

Personal Services Business Tax Rules

Avoid The Potential Pitfalls Arising From The Personal Services Business Rules

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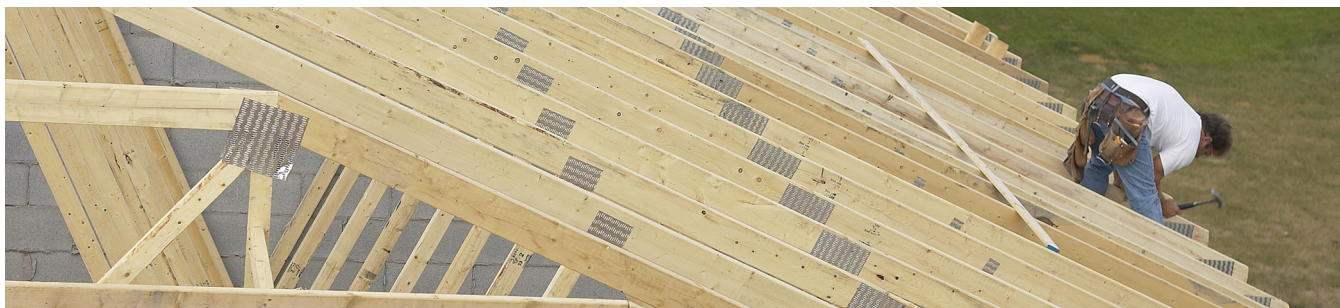
The real estate and construction industry is well known for outsourcing various activities to subcontractors who possess expertise and special skills, which allows for overall cost efficiencies in the construction or erection of various types of projects. However, a common question arises in subcontracting situations: are subcontractors employees of the hirer or independent contractors in business for themselves? The answer to this question can have significant tax impacts on both the hirer and the worker. Furthermore, if the worker is incorporated, the tax advantages one thought would be available in such situations could in fact become disadvantages without proper advice on whether it is possible to structure such contractor-subcontractor relationships.



It is often desirable for both the hirer and the worker to consider their relationship to be that of an independent contractor performing a contract for services rather than an employee performing a contract of services. In such cases, the hirer can avoid paying payroll taxes such as CPP and EI, and the worker is generally allowed to deduct a wider range of expenses than would otherwise be the case if he were considered an employee. However, the common intention of both parties to agree on the status of their working relationship does not always mean that common intention will be shared by the Canada Revenue Agency if the circumstances surrounding their relationship clearly indicate otherwise. The determination of whether a worker is an employee vs. an independent contractor is not clearly defined in the Income Tax Act. Rather, its roots have been established through a long history of case law, which has developed over several decades. The primary factors that courts have considered in making such determinations are as follows:

1. The degree of control exercised by the hirer over the duties performed by the worker
2. The degree to which the work provided is integrated with the business of the hirer
3. Whether or not the hirer provides the tools to be used by the worker in the performance of his duties
4. Whether the worker has a chance of profit or a risk of loss in conducting his activities

One of the key benefits of incorporating for the worker is being able to access the small business deduction, which can effectively reduce an Ontario corporation's tax rate to 15.5 percent on its first \$500,000 of active business income. With such a low tax rate, there is often an incentive to incorporate. However, a common misconception is that workers who offer their services to a hirer through a corporation will always be able to avail themselves of this low corporate rate. Unfortunately, that is not necessarily the case. Individuals who offer their services through a corporation could be in for a nasty shock if it is determined, but for the existence of that corporation, they would otherwise be considered an employee of the hirer. Such corporations are referred to as "personal services



businesses." In addition to losing the small business deduction, the income received is subject to tax without the benefit of the general tax reduction enjoyed by larger corporations, resulting in a corporate tax rate of 39.5 percent. Other than a few limited specified expenses, the only expenses able to be deducted by such corporations are the wages and benefits provided to the "incorporated employee." Consider the following situation:

- HB is a homebuilder that constructs new homes in the GTA.
- In building its homes, HB hires individuals to construct the frames of its houses. With one exception, these individuals are employees of HB and are thus subject to withholding taxes, CPP, EI, etc.
- The exception is Frame Co., a company incorporated and owned 100 percent by Mr. F., a former employee of HB. Frame Co. provides the same services to HB as the employed individuals, and under the terms of a contract is subject to the same rules and policies as the employees.
- The contract between HB and Frame Co. stipulates that HB will provide Frame Co. with nail guns, saws, hammers and all other tools necessary for the work to be done.
- As part of their contract, HB insists that Frame Co. must be on the job site by 8:00am each weekday, and cannot leave without the approval of HB's job foreman. Furthermore, Frame Co. is not able to subcontract its services out to others or hire individuals other than Mr. F. without HB's prior approval.
- Frame Co. is paid an hourly rate for which it issues an invoice (including HST) to HB.
- HB warrants all of its houses for a limited time period for any defects, including those framed by its employees and Frame Co.
- Frame Co. earns \$100,000 of gross income and pays a salary of \$40,000 to Mr. F. It also incurs \$10,000 of other expenses (professional fees, office expenses, etc.) resulting in pre-tax income for accounting purposes of \$50,000.

The above facts clearly indicate that Mr. F. would be an employee of HB if it were not for the existence of Frame Co. HB has a high degree of control over Frame Co., and provides Frame Co. with all necessary tools to do the job. Based on the hourly rate compensation method and the warranties given by HB, limited risk is being undertaken by Frame Co., and there's little chance for the company to earn additional profit beyond its hourly rate. The company is essentially an "incorporated employee." Mr. F. may be shocked to find out that the corporate tax owed by Frame Co. is about \$23,700 rather than the \$7,750 he was expecting.

Of course, the facts associated with most cases will not be as clear-cut as those set out in the above example. In many cases, factors will point in both directions regarding the question of whether a corporation is a personal

services business or not. Therefore, it is crucial to have a properly worded contract in order to avoid being classified as a personal services business. In some circumstances, the hirer will not agree to certain terms of a contract that provide a worker with too much freedom (e.g., ability to hire others, ability to do work when desired, ability to refuse work, etc.). In these situations, it may be impossible to avoid a company from being classified as a personal services business. However, even in these cases, steps can be taken to avoid the otherwise adverse tax consequences of being so classified.

Regardless of whether you are the hirer or the worker, if you are considering entering into an arrangement where there is a degree of doubt regarding the question of whether a relationship is an employment vs. self-employment relationship, proper advice should be sought, particularly where the worker is a corporation. Please feel free to contact a member of BDO's Real Estate and Construction team for further information and steps that can be taken to avoid the potential pitfalls of being caught under the personal services business rules.



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