

History of the Personal Service Business

The Income Tax Act has a clause Section 125(7) which was drafted to respond to a tax avoidance strategy. That strategy involved an employee resigning his/her position, forming his/her own corporation and then entering into a contract with his/he former employee to provide the same services back to his/he former employer.

Essentially the **labour engagement was restructured**, thereby enabling the funds to be sheltered inside the corporation with received revenue, net of claimed expenses being paid out over time thereby enabling them to pay at lower tax rates.

At the time that the strategy was implemented, the motivation was to avoid the crushingly high tax rates which were being applied at the highest marginal tax rate. Top marginal tax rates were in excess of 55%.

Since those “bad” days, the government has changed its strategy with many saying it has improved. The highest marginal tax rate is now 49.53% but applies only when your income exceeds \$509,000.

Government Goals

The Government has indicated that it wants to increase its tax revenues. To do so, it has, as one of its initiatives, targeted Knowledge Workers who provide their services on contract:

1. They claim that contractors do not pay comparable tax rates as full time employees.
2. They claim that contractors are avoiding their responsibilities under the tax act.
3. They claim that such people reduce their taxable income by claiming expenses that a full time employee cannot claim.

Personal Services Business Initiative

The government’s most recent initiative has directed the CRA to try to apply the PSB legislation against Knowledge Workers who would provide their services to client corporations under contract. In brief their strategy appears to be:

- To increase the penalty on people determined to be Personal Service Workers.
- To eliminate the deductibility of all expenses legitimate and otherwise for such PSBs.
- To eliminate the availability of the small business tax rate so that:
 - They are subject to the large corporation tax rate and
 - Are therefore motivated to take out all income in the year that it is incurred
- To provide offer Knowledge Workers some form of amnesty program if they voluntarily self describe themselves as a PSB, even though they might not be one.

Obstacles to the Government Initiative

The challenge to the government is getting the courts to determine that today’s Knowledge Worker, who provides their services through a corporation are a PSB.

Historically a PSB determination involved:

- A restructuring of employment in order to reduce /avoid taxes.
- From one of employee to one of contractor through a corporation.

However, most commonly the contractors being targeted do not have any prior relationship with the clients to whom they are providing their services and as such there is no restructuring of the relationships involved, because there was no prior relationship to restructure.

Secondly today's individuals providing services through a corporation are engaged in a legitimate business model. Where the courts apply the tests used to differentiate between a contract relationship and an employee relationship, the following characteristics emerge:

- Tools
 - For a Knowledge Worker, their primary tool is their brain.
 - Clients may define the tools to be used on site due to security and communication issues, which are fully independent of the working relationships.
- Work Location
 - For a knowledge worker they can work anywhere.
 - Where they work or where their client ask them to work is a function of other factors including
 - Security
 - Accessibility
 - Effectiveness
 - Communication, etc.
- Risk of Loss
 - Being involved in a corp. to corp. relationship
 - They are commonly deprived of the security of ESA legislation.
 - They risk the possibility of non payment if they fail to deliver the services in a manner which is acceptable to their clients.
 - Risk of early termination without consideration.
- Chance of profit
 - Contractors are rewarded with a renewal or extension when they do good work
- Operational Model
 - Contractors are obligated to incur expenses in support of the operation of their business
 - Professional (legal, accounting, etc)
 - Training, professional development
 - Promotion and entertainment
 - Office space
 - They are required to self finance other employee benefits commonly received by a full time employee in addition to salary or per hour income.

Some would say that it is significant that recently when the CRA took what everyone thought would be a test case to in front of a judge as part of the Preliminary Trial review; the CRA abandoned the assessment presumably following comments from the judge.