Why Should IT Consultants Care about Personal Services Corporation Rules?

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In short, because Personal Service Corporation ("PSC") rules virtually negate the tax advantages of having incorporated in the first place.

Moreover, few if any set up their corporation with the intention of being classified as a Personal Service Corporation and as such carry out certain activities which can be challenged on audit by the government. The audit can lead to very large fines, penalties, back taxes owing and interest. In extreme cases, it can lead to incarceration. An example provides some context.

Take an IT consultant whose company has taxable income of $100,000.

If the IT company claims the small business deduction tax rate, in Ontario it would pay corporate income tax at a rate of 15.5% ($15,500) in 2016 and would have $84,500 available for distribution as dividends.

If this $84,5000 is paid out as a dividend to the consultant, additional personal taxation in the IT consultant's hands occurs. To calculate taxes payable, the dividend is first 'grossed up' and tax applied at personal marginal rates, and then a dividend tax credit is applied to reduce the overall taxes payable on the grossed-up amount.

In Ontario, an IT consultant whose only source of income is a "non-eligible" dividend[1] of $84,500 would pay net personal taxes in 2016 of $10,821 after deducting basic personal & dividend tax credits, leaving him or her with a net after tax income of $73,679.

[1] It is considered non-eligible because the corporation paying it is taxed at the lower Small Business rate of 15.5%(in Ontario).

The following table summarizes the situation:

Corporate Income	100,000
Corporate tax (Small Business Deduction Rate) 15.5% - Ontario 2016	(15,500)
Available for dividends (non-eligible dividends)	84,500
Personal Taxes payable on Dividends	(10,821)
Net after-tax income available	73,679
Total Tax leakage 2016	**26,321**

However, if that same IT company is deemed by the CRA to be a **Personal Service Corporation** ("PSC")[2], the corporate tax rate jumps to 39.5% in 2016 meaning that corporate taxes payable on $100,000 of corporate income jump to $39,500 ($24,000 more than in the normal case!!!).

The PSC, having paid $39,500 in taxes will therefore only have $60,500 to distribute in dividends. However, because the PSC was subject to higher corporate taxes, the dividends it pays are considered "eligible dividends" and are subject to lower taxation in the IT Consultant's hands.

In our example, the available $60,500 distributed via "eligible" dividends out of the PSC will attract alternative minimum tax of $2,516 (after the application of personal & dividend tax credits) leaving the IT Consultant with $57,984 in 2016 net after-tax income.

[2] A company will generally be considered a personal service corporation when there is only one client, and but for the existence of the company, the relationship between the IT consultant and the client would have been an employer-employee relationship.

We summarize the tax treatment in the following table:

Corporate Income 2016	100,000
Corporate tax (PSB) 39.5% - Ontario	(39,500)
Available for dividends (eligible dividends)	60,500
Personal Taxes payable on dividends	(2,516)
Net after-tax income available	57,984
Total Tax leakage 2016	**42,016**

Clearly, if the IT consultant paid corporate taxes of $15,500 for 10 years, thinking that the company is not a PSC, but that upon audit CRA took the position in Court that the business meets the definition of a PSC, there would be ($39,500 - $15,500 = $24,000 x 10) $240,000 of back taxes, plus interest, penalties and fines owing.

Many IT professionals may not have this kind of cash available to satisfy the tax authorities.

Where possible, all possible measures should be undertaken to avoid being classified as a PSC. APCC provides a lot of guidance and suggested readings to learn from tax professionals how this can be achieved.

What if I <u>cannot</u> avoid the PSC Designation?

The *Income Tax Act* (Canada) is very clear as to which corporate deductions are permitted to a PSC – and there are very few. Chief among them are salaries paid and the cost of benefit plans including pension plans.

Therefore, in the example above, the IT Company making $100,000 could reduce its taxable corporate income by: (1) participating in a personal pension plan and (2) paying a salary.[3]

By way of illustration only, a salary of say $60,000 could be paid to the IT consultant. Given the current 2016 federal and Ontario tax brackets, personal income taxes payable would generally be $11,796, leaving $48,204 of after-tax income. At $60,000 of salary, a 50 year old IT consultant saving through a personal pension plan would be able to contribute $13,575 as a tax-deductible contribution to the personal pension plan ("PPP").[4]

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[3] Salaries are taxed according to graduated tax brackets. Lower salary amounts pay disproportionally less tax than higher salaries.

[4] On $60,000 in salary, the IT consultant could also contribute up to 18% or $10,800 to a Registered Retirement Savings Plan (RRSP) instead - with similar tax consequences.

The IT Corporation's taxable corporate income would be as follows: $100,000 - $60,000 (salary) - $13,575 (pension contribution) = $26,425. At the PSC tax rate of 39.5%, this translates into corporate taxes of $10,438.[5] (To avoid paying any corporate tax, the salary and pension contributions could be increased.)

At the end of the process, the IT consultant would have $48,204 in after-tax dollars from his or her salary, plus retained earnings in the corporation of $15,987. Moreover, the pension plan now has $13,575 growing without immediate taxation until retirement.[6]

By contributing to the personal pension plan, the IT consultant has saved $5,362 (39.5% x $13,575) in corporate taxes. If dividends are paid on the retained earnings of $15,987, this would leave an additional $14,652 of after tax income to be added to the consultant's after-tax salary of $48,204 for a total take-home pay of $62,856. To this one must also keep in mind that there is also a pension plan available with $13,575.

In the PSC/no salary illustration, the net after-tax income was $57,984 with no pension plan.

We summarize this solution for a PSC IT company using a PPP below:

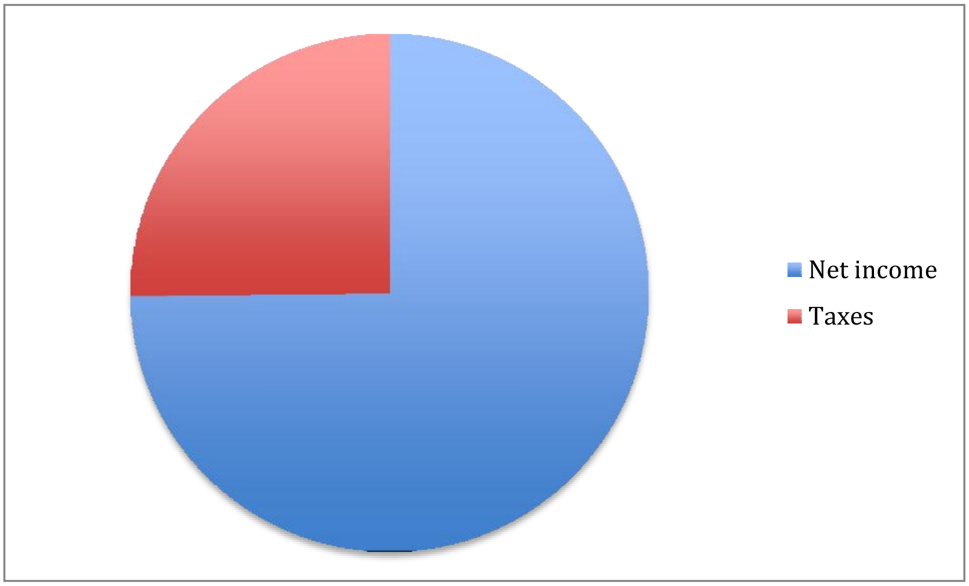
Corporate Income - 2016	$100,000
Salary Paid	(60,000)
Contribution to Personal Pension Plan – age 50	(13,575)
Corporate Income Subject to Corporate Tax at PSC Rate (39.5% Ontario - 2016)	$26,425

[5] For the sake of simplicity, we have excluded CPP premiums and Employment Insurance. CPP is deferred income since it builds a pension entitlement later in life and is not a tax, and Employment Insurance is typically not applicable where the owner/operator of the company is a connected individual and owns shares in the IT company.

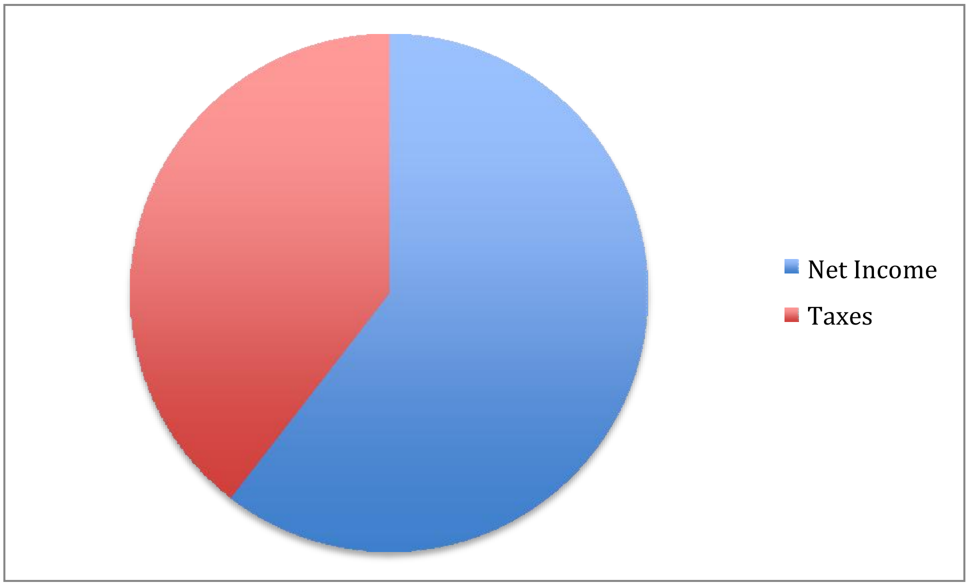
Corporate Taxes Paid	$10,438
Personal Income Tax Paid on Salary of $60,000	(11,796)
Dividends Paid to IT Consultant	15,987
Net Salary For Living Expenses	48,204
Pension Account Balance	13,575
Dividend Taxes Paid on Corporate Dividends	(1,335)
Total disposable Income	62,856 (Net Salary + Dividends)
Total Increases to Net Worth	$62,856 after tax + 13,575 gross pension account balance
Total Tax leakage	**$23,569 (not including tax on future pension payments)**

In short, the use of salary and pension deductions has converted a large percentage of the tax that would have been payable to the Canada Revenue Agency into a pension entitlement. While the IT consultant has experienced a reduction of $10,823 in terms of take-home pay, he/she also has gross before tax personal wealth accumulated in the pension plan of$13,575. If the IT consultant's post-retirement tax rate is 20.27%, the $13,575 accumulated in the pension plan would exactly offset the $10,823 take-home pay reduction.

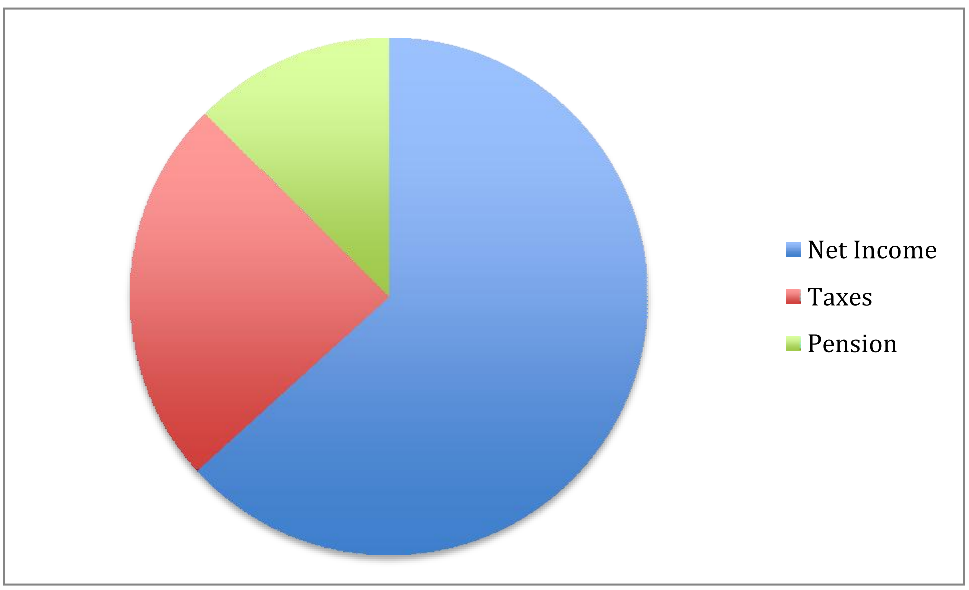
The following graphs provide a snapshot of the 3 illustrations:



CCPC 15.5% tax with Dividends – NON PSC CASE



PSC 39.5% with Dividends if considered as PSC



PSC 39.5% with Salary and Pension

For more information about how IT professionals can mitigate the impact of a PSC designation to protect their income, please contact:

APCC: https://www.integris-mgt.com/events/apcc

Or
INTEGRIS at questions@integris-mgt.com or Toll Free at 1 855 214 5008.