



CESTNICK

TAX MATTERS

How to avoid the taxman's label of an incorporated employee

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Have you had the opportunity to visit a tax professional lately? The first thing most people learn when they visit a tax pro is that every tax problem has a solution that is straightforward, uncomplicated, and probably wrong. The second thing they learn is that a tax specialist is someone who tells you about problems you didn't know you had and then fixes them in a way you don't understand.

Speaking of tax problems that you didn't know you had, I want to talk today about something called a personal services business. There are many Canadians who are carrying on this type of business but don't know it, and don't understand the implications. Let me explain.

The definition

A personal services business (PSB) is a corporation that you or someone related to you owns that provides services to, usually, just one customer and where the taxman would conclude, after looking at the facts, that you're really an employee of that customer. In other words, you're really an incorporated employee in the eyes of the Canada Revenue Agency.

You're pretending to be self-employed – but you're not really. Now, if your corporation happens to employ more than five full-time employees or your customer is "associated" (as defined in the tax law) with your corporation, then you'll escape the label of a PSB.

The implications

So, what does it mean if you have a PSB? It's bad news from a tax perspective. Your company won't be eligible for the general tax rate reduction or the small business deduction, which reduces the company's tax rate on the first \$500,000 of active business income to between just 9 per cent and 12.2 per cent, depending on your province or territory. Instead, your corporation will pay tax at full federal and provincial corporate tax rates (between 36 per cent and 44 per cent), plus an additional 5 per cent.

What about tax deductions? A PSB is limited to deducting salary and wages paid to you (the incorporated employee), any benefits or allowances paid to you, certain expenses related to selling property or negotiating contracts and

legal expenses incurred to collect amounts owing.

The escape

How do you avoid the PSB rules? You'll escape these rules if you and those related to you (that is, non-arm's length to you) do not own 10 per cent or more of any class of shares of the corporation providing the services. In addition, if your corporation employs more than five full-time people – a tough test to meet – you'll side-step the PSB rules.

In order for the PSB rules to apply, the CRA has to arrive at the conclusion that, if it weren't for the existence of your corporation, you'd be considered an employee of the customer who is paying you. If you can structure your arrangement with your customer so that, on balance, you aren't considered an employee, then you may be able to avoid the PSB rules (even if you haven't hired five full-time people and you own 10 per cent or more of your corporation).

There are some tests that have been established by the courts, and are accepted by the CRA, for determining whether someone is an employee or self-employed. The first test is the intention test. Did you sign a contract of service (akin to an employee-employer relationship) or a contract for services (a business relationship)? Your agreement should show an intention for an independent contractor relationship.

The second is the control test. Can you control when and how you perform your work? A self-employed person usually works independently, has the ability to work for multiple customers, can refuse work from a customer, and can hire others to assist with the work. Also, the

relationship between the worker and customer does not normally involve an indefinite period of time, subordination and the worker being closely integrated into the operations of the customer's business.

The third is the tools test. Do you own or lease your own tools and equipment to carry out your work? If you provide your own tools and equipment, and you're responsible for the cost of repairs, maintenance and insurance, and perhaps even provide your own workspace, then you'll look more like a self-employed person.

The fourth is the economic reality test. Do you have the opportunity for profit or the risk of loss? A self-employed person is financially liable if they don't fulfil the obligations of the contract with the customer, receives no protection or benefits from the customer, advertises and actively markets their services, and is free to make business decisions that will affect their profit or loss.

If you think the taxman might consider you to be carrying on a PSB, visit a tax pro and take steps today to structure your arrangement to avoid PSB status. Your wallet will thank you.

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