



Association of Professional Computer Consultants

Briefing Note to the Standing Committee on Finance
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Firm Value in the Market for Flexible Labour
A Briefing Note on Canada's Independent Contractor Market

Respectfully submitted by
The Association of Professional Computer Consultants

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About the APCC

The Association of Professional Computer Consultants (www.APCCOnline.com) is a not for profit organization which provides access to services for and represents the interests of independent computer consultants. A national organization, the APCC was formed in 1985, with the majority of its members providing their services in the Information Technology sector.

Purpose

Engaging computer consultants on a contract basis is a well established business practice used throughout the Canada's public and private sectors. This method of engaging talent is valued by client organizations for the vital role it plays in efficiently allocating scarce technical resources to those clients in need. An efficient contract labour market offers client organizations fast and flexible access to extra capacity or specialized knowledge and skills, thereby allowing them to capitalize on opportunities in their own organizations.

The majority of independent computer consultants working on a contract basis provide their services through corporations for reasons of liability limitation and tax deferral. CRA classification of such companies as Personal Service Corporations is a matter of great concern to the industry.

The purpose of this brief is to provide insight as to the contribution that the small business corporations formed by independent contractors contribute to Canada's economy, and to clarify

- 1) The differences which exist between compensation to full time employees and independent contractors, and
- 2) The manner in which independent contractors are taxed, both within their corporation on retained earnings (if any) and as they take their taxes out of the corporation (Income Tax and Dividend taxes).

It is the submission of the APCC that an opportunity exists to use revisions to the income tax to clarify the terms and conditions under which the original objective of Personal Services Corporation can be re-established in conjunction with other enhancement which will benefit both the government of Canada and the entire independent contractor community.

Introduction

The Contract Services sector is a critical aspect of the Canadian economy and labour force. It provides Private and Public sector organizations a rapid ability to augment their core employee base, thereby providing a source of strategic flexibility and access to specialized knowledge. It is estimated that up to 2.6 million Canadians participate in the contract services sector, spanning a large number of professions and industries.

Providing Contract Services on an independent basis offers significant benefits to both worker and client firms and as such is a rising trend. This is particularly true in the Information Technology sector but affects all categories of knowledge driven services, including Engineering, Creative Design, Management Consulting, Financial Advisory Services and Legal services. Many individuals choose to offer their

services as small incorporated entities which provides them access to limited liability, support for business investment and tax planning/deferral considerations.

On December 3, 2009, The House Standing Committee on Finance was presented a characterization of Personal Services Corporations by CRA that threatens the vitality and strategic role played by Canada's Contract Services sector. It is the APCC's view that the application of the Personal Services Corporation should be reversed and dismissed for the following reasons,

- 1) **It unfairly targets Small Services Businesses.** The definition of a Personal Services Corporation is arbitrary and unfairly persecutes the owners of legitimate Small Services Businesses by applying higher taxes. This definition is often applied retroactively based on highly subjective criteria, thereby creating uncertainty and harming market efficiency.
- 2) **It harms the competitive position of Small Services Businesses.** Removing the ability of a small services business to claim valid business expenses places them at a disadvantage versus their large business competitors. Vital business expenses disallowed by the PSC model include legal and accounting professional fees, business travel, investments in research and development, and investments in skills training.
- 3) **PSC Harms Small Business Investment.** Application of higher taxes serves to inhibit the ability of a Small Service Business owner to reinvest in and grow their business, such as through the hiring of additional employees.

It is APCC's view that the Personal Service Corporation interpretation offered by CRA stands contradictory to Canada's longstanding policy of encouraging small business development, which is widely recognized as the engine of Canada's economy. In support of this position, this briefing paper seeks to achieve three things

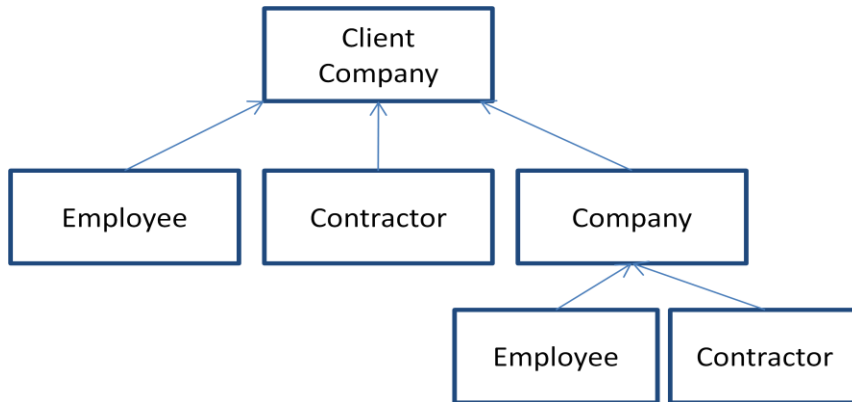
- 1) Provide a context of the role of Incorporated Independent Contractors relative to the overall market for Contract Services
- 2) Describe the benefits of Canada's existing contract labour structure for workers, client organizations and the Canadian economy as a whole
- 3) Provide policy recommendations that reinforce the existing entrepreneurial model while providing a means to clarifying the ambiguity present between government legislation and policy.

Contract Services Market Orientation

A common perception is that the contracting IT sector enables the market to optimize the allocation of scarce professional resources. While the APCC's interest is primarily in the IT sector, it is suggested that contracting achieves similar goals for Engineers and other verticals.

There are only three ways that a client organization can secure labour in Canada. As presented in Table 1 below, an organization can hire the person directly as a Full time Employee (FTE), or as a temporary Independent Contractor (IC). Alternatively they can hire a company which will in turn engage the worker using one of these two methods. Such companies are commonly called System Integrators (SIs) or Management Consulting firms

Table 1 –Employment Methods



This simplified view of alternate strategies to staffing underlines the simplicity of the business alternatives available to companies and government departments in need of labour resources.

Worker Engagement Models

While the Full time Employee relationship may be well understood, the mechanisms for engaging an independent contractor are likely less familiar. When engaging an IC (i.e. the 'Contractor' options described above) there are four ways that an individual can provide their services to the client organization. The individual can,

1. Have their own incorporated company
2. Have a partnership with one or more person
3. Provide their services as a Sole Proprietorship
4. Provide their services as a temporary employee

The following table highlights some of the aspects of each engagement model.

Table 2 – Employment Models

	Incorporation	Partnership	Sole Proprietorship	Temporary Employee
Fiscal Year End	Set by the company	Calendar Year	Calendar Year	Calendar Year
Retained Earnings	Yes	NO	NO	NO
Insurability (Employment insurance)	N/A Bill C56 applies	N/A Bill C56 applies	Yes	Yes
Pensionability (CPP/QPP)	Yes	Yes	Yes	Yes
CPP Employer Premiums	Paid by the Company	Paid by the Partnership	Paid by end client or agency	Paid by end client or agency

Benefits of Contracting

Independent contractors are a crucial aspect of the Services sector which in turn supports the overall competitiveness of the Canadian Economy. Below we provide an overview of the value of the independent contractor market, from the perspective of each stakeholder.

Contracting Benefits for Independent Contractors

- Greater independence and control over work
 - o Able to capitalize on entrepreneurial opportunities
 - o Self manage career development through contract selection
 - o Self manage Skills Development through training and contract selection
 - o Contract market is able to accommodate flexible hours and part time, if desired
- Superior Compensation (typically 30-40% greater than FTE equivalents)
 - o Earn a Flexibility Premium and be directly rewarded for skills development
 - o Capture the ‘business profit’ in addition to personal wages
 - o Contractors are paid for all time worked

Why Client Firms Benefit from Independent Contracting

- Able to procure skilled workers directly, at a lower cost than if engaging a full professional services firm (i.e. System Integrators - SIs)
- This market provides rapid and flexible access to desired skills or extra capacity
- Using Independent Contractors provides a means to access rare or difficult to secure skill sets

- Able to engage with contractors very quickly (short time to hire)
- When work is of a project or temporary nature, engaging independent contractors allows the firm to avoid the administrative burdens associated with FTE's (HR Costs, Administrative Costs, Downtime costs if underutilized, termination costs at project completion).

Value of Independent Contracting to the Canadian Economy

- Provides an efficient means to achieve the optimum allocation of scarce labour resources
- A critical source of labour market flexibility
- Provides very strong entrepreneurial incentives to individual workers
- Delivers more tax dollars vs. employee models
- Attract Services work from offshore
- Supports the formation and growth of technical skill clusters
- Supports a healthy placement agency market, which increases the efficiency of the overall labour market (full time and contract placement)
- Flexible resourcing allows firms to be more nimble in meeting their business objectives, and hence more competitive

Need to Preserve the Small Incorporation Model

Allowing individuals to offer their services through small personally owned corporations is a critical aspect of contract labour market. This form of organization allows the individual several unique advantages, which in turn support the overall structure of the market for services

- 1) **Limited Liability.** As a third party service provider, these contract workers are subject to contractual liability. Providing their services through a personally owned corporate entity allows a high degree of control over their work while also sheltering their personal assets, such as their family home, in the event a liability claim is ever made/realized.
- 2) **Incentive for Self Investment.** Delivering services through a corporate entity provides the individual worker a modest tax advantage when making business investments. In the knowledge economy, the most common investment is in training for new skills or professional certifications. This incentive for self investment/improvement allows continual renewal and advancement of Canada's technical skills market, thereby making it a more attractive environment to engage service professionals with hard to find skill sets.
- 3) **Ability to defer income.** Where tax on income is deferred, the small business has access to capital which it can use to fund its operations and invest in activities which will generate future income for the business. Likewise this deferred income can be used to pay expenses and provide personal income stability for those times between contract assignments.

Impact of Government Tax Collections

Independent contractors typically generate a greater amount of total tax revenue than their Full Time Employee counterparts. This is due to

- 1) Independent Contractors have an ability to earn higher cash compensation (creating a higher tax base) with the taxable income including the premium paid to contractors. In effect, the workers are being paid a premium for the flexibility they offer as contractors and at the same time, the non financial benefits of being an employee are monetized and made available for taxation
- 2) The difference between the tax rates paid by a FTE and the tax rate paid by a contractor in order to get revenue received by the corporation into after tax dollars (i.e. in their jeans) are relatively minor contrary to suggestions made by the CRA in its testimony
- 3) Sales Tax is charged on Services purchased by client organizations, creating a distinct line of tax income that does not apply to traditional employee relationships.
- 4) A healthy services market makes Canada a more attractive place to perform services work. This results in attracting services business from off shore, thereby increasing Canada's tax base

Given the complex nature of this topic, rather than attempt to tackle this issue in the present briefing note, we are able to provide more information upon request.

Economic Benefits

As noted previously, contracting enables the market to optimize the allocation of Canada's scarce resources. The business model which exists in Canada is not unique, similar frameworks are successfully employed in Australia and certain European countries. Within most major corporations, contractors form a significant percentage of the IT work force. The Federal Government for instance is most likely the largest consumer of contract resources in the country. I am unable to comment on other categories of professional services but suspect that the percentages will be similar if not greater.

There is a perception of great potential for the current contract business model to be negatively impacted by changes to the legislation which would enable the CRA to audit PSCs, reassess taxes and disallow expenses.

Most recently CRA officials have confirmed that the CRA is targeting the ICT industry and a number of ICs have reported that they are being audited. This simple occurrence of audit has already sent ripples of concern throughout the industry.

One can only imagine the impact on companies who rely upon contract labour, should access to a fluid labour pool dissipate. In the United States, the introduction of Bill 1706 fundamentally shifted the US contract sector from an Independent Contractor model to a large company driven employee based model. The result was a fundamental shift in the contract sector which resulted in higher unemployment for technology workers, higher costs to secure third party services (due to administration and overhead) and lower wages for the individual workers.

In response to the rising cost of and reduced flexibility of third party labour, a large number of American firms accelerated and expanded their off-shoring strategies, thereby causing these high quality jobs to permanently disappear from the American economy. Should proposed legislative changes compromise the Canadian contracting economy, it is very likely that Canadian companies, many of which already have offshore operations, would pursue a similar course of action with similar catastrophic consequences.

Recommended Actions

1. Defer any revisions to the Income Tax Act and terminate the current CRA program of audit which is currently targeting PSBs, until such time that a more comprehensive view of the role of Independent Contractors in general and Personal Service Corporations in particular are better understood.
2. Restrict the application of Personal Service Corporations to small business where
 - a. The income level is greater than a legislated amount (e.g. \$200,000) per annum
 - b. The individual providing his/her services through a corporation where he/she own more than 40% of the shares was employed by the client corporation immediately prior (six months or less) to the initiation of the contract agreement.
3. Require all corporations and placement agencies which use or provide the services of contract labour to report the funds paid to the firms / individuals which they engage.
4. Develop legislative and policy solutions that provide Canadian Small Services Businesses with fair access to the same benefits and obligations available any other Canadian company under the *Income Tax Act*.