



Briefing Note to the Standing Committee on Finance
40th Parliament, 3rd Session

Respectfully submitted by
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Table of Contents

1	Introduction
1.1	Summary
1.2	Procom (is a placement agency)
1.3	What does a placement agency do?
2	CRA Testimony
3	Financial Considerations
3.1	Taxation
3.2	Salary
3.3	Retained Earnings
3.4	Dividends
4	Non-Financial
4.1	EI Participation
4.2	CPP Participation
4.3	Comparison of Employment Models
5	Economic Impact
5.1	New Immigrants
5.2	Availability and Cost
6	Conclusions
7	Recommendations

1. Introduction

1.1 Summary

- Canada is known for its resources.
- One of its most important resources is its people.
- Contracting enables the market to optimize the allocation of scarce professional resources to corporations and government bodies where there is a need.
- The Canadian labour market has evolved over the past 40 years and as a result there is a need to review and upgrade Canadian tax legislation to reflect the realities of that market and the model which is currently functioning and functioning well to the benefit of the Government, Canadian corporations and professionals who provide their services through corporations.

1.2 Procom is a Placement Agency.

- It places individuals into full time or Contract employment in the Information Technology sector.
 - Formed in 1978, when its founder found himself unemployed
 - It currently services clients
 - from coast to coast through its 10 Canadian offices and
 - across North America, through 2 US offices.
 - It has more than 3,000 contractors on assignment at anyone point in time.

- Its acclamations include:
 - Its founder was recognized as entrepreneur of the year in 2000 in the Business to Business category.
 - It has been recognized as one of Canada Best 50 Managed Companies in each of the past 4 years.
 - An industry survey conducted by the Branham Group lists it as the largest IT staffing firm in Canada.

1.3 What does a placement agency do?

- A placement agency vets the requirements of its clients and vets the skills and expertise of individuals in the job market in an effort to match requirements to available skills.
- Where the match leads to full time employment the agency
 - takes a fee, usually expressed as a percentage of the FTE salary.
- When the match leads to a contract assignment the agency
 - administers the invoicing to the client and
 - payment to the contractor
 - with responsibility to ensure that the rights and interests of the contractor are protected
 - and also that the agreement with the client is properly structured and documented.
- Its services and the services of its competitors are relied upon by virtually
 - every major corporation and
 - All government bodies in Canada, including both federal and provincial.
- The IT contracting sector provides valuable service to the Canadian economy in support of the market allocating scarce resources to those corporations and government departments/ministries where a need exists.

2 CRA Testimony

It was CRA's testimony to the Standing Committee on Finance

1. That individuals providing their services through corporations, which may be considered to be personal Services Corporations were taking advantage of a loop hole
 - a. The Federal Small Business tax rate is 11% and
 - b. These individuals were realizing some unfair tax advantage
2. That individuals were realizing the benefit of reduced taxable income as a result of taking deductions for business expenses.
3. Where people provided their services through Personal Services Corporations it was unfair to FTEs who paid income taxes.

The major concern expressed by the Department of Finance, expressed in the report "was that employees of the employer should be treated in the same way for tax purposes, regardless of the structure of the relationship".

- **The implication that a person providing services through a small business is paying taxes at a preferential small business tax rate in preference to the income tax rate is misleading.**
- **A basic tenet of Canada's tax system is that citizens are entitled to structure their affairs, within the constraints of the tax system in the manner which they consider best to minimize their tax obligations.**

3 Financial Considerations

3.1 Taxation

Canada's taxation system is progressive, with higher tax rates applying at higher levels of income. The following table presents tax rates and taxes payables over a range of incomes from \$50,000 to \$250,000 per year.

- There is pre-tax income, which is what is earned and
- There is after tax income, which are the funds which the individual has in their jeans net of all applicable taxes.

For a full time employee (FTE),

- What they earn is reported on their T4's and represents their pretax income.
- What they have after they have remitted their income taxes is their after tax income.

For Independent Contractors (IC).

- There are two ways to tax money out of the corporation and get it in your jeans as after tax funds:
 - You can be paid a salary
 - Salary income
 - is subject to the same tax rates for FTEs
 - Enables the recipient to participate in CPP with the corporation paying the employer premiums
 - Enables the recipient to defer tax through investment in RRSPs
 - You can be paid in dividends
 - Dividends are taxed at a provincial tax rate which is 31.5% in Ontario
 - Funds distributed as Retained earnings have already been taxed at the Small Business Tax Rate
 - The blended tax rate in Ontario is 26.3
 - How does the blended tax rate work
 - There is no benefit of this rate until income exceeds \$75,000

- Income received as dividends is not eligible for CPP nor RRSP participation

3.2 Salary

Where funds are taken out of the corporation as salary the individual is subject **to exactly the same Income Tax schedule** as a full Time Employee might be.

- Empirical evidence is that individuals earning less than \$125,000 take 100% of their earned income out of the corporation and are taxed on it.
- A major difference is that ICs demand (are paid) at premium rate in lieu of employee benefits and as such pay income taxes at a higher rate due to Canada's progressive tax system.
- As per CRA testimony
 - In 2007 55% of all Small Business claimed the small business tax deduction.
 - This means that 45% did not leave any funds in their corporation.
- A more meaningful insight might be gleaned by identifying the percentages by level of retained earnings (in \$\$10,000 or \$20,000 increments)

3.3 Retained Earnings

- Are those funds left in the corporation after all expenses and salary have been paid out.
- It is these funds and these funds alone upon which the Small Business deduction can be claimed.
- Once funds are claimed as retained earnings
 - The funds are only distributed as dividends.
 - If they were to be distributed a salary, the individual would pay excess taxation (i.e. small business and income).

3.4 Dividends

- Are issued when the individuals wants to get Retained Earnings out of the corporation and into their jeans as after tax income.
- The Dividend tax rate varies by Province and in Ontario is 31.5%
- The following table presents the blended rate when the federal and provincial small business tax rates are combined.

		Retained earnings		
		\$10,000	\$15,000	\$20,000
Small Business tax rate				
	Federal	11%		
	Provincial (Ontario)	5.50%		
		\$1,100	\$1,650	\$2,200
		<u>\$550</u>	<u>\$825</u>	<u>\$1,100</u>

	Retained			
	Earnings	\$8,350	\$12,525	\$16,700
Dividend Tax Rate	31.50%	\$2,630	\$3,945	\$5,261
	Effective Percentage	26.3%	26.3%	26.3%

4 Non-Financial

4.1 EI Participation

The income tax act prevents a person who owns more than 50% of the shares of a corporation from participating in EI through that corporation. Bill C50, which became effective in Jan 2010 modifies that restriction so that the individual now has the option of limited participation in the benefits of EI should they want to do so.

The inability of the individual to participate in EI, is one of the protections that the individuals decides to forego when they decide to offer their services through their own corporation. In effect and in actual practice they enter into contractual agreements with clients either directly or indirectly through placement agencies.

The recommendation presented by the CFIB that the CRA respect the contracts signed between self employed incorporated workers and their clients has great merit and is supported by Procom.

The CRA notes their loss of participation and as a result the premiums (approximately \$2000 consisting of employee and employer remittances) which might otherwise be available to the government if they were a FTE. It should also be noted that the government is avoiding the exposure of unemployment benefits which it might be obligated to pay out in the absence of employment for the individual.

4.1 CPP Participation

Participation in Canada's pension program (CPP) is a right available to every Canadian in the workplace. For individuals working under contract either as temporary employees or as sole proprietorships working through a placement agency, it is a right validated in case law, with the employer or placement agency being obligated to deduct premiums and remit the employers portion of those premiums. .

Likewise CPP is available to individuals working either through partnerships or through their own incorporation with their partnership or their corporation being obligated to deduct premiums and remit the employers portion of those premiums.

There is no situation where people working under contract are denied access to CPP participation

4.3 Comparison of Employment Models

A comparison of employment models shows that individuals who provide their services under contract are paid a premium in partial compensation for benefits realized by Full Time Employees. The simplistic application of tax rates to income earned is not a fair comparison.

The following comparison of non financial benefits of employees highlights the absence of the ability to apply an “apples to apples” comparison. Conversely the comparison of gross incomes and after tax incomes highlights the reality that the IC pays more in after tax income to the benefit of the government, even after allowance for deducted expenses.

Comparison of Non Financial Benefits

Ref.		FTE	Contractor
1	Income	\$80,000	\$75.00 per hr for 1800 hrs = \$135,000
	Less Expenses	N/A	15% = \$20,250
	Net Income	\$80,000	\$114,750
	Effective Tax Rate	34.30%	36%
	Income taxes	\$27,440	\$41,310
	After Tax come	\$52,560	\$93,690
2	Liability	Exposure limited to the employer	Contractually exposed to liability Common obligation to maintain E+O insurance
3	Continuity of employment	employer has this responsibility (8%+ termination pay)	Subject to availability of work
4	Continuity of income	employer has this responsibility (8%+ termination pay)	Subject to availability of work
5	Human resource support	Available through the corporation	Not available
6	career Counseling	Available through the corporation	Not available
7	Training	Available through the corporation	Self Funded
8	Legal Fees	Not applicable	Self Funded
9	Accounting Fees / reporting	Not applicable	Self Funded
10	Stability of work location	Not applicable	Varies with contract assignment
11	Work technology	Available through the corporation	Self Funded
12	Telephone Technology	Available through the corporation	Self Funded

5 Economic Impact

5.1 New Immigrants

- Contracting is a vehicle to assist new Canadians to get jobs and assimilate into the work force, obtain Canadian experience, obtain local references, transition from an unknown resource.
- What is the benefit to the Canadian economy when a new immigrant obtains employment in his//her chosen profession?
- What is the positive impact on the EI program when a new immigrant transitions from a benefactor of the program to a contributor to the program?

5.2 Availability and Cost

- The Contract business model as it exists in Canada provides Canadian companies a competitive edge.
- It attracts individuals who wish to pursue a career based upon their technical skills as opposed to career development within a corporation.
- This attraction provides a broad base of individuals with highly qualified skills for corporations to draw upon.
- It provides those skills at competitive rates
 - The rates charged the clients while above what the clients might otherwise pay a FTE are not significantly greater than the fully loaded cost of a FTE to the corporation.
 - These Independent Contractor rates are well below the rates charged by System Integrators or consulting companies which commonly charge multiples of the individual's salary
- If individuals were to cease to offer their service to corporations through their own corporation, added costs would be introduced to the business model with the inescapable result that the cost for those services would increase. At the same time as individuals transitioned to full time employment their mobility of the services which they offer would decrease.
- It remains to be seen how Canadian clients would react to a further increase in cost, following the application of HST to services combined with a decrease in availability. However if there are lessons to be learned from the US experience, one might expect an increase in the already established practice of outsourcing to locations like India and Indonesia which already offer availability and low costs.

6 Conclusion

Fairness is a fundamental principle of Canadian taxation and Canadian law. The current application of legislation related to Personal Services Corporations is fundamentally not fair as it now stands and as it is now being applied.

One has to ask why the government even cares if a relationship is “employee like”.

- Participation in CPP is available to all
- Admittedly, the individual who incorporates their own small business is excluded from EI program due to the fact that the person owning more than 40% of shares is excluded, but
 - This applies to all small businesses, not just those providing services and
 - Bill C156 has introduced the ability for such individuals to voluntarily participate in some aspects of the EI program.
- The inference that such individuals are being taxed (solely) at the small business tax rate (11%) and/or benefitting from a loop hole is misleading when in fact:
 - All income taken out of the corporation as salary is taxed at the same tax rates applied to FTEs.
 - When income is taken out as dividends the delta in tax rates are minor and are offset by lost access to the benefits of the RRSP program
 - The income level received by the corporation
 - Is a premium to comparable salary levels and in effect monetizes the benefits which a FTE might receive with the result that the taxable income is greater for an IC than for a FTE.
 - Is only partially offset by permissible expense deductions
 - Small Business provisions defer taxation, they do not avoid it.
- The application of HST in those provinces where it is applied against services is in effect double taxation.

When trying to compare apples to apples, one might ask the question:

1. What is the value of a manager who will guide, review and help direct their career?
2. What is the value of knowing your physical work location so that you can manage your life better, plan your commute or even buy a home close to your place of work in order to minimize your commute?
3. What is the benefit of penalizing an individual who is successful in their contract relationship as evidenced by the lengths of that relationship? The structure of the deal should be the sole criteria.

7 Recommendations

We would agree with the conclusions of the Committee report that the federal government examine the Income Tax Act with a view to propose legislative amendments in such a manner that reflect the realities of the modern labour market.

More specifically we would recommend that:

1. The Income tax Act recognize Contract engagements in addition to Employment engagements
 - a. With no consideration being given to similarities of the engagement “employee like” relationships.
 - b. A financial reporting program, similar yet apart from corporate and personal income reporting slips e.g. T4’s, T4A’s etc.
2. The committee reiterate the fundamental belief that all Canadians have the right to arrange their affairs, within the constraints of the law in the manner which enables them to minimize their tax obligations.
3. There be recognition that every Canadian has the right to participate in the benefits made available to Small Business without regard to:
 - a. The number of employees
 - b. The success of their engagements as evidenced by duration
 - c. The nature of the product or service being offered through their small business corporation.
4. The existing rights of all Canadians who provide their services as individuals, as reaffirmed in the 1985 Sheridan decision, to participate in Canada’s social programs including Canada Pension and Employment Insurance.
5. Where an individual provides services through a corporation and enters into a contractual agreement with another corporation, the government should accept the provisions of that contractual agreement without regard to the services being provided or manner in which those services are being provided.
6. It be an agreed principle that there must be protections to ensure that no individual or corporation is able to take advantage and/or deny the rights of individuals to participate in Canada’s Social programs.

