JOLY HEINZLMEIR PROFESSIONAL ACCOUNTANTS

TAX RISK FOR INCORPORATED EMPLOYEES

Main Office

4620 - 48 Avenue

Red Deer, AB T4N 3S9

Phone: 403-986-5298

Fax: 403-343-2650

Email: office@jhpa.ca

Diana Heinzlmeir, CGA
Partner
Email
Dheinzlmeir@jhpa.ca

Richard R. Joly, CA
Partner
Email Rjoly@jhpa.ca

Recent tax changes mean that incorporated employees could face a substantially higher tax bill than salaried employees in the absence of further tax planning.

There are many reasons one may decide to incorporate a business and it is accepted practice in certain industries, such as IT, resource and construction industries, for workers to provide services through a corporation. Commonly expected tax-advantages of incorporation however may not materialize for incorporated employees who fall within the definition of personal services business ("**PSB**") and recent legislative changes can actually put PSBs at a significant tax disadvantage. The purpose of this information bulletin is to highlight this issue and we encourage you to contact one of our professionals directly to review whether these rules will apply to you.

Tax consequences of Operating as a PSB

As discussed below, the fact that an individual choses to operate through a corporation will not automatically characterize the business as a PSB, provided that the relationship would be viewed as a relationship between an independent contractor and a customer but for the interposition of the individual's corporation. However, the objective of the PSB rules is to ensure that individuals who would otherwise be in an employment relationship are not able to unfairly reduce their income tax liability by incorporating.

The expenses that may be deducted in calculating PSB income are extremely restricted. Instead of allowing a deduction of reasonable expenses incurred in generating profits, a PSB can generally only deduct wages paid and benefits provided to the incorporated employee and legal expenses incurred by the corporation in collecting amounts owing for services rendered.

Further, PSB income is not eligible for the small business deduction which is otherwise available to reduce the corporate tax rate on the first $500,000 of active business income.

Despite these restrictions, until recently, a PSB arrangement was often still an attractive option for high salaried employees because it provided the ability to retain income taxed at the corporate rate (25%) in the corporation, thereby deferring the personal tax until funds were withdrawn as dividends (and potential for absolute tax savings where lower income family members are shareholders). Refer to the example below.

- **Non-deductible expenses for a PSB include: incorporation costs, salaries to other employees, home office expenses, training, travel, computers, software, office equipment, accounting fees and professional dues.**
- **Denial of Small Business Deduction.**
- **Denial of General Rate Reduction.**

Tax consequences of Operating as a PSB cont'd

To curb the use of corporations to access this tax deferral advantage that is not available to salaried employees, the general rate reduction of 13% will no longer apply to income from a PSB effective for taxation years that begin after October 31, 2011. In Alberta, the combined federal and provincial corporate tax rate applicable on PSB income is now 38% rather than 25%. This effectively eliminates the tax deferral opportunity, and increases the combined corporate and personal tax on PSB income paid via an eligible dividend to an individual taxed at the top marginal rate to 49.96% in Alberta. This is significantly higher than the top marginal personal rate of 39% that would have been applicable for employment income earned by a salaried employee.

Employment Income versus the first $500,000 of Income Earned by a CCPC carrying on business in Alberta

	Salaried Employee	PSB On or before October 31, 2011	PSB November 1, 2011 on
Corporate Tax			
Income Tax	N/A	38.00%	38.00%
General Rate Reduction	N/A	13.00%	N/A
Small Business Deduction	N/A	N/A	N/A
	N/A	25.00%	38.00%
Personal Tax			
Eligible Dividend (highest marginal rate)	N/A	19.29%	19.29%
Salary	39.00%	N/A	N/A
Combined Tax Rate	**39.00%**	**39.47%**	**49.96%**

There is now a strong tax disincentive to provide services through a PSB and the only real fix may be to flow out all profits as salary if there is another commercial reason to continue to operate through a corporation. In addition to the denial of expenses, and disallowance of the small business deduction and general rate reduction, a successful PSB reassessment can result in substantial tax penalties and possible double taxation so it is important to review your situation with professional advisors before filing a tax return.

Is Your Business a PSB?

A corporation will be considered a PSB where the individual providing services on behalf of the corporation would, if the corporation were disregarded, be viewed as an employee of the person or partnership that is paying the corporation for the services. The PSB rules do not apply if the corporation employs, in the service business, more than five full-time employees throughout the year, or if the corporation is associated with the payor.

In making a PSB determination, the Canada Revenue Agency takes into account a number of factors which are set out in *Employee or Self Employed*, RC 4110. These factors include:

- Control over the work
- Ownership of tools
- Chance of profit and risk of loss
- Degree of integration

The intention of the parties to a contract is not determinative of whether or not a corporation is a PSB.

The application of the PSB rules will depend on the particular circumstances and not on the intention of the parties. The PSB rules are anti-avoidance rules that require the court to ignore the actual relationship and reasonably guess what the parties would have done had the service provider not incorporated.

The risk of successful PSB assessment is generally lowest where there is significant fee revenue from several different clients. If the corporation earns no fee revenue (or nominal revenue) from other sources, there is a significant risk of a PSB assessment.