



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



Published under the authority of the Speaker of the House of Commons

SPEAKER'S PERMISSION

Reproduction of the proceedings of the House of Commons and its Committees, in whole or in part and in any medium, is hereby permitted provided that the reproduction is accurate and is not presented as official. This permission does not extend to reproduction, distribution or use for commercial purpose of financial gain. Reproduction or use outside this permission or without authorization may be treated as copyright infringement in accordance with the *Copyright Act*. Authorization may be obtained on written application to the Office of the Speaker of the House of Commons.

Reproduction in accordance with this permission does not constitute publication under the authority of the House of Commons. The absolute privilege that applies to the proceedings of the House of Commons does not extend to these permitted reproductions. Where a reproduction includes briefs to a Standing Committee of the House of Commons, authorization for reproduction may be required from the authors in accordance with the *Copyright Act*.

Nothing in this permission abrogates or derogates from the privileges, powers, immunities and rights of the House of Commons and its Committees. For greater certainty, this permission does not affect the prohibition against impeaching or questioning the proceedings of the House of Commons in courts or otherwise. The House of Commons retains the right and privilege to find users in contempt of Parliament if a reproduction or use is not in accordance with this permission.

Additional copies may be obtained from: Publishing and Depository Services
Public Works and Government Services Canada
Ottawa, Ontario K1A 0S5
Telephone: 613-941-5995 or 1-800-635-7943
Fax: 613-954-5779 or 1-800-565-7757
publications@tpsgc-pwgsc.gc.ca
<http://publications.gc.ca>

Also available on the Parliament of Canada Web Site
at the following address: <http://www.parl.gc.ca>

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

STANDING COMMITTEE ON FINANCE

CHAIR

James Rajotte

VICE-CHAIRS

Massimo Pacetti

Daniel Paillé

MEMBERS

Kelly Block

Bernard Généreux

Hon. John McCallum

Ted Menzies

Mike Wallace

Robert Carrier

Russ Hiebert

Hon. John McKay

Thomas J. Mulcair

OTHER MEMBERS OF PARLIAMENT WHO PARTICIPATED

Martha Hall Findlay

Jean-Yves Laforest

Hon. Marlene Jennings

Luc Malo

CLERK OF THE COMMITTEE

Jean-François Pagé

COMMITTEE CLERK

Julie-Anne Macdonald

LIBRARY OF PARLIAMENT

Parliamentary Information and Research Service

June Dewetering, Chief Analyst

Mark Mahabir, Analyst

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 regard 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