

# THE Quarterly Dividend

Vol. 21 No. 2 Your guide to income tax & financial planning

## FAST TRACK



### Independent and Not So Independent Contractors

From time to time an individual who has been working as an employee for a company wishes to change his status to that of an “independent contractor”. If he is not careful he risks not satisfying the many criteria that must be met by the Canada Revenue Agency (CRA) before he is to be successful.

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## Living Common-Law

Among the first pieces of information requested of Canadians when they fill out their Income Tax and Benefit returns each spring is the taxpayer’s marital status as of December 31 of the previous year. A choice of six options is presented: Married, Living Common-law, Widowed, Divorced, Separated and Single, with most definitions in the Income Tax Act closely paralleling our understanding of these terms in everyday life.

You might think that this would be the easiest item to complete and, in fact, most Canadians do identify themselves correctly. The only taxpayers who consistently err are those who identify themselves as “single” when they should be classifying themselves as “divorced” and those who are in a common-law relationship but choose to identify themselves as “single” on the income tax form. The reason for the former is perhaps to deny one aspect of their personal history. The reason for the latter is probably due to “wishful thinking” (either way) on the part of the taxpayer.

The definition of “living common-law” has been the subject of much debate going back to as early as 1993. In some cases, this is to the advantage of the taxpayer who wishes to take the definition and apply it liberally to his circumstances. In other situations, the Canada Revenue Agency may desire a stricter interpretation/application of the definition to the consternation of the taxpayer.

The Income Tax Act defines a “common-law” partner to mean a person who co-habits in a conjugal relationship with another

person, has done so throughout a period of at least one year, or is the natural or adoptive parent of his/her child. Finally, once the cohabitation relationship achieves the “status” of a common-law marriage, it is presumed to continue until there is a marital breakdown marked by a separation of at least ninety days. The date of the breakdown may not be at the beginning of the ninety days, but the separation itself must continue for at least that period of time.

Because the classification of marital status is so important, each party in the common-law relationship must declare himself/herself to be living common-law. From time to time, questions arise as to what exactly constitutes a “conjugal relationship”, but for the most part, the individuals themselves know when they are involved in such a situation. When you live together as a couple with a child in common, it will be virtually impossible to avoid the presumption of marriage for income tax purposes. And in the same vein, in cases where separate households are maintained and there are no children, the Canada Revenue Agency will be hard pressed to establish a case of common-law unless there has been a prior co-habitation to establish the relationship.

Former Prime Minister Pierre Elliot Trudeau once declared that the “state has no place in the bedrooms of our nation”. From the above application of the law, it is clear that he never worked a day at the Canada Revenue Agency.



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## Should You Own Investments Personally or Through a Corporation?

**The scenario:** typically an employee works for a company for a period of time and after awhile looks at his take home pay and wonders to himself if there is a way by which he can do the same job and put in the same hours but somehow come home with more cash at the end of the day.

He then suggests to his employer that he no longer be paid as a salaried employee, where the employer withholds Canada Pension Plan contributions, Employment Insurance premiums and income tax deductions from his paycheque, but be paid as a "sub-contractor" all the while doing the same job as he has been doing all along.

**Perceived advantages – taxpayer:** the thinking is that because he is now "self-employed", he will receive his weekly pay without any deductions and will now be entitled to claim certain expenses (typically auto, telephone, promotion and home office "rent") from these earnings on his income tax return.

**Perceived advantages – employer:** the employer often goes along. He sees savings by not having to remit "employer portions" of the Canada Pension Plan contributions and Employment Insurance premiums in regard to the individual. He may also

from dividends as opposed to capital gains, etc. but also how the portfolio as a whole will be taxed. This is because dividends are taxed differently than capital gains, for example, while interest and rent are taxed in an identical fashion. The most important point of the analysis, however, is that the row entitled "difference" tells us some other very valuable information.

A Canadian taxpayer has two options when it comes to how he may choose to hold his investment portfolio and he should be indifferent as to which one he selects. After all, the investments within the portfolio will be exactly the same, no matter which way he goes. So the only decision that remains is how to make the taxation of these investments as "income tax effective" as possible.

He has two options: (1) he can hold the investments in a corporation, or (2) he can hold the investments personally.

The accompanying analysis presents a sample portfolio that generates annual investment returns of \$48000. It shows several things worth noting: (a) the portfolio consists of four different investment vehicles and each of the four scenarios reflects a different mix; (b) the row entitled "corporation income tax" reflects the corporate income taxes that would be due if the taxpayer chose to hold all his investments in a corporation: (c) the row entitled "personal income tax" reflects the personal income taxes that the taxpayer would be required to pay on the investment income if they were entirely in his name; and (d) the row entitled "difference" reflects how much more the taxpayer would have to pay by holding the investments in a corporation as opposed to personally.

You will notice that in each case holding the investments personally is significantly more advantageous than holding them in a corporation, and the investment mix not only determines how much of the annual income will be generated

from dividends as opposed to capital gains, etc. but also how the portfolio as a whole will be taxed. This is because dividends are taxed differently than capital gains, for example, while interest and rent are taxed in an identical fashion.

The most important point of the analysis, however, is that the row entitled "difference" tells us some other very valuable information.

In most cases, the taxpayer is unlikely to have annual earnings that stem exclusively from his investment portfolio. He will probably have income from other sources as well.

To the extent that the taxes owing on these other sources of income equal or exceed the amount indicated in the "difference" row, the taxpayer will benefit by holding his investments in a corporation rather than personally. Thus if a taxpayer holds an investment portfolio as outlined in column (1) and receives any other type of income of \$7000 or more, he would be better off holding the investments in a corporation as opposed to personally because the tax on the \$7,000 plus income will exceed the \$2149 in "Difference" outlined in row (d).

In addition, if the investments are held in a corporation that employs more than five full-time employees and otherwise qualifies as a Canadian-controlled private corporation, the corporation is referred to as a "specified investment business" rather than as an investment company. This means that its earnings qualify for the "small business deduction" and are taxed at an even more favourable rate than the one outlined in this article.

### Summary of Investment Income

		Different Scenarios			
		(1)	(2)	(3)	(4)
		\$	\$	\$	\$
	Investment income				
(a)	Interest	5000	4000	8000	12000
	Dividends	20000	10000	20000	12000
	Capital gains	20000	30000	15000	12000
	Rental income	3000	4000	5000	12000
		<u>48000</u>	<u>48000</u>	<u>48000</u>	<u>48000</u>
(b)	Corporation income tax	3600	4600	4100	6000
(c)	Personal income tax	1451	2420	2235	4260
(d)	Difference	<b>2149</b>	2180	1865	1740

**Note:** Income earned from royalties is also considered investment income.



save money regarding contributions to the Workers' Safety Insurance Board, the payment of statutory holiday pay, vacation pay and severance pay that are only offered to employees.

And so the two parties agree to arrange their affairs in this manner.

Minimum requirements to be satisfied: although this may make sense to the parties themselves, the Canada Revenue Agency may consider this arrangement to be a form of "disguised employment". The "sub-contractor" must be able to demonstrate that he has the freedom to accept or reject individual work assignments offered by his former "boss", he supplies the required tools of the trade that are necessary to complete the allotted job and, most important of all, he has at least one other customer/client for whom he offers his services.

Other considerations include registration with the "authorities" either as a sole proprietor, a member of a partnership or as a shareholder in a corporation (see below), registration with the government for purposes of the Harmonized Sales Tax, the preparation and submission of bona vide invoices for work performed, the maintenance of a separate business bank account and for all intents and purposes the "look" and

## The Loneliest Man in Town – Part II



The Loneliest Man in Town

Last year, we anointed the owner-manager of a small business the title of the Loneliest Man in Town for his inability to delegate work among his employees and his obsession on being in control of every facet of his company. While recognizing that he is ultimately responsible for the success or failure of the enterprise, there comes a time to "let go" and delegate certain day-to-day activities to employees and give them the space to show some creativity on their own on behalf of the organization. Thus freed from the minutiae of every day goings-on he can spend time on strategic decision making that will give the company itself an opportunity to grow.

This year the owner-manager of a small business is again awarded this dubious distinction, but this time for a completely different reason. While last year's award was perhaps due to a conscious decision by the entrepreneur to structure his company in such a way as to isolate himself, he attains this year's award mostly due to circumstances very much beyond his control.

We start by recognizing that every job has its good points and its "not so good" points. There are certain activities that you look forward to doing when you arrive at your place of work because among other things you do them well and you have come to enjoy them and there are others that you dread doing and "put off" as long as you can until you are virtually forced to do them. These are tedious at best and downright unrewarding at their worst.

But, as long as you work with others who are generally "in the same boat" as you, you have someone to talk to when things go well and

someone who will console you when things get tough. You have someone to share your "ups and downs" and you in turn are there to help him/her when he/she experiences similar situations.

Let's say for example, Jack and Joe work in the same office at jobs that are somewhat complementary. If Jack lands a big contract on behalf of the company, who does he have to "brag" about his good fortune and hard work? He could "celebrate" the accomplishment with his boss...but where is the fun in that? He will probably just offer a cursory "congratulations" and then tell Jack to go out and do it again with some other prospect.

He could go home and tell his wife, but although she will be pleased for him and perhaps even genuinely excited, it is unlikely that she will understand all that he went through in achieving what he did. She did not go to work with him every day and did not go through the roller coaster ride of one day looking like the deal was all but consummated and the next day thinking that it had slipped through his fingers never again to see the light of day.

No, the person who best understands Jack in this situation is his co-worker Joe and it is with him that he can sit back and "gloat"...even if for a short time. He was there every step of the way...maybe even offering some words of advice along with his unspoken encouragement. He is there now when things worked out well...and would have been there should things have worked out differently. Just as Jack would have been there for him, if luck had played it out differently and the shoe had been on the other foot.

Unfortunately this scenario does not apply to the owner-manager of a business. When he duplicates Jack's accomplishment and lands a new contract for his company, he has virtually no one with whom to share his excitement and good fortune.

His wife will probably be very much like Jack's wife and listen politely to what he has done but will not really recognize all that went into its fulfillment.

And, of course, he will not feel comfortable sharing his achievements with his employees. They work for him and as such were just not privy to all the behind the scenes manoeuvring



“trappings” of an independent business.

**Potential problems:** if he cannot show at least these minimal characteristics of a business, the Canada Revenue Agency may disallow the entire arrangement and require the former employer-employee relationship to be restored. They will go back to the employer and demand payment of the withholdings (plus interest) that had previously been “saved”.

If the taxpayer had set up a corporation to facilitate this exercise in the hope of being able to claim the “small business deduction” the CRA has the authority to deem the corporation to be a “personal services business”. They will deny him the small business deduction and business income will be taxed at full corporate rates. They allow only limited expenses – typically only the salary and benefits of the individual performing the services.

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that was necessary to land the deal. Although they too will be pleased for him, it would be unseemly to “boast” about what he has done in front of them.

So, once again, the owner-manager of a small business becomes the Loneliest Man in Town...albeit not from his own choosing.

Can this situation ever be corrected? Is there any way that Mr. Owner-Manager can find someone who even remotely understands what

he goes through every day....the highs when a new customer comes on board and the lows when an established client decides to go somewhere else. The answer is yes. But only if he joins a “group” made up of entrepreneurs just like himself. If he is lucky he will find similar minded business persons who can relate to what he goes through on a daily basis. If he is not so lucky, he is destined to remain the Loneliest Man in Town.



## The Art of Getting Your Point Across

For as long as anyone can remember teachers have stressed the importance of written communication to their students. Although “good writing skills” cannot be taught per se, educators can teach students to develop their thoughts in a logical and concise manner for ultimate transmission through the computer or on paper. The ability to get one’s thoughts across is a talent worth nurturing no matter whether most of your “correspondence” is business related on simply sending a text message to your friends.

But while the written word has garnered so much attention, the spoken word has been shown relatively less respect. Just as teachers cannot teach “good oral skills” per se, parents and educators owe it their children to foster in them the ability to present their thoughts clearly and succinctly through oral communication.

I am not referring to the “debating” that undoubtedly anyone living in a household with teenagers knows full well. I am rather referring to the importance of being able to express yourself, often at the spur of the moment and when you least expect it. It could happen at the store when you are speaking to the customer service representative in an attempt to have them adjust your bill for an inaccuracy, or at work or anywhere else where a colleague or friend expresses a viewpoint that you cannot just let go by without comment.

In these and so many other situations, here are a few points to remember: (a) exercise self-control. No matter what the other

person may have said to arouse you, keep your “cool” at all times. The presentation of the argument is just as important as its content. No one will pay attention to another who has raised his voice and displayed inappropriate gestures that have no place in the conversation; (b) isolate one or two points from whatever the other person has been saying and refute their validity based upon facts as you see them. Never allow the discussion to become “personal”. Always display genuine tolerance and respect; (c) present your “case” in a focused and disciplined manner. Do not be impulsive. Never show your frustration no matter how the other person has reacted to what you have said; and (d) slow down and think. The fast “come back” is only appropriate on television “sit-coms”. Take whatever time you need to listen carefully and respond confidently and persuasively.



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