

New CRA campaign focuses on personal services businesses: Are you ready?

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The Canada Revenue Agency is escalating their scrutiny of personal services businesses, and the consequences for breaching these tax rules can be severe. Find out what you need to know about the CRA's campaign.



As more individuals and sole proprietors in Canada are choosing to incorporate, it has become essential to assess if the formed corporation is operating as a PSB and how that can impact the entity's tax situation. The CRA is taking a closer look at the personal services business (PSB) rules that apply when:

- services are provided through a corporation, and
- the individual doing the work would be considered an employee if they provided the services directly

Among its activities in this area, the CRA presented a [webinar in February 2022](https://www.canada.ca/en/revenue-agency/news/cra-multimedia-library/businesses-video-gallery/personal-services-business.html) and sent stakeholder emails to educate corporations and advisers about the rules and how to comply with them.

In a [stakeholder email sent in July 2022](/-/media/site/operational/ex-executive/docs/cra-stakeholders_arc-intervenants.pdf), the CRA said they would be contacting Canadian businesses from June to December 2022 to ask for documentation about their payer/payee relationships.

Taxpayer participation in the program will be voluntary, although businesses that take part will be advised to ensure they correct any errors and comply with the Income Tax Act.

The [campaign](https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/corporations/corporation-income-tax-return/tax-implications-personal-services-business.html) seems to focus on industries that commonly hire service providers who may operate a PSB, such as trucking, IT consulting, accounting, construction and catering – all of which are named in the CRA's webinar.

As more CRA activity on this front is possible, this blog provides an overview of:

- the relevant PSB rules to consider
- some leading practices to consider for taxpayers that deliver services through a corporation

OVERVIEW

Rather than hiring employees directly, many taxpayers retain non-employees to provide services, whether to fill a short-term need, obtain specific expertise or otherwise fill a role that is not suited to a full-time position.

These situations carry significant income tax risk, and that risk depends on whether an individual or corporation is providing the services.

When the service provider is an individual, the key income tax issue is whether the individual is employed or self-employed. If the individual is self-employed but the CRA decides that they are in fact an employee, then the individual's expense deductions may be denied. The payer may also be on the hook for income tax, Canada Pension Plan and Employment Insurance withholdings, as well as penalties for failing to make these withholdings. Both the payer and payee bear tax risk in these situations.

But where the payer engages a corporation to provide services, the income tax risks associated with the proper calculation and payment of tax rest mainly with the service provider. Assuming the provider is a Canadian-controlled private corporation, the tax rules require a determination as to whether the income is:

- income from an active business that is eligible for the small business deduction, or
- income from a PSB

If the payee treats the service income as eligible for small business tax rates but the CRA characterizes the income as earned from a PSB, a significant tax liability could arise for the payee. The payer is in no way affected by the income determination, however, which is one reason why many payers prefer to deal with service providers that are incorporated.

(Note that different rules apply when the corporation provides services to an associated corporation.)

TAX HIT FOR CORPORATIONS EARNING PSB INCOME

When the PSB rules apply, there are two main tax consequences: a higher corporate tax rate on the PSB income and a limitation on the corporation's expense deductions.

Higher corporate tax rate on PSB income

Any income of the corporation that is determined to be from a PSB would not be eligible for the small business deduction. An additional tax of 5 per cent would apply on that income.

This cost climbs even higher when provincial taxes are factored in. In Ontario, for example, the 2022 tax rate on PSB income is 44.5 per cent, while the rate for income eligible for the small business rate is 12.2 per cent.

In the future, even though tax has already been applied at a high corporate rate, a second layer of tax will be paid later when the corporate funds are received as a dividend or capital gain.

Continuing our example, if the after-tax PSB income were paid as an eligible dividend to a top-rate-paying individual in Ontario, the combined corporate and personal tax would be 66.3 per cent. The top rate on ordinary income in Ontario is 53.53 per cent, creating a potential income tax integration cost of almost 13 per cent.

Limited deductions

If the PSB rules apply, the deductions that the corporation could claim when computing PSB income are limited to:

- salary paid to the "incorporated employee"
- employment benefits for that individual
- expenses that would be allowed if the individual were a commissioned salesperson
- legal expenses incurred by the corporation to collect amounts owing to it
Other expenses would be disallowed even if they were paid to earn income.

When do the PSB rules apply?

The PSB rules generally apply when these four tests are met:

1. the individual providing services, or a person related to them, is a specified shareholder of the corporation
2. if the individual had provided services directly (i.e., without using a corporation), the individual would be considered an employee of the taxpayer (i.e., an incorporated employee)
3. the corporation does not employ more than five full-time employees throughout the tax year
4. the corporation's income is from services performed by the provider on the corporation's behalf

A specified shareholder is a taxpayer who owns, directly or indirectly at any time in the year, at least 10 per cent of the issued shares of any class of capital stock of the corporation or a related corporation.

Who is considered to be an incorporated employee?

For an individual doing services through a corporation, the key rule to keep in mind is whether the service provider would be considered an employee if not for the corporation since the other three tests will generally be met.

Whether an individual is an incorporated employee is determined using the same [factors \(https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4110/employee-self-employed.html\)](https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4110/employee-self-employed.html) used to decide whether an individual is employed or self-employed:

- **control** - the degree of control exercised by the payer over the service provider's duties (more control may indicate an employment relationship)
- **tools and equipment** - whether the payer uses their own tools to perform the services (providing tools to a service provider suggests an employment relationship)
- **ability to subcontract** - whether or not the service provider must carry out the work personally or if they can hire or subcontract the work (not being able to subcontract relevant work indicates an employment relationship)
- **financial risk** - whether or not the service provider has an investment in their business, which includes paying for costs before billing for services
- **opportunity for profit** - whether the service provider has both a chance of profit and a risk of loss
- **multiple clients** - providing similar services to other clients also indicates self-employment

Another factor is the parties' intent. Did the payer intend to engage the service provider in a business relationship and not employment? Intention is determined based on specific evidence, particularly the contract for services.

However, if the above factors point to an employment relationship, the existence of a written contract stating otherwise may not help. But where these factors are less clear, setting out this intention in writing may be more persuasive.

MANAGING PSB RISK - TIPS AND GOOD PRACTICES

As you can see, the tax consequences of unexpectedly earning PSB income in a corporation can be severe due to the large tax rate differential and the restriction on expense deductions. Here are some suggestions for managing your PSB risk.

1. Pay out corporate earnings as a salary

One way to manage the risk is to reduce what could be PSB income by paying a salary to the service provider. This reduces the amount of corporate income that could be taxed at the PSB rate. Keep in mind that only salary paid will qualify as a deduction. Any accrued but unpaid remuneration is only deductible from PSB income when paid.

When considering whether income should be paid out as a salary as it is earned, remember that the potential cost of earning PSB income will be multiplied based on the number of years open for assessment in which PSB income was earned. So, recognizing when a PSB may exist is critical for dealing with the associated tax risk.

Although some may voluntarily use a corporation, many service providers find that some payers will only work with service providers who are incorporated, whether to minimize tax risk for the payer or other reasons.

Even if a payer insists on working only with incorporated service providers, this does not necessarily mean that the service provider is carrying on an active business. The PSB rules still need to be considered.

Service providers who are risk averse or unsure of their tax status can still use a corporation to provide services, as long as they pay salaries and benefits related to the PSB income during the year it is earned. This will ensure that the corporation will not have income subject to the high rate on PSB income and that no integration cost arises.

2. Clearly document the relationship

For those who are comfortable that they are not operating a PSB, the key is to clearly document the relationship in a written agreement that states the parties have not agreed to an employment relationship. Even with the agreement in place, the possibility of a CRA review or audit still needs to be considered. Even if the corporation's income is ultimately not reassessed as PSB income, the costs of dealing with a CRA review or audit could still be significant.

3. Consider PSB risk when planning remuneration

The service provider's personal cash needs and remuneration planning should also be considered. When deciding on remuneration levels and whether a salary or a dividend should be paid, remember that paying a salary will reduce the impact of an unexpected PSB reassessment. Unlike a dividend paid from after-tax income, salary paid in the year is deductible.

Also, the dividend's status as after-tax small business income may be an issue. Dividends related to after-tax small business income are generally paid as ineligible dividends while after-tax PSB income can generally be paid as an eligible dividend. If the income is found to be from a PSB, then it would have been possible to pay an eligible dividend, which is generally taxed at lower personal tax rates. The CRA has stated that it will decide case by case whether it would accept a late eligible dividend designation related to a PSB reassessment (see technical interpretation 2013-0495771C6).

4. Consider obtaining a ruling from CRA

According to the CRA webinar, it is also possible to ask CRA for a ruling to determine whether a service provider is employed or self-employed. While this route offers greater certainty, the risk remains that the CRA might decide that an employee relationship exists where self-employment could be successfully justified. So, if the service provider is clearly not an incorporated employee, a ruling request might only draw the CRA's attention to the arrangement.

WHAT'S NEXT?

With the CRA intensifying its outreach in this area and contacting taxpayers to voluntarily take part in an education program, we assume that other CRA activities in the future are possible. If you or your clients earn service income in a corporation, be sure to review whether the PSB rules apply and what action you may need to take. We will continue to monitor the situation — watch for updates as more information becomes available.

Disclaimer

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