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Tax Implications of Extending the Personal Scope of Federal Labour Standards

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***Tax Implications of Extending the Personal Scope of
Federal Labour Standards***

Report to the Federal Labour Standards Review Commission
March 2006

by Lisa Philipps
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I. Introduction and Summary Conclusions

This Report considers whether broadening the personal scope of federal labour standards could have unintended tax consequences to workers or firms. In particular it focuses on whether such a change could alter the tax status of certain workers as independent contractors, transforming them into employees for tax purposes. My brief conclusion is that in the bulk of cases, widening the net of labour standards to cover some workers who currently are excluded would be unlikely to affect their status for tax purposes. It is clear that a worker can maintain dual status, as an employee under labour standards legislation and an independent contractor for tax purposes. In principle then it should be possible for a worker to gain the protection of federal labour standards without losing her tax status as an independent contractor. Indeed amending the definition of “employee” in Part III of the Canada Labour Code (the “Code”) could serve to underline the distinct purposes of tax and labour standards regimes, reinforcing the argument that individuals may have different standing under each.

At the same time, the potential for unintended tax consequences cannot be entirely ruled out. In contrast to labour law, tax jurisprudence has not broadened the concept of employment to encompass hybrid situations like the dependent contractor. Rather, tax law maintains the traditional binary distinction between employment and self-employment. In cases where it is difficult to draw the line, a worker’s rights under labour law may be considered as a relevant factor in determining how they should be characterized for tax purposes. This factor appears to be gaining importance in a new line of tax cases that gives more weight to the expressed intentions of the parties as to the character of their relationship, including their intention to contract out of employment

standards. That is, there is a trend in some recent tax cases toward granting independent contractor status to workers who forgo labour law protections in favour of higher pay and greater job mobility. By implication, workers who enjoy labour law protection may be at a slight disadvantage in establishing they are independent contractors for tax purposes.

The risk of destabilizing the tax status of workers may be heightened by two other contingencies, both of which are difficult to anticipate with any precision. The first has to do with second order effects, that is, whether reforming labour standards might cause changes of behaviour such that certain workers begin to look more like conventional employees in terms of how they are paid, and the kinds of supervision to which they are subject. The second is whether extending labour standards might indirectly stimulate new enforcement activity by revenue authorities, for example if more workers attempt to claim EI, which in turn leads to closer scrutiny of tax returns and payroll remittances.

The Report concludes that while these risks cannot be discounted entirely they are unlikely to materialize in any more than a small percentage of cases. As such it would be unfortunate if the Commission was deterred by tax considerations from recommending otherwise desirable changes to federal labour standards. Any problems that may arise are rooted in an outdated tax statute that has failed to keep up with the blurring of employment and self-employment in contemporary labour markets. These issues should be addressed directly through tax reforms (which are beyond the Commission's mandate), and not by thwarting the progress of labour standards legislation. However in choosing among different possible definitions of "employee", the Commission may wish to consider which is least likely to cause unintended tax consequences. The Report concludes that from this perspective, the best definition would be one that is clearly distinct from the tax law definition, in its language, objectives and scope.

The body of the Report is structured as follows:

- Part II briefly explains the principal tax consequences of being characterized as an employee versus an independent contractor, and why workers and firms usually regard the latter as more advantageous.
- Part III examines the definition of employment in tax law including the traditional legal tests, and recent cases which appear to give more attention to the worker's status under labour law.

- Part IV considers the three alternative definitions of employment being considered in the context of your review, and compares them to the definition in tax law.
- Part V draws on all of the above to analyze the risks that a worker may inadvertently lose status as an independent contractor for tax purposes if they are reclassified as an employee for purposes of the Code, and proposes strategies for reducing any such risks.

II. Tax Consequences of Shifting from Contractor to Employee Status: Defining the Downside Risk

This Report will ultimately conclude that adopting a broader definition of “employee” under Part III of the Code would carry a small risk of unintended tax consequences, in that some workers who have been treated as independent contractors for tax purposes may conceivably as a direct or indirect result of such a change be recharacterized as employees by tax authorities. The purpose of this section is to explain briefly why such a recharacterization, if it occurred, would significantly affect a worker’s liabilities and compliance responsibilities under income tax, payroll tax and GST legislation. While employees do enjoy certain tax benefits, especially the lack of any GST liability, independent contractor status is generally regarded as more advantageous from an overall tax perspective.¹ Indeed tax incentives often are the driving factor in decisions to hire independent contractors rather than employees.²

¹ For a more exhaustive discussion of these tax implications see Alain Gaucher, “A Worker’s Status as Employee or Independent Contractor”, in *Report of Proceedings of the Fifty-first Tax Conference, 1999 Tax Conference Report* (Toronto: Canadian Tax Foundation, 2000) 33:1-98. See also Philip Friedlan, “Employee vs. Independent Contractor vs. Personal Services Corporation – A Review and Update”, in 1997 Ontario Tax Conference Proceedings (Toronto: Canadian Tax Foundation, 1997); and Joanne E. Magee, “Whose Business Is It? Employees Versus Independent Contractors” (1997) 45: 3 Canadian Tax Journal 584.

² See for example FBC, “Be a contractor; pay less tax” (April 2005), online at http://www.fbc.ca/Keep_Current/Articles/articles05170502.asp.

A. Income Tax

Canada's income tax regime is based on a "source concept of income" adopted from British law.³ Under this system income is understood to derive from one of several discrete sources with each being subject to different rules as to what is included in taxable income, what can be deducted, and the time at which receipts and expenses are recognized for tax purposes. Independent contractors (also known as "self-employed" individuals) are considered to earn income from business, which is taxed quite differently from employment income.⁴ The two most significant differences relate to 1. deductibility of expenses; and 2. administrative arrangements for payment of tax.⁵

1. Deductibility of Expenses

A chief attraction of independent contractor status is that taxpayers generally are permitted to deduct all reasonable expenses incurred for the purpose of producing business income.⁶ In computing employment income, by contrast, taxpayers can deduct

³ See Peter Hogg, Joanne Magee and Jinyan Li, *Principles of Canadian Income Tax Law*, 5th ed. (Toronto: Carswell, 2005), section 4.3. The source concept of income is reflected in section 3(a) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supplement), as am. (hereinafter the "ITA"), which defines a taxpayer's "income" to include "the total of all amounts...from a source inside or outside Canada", and section 4 which requires income or loss from each source to be computed separately.

⁴ The detailed rules for determining net employment income are set out in Part I, Division B, subdivision a of the ITA (sections 5-8). Net income from business is computed according to the rules in Part I, Division B, subdivision b of the ITA (sections 9-37). Each of the provinces and territories imposes its own personal income tax which is payable in addition to amounts owing under the federal ITA. All jurisdictions except Quebec use the definition of taxable income in the federal ITA to define their tax base, including the rules for computing business and employment income. Quebec's *Taxation Act*, R.S.Q. c.I-3 does not incorporate ITA provisions by reference but closely tracks the source concept of income used in the ITA (see especially ss. 28 and 29 of the *Taxation Act*, which are analogous to ITA ss. 3 and 4). Quebec's rules for computing net income from employment or from carrying on business in Quebec are broadly similar though not identical to those in the ITA (see *Taxation Act*, Book III, Title II on employment income, and Book III, Title III on income from business).

⁵ A further issue that affects cross-border employment situations is that international tax treaties distinguish between employment and business income, and generally give the source country (i.e. the country where services are performed) greater leeway to tax the former than the latter: see Hogg, Magee and Li, *supra*, section 5.2.

⁶ Income from a business is defined as the "profit" therefrom, referring to the net income realized after deducting overhead expenses (ITA s.9, 65302 BC Ltd). It is not necessary to show a causal relationship between an expense and an item of income, but only that the expense was incurred for an income earning purpose, and not for a personal purpose (ITA s.18(1)(a), (h); case?), and only to the extent "reasonable" (s.67). A variety of conditions and restrictions apply to specific items such as, for example, entertainment, food and beverage expenses which are limited to 50% of reasonable expenditures (s.67.1).

only those limited items which are expressly allowed in the ITA.⁷ The operating assumption is that employees have a limited need to deduct work-related expenses because the employer typically bears responsibility for overhead costs. Yet the reality of current (if not past) labour relations is that employees are often required to contribute to overhead costs by paying for items such as uniforms, tools, equipment, educational literature or training programs, cellular phones, job related travel, or maintaining a home office. In many cases employees are not permitted to deduct such out-of-pocket costs, though they are clearly work related and would be deductible to an independent contractor. The ability to deduct more expenses is thus a key incentive for workers to characterize themselves as independent contractors where possible. Firms will also find this beneficial if they can share in the tax savings by compensating their workers at lower rates.

A few examples serve to illustrate why employees are disadvantaged when it comes to deducting expenses. First, employees are almost never permitted to deduct the cost of capital items such as equipment and tools, whereas independent contractors can claim a percentage of such costs each year under the ITA's capital cost allowance rules.⁸ Employees have sometimes attempted to fit such costs under a provision which allows them to deduct "the cost of supplies...consumed directly in the performance of the duties of ...employment."⁹ However this language has been interpreted narrowly to include only items which are used up or worn out in a short time. It has been held not to include longer lasting assets such as tools, computer hardware, books, or uniforms.¹⁰ Recently

⁷ ITA s.8(2).

⁸ ITA s.20(1)(a). The rates of capital cost allowance for different classes of capital property are prescribed in the Regulations under the ITA (see esp. Part XI and Schedule II to the Regulations). Employees can claim capital cost allowance in only a few narrow circumstances where they are required by their employment contract to purchase a musical instrument, a car used for regular job-related travel, or an aircraft that is required for work-related travel: ITA ss.8(1)(j),(p).

⁹ ITA s.8(1)(i)(iii). Note the employer must certify that the employee is required by contract to supply and pay for such items: s. 8(10).

¹⁰ See for example *Luks (No.2) v. MNR*, 58 DTC 1194 (Exch. Ct.) (electrician's tools), *Carson v. MNR*, 66 DTC 424 (TAB) (books); *Brownlee v. MNR*, 78 DTC 1571 (TRB) (uniforms); *Ouzilleau v. The Queen*, 98 DTC 3410 (TCC) (computers). Additional cases are discussed in David G. Duff, *Canadian Income Tax Law* (Toronto: Emond Montgomery, 2003) at 403-407. See also Canada Revenue Agency, Interpretation Bulletin IT-352R2, *Employee's expenses, including work space in home expenses* (April 26, 1994), paras. 9, 10. Note that since 2002 the ITA has permitted one group of employees - apprentice mechanics - to deduct the cost of tools where the taxpayer spends over \$1,000 in a year, or 5% of their income, whichever is greater: ss.8(1)(r), (6) and (7). Note also that the Conservative government elected in January 2006 promised in its election platform to introduce a Tools Tax Deduction of up to \$500 that would be available

some judges have applied a slightly more generous reading, allowing employees to deduct the cost of special work clothing, a cellular phone, a pager, and up to date computer software.¹¹ However these cases were fought by revenue authorities, and are best seen as limited exceptions to a restrictive rule.

Home offices are another area where independent contractors have a distinct advantage in claiming expenses. Employees are permitted to deduct “office rent” in respect of a home office that is required by their employment contract, and meets certain other conditions.¹² However the Canada Revenue Agency (CRA) asserts that this applies only to employees who rent from a landlord, and that employees who own their homes cannot deduct any portion of ownership expenses in respect of a home office.¹³ In contrast, independent contractors who own their homes can deduct a percentage of their mortgage interest, insurance and property tax costs in respect of a home office, as well as capital cost allowance on furniture, equipment, and other assets.

Other types of expenses which are denied altogether or are more restricted for employees than for independent contractors include travel expenses, meals, professional development courses, fees paid to accountants or other professionals, promotional and client entertainment expenses, and wages paid to assistants.¹⁴

It is important to note that CRA has at least three years to reassess a taxpayer in respect of a particular year.¹⁵ This means that a worker who has filed income tax returns as an independent contractor but who is later recharacterized as an employee may have deductions reversed for up to three previous taxation years, resulting in additional back taxes being payable with significant interest charges.¹⁶

to both employed and self-employed tradespeople: Conservative Party of Canada, *Stand Up For Canada: Conservative Party of Canada Federal Election Platform 2006*, at 17.

¹¹ *Fardeau v. Canada*, [2002] 3 CTC 2169 (TCC); *McCann v. Canada*, [2002] 3 CTC 2422 (TCC), at para. 27; *Glen v. The Queen*, 2004 DTC 2109 (TCC), at para. 11.

¹² ITA ss.8(1)(i)(ii), 8(13).

¹³ See Interpretation Bulletin IT-352R2, paras. 5, 6. The case law is inconsistent but mostly affirms CRA’s position: see *Thompson v. MNR*, 89 DTC 5439 (FCTD); *Felton v. MNR*, 89 DTC 233 (TCC); and *Horbay v. The Queen*, 2003 DTC 3950 (TCC). For contrary results favouring employed taxpayers see *Prewer v. MNR*, 89 DTC 171 (TCC); and *Drobot v. MNR*, 87 DTC 371 (TCC).

¹⁴ See *Gaucher*, *supra*, at 33:8-12. See also *Glen*, *supra* note 11 (accountant’s fees); and *Emery v. The Queen*, 2003 DTC 4034 (TCC) (assistant’s salary).

¹⁵ ITA s.152(3.1),(4).

¹⁶ ITA s.161. The interest rate on arrears of tax payable is comprised of a market rate plus a four percent premium: Regulation 4301(a).

2. Administrative Arrangements for Payment of Income Tax

Another attraction of independent contractor status is that business income is not subject to the source deduction rules under the ITA. The hirer pays a gross amount of compensation to the contractor, who is responsible to pay quarterly installments of income tax directly to the government.¹⁷ Employers, on the other hand, must withhold a prescribed amount of an employee's wages and remit these funds to the government on account of the employee's tax liability for the year.¹⁸ An employer that fails to comply with the source deduction rules can face heavy interest charges and penalties, for which corporate directors and officers may be personally liable.¹⁹

Firms most likely would not welcome the additional administrative costs involved in complying with the source deduction rules. On the other hand the compliance burden is less for onerous for employees, who need not estimate their net income and tax liability in advance of the year end, budget for income taxes, or compute and pay installments of tax to the government.

B. Payroll Taxes

The federal government imposes two payroll taxes on workers and firms: Employment Insurance (EI) premiums, and Canada Pension Plan (CPP) contributions. Independent contractors are not required to pay EI premiums, and are not eligible to apply for EI when they are out of work.²⁰ For employees, EI premiums must be paid by both the employer and the worker. The payment of premiums is administered through the ITA's source deduction regime, and failure to pay or remit EI premiums is subject to the same sorts of penalties and interest charges mentioned above.

Independent contractors do participate in the CPP but are responsible to make all contributions on their own behalf.²¹ By contrast, employers are required to pay a portion

¹⁷ ITA s.156, 156.1.

¹⁸ ITA s.153, Reg. 100-108.

¹⁹ ITA s.227(8), (8.3), 227.1.

²⁰ See Gaucher, *supra*, at 33: 19-20.

²¹ See Gaucher, *supra*, at 33:20-21.

of their employees' CPP contributions, and to administer the payment and remittance of contributions in accordance with the ITA's source deduction rules.

Note that in contrast to income tax which is payable exclusively by employees out of their wages, employers share the costs of CPP and EI coverage for their employees. While employers likely tend to regard these additional payroll costs as disadvantageous, workers may regard them as beneficial. They may particularly welcome having access to EI benefits, especially if their jobs are short term or otherwise insecure.

C. Goods and Services Tax (GST)

A disadvantage of independent contractor status is that GST may be payable on the worker's services (unless the worker is a small supplier earning less than \$30,000 net income per year, or is providing certain tax exempt services). If so, the worker is obliged to collect GST from the hirer (i.e. an additional 7% on top of the amount paid for the worker's services), deduct any input tax credits to which the worker is entitled for the cost of supplies used in performing the work, and remit the balance of GST owing to the government on a timely basis. In other words the GST itself is paid by the hirer, but the worker bears the administrative costs of collecting and remitting the tax.²²

Services provided by employees are not subject to GST. From a GST perspective then, a shift from independent contractor to employee status should be welcomed by firms and workers alike.

III. Defining "Employment" in Canadian Taxation Law: Established Tests and Recent Trends

A. The Legal Tests

The ITA defines "employment" simply as "the position of an individual in the service of some other person" and "employee" as a person holding such a position.²³ The

²² See Gaucher, *supra*, at 33:21-22.

²³ Section 248(1).

Courts have held this definition refers back to the distinctions in common law and civil law between a contract *of service*, which establishes an employment relationship, and a contract *for services* in which the worker is an independent contractor carrying on business for her own account.²⁴ Accordingly the tests used in tax law to determine a worker's status are similar to those in other fields such as tort law. Note however that tax law has never recognized an intermediate category of worker analogous to the dependent contractor in labour law but has instead maintained the traditional binary distinction between employee and independent contractor. Judges are quick to acknowledge that a worker's status can be ambiguous. But rather than developing new conceptual categories they have conducted "a balancing operation, weighing up the factors which point in one direction and balancing them against those pointing in the opposite direction,"²⁵ to determine whether in all the circumstances the "total relationship" of the parties is more like employment, or more like independent contracting.²⁶

The Courts have applied a series of legal tests for determining a worker's status while emphasizing that no one test is conclusive by itself. In a typical case the Court will first apply the so-called "entrepreneur" test, also known as the "fourfold" or more recently the "four-in-one" test, assessing the parties' working relationship against the following criteria:

(i) *control*: If the hirer exerts control not only over what work is done, but the manner in which the worker does it, this points toward an employment relationship. An independent contractor is assumed to have more autonomy to decide how to complete the work. The limitations of this test are well known in that many skilled and professional employees work without close supervision. While control is therefore not

²⁴ See *Wiebe Door Services Ltd. v. Minister of National Revenue*, 87 DTC 5025 (FCA), at 5027 (hereinafter "*Wiebe Door*"). This case involving payroll taxes is still considered a leading decision on the distinction between employees and independent contractors in tax law, as affirmed in *Moose Jaw Kinsmen Flying Fins Inc. v. MNR*, 88 DTC 6099 (FCA); and *671122 Ontario Limited v. Sagaz Industries Canada Inc.*, [2001] 2 SCR 983 (SCC). In *Wolf v. Canada*, 2002 DTC 6853 the Federal Court of Appeal confirmed that "the distinction between a contract of employment and a contract for services under the Civil Code of Quebec can be examined in light of the tests developed through the years both in the civil and in the common law" (para 49, per Desjardins, JA; see also the reasons of DeCary JA at para.113).

²⁵ P. S. Atiyah, *Vicarious Liability in the Law of Torts* (London: Butterworths, 1967), at 38, quoted in *Wiebe Door* at 5030.

²⁶ *Wiebe Door*, at 5030.

determinative, it was the most important test historically and is still the first factor to be analyzed in most cases.²⁷

(ii) *ownership of tools*: If the hirer provides the tools or equipment needed to perform the work this points toward an employment relationship. Conversely, if tools are supplied by the worker this points toward an independent contract.

(iii) *chance of profit/risk of loss*: Here the decision maker considers both the method of payment for the work, and the extent to which the worker is responsible for overhead expenses. A guaranteed rate of remuneration suggests the worker is an employee. To the extent that a worker can increase her remuneration by working more efficiently or to a higher standard, or may suffer reduced pay or even losses, this points toward an independent contracting relationship.

Again, the Courts have stressed that while each of these criteria is important none is determinative, and the decision maker should focus on “the combined force of the whole scheme of operations.”²⁸

The “organization” test (also known as the “integration” test) is frequently applied in tax cases as a supplement to the multi-pronged “entrepreneur” test just described. As first articulated by Lord Denning this test provided that “under a contract of service, a man is employed as part of the business, and his work is done as an integral part of the business; whereas under a contract for services, his work, although done for the business, is not integrated into it but is only accessory to it.”²⁹ The Federal Court of Appeal cautioned in *Wiebe Door* that this test should not be used to find an employment relationship whenever a worker’s services are essential to the hirer’s operations.³⁰ Observing that mutual dependency is a feature of many work contracts, the Court held the organization/integration test should rather be applied from the worker’s perspective, by asking “whose business is it?”, that is whether the worker is in business for her own

²⁷ In Quebec cases this test is often expressed in terms of “subordination” or control of the worker by the hirer, reflecting the language of the Civil Code of Quebec: see *Wolf, supra*, at paras. 36, 44; and *Vulcain Alarme Inc. v. Canada*, [2000] 1 CTC 48 (FCA).

²⁸ *Montreal v. Montreal Locomotive Works Ltd. et al.*, [1947] 1 DLR 161, per Lord Wright at 169-70, quoted in *Wiebe Door* at 5028 and 5029.

²⁹ *Stevenson, Jordan and Harrison, Ltd. v. Mac-Donald and Evans*, [1952] 1 T.L.R. 101, 111; approved by the Supreme Court of Canada in *Cooperators Insurance Association v. Kearney*, [1965] S.C.R. 106.

³⁰ *Wiebe Door* at 5029.

account or is performing services as an employee in someone else's business.³¹ It is questionable whether this test adds very much to the analysis or merely restates the initial question as to the character of the working relationship. In any event the test is frequently cited in the reasons for decision in tax cases.

The "entrepreneur" and "organization" tests remain the central legal principles used by Canadian revenue authorities and Courts to distinguish between employees and independent contractors for tax purposes.³² While different decision makers may interpret and apply them slightly differently from case to case, there is little controversy about the nature of the tests themselves.³³

B. The Relevance of A Worker's Status Under Other Legal Regimes

It is entirely possible for an individual to be characterized as an independent contractor for tax purposes, while maintaining a different status under labour law or other legal regimes, such as worker's compensation, occupational health and safety, or human rights law. In its published guidelines for distinguishing employees from independent contractors the CRA does not even mention the worker's status under other legal regimes as a relevant factor to be considered.³⁴ Cases of dual status are virtually unavoidable given that employment has a range of meanings in different statutory schemes, and sometimes varies across provinces and territories.³⁵ Indeed variations in the scope of coverage, and hence in the definition of employment, are sometimes needed to reflect the distinct legislative purposes underlying different programs and regimes. An additional factor in tax cases is the longstanding tendency of the Courts to construe ambiguous tax

³¹ Ibid. See also *Precision Gutters Ltd. v. Canada* (2002) 291 NR 161, where the Federal Court of Appeal issued further cautions about how to apply the organization test correctly.

³² See Canada Revenue Agency, *Employee or Self-Employed?* (Document No. RC4110(E) Rev. 06). Some commentators identify the "specified results" test as a further, distinct test of a worker's status (see for example Duff, *supra*, at 198). That is an independent contractor is more often hired to complete specified work, whereas an employee normally places her services at the disposal of the employer for the duration of the employment, without a requirement to achieve specified results. However this test is often folded into the control test.

³³ For a thoughtful critique of the legal tests see Lara Friedlander, "What Has Tort Law Got To Do With It? Distinguishing Between Employees and Independent Contractors in the Federal Income Tax, Employment Insurance, and Canada Pension Plan Contexts" (2003) 51:4 Canadian Tax Journal 1467.

³⁴ CRA, *Employee or Self-Employed?* (Document No. RC4110(E) Rev. 06).

³⁵ See Judy Fudge, Eric Tucker and Leah F. Vosko, *The Legal Concept of Employment: Marginalizing Workers* (Report for the Law Commission of Canada, October 2002).

rules in favour of the taxpayer.³⁶ Thus tax law is prone toward a relatively expansive definition of independent contractor as this status is generally more favourable to the taxpayer. By contrast, in labour law and other areas where employment status confers legal protections, Courts have tended to develop broader definitions of employment over time.³⁷ Inevitably, then, a gap has opened up between tax and non-tax definitions of employment, such that a particular worker may have a different status depending on the legal context.

Adjudicators are often prepared to tolerate this gap as a practical matter, but sometimes express discomfort that an individual can switch their status at will to obtain the most favourable treatment under each statute. For example in *Dynamex Canada Ltd. v. Mamona*³⁸ the Court held that bike couriers could qualify as employees under Part III of the Code despite filing their taxes as independent contractors. The referee in the case had commented that,

I remain troubled by the fact that, in arriving at the conclusion (as I now do) that the Respondents were employees for the purposes of Part III of the Code, I am allowing them to 'run with the hare and hunt with the hounds', since they all freely admit that they were fully aware that their contracts designated them as independent contractors and that, indeed, they were quite content with that category since it meant fewer deductions at source from their paycheques.³⁹

The Federal Court of Appeal held this concern was “relevant but not by itself determinative...”⁴⁰ On occasion a worker’s perceived hypocrisy in claiming dual status may contribute to an unfavourable decision. In *509023 Alberta Ltd. v. Canada*, for instance, Teskey TCJ held that a worker who had filed tax returns as an independent contractor could not be considered an employee for EI and CPP purposes, commenting that “It’s all very well to come to court several years later and say, oh, I was an employee but she...took advantage of being an independent contractor to write-off her license fees.”⁴¹ This type of critical remark suggests that while maintaining dual status is in

³⁶ See Lisa Philipps, “The Supreme Court of Canada’s Tax Jurisprudence: What’s Wrong With the Rule of Law” [2000] 79 Canadian Bar Review 120.

³⁷ See Fudge, Tucker and Vosko, *supra*, at 51.

³⁸ (2003) 228 DLR (4th) 463 (FCA); leave to appeal denied March 4, 2004.

³⁹ *Ibid.*, quoted at para. 51.

⁴⁰ at para. 52.

⁴¹ [2004] TCJ No. 628 (TCC), para.14.

principle entirely legitimate, it may provoke a negative reaction from some decision makers.

A recent line of cases has drawn labour standards into tax jurisprudence in a new way. As discussed in the next section, these cases suggest that workers who have contracted out of minimum employment standards may have a stronger case for being treated as independent contractors for tax purposes.

C. The Relevance of Express Contractual Terms: Recent Developments

In applying the legal tests described above, CRA and the Courts consider a wide array of factual details about the parties' working relationship. In general they have focused heavily on the de facto conduct of the parties. The Courts have tended to discount express contractual terms that purport to declare a worker's status, as these may not reflect the actual relationship and may be self-serving attempts to achieve favourable tax results. Significantly, some recent decisions have moderated this stance. Following the Federal Court of Appeal's 2002 decision in *Wolf*, it appears some judges are more willing to defer to the parties' expressed desire to avoid the labour law and other regulations associated with employment status.

The *Wolf* case dealt with an aerospace engineer who left full-time employment to work as a consultant, providing services to one firm at a time under contracts of one to two years duration. The three panel members wrote separate concurring judgments holding that *Wolf* was an independent contractor. All agreed that the evidence concerning how the work was organized, executed and paid for did not point clearly in either direction. The decisive factor, expressed somewhat differently in each judgment, was that the parties had made a conscious decision to trade the security and legal protections of employment for the lower costs, greater flexibility, and higher cash remuneration of an independent contract.

Wolf argued that he belonged to a class of temporary or non-standard workers which is flourishing due to factors such as the globalization of trade, workers' desire for increased autonomy, increased competition among firms and a consequent desire to reduce fixed costs including wages, taxes and the costs of complying with minimum

employment standards.⁴² Moreover he was described in his express contract as a consultant and independent contractor.⁴³ These arguments persuaded all three judges, though on slightly different grounds. Desjardins JA affirmed the traditional position that the “terms of the written contract...will only be given weight if they properly reflect the relationship between the parties,”⁴⁴ but accepted that Wolf’s contract created a chance of profit and/or a risk of loss:

“[i]n consideration for higher pay, the appellant...took all the risks of the activities he was engaging in...He had no job security, no union protection, no educational courses he could attend, no hope for promotion.”⁴⁵

...The completion bonus, the absence of health insurance and pension plan, and the whole risk factor, including the lack of any protection under provincial labour legislation, favour the status of independent contractor.⁴⁶

This interpretation of the worker’s “risk” was novel because it went beyond the chance of financial profit or loss to consider other factors including job security and the lack of labour standards protection. In the final analysis, according to Desjardins, JA, “[n]on-standard employment such as the one of the appellant, which emphasizes higher profit coupled with greater risk, mobility and independence, indicate...the status of contractor...”⁴⁷ This judgment is novel

The other two panel members gave more weight to the parties’ intentions. DeCary JA’s reasons include the following passages:

...the courts, in their propensity to create artificial legal categories, have sometimes overlooked the very factor which is the essence of a contractual relationship, i.e. the intention of the parties...

...We are dealing here with a type of worker who chooses to offer his services as an independent contractor rather than as an employee and with a type of enterprise that chooses to hire independent contractors rather than employees. The worker deliberately sacrifices security for freedom...

In our day and age, when a worker decides to keep his freedom to come in and out of a contract almost at will, and the hiring person wants to have no

⁴² Per Desjardins, JA, at paras. 64-66.

⁴³ Ibid, para. 67.

⁴⁴ Ibid., para 71.

⁴⁵ Ibid., para. 87.

⁴⁶ Ibid., para.91.

⁴⁷ Ibid., para. 94.

liability towards a worker other than the price of work and when the terms of the contract and its performance reflect those intentions, the contract should generally be characterized as a contract for services. If specific factors have to be identified, I would name lack of job security, disregard for employee-type benefits, freedom of choice and mobility concerns.⁴⁸

Noel JA deferred most explicitly to the contractual terms, stating that,

...this is a case where the characterization which the parties have placed on their relationship ought to be given great weight...in a close case such as the present one...the parties' contractual intent...cannot be disregarded.

...I respectfully agree with my colleagues that the appellant in consideration for a higher pay gave up many of the benefits which usually accrue to an employee including job security...⁴⁹

The *Wolf* decision is interesting for purposes of this Report because it draws a new kind of link between a worker's tax status and her coverage under employment standards laws. Wolf was taxed as an independent contractor in part because he had agreed to forego the protections of labour law. The question is whether this line of thinking could extend to the reverse situation: if a worker obtains employment standards protection, does this suggest she has a lower level of "risk" and is therefore more like an employee for tax purposes? I am not aware of any tax case in which this type of reasoning has contributed to an employment characterization. However the language in *Wolf* has been adopted in subsequent Tax Court of Canada decisions. In *Chin v. Canada*, Savoie J. referred to "a new trend in jurisprudence which recognizes new conditions in the market place where employment standards are no longer the same."⁵⁰ After quoting many of the above passages from *Wolf* the Court concluded that Ms. Chin provided English language teaching services as an independent contractor, not an employee. In *Cambrian College v. Canada*, Rip J. found that a day care worker provided services as an independent contractor.⁵¹ The reasons turned mainly on the entrepreneur and organization tests laid out in earlier jurisprudence, but also referred to the written contract between the parties

⁴⁸ Per DeCary JA at paras 117-120.

⁴⁹ Per Noel JA at paras 122, 123.

⁵⁰ 2003 DTC (TCC), at para.27. See also *Ward v. Canada*, 2003 DTC.

⁵¹ [2004] TCJ No. 440.

and Noel JA's comments in *Wolf* concerning the importance of "contractual intent" in determining a workers' status.⁵²

The *Wolf* dicta about "risk" and "contractual intent" appear to be gaining a foothold in Canadian tax jurisprudence, but it is too soon to tell exactly where this line of cases is going. If it leads the Courts to make a stronger connection between labour standards and tax status, then broadening the scope of labour standards could conceivably have implications for the tax liabilities of some workers. However it must be reiterated that the Courts have held in other cases that it is possible to maintain dual status for tax and employment law purposes (see Section III.B. above).

IV. Comparing the Tax Law Definition of Employment to Alternative Labour Standards Definitions

You have asked me specifically to comment on the extent to which the definition of "employee" in tax law overlaps or differs with three alternative definitions being considered in the context of your review of labour standards.

A. Dependent Contractor

For purposes of this Report I have focused on part (c) of the definition of "dependent contractor" in Part I of the Code, which refers to,

any...person who, whether or not employed under a contract of employment, performs work or services for another person on such terms and conditions that they are, in relation to that other person, in a position of economic dependence on, and under an obligation to perform duties for, that other person.

This departs very clearly from the definition of "employment" in tax law in two ways. First, it specifies that a person can be a dependent contractor *whether or not* they have entered a contract of employment as understood at common or civil law. In addition the concept of "economic dependence" overlaps with, but is likely broader than the legal tests applied in tax jurisprudence. On my reading "dependence" is not the same as "control" or "subordination", which are usually understood to mean the hirer's right to determine the time, place and manner in which work is done. Nor is it coterminous with

⁵² *Ibid.*, paras. 85, 86.

“ownership of tools” or “chance of profit/risk of loss”. While each of these refers in some way to the distribution of economic risk between the parties, this differs to my mind from economic dependence which implies a degree of systemic vulnerability or inequality on the worker’s part. In other words a worker could be dependent on a particular firm for her income even though there is significant upside opportunity and downside risk to how she is paid and what expenses she must cover. The “organization” test may overlap most with the concept of “economic dependence”, but as noted earlier the Courts have stated that a relationship of mutual dependence will not by itself satisfy this test. Instead, the “organization” test should inquire into whether the worker is in business for herself, or is merely providing services to someone else’s business. Thus none of the tests in tax jurisprudence occupies quite the same territory, or is quite as expansive, as the definition of “dependent contractor.” Of the three alternative definitions provided this one seems most clearly to go beyond tax law’s concept of employment.

B. U.K. Definition

You indicated that some U.K. employment laws extend coverage to “a worker who undertakes to do or perform personally any work or services for another party to the contract who is not a client or customer of a profession or business carried on by that individual.” This definition seems not dissimilar to tests used in tax law to delimit the concept of employment. It is most reminiscent of the “organization” test in that both ask whether the worker is carrying on a business for her own account. This question may in turn implicate other familiar criteria such as whether the worker bears economic risk and works autonomously. Whether services are performed personally is also a criterion considered in some Canadian tax cases, usually as an indicator of the hirer’s control over the worker. Of the three alternative definitions provided, this one overlaps most with current understandings of employment in Canadian tax law.

C. Quasi-Subordinate Status

You indicated that quasi-subordinate workers are identified in Italian law on the basis of three characteristics: continuity, co-ordination and the mainly personal nature of

the work. For this purpose continuity exists so long as the worker spends considerable time over the work itself, even if the relationship is temporary. Co-ordination is the proxy for subordination, indicating that while the worker must comply with the requirements of the employer, this obligation is not as strong as it would be in a subordinate relationship. The mainly personal nature of the work excludes services provided through a corporation or where the worker's role is limited to directing others who provide the services.

Like the concept of dependent contractor, this definition overlaps with the traditional indicators of employment in tax law but also goes beyond it and would likely cast a wider net that includes more workers. It is semantically distinct from the term "employment." The prefix "quasi" suggests it is intended to catch ambiguous or hybrid relationships that may fall outside of traditional employment. Moreover it does not appear to refer even indirectly to ownership of tools, chance of profit, or risk of loss. This suggests that quasi-subordinate status is broad enough to encompass some workers who from the perspective of tax law look more like independent contractors. This alternative definition occupies an intermediate position between the first two in terms of how clearly it can be differentiated from tax law's traditional understanding of employment.

V. Potential Consequences of Extending Federal Labour Standards: Analyzing the Tax Risk

The question at the heart of this Report is whether enlarging the definition of employee in Part III of the Code might unintentionally disadvantage affected workers by rendering them employees for tax purposes as well. As explained in Part II of the Report, a shift from independent contractor to employee status does carry some tax advantages (especially relief from GST, access to EI benefits, and a reduced administrative burden for employees). However many workers and firms would regard such a change as negative, especially as regards the scope of expenses that can be deducted for income tax purposes.

The likelihood of any such consequence occurring depends on at least three interrelated factors: (i) the extent to which a worker's labour standards coverage is considered by tax law to be a relevant factor in determining employment status for tax purposes; (ii) whether the extension of labour standards might cause behavioural changes that bring the working relationship more closely into line with tax law's understanding of employment; and (iii) whether labour standards reform may trigger new enforcement activities by revenue authorities, resulting in additional scrutiny and reassessments of some workers and firms.

These factors are considered in turn below. In each case I conclude there is a low but not zero risk of unintended tax consequences for particular workers depending on their individual circumstances.

(i) As discussed earlier there is no necessary linkage between a worker's status for tax and labour law purposes. However tax jurisprudence on the definition of employment stresses the potential relevance of all surrounding circumstances, and this Report has provided examples of cases in which a worker's coverage under labour law or other statutes has had some bearing on how they are characterized for tax purposes. This may occur when a decision maker perceives some unfairness in the worker making inconsistent claims, or conversely when the worker's lack of labour and other protections is thought to strengthen their case for being taxed as an independent contractor (the *Wolf* scenario).

I can see two possible strategies for minimizing any potential spillover effect in tax law. The first would be to adopt a modest reform that expands labour standards coverage only slightly, in hopes of avoiding any impact on tax affairs. The second and I think preferable course would be to implement a more ambitious reform that clearly differentiates the two legislative regimes. The latter approach would be more likely to reduce any potential for friction or confusion between these two areas of regulation. A new definition that departed clearly from that used in tax law could help to distinguish the purposes and intended scope of the two regimes, and hence increase the acceptability of certain workers maintaining a different status under each. It is notable that in both *Dynamex* and *509023 Alberta Ltd.* the Courts were faced with an individual claiming

different status under legislative schemes that on their face used the same legal concept of “employment”. The appearance of inconsistency would likely be reduced if the statutes used different terminology and concepts to define their respective coverage. For this purpose the “dependent contractor” or “quasi-subordinate worker” would be more attractive options than the UK definition, for reasons discussed above.

(ii) If minimum labour standards are extended to new workers and firms, I speculate that some may ultimately adapt their labour contracts and practices to better reflect those legislative standards. For instance if a contractor becomes entitled to receive minimum wage and vacation pay, might some firms (or workers) become more vigilant about keeping accurate records of work time, or integrate that person more formally into the firm’s regular payroll processes? Or, if certain contractors can only be dismissed for cause or with sufficient notice, might they be subject to greater monitoring and reporting expectations? To the extent that these behavioural changes align the working relationship more closely with employment as traditionally understood, this may result inadvertently in a change of character for tax purposes. In communicating with the public about any labour standards reform that may be implemented it would be advisable, then, to include information about possible tax implications of altering labour contracts or practices. It is also possible for taxpayers to obtain advance rulings from the CRA to confirm what if any tax consequences will ensue from any planned restructuring of workplace practices or contractual terms.

(iii) This Report has observed that the character of many working relationships for tax purposes is ambiguous, and this is confirmed by the vast amount of litigation on this issue. In many cases taxpayers take a position for filing purposes that may be legally reasonable but which could be challenged if CRA decided to conduct an audit. Although CRA is not directly involved in administering the Code, labour standards reform could lead indirectly to closer scrutiny of certain taxpayers’ affairs and increased enforcement activity. For example workers who enjoy the protection of Part III of the Code might be more likely to assume they can claim Employment Insurance benefits on termination of a job. As the agency responsible for administering the EI, CPP, GST and federal and

provincial income tax systems, CRA will have information as to whether EI premiums have been paid on behalf of particular workers, and whether they have in the past reported their income as employees or independent contractors. An investigation of an individual worker may then lead to a payroll audit of the hirer, in which CRA may examine the characterization of other workers. Given the fuzziness of the distinction between employment and self-employment in tax law, workers and hirers could be open to challenge on past reporting practices that were legally defensible but not clearly correct.

It is difficult to quantify this risk as it depends on the practical interactions among various regulatory systems, citizens and government personnel.