

TAX FLASH

Personal Services Business Proposed Income Tax Legislation

Cary Heller, CA, is a Tax Partner in the Toronto office of Collins Barrow.

On Monday, October 31, 2011, the Minister of Finance released draft legislation to amend the *Income Tax Act (Canada)* (the "Act") which, if enacted, will significantly alter the tax treatment of a corporation which is considered to be carrying on a "personal services business" ("PSB").

Under the proposed legislation, a corporation's PSB income is excluded from the corporation's taxable income that is eligible for the "general rate reduction percentage" under subsection 123.4(2) of the Act. This is achieved by amending the definition of "full rate taxable income" in subsection 123.4(1) of the Act to exclude from the definition "the corporation's income for the year from a PSB."

As a result of these proposed changes, PSB income will now be subject to federal corporate tax at the full unreduced rate, being 28% (assuming the availability of the 10% "provincial abatement"). Essentially, the proposals will increase the tax rate on income from a PSB by 13% for taxation years beginning after October 31, 2011.

A PSB is defined in subsection 125(7) of the Act and applies where a corporation is used as a substitute for what would normally be considered an "employer-employee relationship." The definition provides that a corporation is carrying on a PSB where an individual (referred to as an "incorporated employee") who provides services on behalf of the corporation, or any person related to the incorporated employee, is a "specified shareholder" (i.e. together with non-arm's length persons owns not less than 10% of any class of shares of the corporation's capital stock) and the incorporated employee would "reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation," subject to certain limited exceptions.

Until now, PSB income has been carved out from the definition of "active business carried on by a corporation," so that such a corporation would not be entitled to the small business income tax rates. As a result, PSB income earned is subject to the top corporate tax rates. For many years, these rules were sufficient to discourage the use of PSB corporations, given the otherwise high corporate tax rates and lack of integration on dividends paid by such entities.

However, given the significant reductions in corporate income tax rates both at the Federal and provincial levels over the last several years, coupled with the introduction of a two tier dividend tax regime (one for high rate income and one for income earned at small business rates), the effect of these rules has been largely marginalized. In fact, given the relatively low rates of corporate tax compared to personal tax, such vehicles were seen as good tax deferral opportunities where an individual otherwise had no personal need for funds. Alternatively, they were useful vehicles within which to income split with other shareholders who could receive dividends and pay little or no tax due to personal income tax circumstances.

With the introduction of the October 31, 2011 proposed changes to the rules in the Act, this planning opportunity has effectively been eliminated. Accordingly, taxpayers who are earning PSB income through a corporation should review their situation with their Collins Barrow tax advisor. §

Collins Barrow periodically publishes a *Tax Flash* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While *Tax Flash* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

www.collinsbarrow.com
info@collinsbarrow.com