GREGORY, HARRIMAN & ASSOCIATES LLP
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PERSONAL SERVICE BUSINESS (PSB)

(Also known as “Personal Service Corporation” and/or “Incorporated Employee")

Every year, as part of our professional development, our partners and senior staff at the office attend various taxation courses to improve our knowledge base and to better our services to our client. In recent months, one of the more frequent discussion points was around the recent development in the oil & gas service industry and the potential impact of what is now known as "The G&J Muirhead Case" or G & J Muirhead Holdings Ltd. v. The Queen.

KNOWN FACTS

- G & J Muirhead Holdings Ltd. (Muirhead) was a one person oilfield service corporation providing contract services to Harvest Operation Corp. (Harvest);
- Muirhead was owned by husband and wife (shareholders)
- Husband was the principal and only employee of Muirhead;
- Muirhead entered into a service agreement with Harvest for consultation;
- Harvest was the only client of Muirhead, and was so for several years;
- Compensation was determined by Harvest for a set hourly rate and a set overtime rate;
- CRA audited Muirhead and determined that Muirhead was a Personal Service Business, i.e. that husband was a "de facto" incorporated employee and CRA reassessed accordingly;
- Muirhead appealed the audit findings and reassessment stating that he was an Independent Contractor of Harvest;

The Tax Court of Canada, after review of the facts of the case and pleadings by a reputable law firm determined that Muirhead was a Personal Service Business (PSB) and upheld the audit findings. The corporation was reassessed by CRA as a PSB with all the tax consequences.

WHAT IS A PSB (PERSONAL SERVICES BUSINESS)

In general, a PSB is in the business of providing services where the principal (usually the owner / shareholder) performs services on behalf of the corporation (the "incorporated employee") and the incorporated employee would reasonably be regarded as an employee of the hirer (the Contractee), the business to whom the services are being provided.

WHY IS IT A BIGGER DEAL NOW?

The concept of PSB is not new. It has been a contentious issue for years between the Canada Revenue Agency (CRA) and taxpayers. CRA sees the oil & gas industry and the IT (information technology) sector as prevalent "offenders" and are pursuing various tax audit programs. Other industries are also on CRA’s radar. In the past, usually when an actual written agreement (adequately worded) was in place between the Contractor and the Contractee, the agreement was generally seen as “sufficient” to document the "common intention" of the relationship.

Now recent court cases, including the one noted above, have been dismissing the concept of "common intention", i.e. the courts are essentially saying that having an agreement, written or verbal, is no longer relevant in determining if there is a Contractor / Contractee relationship versus an employee / employer relationship. <u>Other facts have to be considered.</u>

ARE YOU AND INDEPENDENT CONTRACTOR?

To determine if you are an Independent Contractor versus being an employee, CRA applies the following principles:

1. The degree of control;
2. The ownership of the tools and equipment;
3. The chance for profit or loss; and
4. The degree of integration.

Degree of controls means: Who decides when you will be performing the service, what time of the day, which day, etc. Can you sub the work to another Contractor? Can you have employees of your own and have your employee perform the service or does the Contractee requires you to perform the service at all times and no one else. In some instances, the Contractor's agreement with the Contractee will prevent the Contractor to provide services to anyone else.

Ownership of the tools means: Who provides the equipment? What equipment is provided by the Contractee? What equipment is provided by the Contractor? Does the Contractee require the Contractor to use specific equipment?

Chance for profit or loss means: Does the Contractor have a financial risk? Is the Contractor at risk of losing money or not be paid if the services provided are not accepted by the Contractee. Who pays for damaged equipment? Who is responsible for delays?

Degree of integration means: This one is a little harder to explain. If you enter into an agreement to provide services with a Contractee and the Contractee will wait for you to become available to obtain the service, then likely you are a Contractor. If you provide services to a Contractee and it is the Contractee that determines when the services are to be provided, likely you are **not** an independent Contractor.

CONSEQUENCES OF BEING ASSESSED AS A PSB

Prior to 2006, the consequence for being a PSB was that the corporation would be taxed as if the Contractor was employed directly by the Contractee, i.e. the Contractor would receive the same tax treatment as if you were an employee.

- Access to the small business deduction (SBD) would be removed (disallowed);
- Expenses that could otherwise be claimed by an independent contractor would be restricted and limited to the same deductions an "ordinary" employee would be entitled to, being an employee that is paid a salary or wage and receives a T4 at the end of the calendar year. There aren't many;
- Expenses claimed would be limited to the employment income earned, i.e. you could not create a loss from operating the "business"; and
- Ability to "income split" with a spouse would essentially be eliminated or limited.

Before 2006, in the case of a reassessment by CRA, the maximum tax rate in Alberta on employment income would be 39%.

Now, in 2006, Ministry of Finance has introduced new rules regarding the payment of Dividends by a Canadian Control Private Corporation (CCPC). It is referred to as the "Eligible Dividend Regime". In most cases, the Contractor's corporation would be considered a CCPC and the new rules would apply.

By doing so, they have also created a "loophole" that could be beneficial to the Contractor, in the event that the Contractor was deemed to be a PSB or "incorporated employee". CRA saw right through this and changed the law so that the maximum tax rate in Alberta would be bumped to 50% in the event the Contractor's corporation would be reassessed as a PSB.

Since 2006, in the case of a reassessment by CRA, the maximum tax rate in Alberta on income earned by a Personal Service Business would now be 50%. This is very punitive and would not be good in a case of reassessment.

EXCEPTIONS TO THE PSB CONCEPTS.

If your corporation employs more than five full-time employees or it provides services to an associated corporation, it will generally not be considered a personal services business. Generally, the associated corporation exception is impractical for most business owners.

Another option would be to ensure that your corporation has multiple customers.

ARE YOU AT RISK OF BEING CONSIDERED A PSB?

A few simple facts to consider determining if CRA could see you as an "incorporated employee"

- You are incorporated;
- You and/or your spouse are the only person (s) working for your corporation;
- You do not have five or more full-time employees;
- You only have one client (Contractee);
- Your client determines where you work, the hours worked, your work schedule and, in most instances, they determine compensation for your services;

The fact that you provide your own transportation (vehicle), your own tools and other equipment is no longer sufficient.

The fact that a written agreement between the Contractor and the Contractee showing "common intentions" also bears little weight.

If you are concerned that your corporation may be a PSB, you should consider taking a conservative approach when discussing with your accountant and/or tax advisor your corporation's tax planning strategy. A few points:

- The corporation should be paying you a salary, complete with monthly CPP and Tax remittances;
- Stop paying dividends from the corporation;
- Avoid or drastically reduce income splitting strategies with your spouse and/or other family members (children), especially if they are not shareholders of the corporation;
- Review what an "ordinary" employee can claim as a deduction. The corporation should limit the expenses to those same deductions; and
- Avoid leaving any taxable income in the corporation.

In most instances, the Contractee will take the position that they do not want you as an employee and this is why they insist that the Contractor incorporates. They will actually force you to provide services through a corporation. It is OK to provide services through a corporation to a Contractee as long as CRA does not think that you are gaining a tax advantage otherwise not available in an employee – employer relationship. Using a conservative approach and taking the steps noted above will help mitigate the risk of being reassessed as a PSB.