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Independent Contractors
and
Professional Corporations

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Overview

1. Independent Contractors

- Determining a worker's status – independent contractor or employee
- Various tests and related case law
- Taxation of incorporated employees
- Personal Services Business rules

2. Professional Corporations

- Introduction
- Advantages to Professional Corporations
- Disadvantages to Professional Corporations
- Structuring a Professional Corporation

Determining a worker's status

- Many factors should be considered by both employers and employees when establishing a work arrangement
- Is the agreement in place between employer and employee (independent contractor, maybe????), and most importantly is the behaviour of the individual and the corporation representative of a contractor or of an employee.

Employee's Perspective

- Ability to claim the small business deduction if the income earned is considered active business income earned in Canada (Section 125)
- Deduct expenses related to earning that source of income (otherwise deductibility of expenses related to employment income are generally restricted – primarily Section 8)
- Possibly creating more flexible work arrangements
- Must consider loss of EI benefits and other benefits that are generally associated with employment, including worker rights etc.

Employer's Perspective

- Reduces or eliminates the employer's reporting requirements, withholding and remittance of taxes, etc.
- Reduces employer-borne payroll taxes (reduces the employer portion of funding various government or other employee assistance programs, such as health insurance, etc.)
- Minimizes labour law issues, workers' compensation issues and other legal issues that arise in the context of employment
- The risks of treating an employee as an independent contractor could lead to penalties for not withholding income taxes from employees and other required remittances and related reporting.

Basic Principles used in determining status

- There is no legislative criteria to determine status – needs to be done on a case by case basis
- The key determinant may be: Is it a contract **OF** service or contract **FOR** service
- A “contract OF service” generally exists between an employer and employee
- A “contract FOR service” exists when a person is engaged to achieve a desired result

Four Specific Tests

- *Wiebe Door* (87 DTC 5025 (FCA)) discusses many of the aspects related to these tests
- The four tests include: 1) Control Test, 2) Integration Test, 3) Economic Reality Test, and 4) Specific Results Test
- In addition, recently in the *Connor Homes* (2013 FCA 85) case some additional guidelines were provided – the concept of ‘intent’ was considered in this circumstance

1) Control Test

- The objective of this test is to assess if the individual is limited or restricted under a “master-servant relationship”. It recognizes that in most cases, the degree of control an employer has over the employee is greater than it is in an independent contractor relationship.

2) Integration Test

- This test acknowledges that work performed by an employee under an employment contract is done as an integral part of the business. Under a contract for services, although the work is done for the business it is not integral, but only accessory to the business.

3) Economic Reality Test

- This test assesses the economic aspects of the relationship between the parties to determine whether the taxpayer is carrying on business independently or working for someone else. The objective of the test is to verify the existence of various factors of an economic nature and, using these factors, attempt to assess the nature of the relationship.
- Factors to be considered in applying this test include the required investments to be made by the individual, the permanency of the relationship, and the skill required by the individual.

4) Specified Results Test

- This test acknowledges that an independent contractor relationship usually involves the undertaking of a specific task, after which, the relationship ceases. It also does not usually require that a particular individual carry out the undertaking.
- In contrast, in an employer-employee relationship, the employee makes himself or herself available to the employer, to be used by the employer generally, and without reference to a specified result.

Intent – *Connor Homes* (2013 FCA 85)

- In *Connor*, the FCA established two steps to determine whether an individual is performing services as an employee or independent contractor:
 - The subjective intention of each party to the relationship must be ascertained
 - Ascertain whether an objective reality sustains the subjective intent of the parties

Taxation of Incorporated Employee

- One of the many benefits of incorporation include the ability to claim the small business deduction but this is only a deferral (tax savings is minimal)
- Will be able to deduct expenses related to the business subject to certain exceptions
- Biggest concern: Being classified as a Personal Service Business (“PSB”) by the CRA

Personal Services Business

- Where an individual (called an “incorporated employee”) or any person related to the incorporated employee, is a specified shareholder of a corporation (owns more than 10% of any class of shares), and
- The incorporated employee provides services on behalf of the corporation to another corporation where it is reasonable to conclude that the incorporated employee would be considered an employee,
then the corporation will likely be classified as a PSB.
- Unless...there are at least 5 full time employees or services are provided to an Associated corporation

Personal Services Business

- Income from a PSB is specifically exempted from benefitting from the small business deduction – that is the lower tax rate of approximately 10.5-18.5% depending on the province
- Applies to first \$500,000 of income
 - Other than in Nova Scotia – first \$350,000 of income
- On October 21, 2011 the government passed legislation that increased the tax rate on PSB income to the maximum tax rate applicable to business income (i.e. will not benefit from the general rate reduction in Section 123.4). Budget 2016 further increased the federal tax rate on PSB to 33% for 2016 and later years, bringing the Ontario total tax rate for PSB to 44.5%.

Personal Services Business

- The only expenses allowed as deductions by a PSB are those pursuant to paragraph 18(1)(p):
 - Salary and wages to the incorporated employee
 - Cost of benefits and allowances paid to incorporated employee
 - General expenses allowed for “employees” of a corporation
 - Legal expenses to collect amounts owing to the PSB
- Conclusion: If classified as a PSB the tax benefit of incorporation is lost. With the recent changes, the tax rate is higher than that applied to regular corporations.

Professional Corporations (“PCs”): Introduction

- Professionals governed by certain professional bodies or associations are eligible to incorporate
- Tax planning opportunities and structures available depend on province and profession at issue
- Must take into account the relevant provincial legislation and professional body or association
- Numerous advantages and disadvantages to consider

Advantages to PCs

- Advantages to Professional Corporations:
- Access to SBD and Deferral of Tax
- Remuneration Flexibility
- Access to CGE
- Income Splitting
- Miscellaneous Advantages

a) Advantage – Access to SBD and Deferral of Tax

- Small Business Deduction - favourable tax rate for active business income
- Tax deferral opportunities if professional retains income in PC

b) Advantage – Remuneration Flexibility







- Dividends:
 - Advantages of Paying Dividends
 - RDTOH recovery
 - No source deductions for taxes, CPP, EI
 - Employer Health Tax (“EHT”) may be avoided
 - No reasonableness of remuneration test
 - Reduces cumulative net investment losses (CNILs), and increases capital gains exemption (“CGE”) claim
 - Creates safe income on hand
 - Income-splitting opportunities

c) Access to CGE

- Shares of PCs eligible for lifetime Capital Gains Exemption of \$835,716 in 2017.
- May not be useful in all professions as value in business may lie with individual goodwill rather than in PC
- Can incorporate immediately before sale and avoid 24 month holding rule (subparagraph 110.6(14)(f)(ii))
- May be opportunities to multiply CGE, but this is only available where non-professionals (ie. family members) can hold shares in PC















c) Access to CGE (cont'd)

Ability to Use Holding Corporation to “Purify”

	Lawyers	Accountants	Doctors	Dentists Optometrists
Alberta				
BC				
Newfoundland				
Ontario				

c) Access to CGE (cont'd)

Ability for Non-licensed Family Members to Own Shares in PC

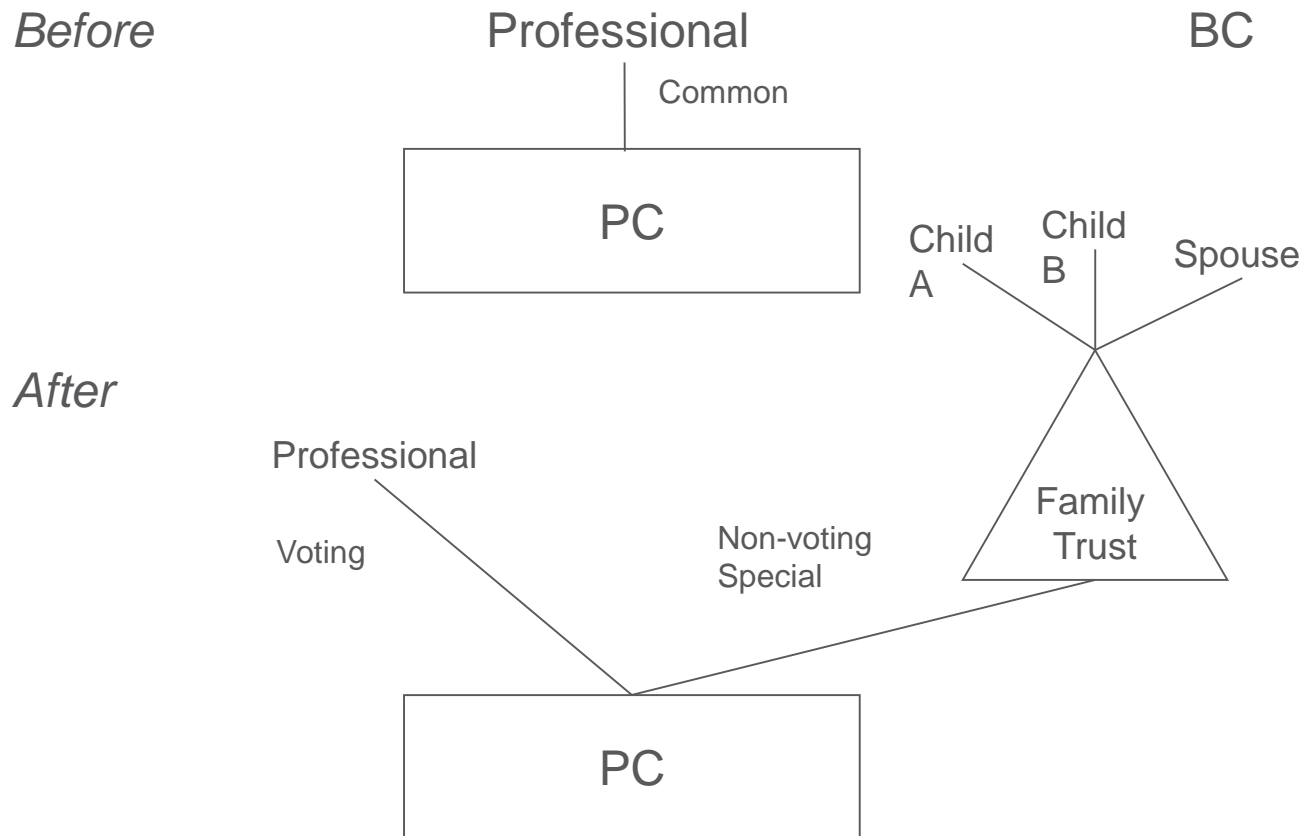
	Lawyers	Accountants	Doctors	Dentists Optometrists
Alberta				
BC				
Newfoundland				
Ontario				 [Dentists only]

d) Advantage – Income-Splitting

- *Salary or Bonus to Family Members:*
 - PC cannot pay salaries or bonuses to non-active family members
 - CRA's policy that it will not challenge the reasonableness of salaries and bonuses paid to principal active shareholder-managers of a corporation does not apply
- PC can deduct salaries or bonuses paid to family members if the family members are active in the business
- In order to pay salaries and bonuses to active family members, the payments must be reasonable based on the work performed
- In order to be considered reasonable, the CRA must reach the conclusion that a reasonable businessperson would have paid the salary/bonus at issue

d) Advantage – Income-Splitting (cont'd)

Use of Trust:













d) Advantage – Income-Splitting (cont'd)

- Use of Trust:
 - Availability depends on ability to issue shares to non-professionals
 - Beware of Kiddie Tax
 - Issue of whether “dividend sprinkling shares” acceptable
 - i.e. whether separate classes of certain types of shares with same attributes on which dividends declared and paid separately acceptable
 - Done in order to retain flexibility with respect to payment of dividends to different shareholders
 - Potential solution to create separate classes of shares that are similar in most regards, but have nominal differences
 - e.g. alterations in voting rights
 - e.g. different rights upon liquidation

d) Advantage – Income-Splitting (cont'd)

Ability to Use Trust to Income Split

	Lawyers	Accountants	Doctors	Dentists Optometrists
Alberta	Where beneficiaries are Minors 	Where beneficiaries are Minors 	Where beneficiaries are Minors 	Where beneficiaries are Minors 
BC				
Newfoundland				
Ontario			Where beneficiaries are Minors 	Where beneficiaries are Minors  [Dentists only]

d) Advantage – Income-Splitting (cont'd)

• ***Use of a Management Corporation:***

- Shares in Management Corporation held by spouse or children
- To provide management and administration services (day-to-day operations of corporation)
 - i.e. planning, direction, control, co-ordination, systems and other functions at managerial level
- Can charge reasonable management fees in respect of services
- CRA accepts charge of a reasonable mark-up over the expenses the company handles (15%)
 - Although there is case law that suggests that reasonable management fees may be more than 15% (e.g. Bertomeu, 2006 TCC 85)
- To be deductible, there must be a legal obligation to pay the management fees

e) Miscellaneous Advantages

- **Deferred Income Plans**
 - Employee Profit Sharing Plan
 - Retirement Compensation Plan
 - Individual Pension Plan
 - No CPP/EI withholding and allows for creditor proofing
- **Loans to Family Members/Trusts**
 - If individual lends funds to spouse, attribution rules may apply, subject to exception where interest is paid by January 30 following each year

e) Miscellaneous Advantages (cont'd)

- Employee Health and Welfare Trusts
- Trade Creditor Protection
 - Protection against commercial claims
 - Distribution of assets to holding corp or family trust
- Insurance Premiums in PC
 - Corporate life insurance – deductible to corp
- Loss Companies
 - If individual has other corps w/ non-capital losses
- Shareholder Loans/Housing Loans
- Non-Calendar Year Ends
 - Short-term tax deferral opportunities

Disadvantage – Cost/Time

- Significant cost and time commitments may have to be made to incorporate
- Numerous costs such as legal and accounting fees for planning, filing of corporate tax returns, T4s/T5s, etc.
- PC also adds complexity to administration of professional's practice
- Requirement to maintain the corporation and require more detailed and complete records

Disadvantage – Specified Partnership Income Rules

- Subsection 125(7) of the ITA - group of corporate partners must share one SBD limit
- Each corporate partner can only claim SBD equal to proportionate share of all income from partnership
- Review these Rules for any structure involving a professional corporation as a partner in a partnership
- Possible remedies include cost-sharing arrangements and creation of central PC, however there are changes on the horizon.
- Be aware of *de facto* partnership

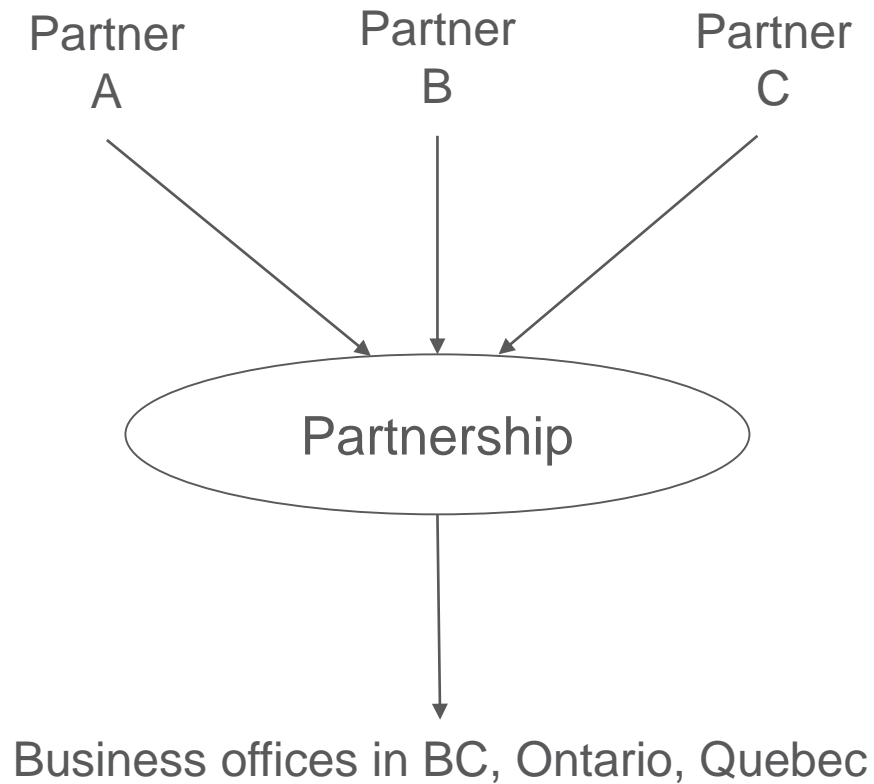
Disadvantage – Deemed Association Rules

- If Deemed Association Rules apply, both corporations must share the SBD limit
- s. 256(2.1) – main purpose for separate corporations is to reduce income tax
 - Could argue non-tax motivation such as asset protection, estate planning or sale of business
- s. 256(1)(c) – where professional owns shares in multiple PCs (25% or more of the share of any class of other corporation)
- S. 256(5.1) – *de facto* control

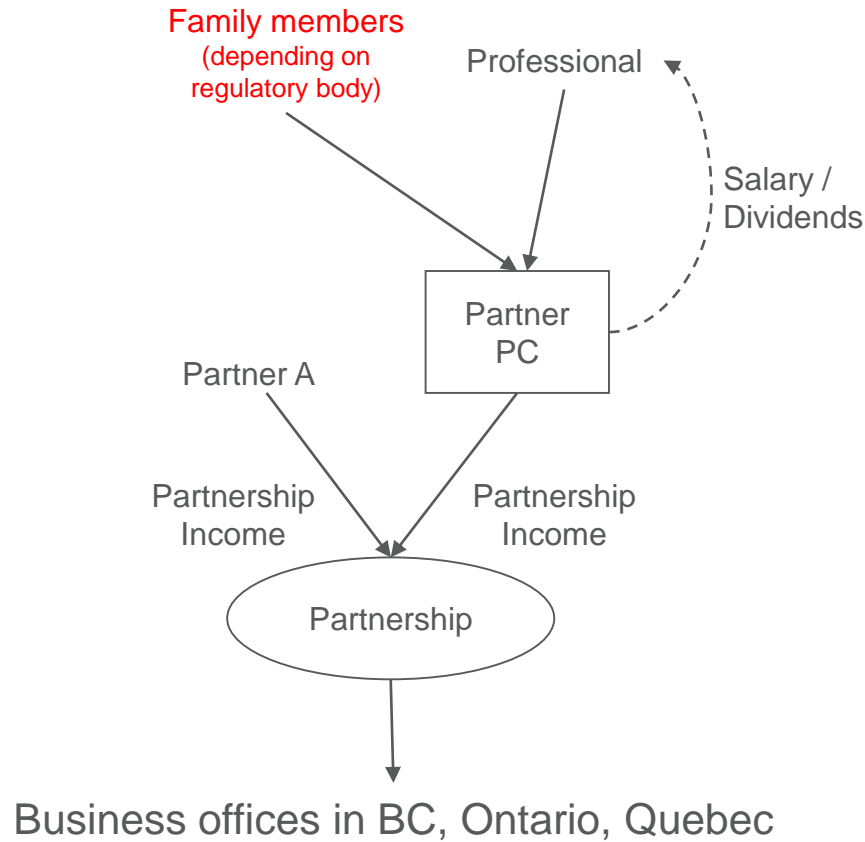
Miscellaneous Disadvantages

- Income Tax Withholding at Source – CPP, EI, Payroll Taxes, etc.
 - No EI if individual owns more than 40% of shares
- Specified Investment Business Rules
 - Taxed as Investment Income but dividend refund
- Restrictions on Corporate Activity
 - Holding corporation could hold investments
- Additional Registration (e.g. Employer Health Tax and Workers' Compensation Board / WSIB)
- No limited liability against malpractice or negligence

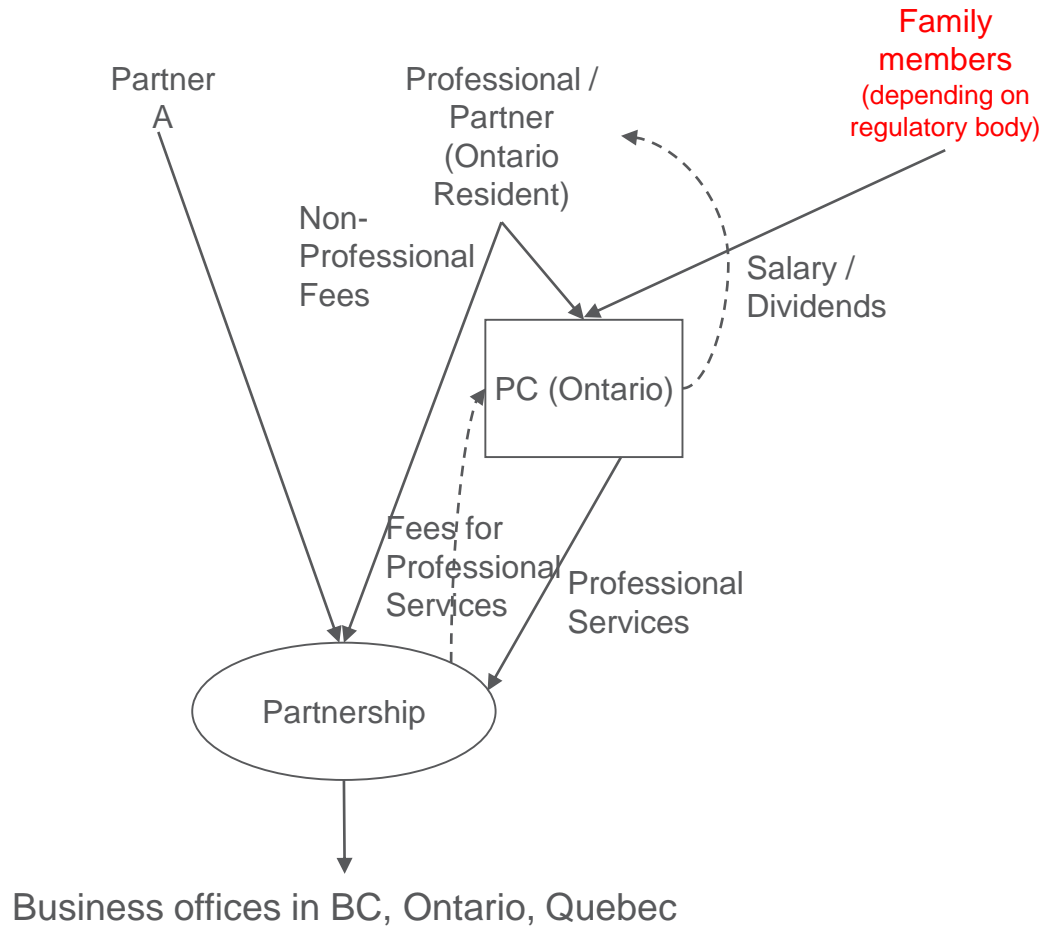
Professional Corporation Structures



Professional Corporation Structures (cont'd)

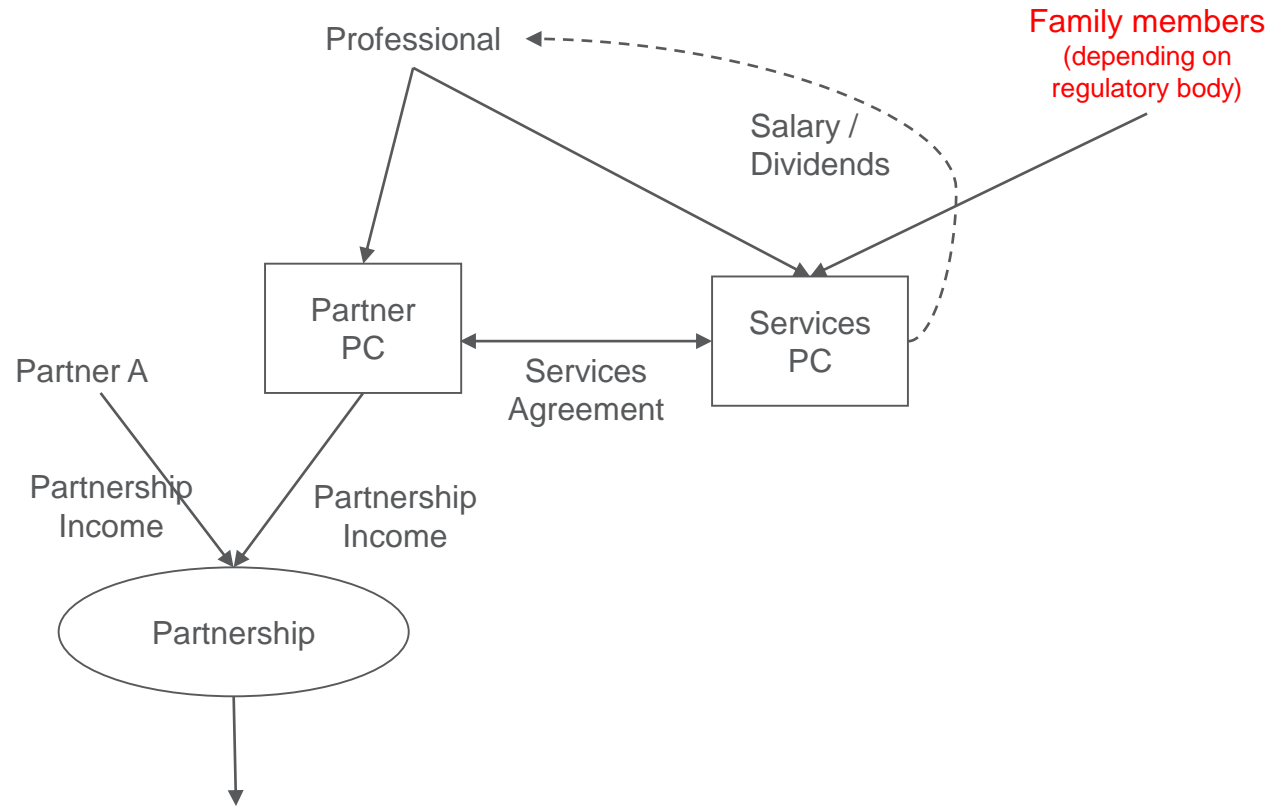


Professional Corporation Structures (cont'd)



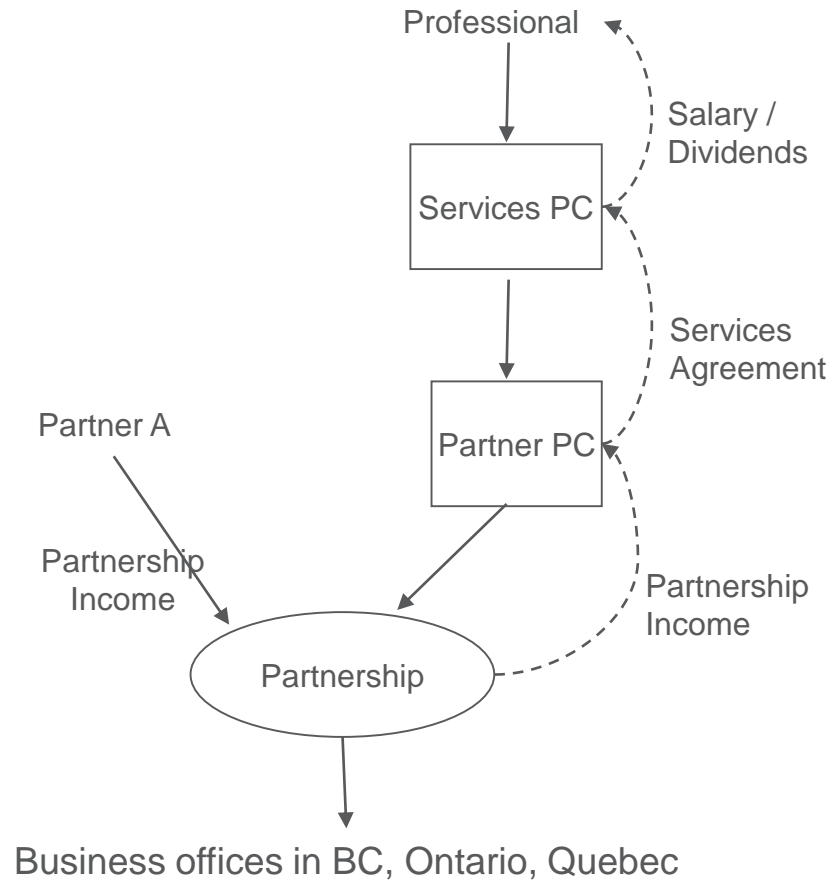
Professional Corporation Structures

(cont'd)



Business offices in BC, Ontario, Quebec

Professional Corporation Structures (cont'd)



Professional Corp – US Persons

- If professional is a US person then additional reporting requirements and income inclusion may apply – Subpart F income
- Professional Services Income may be considered “Personal Services Contract Income” under US tax law and may be required to be included in income on an accrual basis



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THANK YOU

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