Collins Barrow
Chartered Accountants

Tax Alert

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Should You Incorporate Your Personal Services Activities?

An individual in the business of providing personal services may contemplate incorporating as incorporation can be beneficial in certain circumstances. The main benefit is derived from the ability of a corporation to access a lower tax rate. If the work can be considered to involve the carrying on of an active business, the corporation would be eligible for the small business deduction that reduces the income tax rate on the first $225,000 of income in 2003. The result is a deferral of tax on the income that can be retained in the corporation.

The danger of incorporating this type of activity is that the corporation could be considered to be carrying on a personal services business. As such, the income, unless it is earned from an associated corporation, will be taxed in the corporation at the top corporate rate, resulting in no tax deferral and, in fact, a tax cost. Also, the corporation is restricted in its deductions from income to those expenditures that would be deductible by an employee. Thus, there is no advantage to incurring the potentially high costs involved in incorporating a personal services business.

An individual who performs services is considered to be an "incorporated employee", if the individual is a significant shareholder or is related to such a shareholder. The corporation is considered to be carrying on a personal services business, if, in the absence of the corporation, it would be reasonable to regard the incorporated employee as an employee of the business to which the services are provided. The fact of incorporation does not, by itself, establish the needed independent contractor status, which is critical to avoiding the personal services business trap. The court-determined tests used to distinguish between an employee and an independent contractor are used to make the determination of the existence of an incorporated employee, based on the facts. Therefore, factors such as the degree of control over the activities of the individual, the ownership of tools by the individual etc., become important. (Please refer to the spring edition of Tax Alert for a detailed discussion of these factors.)

Where the incorporated employee was formerly an employee of the business to which services are now being provided and those services are much the same as were being provided previously, the argument for independent contractor status becomes more difficult. Providing services to more than one client would help.

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Employee Profit Sharing Plans

A useful incentive in your business?

An employees profit sharing plan (EPSP) involves a non-registered arrangement under which payments are computed by contractual formula based on an employer's business profits and made to a trustee for the benefit of employee beneficiaries of the plan. Employer contributions to the plan, without an upper limit, are deductible. Thus, there is no difference to the employer between such a contribution of profits and a salary or bonus, unlike a non-deductible dividend for a corporation. There are no significant restrictions on the investment of the funds contributed, so reinvestment in the employer's business is possible.

All amounts contributed by the employer and the investment income from those contributions must be allocated to the employee beneficiaries annually. The employees must pay income tax on these allocations, even if their future availability is contingent. While the tax, computed at the individual employee's marginal rate, is prepaid for a future payment, the benefit to the employee is a forced saving that is pooled with the savings of other employees. Since all of the funds in the trust are tax-paid by the employees, the trust is not taxable. *Would an EPSP make sense in your business plan?*

Canada-United Kingdom Income Tax Convention Amendments

A third protocol to the Canada-UK Income Tax Convention was signed May 7, 2003 and will be effective at various future dates once ratified by each of the Canadian and UK governments. The amendments reflect recent trends in Canadian treaty policy.

1) The dividend withholding rate was reduced from 10% to 5% for a shareholder with at least 10% voting control. Branch profits tax was consequently reduced to 5% for UK companies with branch operations in Canada.
2) The capital gains article was amended to prevent double taxation when a Canadian resident individual moves to the UK. For certain properties held at the time of emigration, only gains accruing after emigration can be taxed by the UK
3) The royalties article was amended to exempt from withholding tax payments for the use of computer software, patents and certain know-how payments.
4) Anti-treaty shopping provisions added to the dividends, interest and royalties articles disallow a withholding rate reduction if a main purpose of the payment rights were to take advantage of the reduction.
5) The associated enterprises article now requires a state to provide the other state with notice of a transfer pricing adjustment within 6 years from the end of the taxation year of the adjustment.
6) An "Other Income" article has been added. Income not dealt with in other articles is taxable in the beneficial owner's state of residence unless it arises in or is effectively connected with a permanent establishment or fixed base in the other state.

Stay tuned for the upcoming protocol amending the Canada-US Income Tax Convention.

Non-Competition Payments

The Federal Court of Appeal ruled in the recent Manrell case (2003 DTC 5225) that non-competition payments made to a taxpayer selling his shares of three operating companies were tax-free receipts. The decision was based on the assertion that a non-compete payment does not result in a disposition of "property" subject to capital gains treatment. Taxpayers contemplating the sale of a business should consider the Manrell decision in planning the sale agreement. This may be another reason for a vendor to prefer a share over an asset sale where the agreement involves a non-compete clause.

Cross Border Transactions

Part 2 - Intercompany Loans / Balances

This article is the second in a series highlighting the Canadian tax implications of transactions between Canadian corporations and non-residents.

Any transaction between a Canadian resident corporation and a non-resident that results in a receivable balance owing to the Canadian corporation has potential tax consequences. If the receivable balance is outstanding for more than a year and interest is not accrued at a reasonable rate, an imputed interest benefit is included in the Canadian corporation's taxable income. An exception applies if the borrower is a controlled foreign affiliate of the Canadian corporation and certain conditions are met. If the non-resident borrower is a shareholder or a person related to a shareholder of the Canadian corporation, the corporation could also be deemed to pay a dividend to the non-resident equal to interest on the balance computed at the prescribed rate. The dividend would be subject to withholding tax.

Indirect loans made by Canadian resident corporations to a non-resident can also have negative tax consequences. If funds from a Canadian company result in a balance owing between non-residents, an anti-avoidance rule can deem an amount to be owing to the Canadian corporation. This could again result in an imputed interest inclusion on the Canadian company's tax return. Companies must be diligent in tracking the offshore use of funds loaned to, transferred to or invested in a non-resident person to protect against this anti-avoidance provision.

Finally, if a balance owing to a Canadian resident corporation from a non-resident who is a shareholder or person related to a shareholder has been outstanding for a year or more since the end of the creditor's taxation year in which the balance arose, the entire receivable balance can be deemed to be a dividend paid to the non-resident. The Canadian corporation becomes liable for a withholding tax calculated on the full amount of the debt. In such a case, the interest benefit provisions noted above will not apply unless the balance is repaid and a refund of the withholding tax is obtained.

Cross-border balances and transfers must be properly structured. Otherwise, the above rules designed to prevent the erosion of Canada's tax base can apply. Don't be caught off-guard!

When Does Estate Planning End?

At what point should you feel comfortable that you have done enough estate planning? When you have a will? When you buy some life insurance? When you have done an estate freeze? In many ways it depends on your objective. Here are five to consider:

- Provide enough income and capital for your family to live comfortably;
- Make sure your business survives and prospers after you are gone;
- Make sure someone is ready to take over the business;
- Make sure the surviving family members do not fight over the estate; and
- Minimize tax.

At different stages of your life some of these objectives will be more important than others. If minimizing tax is most important to you now, then you will likely use a different set of tools to accomplish this goal than if you want to make sure your business survives and prospers after you are gone.

Take Paul and Betty for example. They want to make sure that their estate pays as little tax as possible, so they have set up an estate freeze to ensure that future growth will be taxed when their children dispose of their growing assets such as common shares, presumably, long after Paul and Betty are gone. As part of that freeze they also used up their capital gains exemption. They have just finished signing a pile of documents - their wills, powers of attorney, and legal agreements to freeze the value of their common shares. Yesterday, they met with their insurance agent to purchase a corporate owned life insurance policy. While they have done more than most they still aren't comfortable that they have made sure that their estates will pay as little tax as possible.

One way to test the plan to see if their tax minimization objective is met is to pretend that Paul and Betty have just died. First, they should consider the income tax and probate fees that will be paid on their deaths. Then, they need to calculate the tax on the estate and on the beneficiaries as they deal with the assets that they will receive from Paul and Betty. In particular, if the beneficiaries redeem inherited freeze shares, they may find that not only did they pay tax on the accrued capital gain on death, but they will also have to pay tax on the same amount as a dividend. If they cannot use a resulting capital loss on the redemption, then tax will have been paid on the same gain twice. Clearly not a good result. Depending on the province of residence, the tax paid by both the deceased and the next generation may range from no tax, to 23% if taxed as a capital gain, to 31% if taxed as a dividend, to 54% if there is double taxation. The range is staggering.

Minimizing tax on the estate and the beneficiaries is often referred to as post-mortem planning. Tools such as "roll and redeem", the "loss carry back", the "pipeline" and the "bump" can be very effective to minimize the ultimate tax on all parties. But don't be fooled. The phrase "post-mortem planning" is a misnomer. Planning is needed while Paul and Betty are still alive in order to maximize the flexibility to the estate and beneficiaries and to avoid the many pitfalls that may prevent the tax minimization objective from being accomplished.

Make sure your tax plan doesn't stop with you. Tax minimization can also be accomplished for your estate and your children.

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Contact Information:

Internet: www.collinsbarrow.com

Email: info@collinsbarrow.com

Careers: recruiting@collinsbarrow.com

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