

BECOMING A SELF-EMPLOYED CONTRACTOR

INTRODUCTION

As a result of the down-sizing of many large companies that has occurred in recent years, many 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 drastically different than those governing employment relationships. The following is an outline of some of these rules and provide 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. Self-employed persons may not collect E.I. benefits nor do they need to pay premiums. C.P.P. premiums are double what they are for employed persons. 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
- 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, Canada Customs and 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 also provided for your use in determining status.)

- A written, non-exclusive contract exists which specifies that no employment relationship exists.
- The contractor is permitted to hire employees or subcontract work in order to fulfil 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.
- 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 G.S.T., 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 to perform services for the hirer. This may be done in order to allow the corporation to earn income which would be eligible for the 14.5% corporate tax rate for active business income earned in Canada. The penalty for an incorrect determination in these cases is high: 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 14.5% corporate tax rate (instead the company would pay tax at the general corporate rate in B.C. of 30.5%).

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? Is so, how many?
3. Is the individual paid on a basis which is not computed by reference to time spent on the job?
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 Canada Customs and 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.

Revised: October 2008