

INCORPORATED EMPLOYEES

Watch Out – a Personal Services Business May Once Again Be Punitive

Anu Nijhawan
Marshall Haughey
Bennett Jones LLP

Introduction

In the past few years, the federal Department of Finance (“Finance”) has tended to introduce significant proposed amendments to the Income Tax Act¹ on Halloween. Halloween 2011 was no exception. The proposed amendments introduced on October 31, 2011,² while stated to be “technical” in nature, will, if enacted, significantly alter the tax treatment of a corporation that is considered to be carrying on a “personal services business” or “PSB.”

Essentially, these “PSB Proposals” will, if enacted, increase the tax rate on income earned by a corporation from a PSB by 13% for taxation years beginning after October 31, 2011. It is clear that the PSB Proposals will need to be considered carefully in the course of many service relationships. This article explores certain of the impacts of the PSB Proposals, including a consideration of some restructuring options.

Personal Services Business

The provisions governing PSBs in the Act are generally designed to prevent employees from incorporating themselves and thereby

gaining access to lower small business corporate tax rates (rather than the higher tax rate which applies to employment income) and the ability to deduct amounts beyond the limited deductions otherwise permitted to employees under section 8. In particular, a corporation carrying on a PSB is denied the small business deduction³ and is limited in its deductions to salaries paid and employment benefits provided to the individual providing the services on behalf of the corporation (the “incorporated employee”), plus certain expenses which would also be available to an employee.⁴

A personal services business, defined in subsection 125(7), generally refers to a services business carried on by a corporation where the corporation is used as a substitute for what would normally be considered an “employer-employee relationship.” The definition provides that a corporation is carrying on a PSB where an individual (referred to as an “incorporated employee”) who provides services on behalf of the corporation, or any person related to the incorporated employee, is a “specified shareholder” (i.e., together with non-arm’s length persons owns not less than 10% of any class of shares of the corporation) and the incorporated employee would “reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation.”⁵

The question of whether the individual should be viewed as an employee or as an independent contractor is one of fact which is to be determined on a case-by-case basis. In general, the jurisprudence on the issue indicates that the relevant factors will be the degree of control the service provider is subject to by the service recipient, whether the service provider provides his or her own tools, whether the service provider hires its own assistants and subcontractors, the degree of financial risk taken by the service provider,

¹ R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the “Act.” Unless otherwise stated, statutory references in this article are to the Act.

² Department of Finance, *Legislative Proposals Relating to Income Tax and Sales and Excise Taxes and Explanatory Notes* (Ottawa: Department of Finance, 31 October 2011), News Release 2011-108. The draft legislation was open for public comment until November 30, 2011.

³ The small business deduction is available only in respect of active business income, which specifically excludes a personal services business.

⁴ Paragraph 18(1)(p).

⁵ There is an exception if the corporation employs in the business more than five full-time employees throughout the year or if the services are provided to an associated corporation (in the latter case, the small business deduction would need to be shared by the associated corporations in any event).

the degree of responsibility for investment and management held by the service provider, and the service provider's opportunity for profit.⁶ Although other situations could be caught, the classic example of a corporation carrying on a PSB is where an individual agrees to provide full-time services to a corporation or partnership which are similar to services provided by employees but provides such services through a corporation. Potentially high-profile examples include well-paid executives or officers who incorporate and provide their services through the corporation.

Historically, the PSB rules were considered punitive in that they put the individual service provider in a worse after-tax position than he or she would have been had he or she earned the employment income directly. More recently, however, interest in PSBs has increased, in light of tax policy changes impacting corporate taxation generally. In particular, as the corporate tax rate has decreased relative to the top rate of tax applicable to employment income, PSBs offer the opportunity for a deferral of tax where the funds are retained in the corporation, and this deferral comes at little, if any, tax cost.

⁶ See, for example, *Wiebe Door Services Ltd.* [1986] 2 CTC 200 (F.C.A.) and *671222 Sagaz Industries*, [2001] 4 CTC 139 (S.C.C.). While the intention of the parties is also normally a factor, recent case law has suggested that intention is not a factor in the context of the determination of whether a corporation is carrying on a PSA: see, for example, *609309 Alberta Ltd. v. R.*, 2010 TCC 166 and *1166787 Ontario Limited v. R.*, 2008 DTC 2722 (T.C.C.).

Further, the introduction of the eligible dividend regime has meant that dividends paid out from a corporation carrying on a PSB are subject to a much lower rate of tax than other income, thereby allowing significant income splitting opportunities between the incorporated employee and his or her family members, again at a lower overall tax cost.

While Finance has not explained the rationale behind the 2011 PSB Proposals, they appear to be directed at preventing these sorts of tax benefits flowing from PSBs. The PSB Proposals will, if enacted, amend the definition of "full rate taxable income" in subsection 123.4(1) to exclude a corporation's income for the year from a PSB.⁷ The result is that a corporation's PSB income would be excluded from the corporation's taxable income that is eligible for the "general rate reduction percentage" of 13% under subsection 123.4(2), such that PSB income will be subject to federal corporate tax at the full unreduced rate, being 28%, plus applicable provincial tax.

As an example of the impact of the PSB Proposals, consider the circumstance where an individual provides employment services directly in Alberta in 2012, as compared to a circumstance where the services are provided by a corporation carrying on a PSB. The tax results are summarized in the table below.

⁷ Proposed paragraph 123.4(1)(iii).

If PSB Proposals Are Enacted		Position Without PSB Proposals	
Income Earned by Individual		Income Earned by Individual	
Employment income earned by individual	\$100.00	Employment income earned by individual	\$100.00
Tax (top combined marginal rate at 39%)	\$39.00	Tax (top combined marginal rate at 39%)	\$39.00
Net Cash Retained	\$61.00	Net Cash Retained	\$61.00

INCENTIVES AND BENEFITS

Income Earned by PSB		Income Earned by PSB	
PSB Income	\$100.00	PSB Income	\$100.00
Corporate tax (federal rate of 28% plus Alberta rate of 10%)	\$38.00	Corporate tax (federal rate of 15% plus Alberta rate of 10%)	\$25.00
After-Tax Cash in Corporation	\$62.00	After-Tax Cash in Corporation	\$75.00
Eligible dividends paid	\$62.00	Eligible dividends paid	\$75.00
Individual tax on dividend (19.29%)	\$11.96	Individual tax on dividend (19.29%)	\$14.45
Net Cash Retained by Individual	\$50.04	Net Cash Retained by Individual	\$60.55

Note that the result of the PSB Proposals, as illustrated by the foregoing example, is to subject a corporation carrying on a PSB to corporate-level tax at a rate similar to the rate that would have been paid had the incorporated employee earned the income directly. Upon payment of the after-tax funds to the incorporated employee as dividends, double tax accordingly results. If enacted, the PSB Proposals will once again reinstate the punitive effect of a corporation being considered to be carrying on a personal services business. It is questionable whether this impact is truly in keeping with Finance's stated commitment, in 2010, to "ensuring tax fairness" for all Canadians and the intention of the PSB rules to "ensure that incorporated employees are treated comparably to actual employees for income tax purposes."⁸

Potential Defences and Restructuring

The best result for a service provider, under the existing rules or the PSB Proposals, is if a successful argument can be made that the corporation is not carrying on a PSB but rather, absent the corporation, the individual would be viewed as an independent contractor

to (and not an employee of) the service recipient corporation. Practically, this argument stands a far greater chance of success where the corporation has a history of providing services to a number of clients. Where the facts are that the corporation provides services only to one service recipient on, essentially, a full-time basis, the situation is far more complicated. It is particularly in this situation that restructuring should be considered to avoid the punitive impact of the PSB Proposals.

One possibility, which is perhaps in keeping with Finance's unstated goal of the PSB Proposals, is for current PSB-service recipient arrangements to be restructured so that the individual is employed directly by the service recipient (i.e., cease the interpositioning of the corporation). Such a restructuring may, however, be undesirable from the service recipient's perspective, since it could give rise to liability on the service recipient (now an "employer") to deduct and make remittances in respect of source withholdings such as tax, workers' compensation, Canada Pension Plan contributions, and Employment Insurance contributions, to undertake expenses in respect of employee benefits and training, and to be exposed to other employment and labour law concerns such as obligations for severance on

⁸ See 2010 Government Response to the Standing Committee on Finance, "Servant Or Master? Differing Interpretations of a Personal Services Business."

termination of employment and potential for vicarious liability. Due to the relative expense of such benefits and responsibilities, it may well be the case that the salary which can be paid to the individual directly is lower than the service fee previously payable to the corporation. Even if such a restructuring was commercially acceptable, given that the PSB Proposals have effect in the 2012 tax year, there may simply not be sufficient time to implement such modifications to the arrangements between the parties.

One potentially simple solution would be for the corporation carrying on the PSB to pay out all of its income in the form of salary to the incorporated employee, relying on the Canada Revenue Agency's published

administrative position as to the reasonableness of salary and bonuses paid to owner-managed businesses. The effect should be that the corporation's income is reduced to nil (i.e., no corporate tax would be paid) and the individual pays tax on essentially the same basis as if the income had been earned directly. From a tax perspective, this removes any benefit or detriment from incorporating and, from a commercial perspective, may be preferable, at least in the short term, since contractual arrangements with third parties would not need to be amended.

Clearly, no one solution will work in all situations. What is important is that the PSB Proposals be properly evaluated in the particular circumstances.