



Association of Professional Canadian Consultants

Contract Labour Personal Services Business (PSBs)

Standing Committee Report & Government Response

2015

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Introduction

On December 2, 2009, the Standing Committee on Finance held a hearing about taxation and characterization of Personal Service Businesses (i.e. PSB) by the CRA.

The essence of the meeting was CRA classification of small businesses delivering services which are determined by the CRA to be PSBs with the result that:

1. The small businesses were obliged to pay tax at the higher than regular corporate tax rate; and
2. Allowable expenses were limited to salaries and wages, which meant that expenses related to transportation, training, and advertising, were denied.

The view of the committee (refer to the page 6 of the Report of the Standing Committee on Finance¹) was that:

1. The federal government should examine the income tax act with a view to proposing changes which might reflect the realities of modern labour market; and
2. The rules regarding disallowance of the lower small business tax rate and of expenses deductibility, appeared to penalize professionals who have choose to become an entrepreneur and to incorporate.

The Minister of Finance responded to the committee in an Oct 6, 2010 letter² noted that:

1. The objective of the PSB business provisions in the Income tax Act was to ensure that individual who would provide their services through a corporation would be treated comparably for income tax purposes;
2. Comparison of:
 - a. Manitoba's small business tax rate of 11% (11% federal plus 0% provincial) to the federal/provincial personal income tax rate of an unincorporated employee of 35%; and
 - b. Quebec's small business tax rate of 19% (11% federal plus 8% provincial) to the federal/provincial personal income tax rate of 37%;
3. There is an absence of equality, and any changes to these rules with provide preferential treatment to the Information Technology sector.

The following diagram presents a comparison of the tax applicable to an Employee against the income flow and tax applicable to a Contractor.

Employees receive benefits such as employee contributions to a pension plan and/or benefit program, training costs, among others which are additional to the salary that they are paid. Absent eligibility to participate in such programs, contractors charge a premium for their services, which in this instance is presented as being 50%.

While the employee only pays Income tax, the diagram presents the view that when services are provided by a contractor, the government realizes tax in the following forms:

1. Sales Tax (i.e. HST) on the funds received from the client;
2. Income Tax on whatever funds the individual takes out of the corporation;
3. Corporate Tax on the funds residual in the corporation after (expenses and salary); and
4. Dividend Tax on any funds distributed from the corporation by way of dividend.

¹ Servant or Master? Differing Interpretations of A personal Services Business

² House of Commons Committees - FINA - Government Response to the Report of the Standing Committee on Finance

Independent Contractor Chronology

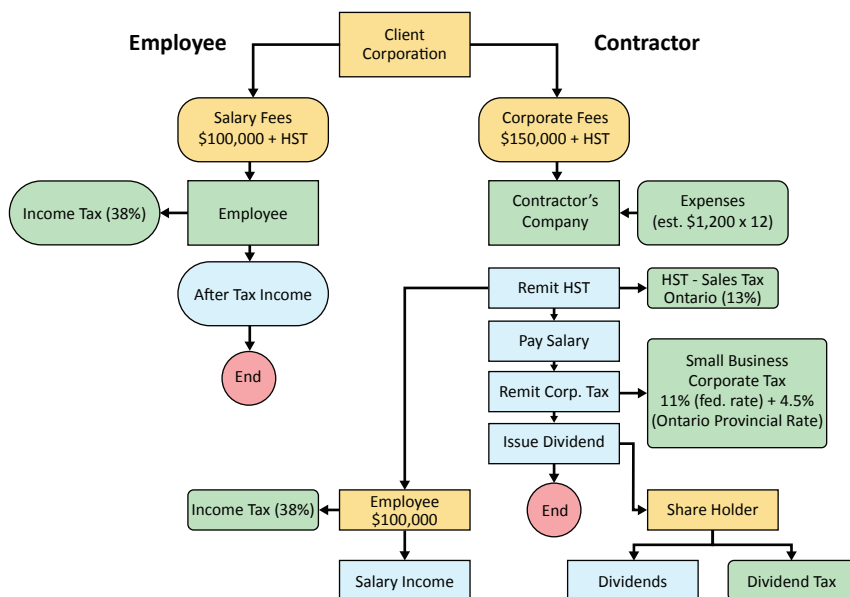
The following chronology lists events relative to evolution of the concept of contract labour and related events.

1. **1959** Peter Drucker's book *The Landmark of Tomorrow* predicts evolution to **Knowledge Worker** and **Service Providers** as foundation of economy in the 21st century.
2. **1969** under Trudeau, highest marginal Income Tax rates were in excess of 60%:
 - a. Ralph Sazio restructured relationship with Hamilton Tiger Cats from Employee to a Contract with his corporation, which then employed him to provide his services.
 - b. Apparent goal was to shelter income in the corporation then take it out over time.
3. **1970s** the CRA lost the Sazio appeal, with steps being taken to prevent a reoccurrence.
 - a. Section 125(7) re PSBs was added to the Income Tax Act.
4. **1986** Wiebe Door Services Ltd. v. MNR case about door installers contracted by the job with Judgment based upon:
 - Control
 - Tools
 - Risk of Loss
 - Chance of Profit.
5. **2001** Sagaz decision adds the concept of integration as a factor to be relied upon by the court.
6. **2010** Standing Committee on Finance (i.e. SCF) makes recommendations to the Minister of Finance to bring PSB provisions in line with modern times.
7. **2010** Minister of Finance responds:
 - a. Rejecting the findings of the Standing Committee Report;
 - b. Comparing income tax rates to Small Business tax rates without consideration of additional Dividend Tax rates;
 - c. Claims it is a matter of fairness of tax rates, even though his comparison is flawed;
 - d. Considers SCF request unique to contractors in Information Technology sector absent an understanding of Drucker's concepts of Knowledge workers; and
 - e. Ignores the Theory of Integration which explains that ITA already had made allowances for different strategies to take funds out of a corporation (Salary versus Dividends).
8. **2013** Government revised the Income Tax Act in its Jan 2013 budget as per its Oct 2009 commitment to do so:
 - a. Increases the penalties where a small business is determined to be a PSB:
 - i. Disallows access to Small Business tax rate.
 - ii. Disallows all expenses deductions other than Salary and wages.
 - b. Stated goals include:
 - i. PSB Income will be taxed in the year it is earned and
 - ii. PSB will not get to deduct expenses which are not deductible by employees.
 - c. Government ignores reality that such expenses (training, sales cost, etc) are paid and deductible by an employee's employer.
9. **2014** CRA versus Clinton Hamilton (Assessed as a PSB)
 - a. CRA offers settlement to Clinton Hamilton of 20% of the assessed amounts, following the completion of Discoveries held preparatory to going to trial.
 - b. Judge in Pre-trial advises CRA that it will lose its case if it came to trial in front of him
 - c. CRA withdraws assessment in apparent attempt to avoid precedent setting decision on PSBs.

Taxation Comparison – Rates and Amounts

The following diagram compares a Full Time Employee's taxation against the taxes paid by a Knowledge Worker who provides his/her services to clients through a corporation owned by the Knowledge Worker and possibly determined to be a PSB.

- A full time Employee (FTE) receives compensation in the form of:
 - Salary (shown here at \$100,000 being taxed at a rate of 38%)
 - Benefits include:
 - Professional development, conference participation, travel, WSIB coverage, etc.
 - Time: paid vacation days, paid sick days, paid stat holidays, etc
- A contractor providing services through his/her own company
 - Bills for their services, at a rate, shown here at 1.5 times their FTE equivalent salary.
 - They charge sales tax on the total billed amount, which they remit to the government.
 - They pay for their own operational expenses (average \$1,200/mo or/ \$14,400/year).
 - They do not get paid for days they don't work (stat hol. / vac. days, training, idle, etc).
- For reasons of comparison the graphic shows the contractor paying him/herself a salary the same as their FTE equivalent (i.e. \$100,000) which is taxed at 38%.
- The remainder of earned income, net of expenses and salary is subject to Corporate Tax.
- Should the company distribute Retained Earnings to a shareholder for personal use:
 - They do so by declaring a dividends
 - The tax rate on the dividend is the same or similar to the tax rate applied to funds distributed as salary according to the Theory of Integration.



Employee:			
Income		\$100,000	
Income Tax (38%)		\$38,000	
Total Taxes Paid		\$38,000	
Contractor:			
Income		\$150,000	
HST (13%)		\$19,500	
Expenses		-\$14,400	
Salary (38%)		-\$100,000	
Net		\$35,600	
Corp Tax (15.5%)			
Dividends (10%)	\$30,082	\$3,009	
Total Taxes Paid		\$66,027	

Summary

1. The tax rates paid on all funds taken out the company for personal use are the same or similar as per the Theory of Integration (for more information on the theory click [here](#)).
2. The contractor earns more money so the same tax rate applied against a bigger dollar amount means more tax dollars for the government.
3. The funds billed to a client by the contractor are subject to sales tax, which again means more tax revenue for the government.

Testimony

Standing Committee on Finance (December 2009)

Care must be taken to ensure that if paragraph (c) were amended to change the tax rate, if the tax rate were ever increased, that there be paragraph (f) which ensures that the amendment would apply retroactively from 2002. We have to ensure that none of the self-employed workers experience problems, because this measure would have an impact on a lot of people.

Hon. Marlene Jennings: Yes, thank you. That is right. I got the answer I wanted. Thank you very much.

The Chair: Mr. Paillé, you have two minutes.

Mr. Daniel Paillé: A comment. I am assuming that neither your costs to come here nor the loss of income will be deductible. When you contribute retroactively and are therefore declared..., does the employer, the company who hired you and who most certainly deducted the fees associated with your company from its taxable income, also receive a notice of contribution in order to charge all of that back?

Mr. Mario Sabourin: No.

Mr. Daniel Paillé: How can you explain that, other than to say that it is a horrible tax inequity?

Mr. Richard Fahey: That is why we are here.

Mr. Daniel Paillé: A single department of revenue, now that would be much better, no?

Some voices: Ah, ah!

Hon. Marlene Jennings: You cannot be asking that of witnesses.

Mr. Daniel Paillé: With all due respect, that was a statement.

A member: Mind you that was [*Inaudible—Editor*].

Mr. Daniel Paillé: They thought that was funny.

The Chair: Thank you for your presentations here today.

[*English*]

Colleagues, we will suspend for a minute or two, and then we will bring forward the officials from the Canada Revenue Agency.

Thank you very much for being with us here today.

- _____ (Pause) _____
-
- (1300)

The Chair: Colleagues, can I ask you to find your seats, please? We will begin with the second panel here today.

We have with us three officials from the Canada Revenue Agency. We have Ms. Lucie Bergevin, director general, audit professional services directorate, compliance programs branch; we have Mr. Wayne Adams, director general, income tax rulings directorate, legislative policy and regulatory affairs branch; and thirdly, we have Ms. Susan Betts, director, technical applications and valuations, audit professional services directorate.

Welcome to all of you. You've obviously heard the previous panel and the concerns they've raised. I don't know if you do have an opening statement, but you certainly have the opportunity for an opening statement, and then we will have questions from members.

Do you have an opening statement?

[*Translation*]

Mrs. Lucie Bergevin (Director General, Audit Professional Services Directorate, Compliance Programs Branch, Canada Revenue Agency): Yes, I do.

May I begin?

The Chair: Absolutely.

Mrs. Lucie Bergevin: Good afternoon, Mr. Chair and members of the committee.

My name is Lucie Bergevin and I am the Director General of the Audit Professional Services Directorate.

With me today are Mr. Wayne Adams, Director General of the Income Tax Rulings Directorate, and Ms. Susan Betts, Director of Technical Applications.

A personal services business is defined in subsection 125(7) of the Income Tax Act, as a business that provides the services of an "incorporated employee" to an entity, where the "incorporated employee" would otherwise reasonably be regarded as an employee.

From a tax perspective, the critical issue relating to a personal services business is whether an incorporated individual is considered to be an employee of the client or an independent contractor, when providing services to a client.

Let's say an employee who is a resident in Canada resigns from his job with a corporate employer. The individual establishes a new corporation. He has his new corporation enter into a contract to provide his services back to his previous employer. The individual is referred to as an "incorporated employee".

In effect, the "incorporated employee" could be using the new corporation to convert employment income into active business income of the corporation, which would be eligible for the small business deduction. Consequently, the "incorporated employee" would benefit from the lower tax rates offered by the corporation.

Therefore, the key question is this: if it were not for the service corporation, would there be an employment relationship between the individual providing the service and the entity receiving the service?

In fact, the personal services business income tax legislation came into effect in 1981 to prevent employees from incorporating simply in order to gain access to the small business deduction and favourable tax rates.

In practical terms, the goal of this provision is to create a level playing field in that incorporated individuals, who are in reality considered to be employees, are treated the same way for tax purposes as a regular employee.

If an "incorporated employee" falls under the income tax definition of a personal services business, it is subjected to corporate tax at the full corporate rate.

In addition, subsection 18(1) of the Income Tax Act limits the deductions that a personal services business can claim to generally only those deductions that employees can claim. The corporation cannot deduct the variety of expenses that would be available to other types of businesses.

Examples of expenses that are not deductible by a personal services business include bank charges, office supplies, professional fees, repairs and maintenance, capital cost allowance and advertising expenses.

An exception is provided where the corporation employs more than five full-time employees. The business will not be considered to be a personal service business and it will therefore be eligible for the lower tax rate and usual business deductions.

In conclusion, whether a person is an employee or a self-employed contractor is a question of fact, which can only be determined following a complete analysis of the service contract. CRA has a guide RC4110, *Employee or Self-Employed*, which assists in determining the nature of the contract.

Thank you Mr. Chair, and we will be happy to take questions from members of the committee.

• (1305)

The Chair: Thank you for your presentation.

Moving on to questions from members, we will begin with Ms. Jennings.

Hon. Marlene Jennings: Thank you, Mr. Chair.

Let us take the example of an incorporated business that has filed a number of annual tax returns over the years. At one point, the Canada Revenue Agency wakes up and decides that it is not dealing with a small business but rather an employee. Therefore, you carry out an audit of the past three or five years and issue a notice.

At that point, do you get in touch with the clients, that person's business clients, to inform them that the contract they signed with the small business is no longer valid under the Canadian Income Tax Act? And will they be asked to pay employment insurance premiums? In Quebec, you have to contribute to the QPP. At the federal level, there is the Canada Pension Plan and Old Age Security. Do you do all that?

Mrs. Lucie Bergevin: I will answer part of your question and then ask my colleague to follow up.

As a general rule, the CRA's auditor will contact the person who is being audited. Referrals of cases from the Quebec region are the exception. That issue was raised earlier. I cannot say whether contact is established in such situations. Besides, each audit is unique. That is why no single, general rule can apply to all audit situations.

Hon. Marlene Jennings: What you have just said reveals an unfairness. You say that you are unable to determine whether contact was made or not because you receive the notices from Revenu Québec. I think, however, that such an obligation should be included in the agreement. Moreover, you say that all cases are different. It is therefore possible that the large corporation be required to pay contributions and file tax returns for those same revised years, and that the person's status change altogether, ie, as an employee of the

corporation. Under those circumstances, the person should receive all the benefits that he or she was not entitled to during those years. But you are telling me that no compensation is given.

• (1310)

Mrs. Lucie Bergevin: As a point of clarification, I would like to say that what we are talking about is whether the person being audited was contacted.

Hon. Marlene Jennings: No. That is not what I asked you. Either I was not being clear, or you did not quite understand. I gave the example of a situation in which you would decide to audit a small personal business and, as a result of that audit, determine that the person could not be considered as a personal business under the law, but rather an employee.

Given those conditions, do you contact all the clients with which the small business dealt during the years covered by the retroactive audit, in order to notify them that you changed the person's status? Do you tell them that the person was in fact an employee of the company, and is required to revise its own income statements and submit to the Canada Revenue Agency the employment insurance benefits to cover those years or, for that matter, any other benefits that you collect on behalf of the agency? Is that something you do?

Mrs. Lucie Bergevin: I will ask my colleague, the director of technical applications, to respond.

[English]

Ms. Susan Betts (Director, Technical Applications and Valuations, Audit Professional Service Directorate, Canada Revenue Agency): Sure.

First of all, in terms of any contact we would have with...I'm going to call them a service recipient, in section 241, the confidentiality provisions would prevent us from going to the service recipient and saying that we've had a look at your service provider and changed the characterization. So we'd be prevented from doing that.

The other question that I sort of want to address is to make a distinction between contracts between two parties and the impact those contracts have on the tax regime in terms of the tax effects those have. The distinction I want to make there is, if the person who's providing the service is a corporation, then we don't effectively say they don't have a corporation anymore, because in law they do have a corporation. So in terms of us going back to the service recipient and saying they have to contribute EI and CPP for this person, that's not the way the law works.

If they were not incorporated, there may be an issue where that is something we would have to look at from an audit perspective, but we can't legally change the effect of what is in place. And if they do have a corporation then—

Hon. Marlene Jennings: Excuse me for interrupting. One minute.

What you're saying is that while you say you cannot legally say they're not incorporated—because legally they are incorporated—the agency can say that their contract they signed with a client is not valid and therefore you are not going to allow the taxation, the reports, their

[Translation]

income tax returns, tax returns,

[English]

that they have filed diligently. You are not going to allow any of the deductions because you have deemed that the contract is not valid and therefore they're subject to a whole other rate of taxation with other rules regarding what's deductible and what's not deductible.

I have a difficult time on the one hand in that you can do that legally, the law allows you to do that, but you're saying at the same time that the law doesn't—

The Chair: Okay, question—

Hon. Marlene Jennings: —allow you to do the opposite.

The Chair: Let's hear an answer.

Ms. Susan Betts: The distinction is that just because somebody has a corporation doesn't automatically make them a personal services business. There are the four factors that have to be evaluated in every case—

Hon. Marlene Jennings: You're missing the point.

The Chair: Do you want to finish, Ms. Betts? You have a few seconds left in this round.

Ms. Susan Betts: Go ahead.

[Translation]

Mrs. Lucie Bergevin: I would like to add that we work under the Income Tax Act. Subsection 125(7) helps us make a determination about a personal services business, or PSB.

• (1315)

The Chair: Thank you.

Mr. Paillé, you have the floor.

Mr. Daniel Paillé: I want to stick with this subject. This is how I understand it. Let us suppose that you determine that an individual is an incorporated employee, to use your terminology. I am talking about a regular person who could have been, for example, employed by company ABC. You come along and tell this individual that he or she is no longer considered to be an entrepreneur who has provided services to company ABC, but, rather, an incorporated employee and that, therefore, his or her expenses, which include—as you well explained—financial charges, bank charges, etc., are no longer deductible. You have the power to reclassify entrepreneurs as incorporated employees; but, company ABC who contracted with the entrepreneur, and who therefore claimed the entrepreneur's fee as a deductible expense, will be unaffected.

Mrs. Lucie Bergevin: The Canada Revenue Agency has a team that monitors large employers. The members of this team ensure that these large employers pay the taxes that they owe. If I understand you correctly, you are asking me if we make a referral when we carry out an audit.

Mr. Daniel Paillé: Exactly.

Mrs. Lucie Bergevin: I would refer you back to section 241 of the act that prevents us—

Mr. Daniel Paillé: I understand the rule, and as a former public servant, I understand your duty of confidentiality. However, to once

again use an expression that you used, is there not a manifest unfairness in the tax regime given the privileged position you have with regard to the various provincial taxation departments? You receive information from Revenu Québec, and you apply it at the federal level—the flood gates are open. However, you are telling us that the act does not allow you to take any measures against the company that signed the contract as it is a third-party signatory. That is hugely unfair.

[English]

Mr. Wayne Adams (Director General, Income Tax Rulings Directorate, Legislative Policy and Regulatory Affairs Branch, Canada Revenue Agency): You have a good observation, but I think it's casting it in a bit of an unfair light. Parliament, through the Income Tax Act in 1981, set out the law that said where the specified shareholder, the principal shareholder, is essentially carrying out the duties of employment, tax outcomes fail. It did not say that you then ignore the corporation or recharacterize the individual. It just says if it could be reasonably considered that the person is carrying out employment duties, which tracks back to the 1800s and your master-servant concept and has kind of transcended through a couple hundred years. We're not talking about a principal-agent relationship here; we're talking about a master-servant relationship. Parliament decided it would effect an outcome that said that corporation will not be eligible for the small business deduction and will not be eligible for other expenses. It did not say that you ignore the corporation, treat the person as an employee, and go back to the payer company and assess EI.

I think the outcome you're looking for is, would we go back to the company and assess EI? That is an option that the EI legislation could add, that where it's determined that payments are made to personal services corporations, there will be an additional assessment of EI. I think that recommendation is available to you. But it isn't an inconsistent action by the revenue authorities.

[Translation]

Mr. Daniel Paillé: Yes, but it remains that paying tax is not a choice.

Mr. Jean-Yves Laforest: I would like to follow on from what my colleague was saying. In your presentation, Ms. Bergevin, you said that one of the main issues the amendment to the act was trying to address was the case of an individual employed by a corporate employer who resigns, establishes his own corporation, and contracts his former employer. Were there any other reasons behind the amendment?

What is more, we know that a lot of public servants do exactly the same thing. They retire and then win contracts with the federal government. Has any particular attention been paid to the status of people who retire and then provide service to the federal government on a contract basis, while at the same time getting their pension? Is that something that has been audited?

• (1320)

Mrs. Lucie Bergevin: With regard to your first question, it is indeed just one example. It is a question of fairness. When the act was amended in 1981, the objective was to be fair both to employees and individuals the Revenue Agency considers to be employees. It was just an example to illustrate the principle.

With regard to your second question on people who resign from the public service and then contract with the federal government, they are taxpayers like you and I and are therefore subject to our risk evaluation system. We have processes for evaluating risk and determining which audits to carry out. These people are not treated any differently than any other taxpayers.

Mr. Jean-Yves Laforest: Fine, thank you.

[English]

The Chair: *Merci, Monsieur Laforest.*

Mr. Menzies, please.

Mr. Ted Menzies (Macleod, CPC): Thank you, Mr. Chair.

And thank you to our witnesses.

I hope you were here earlier to hear some of the compelling presentations we had. It is very troubling, and it's troubling in a couple of different ways. Coming from Alberta, I've never heard this raised.

My colleague asked whether it is just a Quebec issue, so that's one question I have. Why is it different for a backhoe operator in the oil patch in Saskatchewan or Alberta?

Mr. Wayne Adams: I don't believe it is solely a Quebec issue, and I don't believe it would apply differently in any province.

This issue that has come up has involved incorporated specialists, whether they are engineers...and other situations perhaps. A backhoe operator having the cost of his own tools, his own backhoe, would be a lot different from an employee backhoe operator. It wouldn't be typical for an employer of employees who operate heavy equipment in the oil patch or Fort McMurray to expect them to bring their own tools or equipment to work. That could be one difference. With high-tech, maybe it isn't as apparent that you would have a correlation there.

But I can assure you that it's not a Quebec issue. We have had litigation and reviews of individuals who might be considered personal services businesses in all provinces.

Mr. Ted Menzies: To expand on that, we have the same high-tech contractors, if you will, in other provinces. I'm still struggling with why this hasn't been raised. I think we have an agreement from our previous witnesses that it's not just Quebec, but is it something that is administered differently in Quebec?

Mr. Wayne Adams: No, it isn't. There's a focus in Quebec, under the Civil Code, about subordination, so maybe that question of control becomes a more focused analysis. But with respect to the question of whether it would apply equally if people are conducting themselves in the same way in the high-tech industry in other provinces, we'd likely arrive at exactly the same answer.

The Chair: I am sorry, we do have bells. We can find out exactly what the vote is on.

An hon. member: It is ways and means.

The Chair: I do need unanimous consent to proceed when the bells go. Do I have that consent?

Let me explain this. When there are bells, we have to stop the meeting, unless there is unanimous consent to proceed with the meeting.

An hon. member: We'll come back after. We can't take a chance on this.

The Chair: There is no unanimous consent, so we will endeavour to come back afterwards.

Mr. Mike Wallace: Otherwise, can we have them back?

• (1325)

The Chair: Colleagues, perhaps it would be better to have them back later. They could be 30-minute bells. That is the issue.

The meeting is suspended.

• _____ (Pause) _____

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• (1350)

The Chair: We're back to meeting 69 of the Standing Committee on Finance. Thank you for your patience.

I have four minutes left in the question time for the Conservatives, and then we have a seven-minute round for the NDP, which will likely take us right to 2 p.m.

Ms. Block, please.

Mrs. Kelly Block (Saskatoon—Rosetown—Biggar, CPC): Thank you very much, Mr. Chair, and thank you to our guests for being here with us this afternoon.

I heard you say in response to my colleague across the way that you do a complete analysis of the nature of the contract in order to determine the nature of the relationship. Could you tell me what criteria you use to determine that a business is a personal services business rather than a small business that is eligible for the small business tax deduction?

• (1355)

Mrs. Lucie Bergevin: We look at four factors in trying to determine whether it's a PSB—in other words, whether it's an employee versus an independent contractor.

The first factor we look at is control. Control means we look to see whether the payer of the service controls the what, when, and where: what the worker does, how the worker does his business, and where he does his business. That's part of what we look at. We also look to see whether there is a subordination aspect to it.

The second factor we look at is the opportunity for profit or the risk of loss. So we look to see whether the independent contractor could make a profit. We look at things such as, is he able to negotiate a contract; can he have additional clients? In terms of the risk of loss, we look to see if he's bearing some of the risk associated with the work he does. Could his expenses be higher than his income?

The other factor we look at is the tools. Who owns the tools? Normally in an employer-employee relationship the tools are owned by the payer, so we look at that, at how much investment has been made in the tools and who is responsible. Who bears the risk for maintenance, insurance, cost of repairs, and so on?

Integration is the last factor we look at: to what extent is the work done by the worker integrated into the payer's business?

Ms. Susan Betts: I would just add that it's a determination of whether you are considered to be an employee or self-employed.

In terms of whether that then leads to the designation as a personal services business, there are a couple of other factors to consider. The legislation says, if not for the corporation, you would have been considered an employee—those are the factors that Lucie just talked about—but also, you or someone related to you has to own more than 10% of the shares of that corporation, and if you don't have more than five full-time employees throughout the year, that then signifies that you are a personal services business.

Mrs. Kelly Block: Thank you.

The Chair: Thank you, Ms. Block.

Monsieur Mulcair, s'il vous plaît.

Mr. Thomas Mulcair: *Merci, monsieur le président.*

Mr. Adams, earlier you told us that under the employment insurance legislation a company such as CGI that had hired a bunch of people as independent contractors, once they're determined to have not been and they have to pay taxes as individual employees and not as independent contractors, CGI, which never paid its employment insurance, under existing legislation won't even have to pay it back. So there's a retroactive effect with regard to the employee but not the employer. Is that your testimony before this committee?

Mr. Wayne Adams: No, I think that's unclear. If CGI had engaged a number of independent contractors, unincorporated entities, and it was subsequently determined that they were—

Mr. Thomas Mulcair: I'm talking about an incorporated entity.

Mr. Wayne Adams: You started with independent contractors.

Mr. Thomas Mulcair: But I'm asking you about an incorporated entity. My time is limited, so please answer that question.

Mr. Wayne Adams: On your question, if CGI engaged a number of corporations to perform services and it was subsequently determined that those corporations were personal services businesses, there still would not be any EI implications for CGI.

Mr. Thomas Mulcair: Right. So the employees can get hit retroactively but not the employer. That's your testimony.

Mr. Wayne Adams: No, they are not employees. CGI engaged—

Mr. Thomas Mulcair: If they're not employees, how come you're taxing them retroactively as such?

Mr. Wayne Adams: No, we're taxing them as...their corporations are personal services businesses. It didn't undo the corporate form. It didn't characterize them as employees.

Mr. Thomas Mulcair: No, that's not germane. The question is, the employer has made money by saving on employment insurance deductions at source qua employer. The employee is now being told that even though they were incorporated, you've determined—somehow you managed to put the Quebec Civil Code in there—there's not a link of subordination, so you're going to pay your taxes going back for many years and the employer's not even going to get banged out for his EI.

Now we're going to go to you, Madame Bergevin. CGI was receiving a subsidy of at least \$10,000 per year per employee to install itself in certain sectors of the City of Montreal. To achieve those subsidies, CGI had to prove they were indeed employees, otherwise it would lose those subsidies. So they were getting it both ways, and the employees were taking it both ways.

The employees are now getting banged out because they created a corporate structure to allow them to do that work, but CGI, with all its resources and connections and contacts, was able to convince the government to maintain them as employees so that CGI could get its tens of millions of dollars a year of subsidies, and yet the people who just testified in this room and who are still sitting here, and their families, are getting banged out because they're no longer considered to be, properly speaking, independent contractors, and they are employees because of that.

The reality is, and that's why it comes up in the rest of Canada—how come we don't see this anywhere else? It's because of those subsidies that CGI put that many human beings in that position. How come you didn't investigate that? How come you only go after the employees and you never go after the employer?

● (1400)

Mrs. Lucie Bergevin: I can't speak to this case because I don't have all the facts, first of all, and I don't know exactly what transpired. I'll be honest, I don't know that I have a full understanding of your question as it relates to CGI and what they needed to do to get *la subvention*.

Mr. Thomas Mulcair: Different places were set up by the Government of Quebec—*Cité des multimédias* was one of them—where companies that were in the computer sector could get a subsidy of at least \$10,000 per employee. Of course, they had to make the determination that they were indeed employees and not independent contractors, because otherwise they wouldn't qualify for the subsidy.

Mrs. Lucie Bergevin: But that's under a different jurisdiction.

Mr. Thomas Mulcair: Of course it is, just as it's under a different jurisdiction for employment insurance, and we can say no, no, the employees will get hit retroactively, but the employer will never have to pay the employment insurance, even though they should have. Of course it was the Province of Quebec giving the subsidy, but what's pertinent here is that the initial revision of all their cases started with the Quebec revenue department. It was transferred to you, and you had to make the same determination, that contrary to their affirmation they're independent contractors and they should be subject to certain financial and fiscal and taxation rules. You're going after them now, saying no, all this while you were simple employees.

CGI had a strong corporate interest in convincing you and the Quebec department that they were employees because otherwise they lost those subsidies; that's what this is all about. That's why nobody from any of the other provinces has ever seen anything like this. That's why they are indeed the only ones who are in this case. It's because of that system.

So why is everything aligned against the employees? Why doesn't the employer ever take the hit? Why isn't there a level playing field? It's that way at EI; it's that way at Revenue. Have you made recommendations that this be changed or are we just going to continue hitting the individuals who are hard-working, who have done nothing wrong, who have done everything by the book—including your book? Are you at least going to change your interpretation bulletins? This is grossly unfair.

Mr. Wayne Adams: They aren't Lucie's bulletins to change right now; they fall within the responsibility of the branch I'm involved in. We wouldn't be able to comment on your views of what the company engaged in, regardless of whether we knew or didn't know what happened, whether they were motivated for the reasons you have described. It may be an issue that will have to be resolved once your statements here before the House have been out in the public domain, but it's not really a tax issue.

Mr. Thomas Mulcair: It's galling to hear you say it's not a tax issue.

[Translation]

For the people affected, it is a tax issue, because it affects their living standard. They have mortgaged their house, and they have lost

several years' worth of income because of this tax decision. So yes it is a taxation for those men and women who have worked extremely hard and who have always fully complied with the rules. It is in the interest of big employers to ensure that these people continue to be treated as employees. That is way that it has been interpreted in Quebec, and you are following it slavishly.

These workers are being left to pick up the pieces. Everything is always stacked against the employee and in favour of the employer. That is what is grossly unfair here and that is what I find so reprehensible. I appreciate that you do not have the final say on this issue, but I hope that given what you now know, you will report back that this situation is unfair. Thank you.

[English]

The Chair: *Merci, Monsieur Mulcair.*

Unfortunately, the time is up. This is an issue that members, including me, have some questions on for clarification. So as a committee we may revisit this in the future.

I want to thank you for being here with us. If there's anything further you'd like distributed to members, please do so through the clerk. We will ensure they get it.

Clearly an issue has been raised, and the committee will likely want to address it in the future.

Thank you very much for being here.

Colleagues, the meeting is adjourned.

Report

Standing Committee On Finance (June 2010)



HOUSE OF COMMONS
CANADA

SERVANT OR MASTER? DIFFERING
INTERPRETATIONS OF A PERSONAL SERVICES
BUSINESS

**Report of the Standing Committee on
Finance**

James Rajotte, **MP**
Chair

JUNE 2010

40th PARLIAMENT, 3rd SESSION



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SERVANT OR MASTER? DIFFERING
INTERPRETATIONS OF A PERSONAL SERVICES
BUSINESS

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Finance

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JUNE 2010

40th PARLIAMENT, 3rd SESSION

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THE STANDING COMMITTEE ON FINANCE

has the honour to present its

THIRD REPORT

Pursuant to its mandate under Standing Order 108(2), the Committee has studied the Tax Treatment and Characterization of Personal Services Businesses and has agreed to report the following:

Introduction

On 3 December 2009, the House of Commons Standing Committee on Finance held a hearing about the taxation and characterization of personal services businesses by the Canada Revenue Agency.

In essence, the Committee's witnesses were comprised of small businesses¹ in Quebec that provide information technology (IT) services to large corporations. These small businesses were concerned about reassessment of their income tax returns by the Canada Revenue Agency and the imposition of additional taxes resulting from their classification as a "personal services business."

The Committee also heard from the Canada Revenue Agency's compliance and as well as policy and regulatory affairs branches, which enforce and interpret the provisions relating to a "personal services business" in the *Income Tax Act*.²

Tax Treatment of Small Businesses and Personal Services Businesses in the *Income Tax Act*

A. Background

1. The Tax Treatment of Small Businesses

The *Income Tax Act* defines a small business as a Canadian-controlled private corporation where all or substantially all of the assets owned by the corporation are used primarily to generate business income in Canada.³ One tax advantage for small businesses involves taxation of a portion of their business income at a lower rate than the rate applied to income earned by medium-sized and large businesses. For the 2009 taxation year, medium-sized and large businesses paid federal tax at the rate of 19% of their taxable income while the small business federal tax rate was 11%.⁴ This lower rate is due to the operation of the "small business deduction," which is applied to the first \$500,000 of business income earned.⁵ The small business deduction only applies to incorporated entities; it does not apply to income earned by individuals who are obligated to pay tax at the personal income tax rate.⁶ The Canada Revenue Agency

¹ Witnesses are also referred to as "the incorporated self-employed" and are individuals who are the main employee of a corporation in which they are the majority or primary shareholder.

² R.S.C. 1985, c. 1 (5th Supp), as amended.

³ *Income Tax Act*, subsection 248(1), "small business corporation."

⁴ The federal rates provided do not include the rate paid as provincial or territorial tax. Please note that the small business deduction is phased out based on a formula that takes into account the capital assets of the small business (*Income Tax Act*, subsection 125(5.1)). The small business deduction is completely phased out for small businesses with capital assets exceeding \$15 million.

⁵ *Income Tax Act*, section 125.

⁶ *Income Tax Act*, subsection 117(2). Federal personal tax rates range from 15% to 29%, depending on the amount of income earned.

(CRA) has indicated that, for the 2007 taxation year, 548,150 of 994,690 small business tax returns, or 55%, claimed the small business deduction.⁷

2. The Tax Treatment of Personal Services Businesses

In cases where the relationship between a small business and its client is similar to an employer-employee relationship,⁸ the CRA may classify the small business as a "personal services business;"⁹ in that case, the CRA will not allow the small business to claim the small business deduction (SBD).¹⁰ Consequently, the small business¹¹ will be obliged to pay tax at the higher regular corporate tax rate, and individuals who work for the small business will be classified as an "incorporated employee"¹² That being said, businesses with more than five full-time employees will be able to claim the SBD since the definition of "personal services business" excludes small businesses with more than five full-time employees.¹³

Additionally, expenses of personal services businesses are restricted to salaries and wages paid to an incorporated employee, expenses related to the selling of property and similar expenses if deductible by the employee of the business, and legal expenses incurred in collecting amounts owing for services rendered.¹⁴ Thus, expenses previously deducted from the income of the small business, such as transportation, training of employees and advertising, will be denied by the CRA after reassessment of the tax paid, resulting in higher taxable income and more tax payable for that particular taxation year.¹⁵ Businesses with more than five full-time employees will not be classified as a personal services business and will be able to deduct all of

⁷ Small business tax filers are defined as businesses with gross revenue not exceeding \$300,000. Data provided to the Library of Parliament by the Canada Revenue Agency.

⁸ See Appendix A.

⁹ *Income Tax Act*, subsection 125(7). The factors the CRA considers in determining the employment status can be found in Appendix A. For a business to be classified as a personal services business, an individual must perform services on behalf of the business to an entity of which the individual would otherwise reasonably be regarded as an officer or employee unless the small business employs more than five full-time employees.

¹⁰ See Department of Finance, *Explanatory Notes to a Bill Amending the Income Tax Act*, December 1982, subclause 86(9).

¹¹ Self-employed individuals who are incorporated may also be classified as a "personal services business" and pay the higher tax rate that is applied to medium-sized and large businesses.

¹² Shareholders of the personal services business are able to receive dividends.

¹³ Also see *489599 B.C. Ltd. v. The Queen*, [2008] D.T.C. 4107 (Tax Court of Canada), where the court stated that "more than five full-time employees" could include "five full-time employees and one or more part-time employees."

¹⁴ *Income Tax Act*, paragraph 18(1)(p). Other expenses that are deductible include expenses related to the negotiating of contracts if the employee's employment contract requires that the employee pay the expense.

¹⁵ Individuals classified as an "incorporated employee" may also be unable to claim the expenses since expenses for employees are restricted to those found in section 8 of the *Income Tax Act*. Section 8 limits expenses to those incurred by individuals in specific industries, such as, food and lodging for travelling salespersons, tools for apprentices, and food and lodging for motor vehicle drivers in the transportation industry, to name a few.

their expenses since, as noted earlier, the definition of “personal services business” excludes small businesses with more than five full-time employees.

B. What the Witnesses Said

The Canada Revenue Agency told the Committee that the personal services business rules were instituted in 1981 in order to prevent employees from incorporating and utilizing the lower small business tax rate rather than the higher tax rate applied to employment income.¹⁶ The major concern expressed by the Department of Finance was that all employees of the employer should be treated in the same way for tax purposes, regardless of the legal structure of the relationship. The CRA stated that the personal services business rules apply equally across Canada and are not restricted to small incorporated IT businesses in Quebec.

The Canadian Federation of Independent Business (CFIB) commented on a October 2009 *Labour Force Survey* by Statistics Canada which showed that, between 2001 and 2006, there was an 18.6% increase in the number of incorporated self-employed businesses; over that period, there was an 8.5% increase in the number of employees. The CFIB also highlighted that there has been rapid growth in the percentage of self-employed individuals in the 45-64 age group, and that self-employment in this age group acts as a bridge towards retirement.

Mr. Mathieu, who owns an incorporated IT business, provided the Committee with the results of a survey conducted by the Association Québécoise de Informatiennes et Informaticiens Indépendants. The survey of 271 small incorporated IT businesses found that 87.6% of the businesses had only one or two clients at any given time, and that most businesses had long-term contracts with their clients. Mr. Mathieu stated that 80% of self-employed IT professionals in Quebec are incorporated, and that the majority of these professionals use a large consulting firm or employment agency as an intermediary between the IT professional and the final client; consequently, there is no employment link between the service provider and the service recipient. He supported the notion of a specified time limit after which an incorporated IT business would be considered as being in an employer-employee relationship.

Mr. Mathieu also highlighted that self-employed IT professionals may appear to be employees because they are required to be available at the client's place of business and to utilize its information systems for the delivery of service. Another witness, Travailleurs Autonomes Québec Inc., reiterated this point when commenting on the unique nature of services provided by self-employed incorporated IT businesses since service must be provided at the client's premises in conjunction with employees of the client.

Mr. Paul-André Robitaille and Mr. Olivier Guerrero, who are owners and employees of incorporated IT businesses in Quebec, indicated that IT businesses incur significant training costs in order to maintain their technical skills, and that the relevancy

¹⁶ See footnote 10.

of their technical skills is a business risk that is similar to risks faced by other small businesses. They argued that the classification of a small business as a personal services business prevents the business from deducting costs for training, travel, computers, software, office equipment and accounting as well as professional association dues from their taxable income; the result is more tax being paid. Mr. Robitaille commented that it is not possible to predict whether their next job will be classified as an employer-employee relationship or as an independent contractor relationship. Mr. Guerrero stated that there is no formal method to indicate to the tax authorities, on a voluntary basis, that you are a personal services business; moreover, the CRA can reassess a taxpayer for the previous three taxation years.

Mr. Fernand Garceau, also the owner and employee of an incorporated IT business in Quebec, was concerned about the cash flow of small businesses classified by the CRA as personal services businesses due to the higher level of tax payable when compared to a small business that can utilize the small business deduction. Mr. Garceau felt that self-employed incorporated individuals and businesses with at least five employees should be treated in the same manner for tax purposes; he also argued that the “five employee” rule should be removed. Mr. Garceau also commented that an IT professional who is self-employed and incorporated does not have the resources to provide his or her own equipment in order to provide service to the client.

The CFIB recommended that the CRA respect the contracts signed between self-employed incorporated workers and their clients, and argued for the creation of a new CRA interpretation bulletin that would clarify circumstances under which the CRA will deem a small business to be a personal services business and the worker to be an incorporated employee. Regarding the denial of expense deductions by the CRA, the CFIB suggested that the expense deductions of large corporations should be transferred to the salaried person of the small incorporated business so that expenses could be claimed.

Lastly, Travailleurs Autonomes Québec Inc. advocated the creation of a simplified advance ruling mechanism. It also felt that, in situations where the CRA is unable to make a determination regarding the employment status of a service provider, the service provider should be presumed to not be a personal services business.

Employer Source Deductions and Personal Services Businesses

A. Background

Service recipients¹⁷ that choose to purchase the services of an incorporated business and their employees rather than to have services provided by permanent employees do not have to pay benefits – such as health plan payments and training – to the business and their employees, which can be advantageous. Service recipients also do not have to remit payroll deductions, such as Employment Insurance premiums and Canada/Quebec Pension Plan payments. Due to the relatively lower benefit costs and

¹⁷ A service recipient is the entity that would be classified as the employer if the service provider is classified as a personal services business.

payroll deductions paid by the service recipient when purchasing the services of an incorporated business and their employees, an employee of an incorporated business that provides services may receive higher remuneration from the service recipient than a permanent employee who provides similar services.¹⁸

B. What the Witnesses Said

The CRA told the Committee that, due to the confidentiality requirements in the *Income Tax Act*,¹⁹ it cannot inform the service recipient that its service provider has been characterized as an employee and thus the service recipient may not be required to pay Employment Insurance premiums and Canada/Quebec Pension Plan contributions on the remuneration paid to the incorporated business. Additionally, the CRA said that the *Income Tax Act* does not allow reassessment of the service recipient for Employment Insurance premiums after the small business service provider is classified as a “personal services business.”

Mr. Guerrero commented that self-employed individuals cannot contribute to the Employment Insurance fund, and Mr. Garceau indicated that an employee of a small incorporated business is ineligible for Employment Insurance benefits if he or she owns more than 40% of the voting shares of the corporation.²⁰

The Travailleurs Autonomes Québec Inc. reiterated that it is more cost-effective for the employer if the employee incorporates since it does not have to pay Employment Insurance premiums. It suggested that a tax form could be created that would require the IT intermediaries to inform the CRA when they require the subcontractor to incorporate.²¹

The Views of the Committee

The Committee recognizes that section 125(7) of the *Income Tax Act* was created in 1981 in order to prevent companies and their employees from exploiting a legislative loophole in an effort to obtain certain tax advantages associated with terminating their employment agreements and then entering into a contract with the same individual.

Among Committee members, there is some concern that – at present – a number of owners of small information technology businesses enter into lengthy contracts with a single company. The effect of such a contract is the establishment of an “incorporated employee” relationship according to the Canada Revenue Agency, with the result that section 125(7) of the *Income Tax Act* applies to the business owner.

¹⁸ The testimony of Mr. Guerrero indicated that businesses who are service providers receive higher remuneration than salaried employees who are providing the same service.

¹⁹ *Income Tax Act*, section 241.

²⁰ *Employment Insurance Act*, S.C. 1996, c. 23, paragraph 5(2)(b).

²¹ IT intermediaries are large IT consulting and human resources businesses that locate IT professionals for other businesses.

The consequence of this designation is that the "incorporated employee" is denied the benefits of owning a small business, such as access to the small business tax rate, and the benefits of being an employee, such as having the employer make contributions to the Canada/Quebec Pension Plan and pay Employment Insurance premiums as well as accessing Employment Insurance benefits. In the Committee's view, this outcome was not the original intent of section 125(7) of the *Income Tax Act*. Consequently, the Committee recommends that:

the federal government examine the *Income Tax Act* with a view to propose legislative amendments in such a manner that reflects the realities of the modern labour market, particularly in terms of small information technology companies, in order to ensure tax fairness for those small business owners who are deemed to be "incorporated employees."

Conclusion

The rules in the *Income Tax Act* regarding "personal services businesses" are intended to apply in circumstances where an employee utilizes a corporation to benefit from the lower small business tax rate applied to remuneration received for services provided to their previous employer. If the Canada Revenue Agency determines that the relationship is like that of an employer and an employee, the legal arrangement between the parties is ignored and taxes are applied at the regular corporate tax rate. Additionally, expenses related to their business cannot be claimed, resulting in higher tax payable.

The increasing number of small incorporated businesses in the information technology sector and the increase in the use of intermediaries in an effort to obtain clients changes the relationship between the individual providing the service and their clients. The rules regarding the disallowance of the lower small business tax rate and of expense deductibility that is available to other businesses appear to have penalized IT professionals who have chosen to become an entrepreneur and to incorporate. The Committee feels that incorporated self-employed individuals should be taxed fairly and believes that the recommendation should be implemented expeditiously.

Appendix A: Factors Used by the Canada Revenue Agency to Determine Whether an Individual is an Employee or an Independent Contractor/Small Business

The Canada Revenue Agency uses two tests, one for workers in Quebec and one for workers located in the rest of Canada, to determine whether a worker is an employee or an independent contractor and thus a small business.²²

The factors considered for workers in regions outside Quebec include:

- a. the intent of the worker and the payer at the time the two parties entered into the working arrangement;
- b. the level of control the payer has over the worker;
- c. whether the worker or the payer provides the tools and equipment;
- d. whether the worker can subcontract the work or hire assistants;
- e. the degree of financial risk taken by the worker;
- f. the degree of responsibility for investment and management held by the worker;
- g. the worker's opportunity for profit; and
- h. any other relevant factors, such as written contracts.

The factors considered for workers in Quebec²³ include:

- a. the intent of the worker and the payer at the time the two parties entered into the working arrangement;
- b. the performance of the work²⁴;
- c. remuneration²⁵; and
- d. the existence of a relationship of subordination.²⁶

²² Canada Revenue Agency, *Employee or Self-Employed?*, RC4110, 2008, <http://www.cra-arc.gc.ca/E/pub/tg/rc4110/rc4110-08e.pdf>.

²³ The definitions of "a contract of employment" or of "a business contract" in articles 2085 to 2129 of the *Civil Code of Québec* are used by the Canada Revenue Agency. Also see Revenu Québec, *Employee or Self-Employed Person?*, IN-301-V, 2006, [http://www.revenu.gouv.qc.ca/documents/en/publications/in/in-301-v\(2006-09\).pdf](http://www.revenu.gouv.qc.ca/documents/en/publications/in/in-301-v(2006-09).pdf).

²⁴ The work can be part-time or full-time and for a specified or indeterminate period.

²⁵ Remuneration means all consideration and benefits having a monetary value.

²⁶ The relationship of subordination is the capacity, the authority or the right of a payer to exercise control over the worker's activities and the manner in which the work is done. It is the most important factor in determining whether a worker is an employee or an independent contractor.

APPENDIX B LIST OF WITNESSES

Organizations and Individuals	Date	Meeting
<u>40th Parliament, 2nd Session</u>		
As individuals	2009/12/03	69
Fernand Garceau		
Olivier Guerrero		
Jean-Pierre Mathieu		
Paul-André Robitaille		
Canada Revenue Agency		
Wayne Adams, Director General, Income Tax Rulings Directorate, Legislative Policy and Regulatory Affairs Branch		
Lucie Bergevin, Director General, Audit Professional Services Directorate, Compliance Programs Branch		
Susan Betts, Director, Technical Applications and Valuations, Audit Professional Service Directorate		
Canadian Federation of Independent Business		
Richard Fahey, Senior Vice-President, Strategic Development, Montreal Office		
Travailleurs Autonomes Québec inc.		
Mario Sabourin, President		
Patrice Leblanc, Lawyer		

APPENDIX C LIST OF BRIEFS

Organizations and individuals

Canadian Federation of Independent Business

Garceau, Fernand

Guerrero, Olivier

REQUEST FOR GOVERNMENT RESPONSE

Pursuant to Standing Order 109, the Committee requests that the government table a comprehensive response to this Report.

A copy of the relevant Minutes of Proceedings (40th Parliament, 2nd Session: Meeting No. 69) and (40th Parliament, 3rd Session: Meeting No. 25) is tabled.

Respectfully submitted,

James Rajotte, MP

Chair

Government Response to the Standing Committee on Finance

“Servant or Master? Differing Interpretations of a Personal Services Business”

In June 2010, the Standing Committee on Finance tabled the report titled “Servant or Master? Differing Interpretations of a Personal Services Business”. The report recommended that the Government review the Income Tax Act to ensure tax fairness for small business owners, particularly those in the information technology (IT) sector, who are determined to be “incorporated employees” of “personal services businesses”.

The Government recognizes the importance of small businesses to the Canadian economy and is committed to ensuring tax fairness for all Canadians.

The personal services business provisions in the Income Tax Act apply to all industries to ensure that individuals, who would otherwise be employees, are unable to avoid paying their fair share of tax by interposing a corporation between themselves and a service recipient that would otherwise be the individual’s employer. The personal services business provisions are intended to ensure that “incorporated employees” are treated comparably to actual employees for income tax purposes.

Given the varying circumstances in which income may be earned, the Income Tax Act has specific rules to ensure that different types of income are treated fairly.

Business income is generated by an entrepreneurial venture in which investments are made (e.g., capital assets are purchased, workers are hired and trained) with a view to earning revenue by bringing goods or services to the market. An entrepreneur undertakes risks as part of an independent venture seeking to earn a profit in unpredictable market conditions that may affect the venture’s performance and even lead to losses. The income tax system recognizes the risk inherent in business enterprises by taxing the resulting profits appropriately, which means allowing for the deduction of reasonable expenses incurred in generating those profits.

In the case of certain small business income, the small business deduction provides a reduced rate of income tax on the first \$500,000 of qualifying business income earned in a year by an eligible Canadian-controlled private corporation. The federal small business income tax rate for 2010 is 11%. This lower rate helps these small businesses retain more of their earnings for reinvestment and expansion, thereby helping to create jobs and promote economic growth.

In contrast, employment income is subject to a progressive income tax rate structure with rates increasing as income increases. Employment expenses incurred by employees are generally not deductible for income tax purposes since employers typically provide employees with the items required to perform their duties or reimburse their employees for the work-related expenses they incur. To recognise that employees incur some costs personally, employees are eligible for the Canada Employment Credit, introduced in Budget 2006, which provides a 15% tax credit in respect of up to \$1,000 of employment income.

Corporations that operate a “personal services business” do not qualify for the small business deduction and are not eligible for the 11% federal small business income tax rate. ***The objective of the personal services business provisions in the Income Tax Act is to ensure that individuals (“incorporated employees”) who would otherwise be in an employment relationship, if they had not interposed a corporation between themselves***

and the service recipient, are treated comparably for income tax purposes as if they had provided their employment services directly (in other words, as if they had not interposed the corporation). Without the personal services business provisions, incorporated employees could reduce their income tax liability unfairly.

The small business deduction was not intended to be available to individuals who have essentially converted an employment relationship into a business relationship through the interposition of a personal services business corporation.

Whether an individual would be an employee (employment relationship) or an independent contractor (business relationship), if the corporation had not been interposed, is ***determined on a case-by-case basis***. In making this determination, the Canada Revenue Agency takes into account a number of factors, for example: the extent of the service recipient's control over the individual concerning the manner in which the services are performed and what services are performed; the amount of risk the individual has of bearing an economic loss; and the individual's responsibility for providing the tools required to perform the services for the service recipient. The Canada Revenue Agency's determination, of whether an individual is an employee or an independent contractor, may be appealed to the Tax Court of Canada.

Amending the personal services business provisions to exclude corporations of information technology (IT) professionals would result in such professionals receiving preferential treatment compared to employees who are not incorporated, for that portion of their remuneration that is taxed inside the corporation. For example,

- in Quebec, the province of residence of many of the individuals who made presentations to the Committee, it could result in ***the income of a corporation of an incorporated employee earning \$150,000 in 2010 being taxed at a combined federal and provincial small business income tax rate of 19% (11% federal plus 8% provincial)*** while an ***unincorporated employee carrying out similar work for the same company and earning the same amount*** would be taxed at an average federal/provincial personal income ***tax rate of 37%***.
- in Manitoba, where the small business tax rate is 0% in 2011, it could result in the income of a corporation of an incorporated employee earning \$150,000 in 2011 being taxed at a combined federal and provincial small business income tax rate of 11% while an unincorporated employee carrying out similar work for the same company and earning the same amount would be taxed at an average federal/provincial personal income tax rate of 35%.

The Standing Committee's Report also expressed concern that individuals who provide services through a personal services business corporation ("incorporated employees") are not eligible to participate in the Canada Pension Plan (CPP) and the Employment Insurance (EI) regimes.

The provisions in the Income Tax Act that apply to incorporated employees do not prevent them from participating in the CPP and EI regimes.

Individuals are required to participate in the CPP regime if they receive a salary. The income tax provisions concerning personal services businesses would, therefore, not prevent an incorporated employee from participating in the CPP regime where the incorporated employee receives a salary from the personal services business corporation.

The Government recognizes that some incorporated employees have not been eligible to participate in the Employment Insurance regime because the individual controls more than 40% of the voting shares of the corporation. However, since the Committee met on December 3, 2009, the Fairness for the Self-Employed Act received Royal Assent. As a result, the Employment Insurance special benefits provisions have been extended, on a voluntary opt-in basis, to the self-employed and to employees whose employment by a corporation was previously excluded from insurable employment because the individual controls more than 40% of the voting shares of the corporation. Employment Insurance special benefits include maternity benefits, parental benefits, sickness benefits, and compassionate care benefits.

The Government recognizes the importance of the IT sector in fostering innovation and creating jobs and business opportunities. The Business Development Bank of Canada provides financial support for business innovation, often to small firms involved in the IT sector. Small and medium-sized firms in the IT sector also benefit from the improvements to the Scientific Research and Experimental Development Tax Incentive Program that were introduced in Budget 2008. Canada's Economic Action Plan, announced in 2009, also included a number of initiatives that assist firms in the IT sector, including small businesses. For example, businesses may benefit from the temporary two-year 100-per-cent capital cost allowance rate for computers. As well, additional funding was provided to the National Research Council's Industrial Research Assistance Program to enable it to temporarily expand its initiatives for small and medium-sized firms and to Industry Canada to develop and implement a strategy to extend broadband coverage. Further, the Government has indicated it would develop a Digital Economy Strategy to position Canada's information and communications technology sector to establish a global advantage.