior tax return up to 100% of net income in that year.

Administratively, the Canada Revenue Agency allows married or common-law couples to combine their charitable donations and claim all of them on one tax return. This is more efficient because the couple will have only one low threshold (15% on the first $200) on the combined claims.

The CRA keeps a current list of all registered charitable organizations, and that list is accessible to the public on the internet. This is a useful resource when investigating whether a charity is registered or if an individual is looking for more information about the charity, such as its financial data or charitable activities.

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Contributors to this issue of Comment:
James W. Kraft, CA, MTax, TEP, CFP, CLU, CH.F.C.
Deborah Kraft, MTax, TEP, CFP, CLU, CH.F.C.

Published by:
The Institute
390 Queens Quay West, Suite 209,
Toronto, Ontario M5V 3A2
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031
www.iafe.ca • info@iafe.ca

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