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TAX MATTERS

The taxman’s project on incorporated employees is in full swing

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My friend Charlie quit his job recently. He used to work for a company that produces helium, among other gases. “Why did you quit the helium business?” I asked. “I didn’t like the tone of voice my co-workers used with me,” he said. “But I hear they hired you back on a contract basis,” I continued. “That’s right. I’m saving tax now that I’ve got my own corporation,” Charlie replied.

We chatted a little longer. Charlie didn’t realize that he’s caught under the “personal services business” (PSB) rules in our tax law. As it turns out, the Canada Revenue Agency began a pilot project in 2022 to identify PSBs across the country. Today, I’ll share the rules, the CRA’s key findings so far and some tips.

The rules

Plenty of businesses have hired independent contractors rather than employees to meet their staffing needs. In Charlie’s case, the company hiring him required him to incorporate because it’s simpler and less costly for them. On the surface, this seems to make good tax sense for Charlie. How? A small business corporation is generally entitled to a low rate of tax (just 11 per cent on average across Canada) on the first $500,000 of active business income thanks to the small business deduction.

The problem, however, is that the PSB rules will deny the small business deduction and thereby prevent certain people from taking advantage of the lower corporate tax rate. This is the case when, like Charlie, a person is more akin to an “incorporated employee” than a self-employed individual.

As a PSB, Charlie’s corporation can deduct any salary, wages or benefits paid to him but generally can’t deduct other expenses – with the exception of amounts that would have normally been deductible by an employee, such as costs incurred in connection with the selling of property or negotiating contracts and legal expenses to collect amounts owing for services rendered.

If the earnings of a PSB are kept in the corporation and not paid out as taxable salary, wages or benefits to the incorporated employee, the company will pay tax at a much higher corporate tax rate (an average of 40 per cent across Canada).

The findings

The CRA has completed Phase 1 of its pilot project on PSBs. The department surveyed 2,100 corporations and found that 220 of them (about 10 per cent) were using the services of a PSB. About three-quarters of PSBs work in three industries: (1) transportation and warehousing (35 per cent, with 95 per cent of these in general or specialized freight trucking); (2) professional, scientific and technical services (26 per cent); and (3) construction (13 per cent).

Furthermore, almost two-thirds (64 per cent) of PSBs are incorrectly claiming the small business deduction, which they are not eligible to claim. The CRA found that this error results in having to repay the CRA an average of $16,711 in corporate taxes.

Phase 2 of the CRA's PSB project is under way until June of this year. In this phase, the agency is trying to identify more corporations that may be PSBs, review their 2022 tax years and "educate" (or reassess?) taxpayers to ensure taxes are paid.

The definition

Our tax law will consider your company to be a PSB if the following conditions are met:

- as the incorporated employee you are a "specified shareholder" of the PSB corporation (generally, you and/or those related to you own 10 per cent or more of any class of shares of the company).
- if it were not for the corporation, you'd be considered an employee of the hiring business.
- your corporation does not employ more than five full-time employees throughout the tax year; and
- the amounts received by your corporation for services were not received from an associated corporation.

The second point is where most people get caught under the PSB rules. There are tests that have evolved from court cases that can be used to determine whether you are self-employed or really an incorporated employee (see my article from July 7, 2022, for more).

The tips

Your best bet is to avoid PSB status by structuring your written agreement properly with the business hiring you. Make sure that your intention to be treated as self-employed, not as an employee, is clear. Also make sure, to the extent possible, that you have control over when and where you work, that you're not providing services to just one company, that you provide your own tools to perform your services and that you're taking on some economic risk (a chance for a profit or a loss).

Finally, if your company is considered a PSB, it may make sense to pay all its income out to yourself as taxable salary, wages or benefits to avoid the higher corporate tax rate on the income.

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