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Personal Services Businesses: Game Over

According to draft legislative proposals, corporations carrying on a personal services business (PSB) will be subject to significantly higher tax rates for tax years beginning after October 31, 2011. A PSB is defined in subsection 125(7), in part, as a business carried on by a corporation through which services are provided by an individual who would, but for the existence of the corporation, be considered an employee of the recipient of the services.

The proposals, released on October 31, 2011, amend the definition of "full rate taxable income" in subsection 123.4(1). The new definition will exclude the corporation's income for the year from a PSB, causing any income earned from a PSB to be ineligible for the general rate reduction in federal corporate tax from 28 percent to 16.5 percent in 2011 and to 15 percent in 2012 (see subsection 123.4(2)). The proposals effectively increase the tax rate on income from a PSB by 11.5 percentage points for 2011 and 13 percentage points for 2012. Provincial rates are not affected.

The changes proposed by the minister of finance are consistent with the attempts of past governments to curtail the use of corporations to carry on PSBs. This has been achieved by not allowing the deduction of most ordinary expenses and denying the eligibility of PSB income for the small business deduction. In recent years, however, decreasing corporate tax rates and reduced rates on eligible dividends have enabled an "incorporated employee" to enjoy the benefits of income splitting with family members and obtain tax deferrals (relative to the personal tax rates that would otherwise apply) on income earned through a PSB. Despite the unavailability of the small business deduction, these benefits created opportunities for tax planning, particularly for individuals who could afford to leave the income in the corporation long enough to benefit from a deferral of taxes.

The punitive effect of the proposed amendments means that tax planners should reconsider any planning that involves the use of a corporation to earn income from a PSB. Taxpayers who provide or receive independent contractor services through a corporation should review all their contracts and terms of engagement and reassess the characterization of the independent contractor's employment; under the proposed new rules, a CRA determination that an incorporated independent contractor is actually an incorporated employee is certain to raise the cost of doing business.

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