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Personal Services Businesses

What is a Personal Services Business ("PSB")?

A business may be classified as a PSB if it provides services to clients through an incorporated company but is structured in a way where the individual providing the service would be considered an employee if not for the existence of the corporation. Typically, this occurs when a "one-person corporation" contracts with one client and wouldn't qualify as an independent contractor under CRA's guidelines if they weren't incorporated. In other words, they act like an incorporated employee. The payors tend to have a lot of control over work hours, methods, and supervision similar to employment terms. PSB's also tend to have little profit and loss risk.

CRA is in the second phase of a pilot program for reviewing personal services businesses. Of 2100 businesses they contacted, they estimate that 10% are acting as a PSB. CRA also determined that 74% of PSB's seem to be in the following 3 categories:

- freight trucking;
- professional, scientific or technical services;
- and construction.

Key Tax Implications of a PSB Classification

Being classified as a PSB comes with tax consequences that increase your tax liability. Here's a breakdown:

- **Higher Corporate Tax Rate:** Instead of the "small business deduction" federal corporate tax rate of 9%, a PSB is taxed at a 33% federal corporate tax rate. Once the provincial tax rate is added, you end up with an approximate combined federal and provincial corporate tax rate of 45% instead of 12%.
- **Limited Deductions:** A PSB cannot claim the usual business expenses available to corporations, for example, things such as rent, utilities, and advertising. Only specific expenses, such as salaries and benefits paid to employees, are allowable.
- **Non-deductible penalties and interest:** If CRA determines your business is a PSB, the corporation will owe back taxes, interest, and penalties that are non-deductible.

Strategies to Avoid PSB Classification

If you want to avoid PSB classification, here are some strategies to consider:

- **Diversify Your Client Base:** Serving multiple clients can support your status as a business rather than an "incorporated employee" (PSB).
- **Negotiate Service Contracts Carefully:** It's important to have a written contract that states that both parties understand the terms of the contract to be a contract for services. The facts of the work situation should reflect that relationship. Ensure the contracts reflect your autonomy in providing services to multiple clients and that you pay for tools required for providing the services. Try to negotiate as much independence as possible in terms of hours worked and work methods, including the ability to hire employees to deliver the work. In other words, you are providing the results of your work ("contract for services"), not yourself as a worker ("contract of service").
- Having **more than 5 full time employees** – in this case your corporation will not be considered a PSB.

What to do if You're at Risk

- **Maximize salary payments:** If your corporation is at risk of being classified as a PSB you should manage the financial impact by maximizing salary payments. Since salaries and benefits paid to you or other employees are deductible, paying yourself through salary to reduce taxable income to zero, is a good way to minimize the tax risk. You will pay much less tax this way than taking dividends and getting caught as a PSB later.
- You can also **consider operating as a sole proprietor** to reduce the tax burden. This depends on the reason you chose to incorporate in the first place. Some people incorporate to limit their liability, which may be mitigated by insurance instead. Some incorporate because they want profits in excess of their personal needs to be taxed at the lower corporate tax rate (tax deferral), and others because they are obligated to incorporate to get the contract, or to obtain financing. If you incorporated thinking you'd benefit from the tax deferral of surplus profits being invested in the company, if you have a PSB risk, you may be better off as a sole proprietor and maximizing your RRSP and TFSA contributions.