

A rare example of a one-client business found by the Tax Court to not be a personal services business

Kenneth Keung CA, CPA (CO, USA), CFP, LLB, MTAX, TEP
August 25, 2015

On August 12, 2015, the Tax Court of Canada (“TCC”) released its [judgment](#) in *C.J. McCarty Inc. v The Queen*¹. *McCarty* is one of many personal services business (“PSB”) reassessment cases published in the recent years, but what makes this case interesting is that it is one of few where the taxpayer emerges successful despite having only one significant client and being compensated at a fixed hourly rate. In this short article, we will examine the unique facts that led the court to its judgment.

For a detailed explanation of the PSB rules and their implications, see our previous [blog](#)². In short, determining whether a PSB exists involves an analysis of the objective facts to determine, but-for the interposition of a corporation, whether a specified shareholder of the corporation (or a related person) would be reasonably regarded as an employee of the service recipient³. The consequences of a determination of PSB are severe, particularly for Albertans after 2015. This is due to an increase in Alberta tax rates which may result in a total tax burden of approximately 55% on a flow-through basis, as well as denial of almost all tax deductions.

In *McCarty*, Mr. McCarty, a very experienced construction manager, was a specified shareholder and employee of C.J. McCarty Inc. (“CJ Inc.”). From December 2005 to the end of 2008, CJ Inc. was retained by MEG Energy Corp (“MEG”) to provide construction management services including the oversight of the building of a \$900 million SAGD pilot plant. Similar to traditional employment arrangements, the parties’ written contracts provided a fixed hourly fee and specified that the services are to be performed by Mr. McCarty during MEG’s usual business hours. Further, the contracts provided for reimbursement of certain out-of-pocket expenses and stated that MEG has the right to not authorize hours exceeding 200 hours per month. Except for three months during the time period in question, CJ Inc.’s only client was MEG.

The Canada Revenue Agency reassessed CJ Inc. for its 2007 and 2008 taxation years on the basis that it was a PSB and therefore denied CJ Inc. the ability to deduct its business expenses and to claim the small business deduction under subsection 125(1) of the Income Tax Act. Accordingly, CJ Inc. appealed such reassessments to the TCC.

In its analysis, the TCC dismissed the intention of the parties (the contracts explicitly characterized CJ Inc. as an independent contractor) as irrelevant in determining whether a PSB exists, and focused only on the objective factors. This approach is consistent with prior jurisprudence on PSB determination⁴.

The following are observations made by the court that led to its conclusion that Mr. McCarty could not reasonably be viewed as an employee of MEG, despite CJ Inc. having only one significant client and being compensated at a fixed hourly rate:

- MEG did not, nor did it have the ability to, exercise any meaningful control over how Mr. McCarty carried out his work due to Mr. McCarty’s specialized expertise and significant management construction experience. He was simply told to “get it built” with no direction as to how to

accomplish the desired result.

- MEG did not control Mr. McCarty's business hours despite the written contracts specifying otherwise. This was because, in reality, the construction and hence Mr. McCarty's responsibilities carried on 24-hours a day.
- The court looked at whether the fact that CJ Inc. only had one significant client during the periods in question was evidence of MEG's control over Mr. McCarty's right to work for others. The court found that it did not, because the contracts did not require exclusivity and CJ Inc. performed services exclusively for MEG due to the unusual magnitude of the project.
- In determining whether Mr. McCarty was integral to MEG's business, the court reviewed the history of Mr. McCarty's business dealings and concluded that he was not. The court noted that Mr. McCarty had no relationship with MEG prior to the contracts, rendered services to another client of CJ Inc. during a three-month lull in between contracts with MEG, and that his responsibilities with MEG would end at the end of the project except for warranty work.
- With respect to the hourly rate by which CJ is compensated, the court noted that the "cost-plus" hourly rate basis contract is commonly used by subcontractors in the construction management business. Also, Mr. McCarty did not receive any overtime, bonus, stock options or any other fringe benefits that MEG employees were normally entitled to.
- CJ Inc. invoiced MEG for the hourly fees (plus GST) and there were instances of delay between the issuance of the invoices and the corresponding payments which was not consistent with an employment arrangement.
- The court also saw the 200-hour cap as an opportunity for profit because Mr. McCarty often had and indeed took the opportunity to exceed that limit.
- The arrangement also entailed risk of loss such as the risk of not getting paid on time (which actually did occur and not just a hypothetical risk), and potential risk of being sued.

All-in-all, the court concluded that the remuneration arrangement was not typical of an employee. As can be seen from the above, the TCC's finding that CJ Inc. was not carrying on a PSB was a function of the case's unique facts and circumstances, particularly Mr. McCarty's specialized skillset and the unique nature of the project. The *McCarty* case, in our opinion, clearly does not represent any shift in the judicial thinking in this area. In fact, what this case is demonstrative of is how rare (difficult) it is for a one-person service corporation servicing one primary client to have the right facts in order to not constitute a PSB.

One-client service corporations need to continue to be careful out there!

1. C.J. McCarty Inc. v The Queen (2015 TCC 201)

2. We have also previously summarized how incorporated contractors can avoid the PSB rules [here](#), and explained how the PSB determination differs from the traditional employee versus independent contractor analysis [here](#).

3. See definition of a "personal services business" in subsection 125(7) of the Act.

4. *G & J Muirhead Holdings Ltd. v Canada* (2014 TCC 49)