

BECOMING A SELF-EMPLOYED CONTRACTOR

INTRODUCTION

As a result of the down-sizing of companies that has occurred in recent years, former employees of such companies have endeavoured to “strike out on their own” to provide their services (perhaps to their former employers or to others) on a self-employed basis. The income tax rules governing self-employment relationships are different than those governing employment relationships. The following is an outline of some of these rules and guidance on how self-employed status can be achieved.

WHY ESTABLISH INDEPENDENT CONTRACTOR STATUS?

Businesses typically utilize self-employed persons because they are cost effective. In particular, the following cost savings can be achieved from the business’ perspective:

- the requirement to pay employment benefits (C.P.P., E.I., medical, pension, sick pay, holiday pay) is eliminated.
- the requirement to give notice of termination is limited to that specified in the contract.

Workers may find self-employment status a mixed blessing. C.P.P. premiums are double what they are for employed persons. Self-employed persons may elect to pay E.I. premiums in order to be eligible to receive special benefits or, alternatively, they may choose to not be covered. Most importantly, self-employed persons may typically deduct a much wider range of expenses for income tax purposes than an employee can (unless the employee is a commissioned sales person in which case the range of deductible expenses is quite similar). Self-employed persons will usually have greater flexibility in obtaining deductions for the following expenses, among others:

- meals and entertainment
- capital expenditures (computer, cellular phone)
- home office
- reasonable salary to an assistant (including a spouse or other family member)

HOW IS SELF-EMPLOYMENT STATUS ESTABLISHED?

In many cases, it is difficult to determine whether or not a relationship between a business and a worker is one of employment or self-employment. Over the years, the tax courts have developed numerous tests designed to determine whether or not a worker is employed or self-employed in a given situation. In general however, the Canada Revenue Agency will look to all the factors surrounding a particular situation in order to make their determination. Some of the factors that they will normally consider are described below and these can be used to provide a blueprint for achieving self-employment status. (A checklist is attached for your use in determining status.)

- A written, preferably non-exclusive contract exists which specifies that no employment relationship exists.
- The contractor is permitted to hire employees or subcontract work in order to fulfill the contract.
- Work is performed on a project or a limited time basis.
- The contractor provides his own tools (vehicle, computer, etc.) and is not reimbursed for work related expenses. (However, these may be negotiated into the gross fee for service.)
- The contractor has business income from other sources.
- The contractor has no entitlement to company benefits or paid vacation.
- The contractor is paid from invoices, generally based on production or time spent rather than on a specific pre-determined amount.
- The contractor provides his own business premises.
- The contractor is registered for, and collects GST/HST, unless small supplier provisions apply.
- The contractor's tasks are not a regular or integral part of the business of the employer.

None of the above factors will be determinative by themselves but satisfying most of the above criteria will usually lead to a conclusion that self-employment status has been achieved.

ARE THERE PENALTIES FOR AN INCORRECT DETERMINATION?

An employer who fails to withhold tax, C.P.P. and E.I. is liable for a penalty of 10% of amounts which should have been withheld plus interest. Where gross negligence is evidenced, the penalty may be increased to 20%. The employer may also be liable for the unremitted tax if the payee is a non-resident.

The worker may be reassessed to have tax deductions disallowed to the extent that they cannot be deducted from employment income. Taxes and interest could be owing.

In some cases, the worker may have established a corporation through which to perform the services. This may be done in order to allow the corporation to earn income which would be eligible for the 13.5% corporate tax rate for active business income earned in BC. The Income Tax Act includes a series of rules (the "personal services business" rules) designed to prevent someone who would otherwise be an employee from directing their employment income to a corporation. Expenses may be disallowed within the corporation (to the extent that they would not have been deductible to the employee) and income earned by that corporation may be denied the benefit of the 13.5% corporate tax rate (instead the company would pay tax at the general corporate rate in B.C. of 26.5%). As this still represents a significant tax deferral when compared to the top personal tax rate of 43.7%, there may be an incentive to earn such income via a corporation even if it is arguably not eligible for the 13.5% rate, particularly because income taxed at the 26.5% rate is eligible for the enhanced dividend tax credit (GRIP) treatment when dividends are paid by the company.



CHECKLIST

YES / NO

1. Is there a written contract in existence which specifies that the individual is an independent contractor?
2. Does the individual do work for more than one payor? (The more the better)
3. Is the individual paid on a basis which is not a “flat fee”?
4. Does the individual supply substantially all tools and equipment used on the job?
5. Is the individual required to pay his own expenses in the course of his work?
6. Does the individual have the ability to accept or reject jobs at his discretion?
7. Does the individual have the ability to delegate work to subordinates at his discretion?
8. Does the individual have substantial discretion as to how and when a given task is to be accomplished?

Although it is difficult to generalize, in order for independent contractor status to be established, it should be possible to answer “Yes” to most of the above questions. A ruling may be obtained from the Canada Revenue Agency, if certainty is required in a given situation.

CONCLUSION

The trend for businesses to hire contractors rather than employees is expected to continue into the foreseeable future. Such a structure can provide benefits to both the hirer and the worker; however, competent professional advice must be sought to ensure that adverse income tax consequences do not arise as a result of utilizing this business structure.

The information provided in this publication is intended for general purposes only. Care has been taken to ensure that the information herein is accurate; however no representation is made as to the accuracy thereof. The information should not be relied upon to replace specific professional advice.

