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TAX LETTER

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**EMPLOYEE OR INDEPENDENT CONTRACTOR?
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EMPLOYEE OR INDEPENDENT CONTRACTOR?

If you “do work” for a company, are you an employee or an independent contractor? And why does it matter?

For tax purposes, it matters a lot. Generally, being an independent contractor is much preferable from a tax point of view, though there are some drawbacks.

If your relationship to the company is that of **independent contractor** (i.e., you are carrying on your own business and providing services to the company), then:

- You can deduct for tax purposes all legitimate **business expenses**, except those that are specifically prohibited by the *Income Tax Act*. Essentially, the way you calculate income is no different than

General Motors or Apple: total revenues minus the expenses of doing business.

- You will not have tax withheld at source. Instead, in the year that you start your business, you can normally keep all the funds you collect until you have to pay your income tax to the Canada Revenue Agency, next April 30. (However, by September 15 of the second year of doing this, you will normally have to start paying quarterly instalments.)
- You are more likely able to deduct the costs of a “home office”, which will be considered your principal place of business.
- Your income tax return filing deadline will be June 15 instead of April 30. (However, any balance you owe must still be paid by April 30, or interest will run on the balance.)

- You will not be required to pay Employment Insurance premiums. (The downside is that you will not be eligible for EI if you stop working.) However, you will be required to pay double Canada Pension Plan (CPP) contributions, which are collected on your tax return. For 2013, assuming your earnings are over \$47,400, you'll save \$891 in EI premiums but will pay \$2,306 extra CPP contributions. (In Quebec, you pay Quebec Pension Plan (QPP) instead of CPP.)
- Your income for tax purposes will include amounts that you have invoiced, even if you have not yet received payment, and may also include "work in progress".

On the other hand, if you are an **employee** of the company, then:

- You will normally have income tax, CPP (or QPP) contributions and Employment Insurance premiums withheld at source by your employer. If too much tax is withheld, you will receive a refund after you file your tax return in the spring.
- You can only deduct for tax purposes the expenses that are specifically allowed by the *Income Tax Act*. Very few expenses are allowed to employees (certain work-related travel expenses, for example). However, you can claim the Canada Employment Credit on your tax return; this credit, which is worth \$168 in 2013, is available only to employees.
- You generally cannot deduct expenses of a home office, unless the company requires you to have such an office and you spend *most* of your work time at home rather than at the company.

- Your income tax return filing deadline will be April 30 (unless you have a spouse or common-law partner who is self-employed). If you miss the deadline, a penalty of 5% (escalating by 1% per month to 17% for 12 months) automatically applies to any unpaid balance of tax.
- You must pay tax on all employment income you receive in the calendar year, but not on amounts that you have earned (worked) but not yet been paid for.
- You are usually eligible for Employment Insurance, and required to pay EI premiums.
- You do not charge or collect GST or HST on your income.
- You are subject to tax on most employment benefits. As an independent contractor you generally will not receive such benefits.

Not surprisingly, the CRA will often take the position that you are really an employee. This is especially likely if there is only a single company paying you income (i.e., you only have one "client"). However, you may be still able to show that you are not an employee.

There is no clear or definitive test to apply. The Courts have come up with a number of guidelines, but each case depends on its facts.

The following criteria are important:

- Do you receive typical **employee benefits**, such as sick leave, termination pay, a pension plan, group health plan coverage, life insurance and/or stock options? If so, you are more likely to be considered an employee.

- Who **controls** your work environment, what you do and when you do it? Are you required to be at a particular office from 9-5 each business day, or are you paid more for getting a task done than for putting in time? If the former, you are more likely an employee.
- **Whose equipment** or tools do you use? Do you provide your own? If not, you are more likely an employee.
- Are you an **integral part** of the company, or do you provide a separate service that can be easily dissociated from the company's core operations? For example, if you manage a plant, you are more likely to be considered an employee than if you provide occasional safety training to employees.
- Do you personally have any **chance of profit** or bear **risk of loss**, or will you simply be compensated for your time? For example, if you make a mistake in your work, are you required to fix it on your own time? If you are simply paid for your time regardless of the results, you are more likely an employee.
- If you have a **contract** stating that you are an independent contractor, the Courts are more likely to accept that, provided the other criteria do not point strongly in favour of an employment relationship.

Remember, if you are an independent contractor and your total billings exceed \$30,000 per year, don't forget to **register for and invoice the GST or HST**. (See the next article regarding GST and HST rates.) The company generally will not care about this; most businesses recover all the GST they pay out by claiming input tax credits, so the

GST you add to your invoices will not cost the company anything unless it is in the business of making "exempt" supplies (such as financial services, residential rent or certain health care services).

SALES TAXES — GST, HST, PST OR QST?

There are a number of changes in Canadian sales tax rates this year.

The **GST (Goods and Services Tax)** applies at **5%** throughout Canada. However, in the provinces that have "harmonized" with the GST, the **HST (Harmonized Sales Tax)** applies instead, at a higher rate (13% to 15%). The HST is just the GST at a higher rate, with a few exceptions. The HST is administered by the Canada Revenue Agency, even though 8-10 percentage points of the revenue are ultimately destined for the province.

In **British Columbia**, the 12% HST is being dropped on April 1, 2013, and the province will revert to having the 5% GST plus a 7% provincial sales tax (PST). For most purchases the combined taxes will still be 12%. Some goods and services will not have PST, so the tax will go down from 12% to 5%.

In **Alberta and the territories**, there is only the GST at 5%. In **Saskatchewan and Manitoba**, there is 5% GST plus a PST administered by the province (5% in Saskatchewan, 7% in Manitoba).

In **Ontario, New Brunswick, and Newfoundland & Labrador**, the HST applies at 13%.

In **Quebec**, there is the Quebec Sales Tax (QST) which uses the same rules as the GST but is not harmonized as part of the HST,

and is a separate tax. Revenu Québec administers both the QST and the GST in Quebec. The QST rate technically changed from 9.5% to 9.975% on January 1, 2013, but this was not a real change, because it also changed from applying to GST-included prices to pre-GST prices. Thus, for example, on a \$1,000 purchase, the tax used to be 9.5% of \$1,050, or \$99.75; and at 9.975% it is still \$99.75.

In **Nova Scotia**, the HST applies at 15%. However, it will be reduced on July 1, 2014 to 14%, and on July 1, 2015 to 13%. (These reductions were announced some time ago but the dates they will take effect were announced only recently, in January 2013.)

In **Prince Edward Island**, the HST is being adopted on April 1, 2013, at a combined 14% rate. It replaces the 5% GST and a 10% PST (actually 10.5% since it is imposed on GST-included prices).

Note that **if you are selling goods or services to customers in another province**, you must in most cases use the customer's province to determine what rate of tax to charge. For example, if you are in Calgary but you provide consulting services to a customer in Vancouver, you should generally charge 12% HST through March 2013 but only 5% GST starting April 2013. However, the "place of supply" rules that determine which province's rate applies are very complex, and you may want to obtain professional advice to determine which rate applies. If you have no base in a particular province, you normally do not need to charge that province's PST or QST (but you *do* need to charge HST if it is an HST province).

STARTING A HOME BUSINESS —

POINTS TO PONDER

Are you considering starting a home business? Here are some planning issues, tax ideas and tips to keep in mind.

Incorporation

Many people are not clear on the difference between a business and a corporation, but the difference is extremely important, for both tax purposes and liability purposes.

You can carry on business without creating a corporation. Although you may give your business a name, without a corporation it is simply you carrying on business. You are a "sole proprietor".

If you create a corporation, it will have "Limited", "Inc." or "Corporation" as part of its name. The corporation is a **legally separate person** from you, and the corporation, not you, carries on the business. Although you control the corporation, the business is legally not "your" business. This means that you are not liable for the corporation's debts. (However, if the corporation needs to borrow money from a bank, the bank will insist on a personal guarantee from you, so you will be liable if the corporation cannot repay the bank loan. Also, as a director, you are liable for certain obligations of the corporation, such as an assessment of GST/HST or employee source deductions that the corporation fails to remit.)

If you create a corporation, then the corporation will have to file annual tax returns and pay tax on its profits. **You should not simply take the corporation's money for yourself.** When you want to extract profits from the corporation you should either have the corporation pay you salary (which the

corporation can deduct and is taxable to you), or have it pay you dividends (which are not deductible to the corporation but are taxed to you at a lower rate, due to the dividend tax credit). These steps require certain paperwork and it is important to document properly what you are doing; otherwise the tax consequences can be serious if you or the corporation are audited. The corporation can also repay any money you have loaned to it, with no tax consequences.

Sole Proprietorship

In many cases, a home business is simply carried on as a sole proprietorship. There are no legal requirements for doing this; you are not required to have a separate business name, though you may wish to create one in order to appear more professional to your customers. (If your business will be visible, such as with customers regularly visiting you, then you should check whether you may run afoul of local zoning bylaws, or condominium or apartment rules if you live in a building.)

GST or HST

If your total sales exceed \$30,000 per year, you must register for and collect the GST and HST (see the previous article). Until your sales top the \$30,000 mark over four consecutive calendar quarters, you do not have to register or charge GST/HST.

Even if you are under \$30,000 in sales, if your sales are to businesses rather than consumers, you may wish to register for the GST. You will need to collect GST/HST from your customers, but they generally will not care since most businesses get back all GST or HST they pay. You in turn will be able to recover all GST/HST that you pay on

your business expenses. (You may also be able to profit from the Quick Method of filing, which can allow you to make a little money out of the GST if you have few GST-bearing expenses.)

You may need to register for and collect provincial sales tax as well, depending on the nature of the goods and services you provide (see the previous article).

Reporting Your Income

When you are carrying on a sole proprietorship, any income earned by the business is reported on your tax return under “Business income” (or Professional, Farming or Fishing income if you are engaged in one of those kinds of businesses).

The tax return requires you to show both gross revenues (total sales) and business income (after expenses). You will also need to file an income statement showing the details of your revenues and expenses (broken down by category — e.g. Advertising expenses, Office supplies, Meals & entertainment, Telephone, etc.). This can be done on Form T2125, but is not required to be.

Your net business income is simply combined with your other sources of income on your return, like employment income and investment income, to reach “total income”.

Deducting Business Expenses

When calculating your (net) business income, you can deduct the expenses of carrying on business. Here are some things to make sure you do not miss:

Office supplies. This would include computer paper, printer toner cartridges, USB sticks,

pens and similar items that you buy for use in the business. It may also include publications such as business magazines and journals. Keep your receipts! If you buy supplies for a combination of personal and business use, estimate the business proportion.

Telephone. If you have a separate business line, the cost is fully deductible. If you are using a personal line partly for business purposes, it probably falls within the “Home office expenses” category below. And don’t forget to deduct your monthly Internet connection service fees, and cell phone costs if you use your cell phone for your business (make sure to pro-rate based on business use versus total use).

Equipment. For long-lasting “capital” items like computers and furniture, you cannot deduct the expense directly. Rather, you can claim depreciation, called “capital cost allowance” (CCA), applied to a declining balance over many years. The CCA rate depends on the kind of equipment; for example, it is 55% for computers and 20% for furniture. You combine all assets of the same “class” into one pool and claim CCA on the pool. For the year in which you acquire an asset, only 1/2 of the normal rate of CCA can be claimed for that asset. After that you claim the regular rate based on the balance left in the pool after the previous year’s claim.

Automobile expenses. You will need to track your business use of your car as opposed to your personal use. It is advisable to keep a daily logbook recording business use, and note the odometer reading at beginning and end of the year. You can then figure out your business use proportion, and deduct that percentage of your gas, insurance, licence, car-washes, maintenance

and repair costs. You can also deduct that percentage of capital cost allowance (which is 30% per year for cars; ½ of that in year of acquisition). However, there is a dollar limit on a car’s cost that can be used as your base for claiming CCA. The limit is reviewed each year; for cars purchased in 2001 through 2013 it has remained at \$30,000 (plus sales taxes).

Meals and entertainment. You can claim restaurant meals and tickets to sports events, shows, etc. where the expense was required for your business — e.g. you take a prospective client to dinner or a hockey game. However, you can only claim 50% of the cost as a business expense (long-haul truck drivers can claim 80% of meals).

Home office expenses

Home office expenses are deductible only if you fall into one of these two categories:

- Your home is your principal place of business. Note that even if you have a major client that provides you with an office on its premises, it is still the client’s premises and it will not disentitle you to your claim for a home office.

or

- The home office is used exclusively for your business, and is used “on a regular and continuous basis for meeting clients, customers or patients”.

You can only claim the expenses against your income from the business. You therefore cannot use home office expenses to produce an overall business loss that is applied against other income.

However, losses disallowed because of this rule can be carried forward and used in any

later year against income generated from the same business (you will need to bring them in on each year's return to carry them forward).

The allowable expenses will normally be based on the fraction of the home that is used for your office. When making this calculation, you can normally exclude common areas, such as hallways and bathrooms, from both the numerator and the denominator. You can choose any calculation that is reasonable; for example, calculations based on square footage or number of rooms are usually considered reasonable.

The expenses you can claim include:

- rent, if your home is rented
- mortgage interest (but not the principal portion of blended mortgage payments)
- home insurance
- property taxes
- utilities: electricity, heat, water, gas
- telephone, if your personal line is used partly for business
- outside maintenance: lawn care, snowplowing (if they are justifiable because you have to keep the house presentable for business visitors)
- minor repairs, supplies (e.g., light bulbs) and maintenance

AROUND THE COURTS

Alberta judge puts the boot to "tax protestors"

Claims by "tax protestors", "detaxers", "natural persons", "freemen" and others have been clogging up Canada's courts for some time. These people maintain that they have some magic way of exempting themselves from tax obligations including paying GST and

HST. Their claims have never succeeded in the courts.

Beyond tax law, the same characters show up in family court, traffic court, civil litigation courts and other courts, claiming exemption from Canadian laws, refusing to accept the court's jurisdiction, and generally disrupting the judicial system.

Associate Chief Justice John Rooke of the Alberta Court of Queen's Bench finally had enough. He took the opportunity in *Meads v. Meads* — a family law dispute — to write the definitive thesis on what he calls "Organized Pseudolegal Commercial Argument" (OPCA) strategies.

Justice Rooke's *opus* is 156 pages, thoroughly researched and elegantly written. It surveys and catalogues the various OPCA strategies used in the courts. Most importantly, it recommends strategies and approaches the courts can use to reduce disruption by OPCA litigants, including identifying them early on by certain "fingerprints", refusing to accept filing of documents, and finding the person in contempt of Court.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.