

Suggestions on How to Safe Guard Your Self Employed Tax Status

Over the past few years the term “PSB” referring to a Personal Services Business has been given some notoriety in the media with the suggestion that individuals who provide their services through a corporation are in some way avoiding their tax obligations and possibly even remitting taxes at a tax rate lower than that of a full-time employee.

The Federal Government has supported these misconceptions by initiating a number of “amnesty” strategies with the apparent goal of getting individuals to self-declare their status as a Personal Services Business to minimize or avoid prosecution or assessment by the CRA. These initiatives are problematic insofar as those self-declaring individuals may not have a clear understanding of the Tax Act or may be self-declaring just to avoid expensive and stressful dealings with the CRA.

While in some quarters there has been the suggestion that this PSB initiative is targeting contractors in the Information Technology sector, in reality the PSB concepts are applicable to all Knowledge Workers¹ and in all professions where services are engaged by clients under contract.

The APCC is committed to helping our members protect themselves against the risks associated with being assessed as a Personal Service Business (PSB), through education and communication. Individuals who pursue careers as independent contractors take on the risk of work continuity, taking on new projects in an ongoing effort to expand their skill sets, in pursuit of rewarding and challenging careers in a field where job security is measured only by what you have in your head - not what you have in the bank.

The Inconsistency of the Government’s PSB Initiative

There are certain inconsistencies in the Government’s and the CRA’s positioning on this matter:

- Firstly, the Income Tax Act is a well structured piece of legislation that contains provisions that ensure that regardless of whether income is taken out of a corporation, as salary (the government’s preference), or as dividends, the individual pays the same tax rate. This equality of tax rates is discussed more fully on the APCC website, in the article, [The Theory of Integration](#).
- Secondly individuals who provide their services on contract through their own corporation commonly are paid a premium by their client over the rate that the same client’s employees receive. This charged premium is reflective of a number of factors including:

¹ Please refer to the APCC blog on Peter Drucker and his 1959 predictions of Knowledge Workers in the new millennium: <http://www.apconline.com/index.php/archives/2240>

1. That they come to the job trained and experienced;
2. That the client (i.e. the corp. employing them) is only going to retain their services for a definite period of time and
3. The client will not be paying any of the employee benefits which their salaried employee might receive.

The benefit to the government here is that people, who are taxed at the same tax rate as an employee but on a larger amount, will be paying more in absolute tax dollars.

- Finally, there has been the suggestion advanced in the media that the Government's initiatives relative to PSBs in some way reflect new rules. In fact there has been no change to the rules. The rules relating to PSBs have been in place since 1985, when Section 125(7) of the Income Tax Act was made a law. Rather, the government has only raised the table stakes (i.e. risk) for people who would pursue a career as a contractor and has introduced harsher penalties and also has become more aggressive in their efforts to prosecute.

Government Penalties

In 2011, the Government indicated its intent to increase the penalties which would be applied against businesses determined to be PSBs. More recently, it reaffirmed that these penalties would be applied retroactive to Oct 2011. There were two new penalties:

1. It was going to disallow the deductibility of all expenses claimed by a PSB other than Salary and other directly related costs (i.e. such as Employer Premiums for CPP).
2. It was going to have all income taxed as if it was salaried income received in the year that payment was received from the PSB's client(s).

In the budget passed in 2013, the Government modified the Income Tax Act, as it said it would, disallowing usage of the small business tax rate by PSBs. As a result, the PSBs were then subject to the large business corporate tax rate.

If a consultant providing services under contract is determined to be a PSB, then the results of these two punitive measures include:

1. Inability to shelter income within your corporation after paying corporate tax

If you were working as a contractor through your own corporation it has now become cost prohibitive to shelter income within your corporation (after paying at the large corporate tax rate) as retained earnings for that rainy day when you did not have a contract or had retired. All

individual contractors' pension contributions would be subject to RRSP legislation and limits, as contractors now have to contribute with dollars outside of their corporation.

2. **Inability to reduce your taxable income by what other businesses can declare as legitimate business expenses**

While there are well-established and long-standing rules that determine which expenses are valid business deductions for businesses, all such legitimate expenses when incurred by a PSB would no longer be available as potential tax deductions.

One beneficiary is the CRA auditor whose job was simplified when they were given the ability to look past the possible validity of any claimed expenses and disallow them all (salary-related expenses excluded) with one stroke due to a PSB determination.

The Definition of “Personal Service Business”

There is a history to the term Personal Services Business (PSB) and the reader is referred to the CA4IT article on [the first PSB](#) to be found on the APCC web site.

The CRA defines business as “an activity that you intend to carry on for profit and there is evidence to support that intention.”² According to Income Tax Act, Income Tax is payable on income received from consulting services of a business.

From the most common business structures (sole proprietorship, partnership, and corporation), majority of contractors choose to incorporate for a number of reasons.

Some, including the CRA, might suggest that consultants incorporate because, the contractor's corporation is taxed separately from him/herself and the corporate tax rate is generally lower than the individual tax rate.³

However that reason reflects an inaccurate understanding of Canadian tax law in that it fails to reflect the fact that money left in a corporation as Retained Earnings is for the **exclusive benefit of the corporation**. This means that the individual (i.e. the consultant) does not have access to these funds, like he/she would if it had been paid to him/her as salary.

This is an extremely important distinction. The small business tax rate was created to help smaller companies. When smaller companies pay a lower tax rate, they get to keep a greater amount of after tax funds (i.e. Retained Earnings) in the business to help the business operate.

² <http://alis.alberta.ca/pdf/cshop/contractor.pdf>

³ [Personal Income Tax Rate information](#) and [Corporation Tax Rates information](#) (refer to Small Business Deductions)

When a consultant leaves funds in his/her corporation, all they are doing is deferring to the days that they will take those out as income and pay dividend tax on them or use them to pay legitimate company expenses.

Insights on PSB Determination

The rules used to determine whether a PSB exists are Common Law based and require a determination as to whether the contractor is engaged in a Contract **OF** Services (Employer-Employee relationship) or Contract **FOR** Services (Business-Client relationship)

It is equally significant to note that the specifics of each individual relationship need to be examined to determine the true nature of the relationship and as such, any PSB matter is determined on a case by case basis.

The CRA has released several interpretative bulletins and guidelines⁴ with the following list of factors that should be considered:

1. Whether the intention of the parties was to enter a 'contract of service' (employer-employee relationship) or a 'contract for services' (business to business relationship).
2. Whether the contract adequately reflects the original intention of the parties and whether this intention changed during the course of the working engagement.
3. The level of control the payer has over the worker's activities. Elements of control include:
 - a) Is worker supervised or managed by anyone?
 - b) Who has the right to control the amount, the nature, the direction, the manner and the work hours of the work to be completed?
 - c) Whether the worker is able to subcontract the work or hire assistants?
 - d) Can worker provide his services to other clients?
4. Who provides the tools, equipment, materials and facilities to the worker?
5. What degree of financial risk does the worker take?
6. What degree of responsibility for investment and management does the worker hold?
7. What is the worker's opportunity for profit? Independent IT consultant has the freedom to make decisions that affect their ability to make a profit (such as receiving extra remuneration for completion of projects or achievement milestones) or suffer a loss (such as deciding on the type of work tools to buy or the type of training courses to take)?

⁴ [Information technology consultants - Employees or self-employed workers?](#) and [Servant or Master? Differing Interpretations of A Personal Services Business](#)

8. Independent IT consultant is engaged to work on identifiable project and the payer doesn't normally redirect or reassign work. However, the IT consultant may choose to perform services unrelated to their main role as a way of marketing their skills.

These factors indicate that IT consultant is a potential PSB:

The payer:

- has the right to redirect and assign new tasks, projects, or priorities as needed;
- sets out the procedures to follow in performing tasks and the methods to use;
- requires that the IT consultant get approval before taking certain actions;
- has the right to assign the IT consultant to specific projects and specific work locations and direct them on how the work has to be done and the period of time to complete the work;
- requires that the IT consultant provide services at the payer's place of business to allow the payer to monitor or provide direction as to how the work is done;
- assigns the IT consultant to work in specific locations where their mandatory presence is required;
- requires that the IT consultant respect certain conditions of employment or rules of conduct or behaviour as described in the example below;
- can take disciplinary actions if the rules of conduct or behaviour are not respected;
- requires that the IT consultant ask permission to be absent or to take vacation;
- requires that the IT consultant devote their full time and attention to the payer's business (exclusive service). The IT consultant is an integral part of the payer's business;
- reimburses the IT consultant for any expenses relating to the payer's business;
- decides where the IT consultant must buy or get supplies and services;
- provides benefits to the IT consultant, such as:
 - paid vacation;
 - sick days;
 - bereavement leave;
 - other types of paid leave;
 - medical/dental insurance; or
 - a pension plan.

Some of the above facts may be considered to be **neutral or inconclusive** when it is established that they are present because of the nature of the work, for example, security issues.

The following are factors that if followed, will reduce the likelihood of the corporation being deemed a PSB:

1. Make the client well aware the contract is for services through a corporation;
2. Gain control over your work hours and work methodology;
3. Negotiate your rate of pay when contract is signed and at each contract renewal;
4. Own the tools used to provide services:
 - a. This is a contentious factor of PSB determination in the Information Technology sector for at least two reasons:
 - i. The IT contractor often must adhere to its clients' security standards, which may prohibit Bring Your Own Device (BYOD) on its premises
 - ii. Tool ownership is more relevant to contractors providing physical products or manual labour, such as painters or electricians. An IT contractor's primary tools are knowledge and expertise, which (s)he uses regardless of hardware.
5. Hire employees or subcontractors where possible;
6. Actively seek new contracting opportunities;
7. Restrict attendance to employee functions unless you're paid to attend;
8. Have several mandates with various payers or you may perform services for the same payer for an extended period of time, as long as you have several clearly defined mandates;
9. Establish a true business presence with well-maintained financial records, tax returns and records, always ensuring that the corporation enters agreements as a separate entity;
10. Some consultants consider investing into liability insurance, as an independent IT consultant is responsible for any penalties or costs resulting from late delivery of work as well as incomplete or poor quality;
11. You may have disability insurance to cover fixed business costs in case disability;
12. Seek independent professional advice.

To see whether your business follow these factors, please review the Association of Professional Computer Consultants [My Own Business Check List](#).

What should I do?

For any decision on how you as a contactor should structure /restructure your affairs, the APCC suggests that you seek the guidance of a professional financial and/or legal advisor because there are alternatives available to you. For instance, you can wind down your corporation and forgo the flexibility that it provides to defer income (i.e. shelter funds for that rainy day between contracts) and then register yourself as a sole proprietorship or partnership.

As a sole Proprietor, when you provide your services through a placement agency, that placement agency will assume the responsibilities of your employer and be obligated to contribute the employer's portion of the CPP and the EI premiums. In other words, you will now

be able to participate in EI and claim unemployment insurance. Perhaps this is one of those unintended consequences of the Government's PSB initiative.

On balance:

1. All income earned in a fiscal year will be reported on a T4 which will be issued by the Placement Agency and as a result be taxed in the year it was received.
2. The disallowance of expenses which results from a PSB determination will no longer apply and as such will once again be deductible, granted the deductions are valid business expenses. As a partnership, with a spouse, family member, or business associate, you will have the ability to split income according to the terms of any partnership agreement which may exist between the partners.

What can I do?

One may never really understand the Government's motives in this matter. As the largest user of contracted resources in Canada, the Federal Government would not benefit from eliminating the availability or increasing the cost of independent contract resources to both themselves and corporations across Canada that rely upon them.

Independent Contractors in the Knowledge Worker sectors play a vital role in the Canadian economy and have done so for more than 30 years. Even so, policy makers don't seem to know about the lack of understanding surrounding knowledge workers and their contribution.

Therefore there are two suggestions for your consideration:

1. You should help the government better understand the story of the Independent Contractor in Canada by taking the APCC's survey which can be found on its web site here: https://www.surveymonkey.com/s/APCC_WOW
2. You should contact your representative in the Federal Government to express your concern at the government's ill considered PSB strategy. To help you in this regard some sample letters have been drafted and are available on the APCC web site at along with a list of Federal MPs and their contact details: <https://www.apconline.com/index.php/change-psb>