Being Declared a Personal Services Corporation Can Really Cost You

Canadian Consultants & Contractors Need to Take Special Care

By Susan Ward

I would venture to guess that the one shareholder small corporation is the most common kind of corporation created in Canada.

Canadian corporation or personal services business?
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But tax-wise, it's also one of the most dangerous. As more and more contractors are discovering to their chagrin, if your small corporation is declared to be a personal services corporation (a.k.a. personal services business) by the Canada Revenue Agency, you might as well not have a corporation at all as far as income tax deductions go. Worse, you may be on the hook for a hefty tax bill to make up for tax deductions of previous years that have been disallowed.

There are two sections to this article:

1) An outline of the problem – what could happen to you if your small business is declared to be a personal services corporation;

2) What you can do to avoid having the Canada Revenue Agency (CRA) view your business as a personal services corporation.

You may want to read What Is a Personal services corporation? first and then return to this page.

Why You Don't Want a Personal Services Corporation

The basic problem is that income from a personal services business is not considered to be active business income by the Canada Revenue Agency.

So if the Canada Revenue Business determines that your incorporated business is a personal services business, you suddenly have three tax problems:

1) You will not be able to claim the Small Business Deduction, as the Small Business Deduction can only be applied to active business income.

So instead of having the first $500,000 of your corporation's income taxed at a much lower rate, that income is now taxed at the (much higher) personal rate. Corporate tax rates vary from province to province, but the difference can be very expensive tax-wise, as Mark Goodfield, managing partner of Cunningham LLP, a Toronto based law firm, explains in his The Blunt Bean Counter blog:

"In Ontario that means the corporation will be subject to income tax at a rate of 39.25% (in 2012). For comparative purposes, the current small business income tax rate is 15.5%. As a consequence, when taking money out of a PSB by way of dividends, the ultimate combined personal and corporate tax rate will approach 58% in Ontario, a very punitive amount which is 12% greater than a high-rate employed taxpayer would pay."

2) You will not be able to claim many standard business deductions.

As a shareholder in a personal services corporation, you are an incorporated employee; therefore, tax-wise, you are not self-employed. You can no longer write off any expenses, such as accounting and legal fees, supplies, and office space, against your corporation's income. The only eligible deduction for your corporation will be any salary and benefits paid to the incorporated employee.

3) Possible tax penalties because of reassessment.

Worst of all, if your corporation is classified as a personal services corporation, you can be hit with a large tax bill because you "got it wrong" when you filed your corporate taxes and claimed the Small Business Deduction and business expenses.

And the Canada Revenue Agency is not limited to auditing or re-assessing only last year's tax filings; as there is no stated time limit on the audit process, the Canada Revenue Agency can examine business records from previous years as well during a tax audit. You could be re-assessed and found owing for years of back taxes.

How to Avoid Being Classed as a Personal Services Corporation by the CRA

The obvious way to ensure that your small corporation is not deemed to be a personal services business at some point is to ensure that your corporation has more than five full-time employees throughout the year and/or that your corporation only provides its services to an associated corporation, as these are the two things that the Canada Revenue Agency lists as clear evidence that a small corporation isn't a personal services business. (See Ch. 4 of *T4012 – T2 Corporation Income Tax Guide*.)

Just as obviously, this is not a serious option for many small corporations.

However, there are other measures that you can take. First and foremost, you want to avoid being in the situation of working only for a single client, especially in a long-term relationship. The more clients you have the better in terms of avoiding the personal service business designation.

Even if you don't have five, having any employees is a help and something that the CRA considers when determining a small corporation's status.

You also need to pay close attention to the four issues that the Canada Revenue Agency uses as a litmus test to determine whether a person is an employee or an independent contractor:

1. how much control over the work a contractor has
2. ownership of tools
3. the chance of profit or risk of loss that a contractor is exposed to
4. the degree of integration

Are You a Contractor or an Employee? provides detailed explanations of each of these points.

And you want to avoid the perception that you are an employee of a particular client. If a third party could mistake you for an employee of the company, you're in danger of the CRA viewing you that way, too.

Little things can loom large when it comes to perception. For instance, you should always invoice your client, monthly or by project. If your client just pays you without the submission of an invoice on your part, it's a red flag.

In Closing

If you are a contractor who provides your services primarily to one other company, don't panic. But do familiarize yourself with the issue, particularly the Canada Revenue Agency's distinction between employees and independent contractors and take what steps you can to enlarge your small company's horizons and protect your corporate status.

Besides reading my article that explains the basic factors that the Canada Revenue Agency uses to decide who is an independent contractor and who's not, I recommend that you take a look at these Canada Revenue Agency documents:

- RC4110 Employee or Self-Employed?

- Workers Engaged in Construction - Employees or Self-employed Workers?

You may also wish to consult a professional such as a tax accountant as to how best to safeguard your corporate status.

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