Perils of a Personal Services Business

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A recent Canada Revenue Agency (CRA) technical interpretation highlights the limitations imposed on a corporation that carries on a "personal services business" (PSB).

A PSB is a business of providing services where an individual who performs services on behalf of the corporation (sometimes referred to as an "incorporated employee"), or a related person, holds 10% or more of the shares of any class of the corporation and the incorporated employee would reasonably be regarded as an officer or employee of the person to whom the services are provided (the customer) but for the existence of the corporation. A business will not constitute a PSB if it employs throughout the year more than five full-time employees or if it only receives income from an associated corporation. A PSB is often used by consultants and other service providers to avoid being characterized as an employee of the customer.

Generally, a taxpayer carrying on a business may deduct reasonable expenses incurred to earn business income. However, a corporation that carries on a PSB is limited to deducting:

1. the salary, wages or other remuneration paid in the year to the incorporated employee;
2. the cost of any benefit or allowance provided to the incorporated employee; and
3. selling and similar expenses that would have been deductible in computing the incorporated employee's income if he had been employed and had been required by a contract of employment to incur such expenses.

Further, a corporation that carries on a PSB is not eligible for tax at the preferential small business rate. Essentially, the PSB rules are intended to equate the tax position of a PSB with that of an individual employee.

In the technical interpretation, the CRA commented on the situation where a corporation carrying on a PSB acquired a motor vehicle for use by its employee. Based on the rules applicable to employment benefits, the incorporated employee would have been required to include an amount in computing employment income in respect of the use of the "company car". However, because the corporation carried on a PSB, the corporation was not eligible to deduct capital cost allowance in respect of the motor vehicle, resulting in a measure of double taxation. Proper tax planning could have avoided this result.

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