

Tax Alert

Personal Services Business

Increase in Taxes for Income Earned by a Personal Services Business

On October 31, 2011, the Department of Finance released draft legislation which included proposed changes to the taxation of income from a personal services business.

The proposed changes provide that the general rate reduction percentage will no longer apply to the portion of taxable income of a corporation earned in the year from a personal services business. The proposed changes will apply to taxation years that begin after October 31, 2011. The Alberta corporate tax rate is not affected by these changes and remains at 10%.

The federal general rate reduction percentage for 2011 is 11.5% and for 2012 it will be 13%. This means that under the old rules a corporation which had a December 31, 2012 taxation year end and earned personal services business income would have been subject to a combined Federal / Alberta tax rate of 25%. Under the new rules the combined Federal / Alberta tax rate will now be 38%.

Income earned from a personal services business multiplied by the appropriate “general rate factor” will continue to be added to the general rate income pool (“GRIP”) balance of the corporation. The “general rate factor” for 2011 is 0.70 and for 2012 it will be 0.72.

Under the new rules, it will no longer be advantageous to defer income tax otherwise payable by retaining personal services business income in a corporation. Personal services business income for a particular year should be paid out as a salary to the incorporated employee by the end of the corporation’s taxation year.

Background with respect to personal services business

The rules with respect to income earned from a personal services business are in place to prevent individuals from attempting to convert what would otherwise be employment income into business income earned by a corporation.

“Personal services business” is a defined term in the Income Tax Act. Basically a personal services business carried on by a corporation in a taxation year means a business of providing services where an individual who performs services on behalf of the corporation (referred to as an “incorporated employee”), or any person related to the incorporated employee, is a specified shareholder of the corporation and the incorporated employee would reasonably be regarded as an officer or employee of the person or entity to whom or to which the services were provided, were it not for the existence of the corporation.

“Specified shareholder” is also a defined term in the Income Tax Act. Essentially a specified shareholder of a corporation in a taxation year means a taxpayer who owns, directly or indirectly, at any time in the year, not less than 10% of the issued shares of any class of the capital stock of the corporation or of any other corporation that is related to the corporation. For purposes of the definition of specified shareholder, a taxpayer will be deemed to own each share of a corporation owned by a person with whom the taxpayer does not deal at arm’s length, which includes a spouse of the taxpayer. Also, if a partnership or trust owns shares of a corporation, there are rules in place which could deem a partner or beneficiary to own those shares.

The personal services business rules do not apply when a corporation employs in the business throughout the year more than five full-time employees nor do the rules apply to income received from an associated corporation.

When the personal services business rules do apply only certain types of expense are allowed to be deducted by the corporation. The only expenses that are allowed to be deducted by the corporation are:

- 1) Salary, wages or other remuneration paid in the year to an incorporated employee of the corporation,
- 2) The cost to the corporation of any benefit or allowance provided to an incorporated employee in the year,
- 3) Any amount expended by the corporation in connection with the selling of property or the negotiating of contracts by the corporation if the amount would have been deductible in computing the income of an incorporated employee for a taxation year from an office or employment if the amount had been expended by the incorporated employee under a contract of employment that required the employee to pay the amount, and
- 4) Any amount paid by the corporation in the year as or on account of legal expenses incurred by it in collecting amounts owing to it on account of services rendered.

Kenway Mack Slusarchuk Stewart LLP
CHARTERED ACCOUNTANTS

220, 333 – 11 Avenue SW
Calgary, AB T2R 1L9
403-233-7750
403-266-5267 (fax)

3, 714 10 Street
Canmore, AB T1W 2A6
403-675-1010
403-675-6789 (fax)

www.kmss.ca