

Independent contractors - read this before incorporating

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In Greek mythology, [Icarus](#) flew with wings made of feather and wax but he was overly-ambitious. Ignoring his father's warnings, Icarus flew too close to the sun and the sun melted his wings causing him to fall into the water where he then drowned. Structuring oneself to provide services as an independent contractor comes with many advantages, and incorporating that business may bring additional advantages. However, in some circumstances, incorporating a 'one-person' business may be the same as flying too close to the sun.

The analysis of whether an individual is carrying on business as an independent contractor and whether a corporation is carrying on a personal services business ("PSB") requires an examination of whether the relationship between the service recipient and the service provider is akin to an employer-employee relationship. In March, we wrote about [G&J Muirhead Holdings Ltd. v. Queen](#) ("*Muirhead*"). That case analyzed the business of a 'one-man' corporation and concluded that a PSB existed. On October 31, 2014, the Tax Court of Canada released ("*3193099*") in respect to an assessment under the *Canada Pension Plan* and concluded that the provision of services by an individual, Mr. Eissner, was as an independent contractor, as opposed to an employee of the service recipient. Both cases were in respect of services provided in the oil and gas sector. Though there were objective facts differentiating *Muirhead* from *3193099* (such as that Mr. Eissner provided services to multiple companies), the consideration of subjective intent in *3193099*, and lack thereof in *Muirhead*, reframed the analysis of the relationship between the service provider and the service recipient and was likely a significant factor in the differing results.

There is nothing new or earth-shattering about the PSB test and employee-independent contractor test being different, but viewing *Muirhead* and *3193099* in tandem highlights this difference, and prompts an examination of the added advantages and risks of incorporating an independent contractor.

In short, determining whether a PSB exists is an analysis of the objective facts to determine, but-for the interposition of a corporation, would the individual performing the services be reasonably regarded as an employee of the service recipient. The Courts ignores subjective intent in a PSB determination because such intent, usually evidenced by the service agreement, never points to an employer-employer relationship (see our previous blog for more details). On the other hand, determining whether an individual is acting as an independent contractor, as opposed to an employee, is a two-step analysis (see paragraph 13 and 14 of *3193099*). First, the subjective intent of the service provider and service recipient is determined. Then, that intent cannot be contradicted by the objective realities of the relationship.

The more easily met independent contractor test, given the weight afforded to intention, is evident by the findings in *3193099*:

- Based on the service agreement, the Court found that the parties had a subjective intent that Mr. Eissner was contracted by Falcon (the service recipient) as an independent contractor.

- “The actions of [Mr. Eissner] and Falcon do not contradict their subjective intention.” (paragraph 21)
- “...the intention was clear at the outset and has not been revealed as unrealistic by an examination of the Wiebe Door” (paragraph 23)

Contrast this rebuttable presumption based on intention against the purely objective PSB test, to which the taxpayer bears the burden of proof at court. In 3193099, there were a number of adverse facts that, under a purely objective test, may have led to a finding of employer-employee relationship. For example, Mr. Eissner never invoiced Falcon, was paid a fixed amount on a bi-weekly basis, and was effectively Falcon’s COO. Yet, the Court still concluded an independent contractor relationship using the two-step approach.

What is the takeaway? Incorporating a ‘one-person’ independent contractor business has its advantages, but may also have its risks.

Generally speaking, an unincorporated independent contractor is entitled to deduct business expenses pursuant to sections 9 and 18 of the *Income Tax Act* (“All Business Expenses”), as opposed to the very limited deductions afforded to an employee pursuant to subsection 8(1). Incorporating that same independent contractor business takes the tax advantages to a new level. Not only may the corporation deduct All Business Expenses, it also has access to the small business tax rate and the ability to facilitate income splitting using multiple shareholders. However, these benefits are available only if the incorporated business is not a PSB. If it is found to be a PSB, it is limited to deducting essentially only the incorporated employee’s salary and is no longer an efficient income splitting vehicle, as the small business tax rate and the federal general rate reduction of 13% no longer applies to the PSB income. As a result, net effective tax ends up substantially higher than if the worker had earned the income as a straight employee. On top of that, arrears interest and penalties may be imposed on a CRA reassessment.

Consider a ‘one-person’ business, *Acme*. Assume that the objective facts in respect of *Acme*’s relationship with its client are unclear as to whether such relationship is akin to an employee-employer relationship. However, the intent of *Acme* and its client is that *Acme* provides services as an independent contractor. Let’s assume that when viewed through the lens of this intent, the objective facts in respect of *Acme*’s relationship with its client yield that *Acme* is an independent contractor. *Acme* can deduct All Business Expenses. However, the *Acme* business then incorporates into *AcmeCo*. *AcmeCo* continues to claim All Business Expenses, claims the small business tax rate and sets up a share structure which facilitates income splitting with the spouse of *AcmeCo*’s principal. Pursuant to an audit, the CRA reassesses *AcmeCo*’s business on the basis that it is a PSB and the matter goes to Tax Court.

At the Tax Court, the intent of *AcmeCo* and its client is ignored by the Court and *AcmeCo* bears the burden of proof in establishing that *AcmeCo* and its client do not have a relationship akin to employee and employer. Within this context, the Court finds that *AcmeCo*’s business is a PSB. As a result, the only business deduction *AcmeCo* is allowed is wages paid to its principal. Also, *AcmeCo* is denied the small business tax rate and any income splitting opportunities lose their efficiencies given that *AcmeCo* is not afforded the federal general rate reduction. *AcmeCo* would have been far better off continuing as an unincorporated business that could deduct All Business Expenses.

Acme flew too close to the PSB sun with its independent contractor wings, got burnt and drowned.

Of course, there are situations in which incorporating makes good sense. If the objective facts are not

reflective of an employer-employee-like relationship, the incorporated independent contractor would not be a PSB and can enjoy all the benefits outlined above. A tax advisor should be consulted to help determine whether an employer-employee-like relationship exists and to help structure the business to avoid such a finding.

Additionally, the tax tail should not wag the dog – there may be other compelling reasons to incorporate, such as liability protection or industry requirements. In such cases, if one cannot confidently support an independent contractor fact pattern, the right approach may be to pay out all annual profits of the corporation to the principal as salary. No tax advantages will be gained from this approach, but there would be no downside risk if the corporation is found to be carrying on a PSB. There is wisdom in flying low in the cool shade.