



Small Business Deduction and Personal Services Businesses

any business carried on by the corporation other than a “specified investment business” or a “personal services business”, and includes an adventure or concern in the nature of trade. This article discusses the exclusion of income from a personal services business from the small business deduction.

A “personal services business” is excluded from the definition of “active business” and, therefore, income from such a business is not eligible for the small business deduction. By virtue of this outcome and an additional tax, income from a personal services business is subject to a much higher tax rate of 33%. Therefore, if there is a possibility that a corporation’s business might be classified as a personal services business, it is very important to verify that it is not subject to this restriction.

What is a Personal Services Business?

The expression “personal services business” consists of providing the services of an “incorporated employee” to an entity of which the incorporated employee would otherwise reasonably be regarded as an officer or employee. Accordingly, it will be necessary to determine whether the corporation is providing the services of an employee or an independent contractor. The critical issue is whether there is a contract of services (an employee) or a contract for services (an independent contractor).

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Overview

A corporation which is a Canadian-controlled private corporation (“CCPC”) throughout a taxation year has a preferential tax rate on its active business income earned in Canada not exceeding its “business limit” for the year, which is currently \$500,000. Technically, the effective tax rate is determined by deducting an amount from a corporation’s tax otherwise payable, so the mechanism is referred to as the small business deduction. Starting with the basic federal corporate tax rate of 38%, deducting the 10% federal abatement for provincial taxes, and further deducting the 19% small business deduction on active business income, yields an effective tax rate of 9% for small businesses. Generally, an active business means

Paragraph 3 of the CRA's Interpretation Bulletin [IT-525R](#) states that "a contract of service generally exists if the person for whom the services are performed has the right to control the amount, the nature and the management of the work to be done and the manner of doing it. A contract for services exists when a person is engaged to achieve a prescribed objective and is given all the freedom required to attain the desired result".

To have a "personal services business", the incorporated employee or a person related to the incorporated employee must be a "specified shareholder" of the corporation providing the services. A specified shareholder is a person who owns, directly or indirectly, 10% or more of the issued shares of any class of the corporation at any time in the year and includes a person who owns at least 10% of the shares of a "related corporation". Shares owned by someone who does not deal at arm's length with a taxpayer are deemed to be owned by the taxpayer. Similarly, shares owned by a trust are deemed to be owned by the beneficiaries in proportions based on the fair market value of their interests in the trust. In cases where different beneficiaries have interests in the income and capital of a trust it may be difficult to determine the relative fair market value of their interests. If a discretionary trust owns shares of a corporation, a beneficiary of the trust is deemed to own each share of the capital stock of the corporation owned at that time by the trust. As well, shares owned by a partnership are deemed to be owned by the partners in proportions based on the fair market value of their interests in the partnership. In addition, an individual is deemed to be a specified shareholder of a corporation carrying on a personal services business if the individual performs services for the corporation and the individual, or a person or partnership not dealing at arm's length with the individual, may under some arrangement become entitled to at least 10% of the assets or shares of the corporation.

Exemptions to the Personal Services Business Rules

Business income will be exempt from the personal service business rules under either of the following two circumstances.

More than Five Full-Time Employees

The first exemption is where more than five full-time employees are employed in the business. Note that major shareholders and their relatives will count. As stated previously, it should also be noted that, to be exempt, there must be more than five full-time employees throughout the taxation year. Accordingly, dropping to five or fewer employees at any time in the taxation year will destroy the exemption for the entire year.

Also note that more than five full-time employees must be employed in the personal services business. This means that employees involved, for example, in a separate active business will not be counted in the determination.

Payments from Associated Corporations

Another exception applies if the amount paid or payable to the corporation for the services is received or receivable from an associated corporation. Thus, for example, an owner-manager of a manufacturing corporation who sets up a separate but associated incorporated sales outlet would escape the impact of the personal services business rules, assuming that no separate personal services business is carried on, apart from those relating to the payments received from the associated corporation. As a further example, consider an executive with a large CCPC carrying on an active business. The executive could set up a wholly owned corporation to provide services to the large associated active business. Under the rules, the executive's corporation and the associated large CCPC would together be eligible for the low rate of tax on the first \$500,000 of active business income. Accordingly, all or a portion of the annual business limit could be allocated to the incorporated employee's company.

Taxation of Income from a Personal Services Business

As mentioned above, income from a personal services business earned by a corporation is subject to an unfavourable tax rate of 33%. This rate is equal to the highest federal tax rate that an individual can be subject to. These rates being equal achieves the

government's intended goal of eliminating any tax benefits of earning employment income through a corporation rather than directly. However, there is another disadvantage of the personal services business treatment.

All deductions in computing income for a personal services business are disallowed except:

- i. salary, wages, or other remuneration paid in the year to an incorporated employee;
- ii. the cost of any benefit or allowance provided to the incorporated employee;
- iii. selling and similar expenses that would have been deductible in computing the individual's employment income if he or she had expended them under a contract of employment that required the employee to pay the amount; and
- iv. amounts paid by the corporation as or on account of legal expenses incurred in collecting amounts owing for services rendered.

These only permitted deductions are intended to put the corporation on the same footing as if it were an employee itself, limited to the deductions an employee could claim. All other expenses which would otherwise be deductible to the corporation are specifically denied.

Although intended to capture the incorporated employees, this provision may also apply to management companies serving professionals (e.g., doctors), especially if the professional's spouse is an employee. If you think that your business might be subject to these rules, you should seek professional advice on the matter.