

TAX BULLETIN

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Self-Employment: Is it for you?

So you're tired of the office politics. Nothing would be better than working for yourself. You want to become an independent contractor.

Should you? This is a question more and more individuals are asking themselves. You may have been a victim of downsizing and find yourself seeking new work. You may just be tired of working for someone else and have decided to set out on your own. Or, your current employer may have approached you to see if you are interested in restructuring your work arrangement so that you would be considered self-employed.

This bulletin is intended to help you answer this question. First, we'll discuss some of the advantages and disadvantages of being self-employed that you should consider. Then, we'll review the common law tests that must be met for you to be considered to be an independent contractor because you can't just state that you are self-employed and be treated that way for tax purposes. Finally, we'll review the tax consequences of becoming an independent contractor - we'll look at the types of expenses you can deduct, the choices you have in selecting a year-end for your business, and the Goods and Services Tax (GST)/Harmonized Sales Tax (HST) consequences of running your own business.

The advantages and disadvantages of being your own boss

There are definite tax advantages of being a self-employed individual. The biggest advantage is being able to deduct expenses from your income when you prepare your tax return each year. We'll review the type of expenses you can deduct, starting at page 6.

You shouldn't be blinded by the tax advantages, however. There are many other factors you need to consider. These include:

- **Increased Canada Pension Plan/Québec Pension Plan (CPP/QPP) costs**
 - As an employee, your employer matches your CPP contributions dollar-for-dollar. In Québec, the QPP applies in place of CPP, and references to CPP in the balance of this bulletin apply equally for QPP purposes. As an example, if you make the maximum CPP contribution in 2011 of \$2,217.60 your employer also contributes that amount on your behalf. As a self-employed individual, you must pay all CPP contributions yourself, meaning your maximum annual premium will

increase to \$4,435.20 (based on 2011 contribution levels). The “employer” portion of these premiums is deductible by self-employed individuals, however.

- **Loss of security** - If you are no longer employed, you won't have the security that comes with a job. If you take a vacation, for example, you don't get paid, nor do you get paid for statutory holidays. If you lose a contract, you won't be entitled to any severance pay or notice period unless provided for in the contract.
- **Loss of tax-free benefits** - Employees are often entitled to certain tax-free benefits, such as dental and medical plans. Self-employed individuals must pay for their own dental and medical costs out of their own pocket. However, self-employed individuals are allowed to deduct the costs of private health services plans, under certain circumstances. This is discussed in further detail on page 10.
- **No company pension** - If you're a member of a company pension plan, you don't have to pay tax on employer contributions to the plan. You also get a tax deduction for contributions that you make. As a self-employed individual, currently you will have to fund your own pension using your RRSP or non-registered savings.

However, recently the federal government proposed another self-funded retirement plan that would improve the range of retirement savings options for self-employed Canadians. Specifically, they have proposed introducing Pooled Registered Pension Plans (PRPPs) across Canada. PRPPs are expected to provide an accessible and administratively low-cost retirement option for the self-employed (and for small employers to offer their employees). In order for these proposals to succeed, the federal government will need to work with the provinces to coordinate this offering on a national basis. To date, PRPPs are not available. For more information on the PRPP proposals, contact your BDO advisor.

- **Loss of social aspects of a job** - Many individuals who become self-employed find they miss the daily social interaction with their fellow employees, if they work out of their house. Of course, they don't have to deal with the office politics either.
- **Difficulty in getting credit** - Your income stream may no longer be predictable, which will make it more difficult to obtain credit for either business or personal reasons.
- **GST/HST** - You will need to consider whether you have to register for GST/HST purposes and collect this tax on your revenues. This is discussed in further detail on page 13.
- **Recordkeeping/compliance aspects** - As a business owner, you will have to keep records for income tax, GST/HST and other purposes. You will likely have to keep more records than you did as an employee (see page 14 for more details). As well, it should be remembered that if your total income tax liability, less the portion that was withheld at source, is greater than \$3,000 for both the current year and either of the two preceding years, you must make instalments for the current year. In Québec where provincial tax is collected by the province, the threshold is \$1,800 for federal tax and \$1,800 for provincial tax.
- **Legal considerations** - It is important to remember that there are a number of legal issues to consider when contemplating becoming self-employed. For example, there are legal protections to employees that are not available to individuals who are self-employed. Ensure that you consult with a lawyer who can advise you in this area.
- **Business Risks and Insurance** - It's not possible to list all of the business risks involved in running your own business, however, as a self-employed person they will be your responsibility. You may want to explore insurance offerings that will help you to manage these risks.

We're not trying to convince you that you should be an employee rather than an independent contractor. You just need to understand all of the factors you have to take into account - in addition to the tax advantages - to determine whether it makes sense for you to be self-employed. And, keep in mind that one of the reasons independent contractors generally make more money is to compensate them for the fact that they don't get any of the benefits of being an employee.

Incorporating your own business can also provide certain tax advantages. For example, you will be allowed the small business deduction on active business income up to certain income thresholds. To find out more about incorporation, ask your BDO advisor for a copy of our bulletin, *Incorporating Your Business*.

As well, under new Employment Insurance (EI) measures that have been in effect since January 2010, self-employed individuals can, on a voluntary basis, choose to pay EI premiums to be eligible to receive EI special benefits. There are four types of special benefits available to self-employed individuals including maternity, parental, sickness and compassionate care benefits. To participate, you must enter into an agreement with the Canada Employment Insurance Commission through Service Canada and pay the annual premium with your personal income tax return. Currently, if you are a self-employed person in Québec, you are already entitled to apply for maternity, paternity, and parental benefits through the Québec Parental Insurance Plan. If you choose to participate in the EI program, you will also be eligible to apply for EI sickness and compassionate care benefits.

If you decide to become self-employed and also incorporate your business, you need to be aware of the Personal Services Business (PSB) rules. Generally, the PSB rules will apply if the following conditions are met:

- Income of the business is from services rendered by an individual, referred to as an "incorporated employee";

- The "incorporated employee" rendering the services, or a related person, is a specified shareholder. Generally speaking, a specified shareholder is a person who owns, directly or indirectly, at any time during the year, 10% or more of the issued shares of any class of the corporation or of any related corporation;
- The incorporated employee might reasonably be regarded as an officer or employee of the entity for which the services are provided if the corporation is ignored (we discuss this in more detail in the next section); and
- Throughout the year the corporation does not employ in the business more than five full-time employees.

Where the PSB rules apply, income from the PSB will not be eligible for the small business deduction, and deductions claimed by the corporation against PSB income will be restricted. Generally, deductions are limited to salaries paid and employment benefits provided to the incorporated employee. The PSB also will be allowed a deduction for amounts that would have been deductible by an employee for selling property and negotiating contracts, as well as legal expenses incurred by the corporation in collecting amounts owing for services rendered. Note that the PSB rules do not apply where services are provided to an associated corporation.

Because of the restrictions on deductions in a PSB, earning income in a corporation as a PSB may not be as beneficial as if the business was earning income eligible for the small business deduction. However, given the generally low corporate tax rates that apply to PSB income, structuring your business as a PSB can still be to your advantage - consult your BDO advisor.

Can I become an independent contractor?

You can't just state that you are self-employed and expect to be treated that way for tax purposes. A series of common law tests have evolved from decisions in the Canadian courts

that are used to determine whether you are an employee or an independent contractor. So, if the tests currently indicate that you are an employee, you'll have to make fundamental changes to your arrangements with payers to be considered self-employed.

You should note that the factors to be considered when determining whether or not you are independent contractor differ in Québec. In particular, the rules in Québec under civil law generally place a much greater emphasis on the control the employer has over an employee, although the courts in Québec have not always ruled consistently on this issue.

No matter where you live, you should always consult with your BDO advisor before attempting to become an independent contractor.

If you want to be considered self-employed, it's important that the Canada Revenue Agency (CRA) also views your arrangement in that light. If it doesn't, you could find yourself being disallowed all the tax deductions available to independent contractors, which means your tax bill could be substantially higher. In addition, the organizations you work for have a lot at stake if they treat you as self-employed and you're really an employee. They are responsible for paying a number of federal and provincial taxes on your salary, including income tax, EI premiums, CPP contributions, Worker's Compensation (in Ontario the premiums are known as Workplace Safety & Insurance Board Premiums) or levies and other payroll taxes. If they mistakenly treat you as an independent contractor, they will not have deducted and remitted from your salary income tax or your EI and CPP contributions. When these remittances have not been properly made on behalf of an employee, the CRA will expect the employer to pay up and will apply a penalty from 10%-20% of the amount owing, in addition to interest on the late payments.

We have summarized below the key tests that have evolved from court cases, and which the CRA also considers to be important in

determining your status as either an employee or an independent contractor.

1. Control test

This test looks at the relationship between you (the worker) and the person paying for your services (the hirer). If the hirer controls how and when you must perform your duties, this is indicative of an employment relationship. For example, are you required to work on the hirer's assignments between 9 and 5? Are you told how you should do your work, instead of just being assigned a task and having the freedom to determine how it should be done? If you are hired to perform services and you have flexibility in deciding how and when the services are to be performed, or even if the service will be performed at all, this indicates you are an independent contractor.

2. Integration or organization test

This test examines your relationship with your hirer. Are your activities integrated with the hirer so much so that an independent observer would conclude that you're an employee? Or are you independent enough to be viewed as an independent contractor?

3. Economic reality or entrepreneur test

This test looks at the economic reality of your relationship with your hirer in determining whether you are an employee or an independent contractor. Who provides the tools you need to perform your work? For example, if you're a computer consultant and your hirer buys the computer equipment you need, this tends to indicate that you're an employee. On the other hand, if you're required to pay for your own tools, this indicates you are self-employed. Another element of this test is whether you can hire assistants or subcontract the work. If you can do so, without the permission of the hirer, this indicates that you are self-employed.

This test also looks at whether you have a chance of profit on your activities and whether you have the risk of loss. If you can make more money, perhaps because you've performed a job under budget, this indicates you're self-

employed. The same goes for losses - if you're over budget but your hirer covers the costs of going over budget, this indicates you're an employee. If you have the risk of incurring a loss, this indicates you're self-employed. In addition, a self-employed person can negotiate the price for their services and offer their services to more than one payer.

4. Specific results test

This test looks at the length of your relationship with your hirer. If, for example, you've been hired to do a certain project (i.e. work towards a specific result) at which time your relationship will end, this indicates you're an independent contractor. However, if you are "hired" for an indefinite period of time and you anticipate the work will be ongoing, this is indicative of an employment relationship.

5. Contractual Intent

Most recently, as workers' relationships with hirers continue to evolve, the courts and the CRA have begun to consider the intention of both a worker and a hirer when a working arrangement is entered into. Specifically, consideration is given to whether you both intend to enter into a contract of service (employer-employee relationship) or a contract for services (a business relationship). In this regard it is important for both you and your hirer to clearly define your working arrangement and ensure that you have a common intent at the time you enter into an agreement. Note that this test is really more of a tie-breaker when the results from applying tests 1 - 4 are inconclusive.

Remember - no one test will determine whether you are considered to be an employee or an independent contractor. One or more of the above tests may not apply when analyzing all the facts surrounding a particular relationship or they may require different weightings in particular cases. For example, the test of control may be difficult to apply to professionals, knowledge workers and skilled trades-people, as the nature of their work tends to allow them to work independently, but they can still be considered employees when

the tests are applied to all of the facts. Therefore, whether you are employed or self-employed can only be determined by considering and weighing the factors specific to your situation. As mentioned, where the tests 1 to 4 described earlier do not result in a clear conclusion either way, a written agreement between the parties (test 5) documenting their intention that the contract is for services should serve as a tiebreaker.

In order to avoid reassessments, it's important to ensure that the CRA will consider you to be self-employed based on the tests noted above. However, as there is an element of variability in applying the tests and in the weight given to various facts, it is possible that the CRA may conclude differently than you. The good news is that you can ask the CRA to determine if your relationship with a particular hirer is one of an independent contractor or an employee. By filing Form CPT1 with the CRA, they will rule on your status for purposes of payment of CPP and EI premiums. You should consider filing this if it's important for you and your hirer to be absolutely certain of your status in their eyes.

Improving your chances

With these tests in mind, there are a number of steps you can take to improve the likelihood you'll be considered an independent contractor in the CRA's eyes. If you're self-employed, make sure you do the following:

Document your situation in a contract

Where possible, you should have a written contract with your hirer, specifying the intention of the working arrangement and the work to be done. However, the contract should not set out how and when you are to do the work (other than, of course, the setting of the necessary deadlines for the completion of the work). The contract should allow you to hire your own employees to do the job, if necessary. You should also specifically state in the contract that you are an independent contractor and you have not entered into an employment contract with the hirer. The fact that you and your hirer have specifically agreed

that you are not an employee will be a factor in your favour. We recommend that you consult your lawyer for advice when drafting this agreement.

It is also important that you conduct your business affairs according to the terms of the contract. If you have a contract but don't follow its terms, it won't be of much assistance to you in establishing that you are an independent contractor.

Use your own equipment

You should always use your own tools and equipment to perform the work you've been contracted to complete. If it's necessary to use the hirer's tools, consider paying rent for the use of the equipment as part of the contract.

Consider penalties for failing to complete a project on time

If your contract spells out that certain penalties will apply if you fail to complete the work on schedule, this shows the CRA that you do indeed have a financial risk in completing the work.

Invoice your hirer

Always submit invoices for the work you are performing. Payment for your services should be based on the invoices you submit and should not just be made periodically to you. Having this paper trail will help support your position that you are an independent contractor. In addition, you should not get paid if you don't do any work (e.g. if you are on vacation, your hirer shouldn't pay you while you're not working). You should bill in a manner that is similar to other independent contractors in your industry (e.g. per piece/file or per hour, as the case may be).

Do not accept fringe benefits

You should never be part of any benefit program your hirer might have. If you are, this definitely indicates you are an employee (especially if the benefit in question is generally only available to employees). Your billing rates, however, should reflect the fact

that you have to pay for these expenses personally.

Work for more than one hirer

If you work for only one business, this could be considered evidence that you're an employee. Doing work for several clients is a strong indication that you're an independent contractor and it is a key issue reviewed in tax cases.

Establish yourself as a business

You can take a number of simple steps that will all work in your favour in establishing your status as an independent contractor. Register a business name with the province (usually the Department of Consumer and Corporate Affairs). Set up your own office (this could be a home office). Advertise your services. Get a separate business telephone line, etc. All of these factors help support the position that you're an independent contractor.

The tax advantages of being self-employed

You've heard people talk about tax advantages of being self-employed. They're right - self-employed individuals have much more flexibility in the expenses they can deduct for tax purposes. However, always keep in mind that if you don't have a lot of expenses, being able to deduct them will not mean that much to you.

If you are self-employed, you'll have to keep track of your income and expenses. Generally, for tax purposes you will need to report your income and expenses by using the accrual method of accounting. This means you will include in income all the income you've earned for your fiscal year, whether you've received a payment or not, and you will deduct the expenses you have incurred in the fiscal period, whether or not you've paid them.

Deducting expenses

Self-employed individuals can deduct any reasonable expense they incur to earn their

business income, unless the expense is specifically denied under our tax law.

In this part of the bulletin, we'll review a number of expenses you will be able to deduct from your business income. We will also look at some specific tax rules that deny you the ability to deduct all or a portion of certain expenses.

Keep in mind that this list is not exhaustive. If you incur a reasonable expense, you usually are able to deduct it. Remember, however, that personal expenses are not deductible.

Accounting and legal fees

You can deduct the accounting and legal fees necessary to earn your business income.

Planning tip - *Because you have business income, you can deduct the cost of having your income tax return prepared.*

Annual fees and business taxes

You can deduct annual licence fees and business taxes you incur to run your business. You can also deduct annual dues or fees to keep your membership in a trade, professional or commercial association.

Canada Pension Plan contributions

As a self-employed person you may deduct from your income one-half of the CPP contributions payable on your self-employed earnings. This deduction is limited to one-half of the maximum CPP contributions payable by you under the plan. The appropriate percentage of the other half of such contributions is allowed as a tax credit.

Capital expenses—equipment/furniture

Office furniture (such as desks, chairs, and filing cabinets), equipment (such as a computer, cellular phone, and a fax machine) and computer software are capital assets. You are eligible to deduct tax depreciation or capital cost allowance (CCA) on these assets, provided they are used in the business. If you only use an asset partially in the business, then you have to prorate the expense between your business and personal use and deduct the

business use amount. Generally, office furniture, fax machines, and cellular phones are considered Class 8 assets and you are entitled to claim 20% of the pool's balance annually as CCA (only 10% in the year of purchase). For computer equipment purchased after March 18, 2007, including operating system software, you can claim CCA at a rate of 55%. Software, other than operating system software, is a class 12 asset, deductible at a 50% rate in the year of acquisition. The remainder is fully deductible in the following year. Also, under a change introduced in the 2009 federal budget, a temporary increase in the CCA rate, from 55% to 100%, was available for eligible computers and software acquired after January 27, 2009 and before February 2011. This 100% CCA rate is not subject to the half-year rule. A business would have been able to fully deduct the cost of an eligible computer (including the systems software for that computer) in the first year that CCA deductions were available.

Convention expenses

You can deduct the cost of attending up to two conventions a year. The conventions have to relate to your business and generally be held by a business or professional organization within the geographical limits of where the sponsor of the convention usually does business. If the convention entitles you to food, beverages or entertainment (not including coffee and doughnuts on breaks) and a reasonable portion of the convention fees has not been identified as pertaining to this benefit, then you must deduct \$50 per day for these expenses from the cost of the convention. The \$50 per day is a meals and entertainment expense and is subject to restrictions on its deductibility (see below under "meals and entertainment").

Insurance

You can deduct regular commercial insurance premiums paid on buildings and equipment you use in your business. You can also deduct the premiums paid on income replacement, business interruption, and general business insurance.

Generally, you cannot deduct the cost of life insurance premiums. However, there is an exception if a financial institution requires the policy as collateral for a business loan. Your deduction is limited to the lesser of the annual premiums on the policy and the net cost of pure insurance (this excludes the savings component of a whole life policy) under the policy for the year. As well, only the portion of this amount that can reasonably be considered to relate to the amount owing under the loan is deductible.

Interest expense

You can deduct interest expense on money borrowed for the purpose of earning or producing income from your business. This may be the case, for example, if you had to borrow to finance the start up of your business or the purchase of a business asset.

Meals and entertainment

Our tax rules allow you to deduct 50% of the amount you pay for meals and entertainment, so long as these expenses have a business purpose. This includes taking a client out to lunch or to a sporting event.

However, some entertainment expenses are specifically not deductible. You cannot deduct any amount for the use of a golf course (such as membership or green fees), a yacht, a camp or a lodge. The CRA allows the deduction of payments for the use of a golf club for a business meal or other business purposes (such as renting the facility for a client seminar), even if the recreational facilities were used on the same trip to the club. Remember that the deduction for a business meal is still restricted to 50%.

Planning tip - *If you entertain at a golf course, ensure that your bill segregates the deductible business costs from non-deductible costs. This means that deductible expenses, such as meals and entertainment, or the cost of renting a room for a seminar, should be separate from the non-deductible costs (i.e. the cost of a round of golf).*

Office rent/home office expenses

If you rent office space for your business, you can deduct this expense for tax purposes. But what if your office is in your home? You can deduct the cost of maintaining a home office as long as you pass one of the following two tests:

1. Your home office is your principal place of business. Basically, this means that you work more than 50% of the time from your home office. This can be a difficult test to meet if you have another office that you rent or if you work a large portion of the time at client sites.
2. Your home office is used exclusively for business purposes and is used on a regular and continuous basis for meeting clients, customers or patients. This test is designed primarily for individuals such as doctors, chiropractors or massage therapists - in other words, people who have an office away from their home where they usually work but they might also see clients or patients at home. These individuals can deduct home office expenses as long as they use the office space exclusively for business purposes (in other words, so long as the office is not part of their personal living space).

There is an important difference in these tests to note. Under the first test, as long as you work primarily out of your home office (50% of the time), you don't have to use your home office exclusively for business purposes to be able to deduct home office expenses. The office can be combined with personal living space. In such a case, you prorate the expenses related to your home office between its use for business and personal use. If you use it 60% of the time for business and 40% for something else, then only 60% of the expenses relating to the maintenance of the home office will be deductible.

What expenses can you deduct? Basically, you can deduct the business portion of the following amounts that relate to your home office:

- Rent (if you rent your home)

- Utilities
- Maintenance and repairs
- Insurance
- Property taxes
- Mortgage interest

For example, assume you own a three-bedroom townhouse and you use one of the bedrooms as a home office. You make monthly mortgage payments of \$1,200, of which \$800 is interest. You also have to pay \$200 a month for utilities, property taxes, and insurance expenses. The office is 20% of the total square footage of the townhouse and you use the room that is the office 80% of the time for work. You will be able to deduct \$160 a month for home office expenses, calculated as follows:

Interest	800
Utilities, property taxes & insurance	<u>200</u>
Total costs	<u>1,000</u>
Office portion @ 20%	<u>200</u>
Time used for business @ 80%	<u>160</u>
If your marginal rate of tax is 45%, then your monthly tax savings would be \$72.	

Note that you cannot create a business loss by claiming home office expenses. However, you can carry forward the undeducted amount indefinitely and deduct it from business income in the future.

Principal residence exemption and home office expenses

If you own your home and use it for business purposes and you claim home office expenses, you need to consider the impact, if any, this will have on your ability to claim the principal residence exemption when you sell your house.

Under Canadian tax rules, each family is entitled to designate a home in which they live as their principal residence on year by year basis. The home designated can be the place where you regularly reside or a vacation property, such as a cottage. If a property has been designated as your principal residence for each year that you own it, you will not have to pay any tax on capital gains you realize when it is sold.

If you convert a portion of your house to a home office, however, the use of that part of your house will change from personal use to business use. If you apply the tax rules literally, you are deemed to have disposed of that portion of your house at its fair market value at that time. This gain will not be taxed if your home is designated as your principal residence - but, any gain that accrues on the business portion of your residence after that time will be subject to tax when you ultimately sell the property.

Fortunately, the CRA takes a much more reasonable approach when there has been a change from personal use to business use for a portion of your home. Your entire house will continue to qualify as your principal residence, after a conversion of a portion of the property to a business use, as long as you meet the following conditions:

- The business portion (i.e. your home office) is reasonably small when compared with the size of the entire house;
- You do not make any structural changes, such as an addition, in creating your home office space; and
- You do not claim any CCA on the business portion of your home.

To preserve your ability to claim the entire property as your principal residence, it is normally advisable that you not claim CCA on the business portion of your home. However, there may be circumstances when it is to your advantage to claim CCA - for example, if you do not expect your home to increase in value in the future, the ability to claim the principal residence exemption may not be of value to you. Or perhaps you will claim your principal residence designation on another residence. Before claiming CCA on the business portion of your residence, it's best to discuss your situation with your BDO advisor.

If you make significant changes to your home for business reasons, such as an addition, this portion of your home may not qualify for the principal residence exemption. You can claim CCA on this part of your house at the rate of 4%

annually on a declining balance basis. In such cases, when your home is sold you will have to pay tax on any capital gain realized on the business portion of the residence and on the recapture of any previously claimed CCA deductions on your property.

Private health services plans premiums

A self-employed person can deduct premiums paid for private health services plans (PHSP), which are plans that provide supplementary health or dental coverage. So long as certain conditions are met, you are allowed a deduction for premiums under a PHSP for yourself, your spouse or any member of your household. One of the conditions is that your primary source of income must be self-employment income, either alone or as a partner in a partnership, or where income earned from sources other than self-employment does not exceed \$10,000.

Further conditions may limit the amount of your deduction. If you did not have any employees throughout the year, your PHSP deduction is restricted by an annual dollar limit. The limit is a maximum of \$1,500 for yourself, \$1,500 for your spouse and household members 18 years of age or older at the start of the period when they were insured, and \$750 for household members under the age of 18 at the start of the period. The maximum deduction is also limited by the number of days the person is insured.

If you have at least one qualified employee throughout the entire year, and at least 50% of the insurable persons in your business were qualified employees, your claim for PHSP premiums will be limited based on the lowest cost of equivalent coverage for each of your qualified employees. Finally, any undeducted PHSP premiums may be included in the calculation of your medical expense tax credit. It should be noted that these premiums are not deductible for Québec tax purposes.

Professional membership dues

If you pay annual fees to maintain your professional status you can deduct these

expenses (e.g. fees paid to the Professional Engineers Association to maintain your P.Eng.).

Rental costs of equipment

The business portion of the cost of leasing equipment, such as computer or office equipment, can be deducted. It is important to note that the arrangement must be a bona fide lease, not finance payments for a purchased asset.

Salary paid to an assistant

You can deduct the costs of salary paid to an assistant. You can also deduct all related costs, such as the employer's portion of CPP contributions and EI premiums. The amount you pay an assistant must be reasonable for the services performed.

You should note, however, that this provision does not allow you to deduct amounts paid to someone to take care of your children to allow you to work. You can deduct child care costs up to certain limits, but only under the child care expense rules. Generally, the spouse with the lower income can deduct child care expenses, limited to the lesser of:

- 2/3 of earned income, which includes income from a business, and
- \$10,000 for each child having a severe and prolonged physical or mental impairment. For other children, \$7,000 for each child under 7 years of age at the end of the year or \$4,000 for each child between 7 and 16 years of age at the end of the year.

Planning tip - *You can hire a family member to assist you in your business. However, you need to ensure that their salary is reasonable for the services performed.*

Supplies

You can deduct the cost of supplies you use in your business. This includes such items as:

- Paper
- Office supplies
- Long distance telephone call charges
- Basic telephone charge for a phone, if you get a separate business line
- Postage and courier costs

- Business portion of cellular phone airtime
- Business portion of internet charges

Planning tip - *If you install a separate business phone line, you can deduct this expense.*

Travelling expenses

Travelling expenses include the cost of transportation for business purposes (e.g. taxi and air fares) and the cost of accommodation on business trips. The most common travelling expenses claimed by self-employed individuals, however, are automobile expenses.

You can claim car expenses that are incurred for business purposes. Your tax deduction for these expenses is usually calculated as the business portion of your total automobile expenses, calculated by prorating your total automobile expenses by your business kilometres divided by your total kilometres. To deduct your automobile expenses you must properly document your expenses, which includes maintaining an automobile log to document the business kilometres you have driven.

In determining your total automobile expenses, include the following:

- Fuel
- Maintenance and repairs, such as tune-ups and oil changes
- Insurance
- License and registration fees
- Interest incurred on a car loan
- CCA or leasing costs if you lease your vehicle

The amount of interest expense you can deduct on a car loan is limited to \$300 per month for vehicles purchased after 2000.

There are also limits on the amount of CCA you can claim on your automobile. The rules are complex, but basically you cannot deduct CCA on any purchase price greater than \$30,000 plus applicable GST/HST and provincial sales tax (PST). If the cost of your car exceeds the limits, the maximum deductible amount will go into its own separate CCA class, known as class 10.1.

If the cost of your automobile is less than the limits above it is considered a "class 10" asset and there is no restriction on the cost you can depreciate.

Each year, you can claim up to 30% of the balance of the undepreciated capital cost in the class as CCA (only 15% in the year of purchase). Any amount claimed in one year reduces the balance in the class for the next year's calculation.

If you sell a Class 10 car in the year you may have a gain or loss, depending on whether the proceeds are greater or less than the remaining balance in the class. The rules are complicated so we suggest you discuss the consequences with your BDO advisor.

If you lease your car instead of buying it you can deduct the lease payments subject to certain limits. The formula for determining the deductible amount basically restricts you to deducting only the portion of the lease payments that relates to the first \$30,000 (plus tax) of the cost of the car.

In determining your business kilometres, it can be difficult to decide whether a particular trip is business or personal. For income tax purposes, travelling from your home to your place of business is not usually business travel. However, if your home is the base for your business, then travelling from your home for business purposes would be considered to be business travel. If your home is not your main work location, the CRA has stated that it considers the following trips to be business travel:

- a trip from your home to a client's place of business and back home;
- a trip from your home to a client's place of business and then to your regular place of work; and
- a trip from your regular place of work to a client's place of business and then home.

Therefore, it appears you can maximize your business travel by scheduling business appointments on the way to and from your regular place of business.

If you have further questions about the automobile expenses you can deduct and the records you need to keep, ask your BDO advisor for a copy of our bulletin *Automobile Expenses and Recordkeeping* or visit our web site (www.bdo.ca) for a copy of the most recent version.

Selecting a business year-end

Choosing a business year-end for tax purposes is a critical decision for you. The selection of your first year-end is governed by the date you first commence business. The business year cannot exceed twelve months for a proprietorship or partnership.

Most self-employed individuals are now required to have a December 31st year-end. However, self-employed individuals, as well as partnerships that only have individuals as partners, have the option of selecting an off-calendar year-end provided they use the "alternative method" when calculating income for tax purposes. Let's look at how this might work.

- You, as a self-employed individual, started your business on February 1, 2010. You choose to have an off-calendar year-end of January 31, 2011.
- In 2010, you wouldn't have an income inclusion because your fiscal period ended in 2011.
- In 2011, you would have to include income for the period February 1, 2010 to January 31, 2011, as well as an estimate of income for the period February 1, 2011 to December 31, 2011. The estimate is based on a proration of your income for the year ending January 31, 2011.
- In 2012, in addition to reporting your actual income for the fiscal year ending January 31, 2012, you would also have to include a new estimate to December 31, 2012. You will be able to deduct the previous year's estimate of income to December 31, 2011.

Note that you can elect to include some income from the January 31, 2011 fiscal year in the 2010 taxation year to maximize your RRSP contribution or to "even out" your tax burden. Any amount included in 2010 would be deducted on your 2011 tax return.

Once you start using the calendar year-end method you can't change to the alternative method. However, you can switch from the alternative method to the calendar year method at any time.

If you qualify for an off-calendar year-end you should consider whether the timing of your year-end can defer or save income taxes or can be used to coincide with a cyclical slow period in your business.

Business losses

Though you don't go into business to lose money, tax relief is generally available if losses do arise. Court cases have set out a framework for determining whether losses can be deducted against other income for income tax purposes. First, consideration must be given to whether the business has been undertaken in pursuit of profit, or whether it is a personal endeavor. Where the nature of an activity is clearly commercial, your pursuit of profit is established. It will then be necessary to determine whether the source of the income is from a business or property. However, if there is a personal element to the activity, you will need to provide evidence to support your intention to carry on the activity for profit. The CRA may argue that you don't have a reasonable expectation of profit if your business has a personal element - a good example might be a hobby-type business. In such cases, in order to deduct business losses you will need evidence that:

- you have a genuine commercial operation;
- your profit expectations are reasonable;
- you have done your homework in preparing to go into the venture; and
- you have appropriate training or have hired staff that have the appropriate training to run your business.

You should always be prepared to demonstrate that your venture is undertaken in a sufficiently commercial manner, particularly if you are currently experiencing losses.

GST/HST

As an independent contractor, you will have to deal with the GST/HST. As of July 1, 2010, the provinces of Ontario and British Columbia (BC) joined Nova Scotia, New Brunswick and Newfoundland and Labrador and harmonized their sales tax with the GST. As a result, Ontario's HST is 13%, which is comprised of the 5% GST and the 8% provincial (Ontario) portion of the tax and BC's HST is 12%, which is comprised of the 5% GST and the 7% provincial (BC) portion of the tax. Nova Scotia also increased its HST rate effective July 1, 2010 to 15%. Although there are some differences, the Québec Sales Tax (QST) essentially functions in a manner similar to the GST/HST and applies on most automobile expenses incurred in Québec. In this regard, effective January 1, 2011 the QST is now 8.5% and since it applies to prices inclusive of GST the combined effective rate is 13.925%.

As an independent contractor, you will generally be in the business of supplying goods and services to your customers or clients. Therefore, you will likely have to collect the GST/HST on your revenue and remit it to the government.

The GST/HST does not have to be collected on all goods and services (known as "supplies" under the rules). Certain supplies are exempt from GST/HST - if you're in the business of making these types of supplies you do not have to collect and remit the GST/HST. Your BDO advisor can help you determine the GST implications of your particular business.

If you are in the business of producing taxable supplies you will have to register for the GST/HST with the CRA. However, the news isn't all bad. If you have to collect and remit the GST/HST on your revenue, you can claim a refund (known as input tax credits - ITCs) for the GST/HST you pay on your expenses,

including capital purchases. You have to file GST/HST returns with the CRA to remit the GST/HST you have collected, less any ITCs you are entitled to.

There are special GST/HST rules for small business, including the following:

Small supplier rule

If your taxable revenue from worldwide taxable supplies was equal to or less than \$30,000 in a single calendar quarter or in four consecutive calendar quarters, you are a "small supplier" and you're not required to register for GST/HST purposes. This means you don't have to collect and remit the GST/HST to the government on your revenue. However, if you don't register for the GST/HST, you will not be able to recover the GST/HST you pay on your expenses. If your clients are already registered for the GST/HST they won't care if you charge them this tax because, as registrants themselves they will be able to recover any GST/HST paid as an ITC.

As soon as you exceed \$30,000 for any 12-month period, you must then register for the GST/HST before the second month following the quarter in which you've exceeded the \$30,000 threshold. When you register, you can recover the GST/HST that you pay.

If you do register for the GST/HST you should consider the quick method, which is a simplified way to calculate the GST/HST that you have to remit.

Quick method

The quick method allows small businesses providing certain services or goods for resale to remit the GST/HST without having to separately track the GST/HST collected or claim ITCs. Under this method, you continue to collect the GST at 5% on your revenues or HST at the applicable rate on your revenues. You then remit to the government a certain percentage of your taxable supplies. This percentage will depend on the following factors:

- the nature of your business;
- the amount of eligible sales;
- the province in which the sale is made; and

- the province in which the permanent establishment that the sale is made through, is located. A permanent establishment is a fixed place of business that includes, but is not limited to, a place of management, a branch or an office.

Note that you may be entitled to a credit of 1% on the first \$30,000 (including GST/HST) of eligible supplies on which you must collect 5% GST or HST at the applicable rate, in each fiscal year.

You are generally eligible for the "quick method" if your annual worldwide taxable supplies (including zero-rated sales) and those of your associates is \$200,000 or less, including the GST/HST. Note that this threshold does not include other transactions on which you might have to collect GST/HST, such as the sale of real property or capital assets, such as equipment that you use in your business. If you are in the business of providing legal, accounting, financial consulting or actuarial services, you cannot use the quick method.

As a wholesaler or retailer, to qualify to use the quick method your purchases of goods for resale or use (other than basic groceries) must equal at least 40% of your total annual taxable supplies (including GST/HST).

The disadvantage of using the quick method is that you cannot claim specific ITCs on your operating expenses (such as utilities, rent, or telephone expenses), meal and entertainment expenses, and inventory purchases. The reduced percentage of GST/HST that you remit is intended to compensate you for giving up the right to these credits. You may, however, claim ITCs for all capital purchases, such as real property or equipment.

If you want to use the quick method you have to elect on Form GST74 "Election and Revocation of an Election to Use the Quick Method of Accounting." If you file monthly or quarterly GST/HST returns you have to file your election form by the due date of the return for the reporting period in which you begin using the quick method. If you file annually you have to file the election form by the first day of your

second fiscal quarter. Once you elect to use this method you must continue to use it for at least one year (so long as you still qualify during that year).

Planning tip - *If your business is labour intensive, the quick method may be beneficial for you. Your GST/HST taxable expenses will likely be small compared to your revenue. Therefore, the advantage of only having to remit a portion of the GST/HST you collect will likely outweigh the cost of not claiming specific ITCs.*

Recordkeeping

You should keep all records of your income, as well as your expenses. If your records are organized, not only will this save you time (and accounting fees) when you prepare your tax return, it will also help ensure you are prepared should the CRA decide to review your return. Write down the purpose of the expense on your receipt and keep it in an organized filing system, such as by type of expense (e.g., meals and entertainment, car and insurance expenses, etc.).

Receipts are crucial for all of your expenses. Here are some additional points to keep in mind.

- If you're claiming a deduction for meals and entertainment expenses, it's a good idea to write on the receipt who you took to lunch and why.
- Make sure you only claim your business expenses. The CRA will likely review your expense claims and compare them to the norms of your particular industry to see if they are reasonable. For example, if your meals and entertainment expense is 5% of your revenue, but the norm for your industry is only 2%, you will need to be able to explain why your expenses are so high. If your expenses are abnormally high you can expect an auditor to pay you a visit. You do not need to worry, however, if you have receipts and your records are organized.

- You should document your automobile expenses well. It's extremely important to keep a logbook of your driving to support the number of kilometres you drive for business purposes. Your BDO advisor can provide you with a BDO logbook you can use to keep track of your driving.
- Generally speaking, for income tax purposes, you must keep your receipts for six years from the end of the last taxation year to which they relate. If you wish to destroy them before this time you need permission from the CRA.

Miscellaneous matters

You also need to consider whether any of the following apply to your business:

Provincial sales taxes (PST)

Most of the provinces have a basic sales tax on goods and in some cases, services. If you provide goods or services, you need to consider whether you have PST obligations, as well. Québec has the QST system, which applies to most transactions, much like the federal GST. As previously mentioned, HST applies in Ontario, BC, Newfoundland, Nova Scotia and New Brunswick.

Licenses

You may have to obtain a business license, depending on your particular municipality's requirements.

Employee withholdings and remittances

If you hire employees, rather than independent contractors, you will be responsible for remitting employee withholding taxes, such as EI, CPP, income taxes (federal and provincial), and provincial payroll taxes (in the Northwest Territories and Nunavut as a source deduction). As an employer, you may also be subject to payroll taxes in certain provinces. To make your employer remittances you will need to obtain a Business Number (BN) from the CRA.

To obtain a BN you will need to have determined your fiscal period. You will also need a Québec business number if you have employees in the province of Québec, because you will have to report separately for Québec provincial purposes.

Conclusion

In this bulletin, we have discussed the advantages and disadvantages of becoming self-employed. If you have any questions about self-employment, talk to your BDO advisor today.

The information in this publication is current as of March 1, 2011.

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