Are you walking into a tax disaster - Incorporated contractors & taxes (part I)

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The Tax Court of Canada ("TCC") decision in G&J Muirhead Holdings Ltd. v Queen, released on February 13, 2014, dealt with whether a one-person service company was carrying on a personal services business ("PSB"). Although the decision did not represent any shift in judicial thinking on the subject, it is nonetheless useful in clarifying the role of subjective intention in PSB determination and serves as a stern reminder for incorporated contractors to structure their engagements with eyes wide open.

The PSB rules: Origins and implications

To appreciate the intent behind the PSB regime, we shall step back in time to 1969. While the USA was occupied with landing the first man on the moon, our courts ruled on the case of *Ralph J. Sazio* v *MNR*. Sazio was a CFL Hall of Famer who led the Hamilton Tiger-Cats to three Grey Cup championships. He also figured out that, rather than offering his coaching services to the Tiger-Cats as an employee, he could offer the same services through a corporation and benefit from lower tax rates offered by a corporate structure. The Canadian government disagreed but the Court sided with Sazio and held that the company was a properly constituted legal entity and the income belonged to it.

Having been thwarted in its attempt to stop such arrangement, the government feared for its ability to finance its operations if the masses began converting their employment into corporate service arrangements. In addition to the small business tax rate, a corporate structure also provides workers with the ability to reduce tax by income-splitting and avoid payroll withholding (a primary revenue source for the government). Therefore, in 1981, Parliament introduced the PSB regime for circumstances where a corporation is inter-posed into what would normally constitute an employee-employer relationship.

Prior to 2006, the consequence for being a PSB was that the corporation would be taxed as if the worker was employed directly by the hirer, i.e. disallowance of the small business deduction and limiting of deductions to remunerations paid to the "incorporated employee" and certain other deductions otherwise available to ordinary employees. Due to the introduction of the eligible dividend regime in 2006 and overall decline in corporate tax rates, a PSB structure became tax-efficient since it enabled a tax deferral while keeping the total tax on fully-distributed income similar to that of an employee. Finance was not keen on this tax result and redefined the definition of "full rate taxable income" in subsection 123.4(1) of the Act, effective for tax years beginning after October 31, 2011, so that the federal general rate reduction of 13% no longer applies to PSB income. This eliminated any deferral opportunity and effectively increased the fully-distributed tax rate on PSB income in Alberta to approximately 50% at the top marginal rates (compared to 39% for employment income).

Determining whether a corporation is carrying on a PSB

With limited exceptions, a PSB is a business of providing services where an individual who performs

services on behalf of the corporation (the "incorporated employee") or a related person is a specified shareholder, and the incorporated employee would *reasonably be regarded as an officer or employee* of the hirer (as opposed to an independent contractor), but for the existence of the corporation.

Since the Act does not define an employment relationship, the determination of whether a person is an employee or an independent contractor has been frequently litigated. The ultimate test, as set out by the Supreme Court of Canada in *Sagaz Industries Canada Inc.*, is whether the worker performing the services "is performing them as a person in business on his own account". The test traditionally focused on objective facts, in particular the ones set out by the Federal Court of Appeal (the "FCA") in *Wiebe Door*: the degree of control exercised over the worker, the ownership of tools, chance of profit and risk of loss, and integration (although the role of integration as a factor has been significantly reduced in later jurisprudence). However, over the last decade, the FCA began to afford more weight to the common intention of the parties (see *Wolf* and *Royal Winnipeg Ballet*). In 2013, the FCA in *Connor Homes* explained that the determination of employee versus independent contractor is actually a two-part test: first establish each party's subjective intent based on contractual relationship or actual behavior, then determine whether objective reality supports the parties' subjective intent.

The *Muirhead* case concerned an incorporated one-person oilfield services contractor¸ a phenomenon prevalent in the oil and gas and IT industries. A corporation was jointly owned by a married couple and the husband was the corporation's sole employee. The corporation entered into an operating agreement with a resource company whereby the husband, as an employee of the corporation, provided oilfield services on a full-time basis to the resource company for a set hourly rate with an increased rate for overtime. The resource company was the corporation's only client for a number of years, even though exclusivity was not required as part of the agreement. The CRA reassessed the corporation on the basis that it carried on a PSB. Counsel for the taxpayer argued against the reassessment by relying heavily on the intention as stated by the parties in the operating agreement that the relationship was to be a *contract for services* (rather than a *contract of service* inherent in an employer-employee relationship).

The TCC has ruled previously (most recently in *Gomez Consulting Ltd*) that, in spite of judicial development at the FCA on the employer vs contractor issue, common intention of the parties is not a relevant consideration in a PSB case. In his judgment, Boyle J. articulated the Court's rationale. Since an agreement between a hirer and corporate service provider will always be a contract for services (as a corporation can never be an employee), the definition of PSB would be rendered meaningless if the parties' common intention were taken into account because such intention would be "always present and always on the same side of the balance". Boyle J. was also clearly not impressed with the taxpayer's counsel for ignoring the TCC's jurisprudence on this issue.

With common intention discarded as a relevant consideration, the Court looked to the traditional *Sagaz/Wiebe Door* factors. It found the relationship to be indicative of an employer-employee relationship due to the control the resource company has over the work to be done, and the lack of a material chance for profits or loss with a one-man operation working on full-time basis. In particular, the Court noted that an increased rate for overtime hours is unusual for an independent contractor that has the right to hire subcontractors: "customers of a business normally seek to negotiate volume discounts, not volume surcharges…". The fact that the individual worker was required to provide his own protective clothing, hand tools and truck did not have any weight in the determination, as such arrangement is not uncommon in employment contracts.

The takeaway

The *Muirhead* decision should serve as a reminder to one-person operations that the CRA indeed

pursue PSB cases. Often, many working in the oil patch and IT sectors are required by their hirers to enter into independent contractor structures. There are numerous motivating factors behind companies requiring this: avoiding the employer's portion of CPP and EI, not having to comply with provincial Employment Standards legislation, and the administrative burden of maintaining employees. Also, by requiring the workers to incorporate, the companies shift the entire payroll withholding risk to the worker's corporations (the CRA's published administrative policy is to reassess the worker's corporation rather than go after the hirer for source deductions – CRA Doc #9611625). In a lot of these situations, the worker will not meet the independent contractor test because the worker only has one 'client' and it is not realistic or practical to subcontract out the work. Such workers should routinely strip out all of the service fees as salaries to themselves (rather than attempting to deduct business expenses or to split-income with family members) so that there is no corporate income subject to the punitive PSB corporate tax rate. The ending tax result would be the same as if the worker were employed directly by the hirer, but here, the worker bears the administrative burden of maintaining a corporation and payroll, misses out on CPP/EI otherwise contributed by the hirer, and protection from the Employment Standards legislation.

Part II of our blog on this topic (to be released later this month) will discuss the strategies that incorporated contractors should consider to minimize or mitigate their risks.