

The New Peril of Incorporated Contractors in Canada

By Robert R. Worthington

Canada, like elsewhere in the world, has long identified tax planning mischief where a person is hired as a contractor but otherwise conducts their affairs in an employee-like manner. Where the relationship is in fact employee-like, contractors who contract through personal corporations will be subject to recent legislative changes that are increasingly punitive. This issue will have significant international structuring implications for planners.

The benefits of independent contractor status through a personal corporation in comparison to employee status often favour both the individual and the business to which the contracted services are provided. The tax benefits sought by the independent contractor are the ability to income-split and access to the small business tax rate. The small business tax rate is significantly lower than personal tax rates, creating a significant tax deferral opportunity. Both domestic and non-resident businesses often prefer to hire contractors instead of employees. From their perspective, this strategy avoids social security deductions, provides increased flexibility for restructuring, and potentially provides other advantages. Tax planning may also favour incorporated contractor status to reduce the risk that a permanent establishment exists in Canada.

The tax policy in Canada attempts to penalize the perceived mischief of contractor structuring where the relationship is in fact employee-like by classifying the corporation as a "personal services business" (a "PSB"). As a consequence of significant reduc-



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tions to corporate tax rates over the past decade, the penalty of PSB classification has not successfully deterred the business community. With new legislation, we may see a significant increase in PSB reassessments and a long-term decreasing trend away from independent contractors as a result.

Legislative Change

Newly legislated tax rates have dramatically increased the risk of contracting through a PSB. In particular, the general corporate tax rate of 25% (assuming Alberta rates) normally afforded to corporations will no longer be available to PSBs for taxation years that begin after October 31, 2011. Income of a PSB will not be taxed at the small business rate of 14% (assuming Alberta rates), nor will also not be taxed at the general corporate rate of 25%. Instead, its income will be taxed

at a punitive rate of 38%.

What is a PSB?

The courts and the Canada Revenue Agency consider various factors in determining whether an individual is an incorporated employee. Key factors include, among other things, (a) the degree of control exercised over business decisions; (b) ownership of tools; (c) the ability to substitute another person to do the work, (d) whether there is a chance of extra profit or the risk of additional loss; and (e) the number of clients the contractor has.

Although Canada is often characterized as a form over substance jurisdiction in international planning, recent case law also demonstrates that it is not possible to contract out of what is in substance an employment relationship. If the factors weigh more heavily towards an employment relationship, it will not matter if the contract defines the relationship as that of an independent contractor. This test is highly fact specific and many individuals (or international businesses) that intend to be contractors may still be classified as PSBs.

Possible Solutions

An obvious solution to the PSB problem is to simply cease being an independent contractor and become an employee. The employer, however, may prefer the flexibility of a hiring contractor.

The owner of a potential PSB can choose to be paid a salary as opposed to dividends. While this approach does mitigate the tax risks of being re-

assessed as a PSB, from a tax perspective it defeats the purpose of incorporating because there will be no deferral advantage.

Another possible solution is to revisit the contractor's written agreement and ensure that its terms are indicative of an independent contractor relationship and not that of employment. Dealing with the PSB problem through the terms of the agreement may reduce the PSB risk; but it does not eliminate it.

Since none of the solutions described above are ideal, practitioners have begun to recommend alternative structures that provide similar tax benefits but avoid the risk of PSB classification.

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