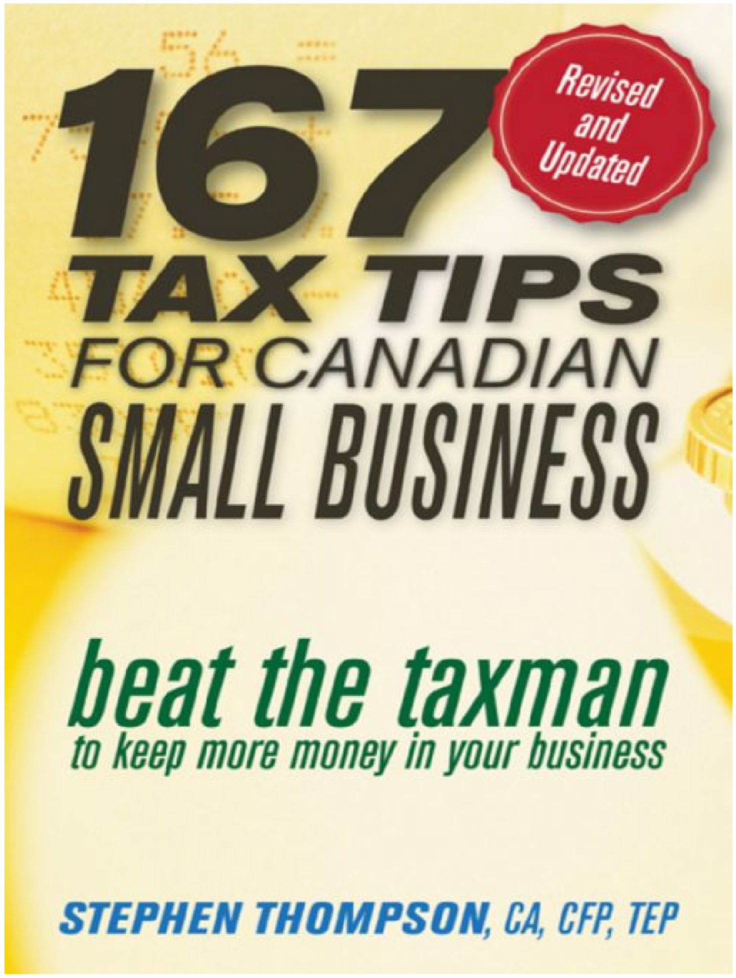
# 167 TAX TIPS FOR CANADIAN SMALL BUSINESS

Revised and Updated

## beat the taxman
### to keep more money in your business

**STEPHEN THOMPSON**, CA, CFP, TEP


Revised and Updated
167 TAX TIPS
FOR CANADIAN
SMALL BUSINESS
beat the taxman
to keep more money in your business
STEPHEN THOMPSON, CA, CFP, TEP

## Table of Contents

# *167 TAX TIPS FOR CANADIAN SMALL BUSINESS 2010*

*beat the taxman to keep more money in your business*

UPDATED FOR THE 2009 TAX YEAR

***STEPHEN THOMPSON**, CA, CFP, TEP*

WILEY
John Wiley & Sons Canada, Ltd.

John Wiley & Sons Canada, Ltd.
6045 Freemont Blvd., Mississauga, Ontario, L5R 4J3

Production Credits
Cover Design: Ian Koo
Inteior design: Natalia Burobina
Printer: Printcrafters Inc.
Printed and bound in Canada
eISBN : 978-0-470-67834-3
PC

# Year-Round Tax-Planning Calendar

### January

- Don’t forget to record your odometer reading on the 1st for allowable automobile deductions. (Page 165)
- Pay interest on funds borrowed from your spouse or parent used for investing to avoid attribution by the 30th. (Page 41-42)

### February

- Have you paid a family member EI? If so, consider applying for a ruling to make them EI exempt. (Page 49)
- Deadline for filing T4 Short, T4, T4A, and T4F Summary and Supplementary is the 28th. (Page 120)

### March

- Deadline for making your 2009 RRSP contribution is the 1st (unless extended by the government).
- First 2010 tax instalment due on the 15th. (Page 110)

### April

- Review flexible deductions such as RRSP contributions, CCA, and allowance for doubtful accounts to ensure you maximize your tax rate stairway. (Pages 52, 56, 57)
- Deadline for filing personal income tax returns is the 30th unless you or your spouse carry on an unincorporated business. If you owe tax, the liability is still due on April 30th. (Page 107)
- The 30th is the last day in which to file a Notice of Objection for your 2008 tax return if you or your

spouse did not carry on an unincorporated business in 2008. (Page 197)

**May**

- Consider hiring your children in your business over the summer and save. (Page 43)

**June**

- Deadline for filing personal income tax returns if you or your spouse carry on an unincorporated business is the 15th. (Page 107)
- Second 2010 tax instalment due on the 15th. (Page 110)
- The 15th is the last day in which to file a Notice of Objection for your 2008 tax return if you or your spouse carried on an unincorporated business in 2008. (Page 197)
- The 15th is the deadline for filing the GST annual return for unincorporated businesses with a December year-end and that file on an annual basis. (Page 97)

**July**

- Review your instalment options for the upcoming tax instalment. (Page 112)

**August**

- Review your tax assessment notice to ensure it agrees with how you filed your tax return. Investigate any significant differences. (Page 193)
- If you have been charged penalties or interest, consider if you can get them reversed. (Page 203)

**September**

- Third 2010 tax instalment due on the 15th. (Page 110)

**October**

- If you’re considering using the Quick Method for the GST, apply now for the upcoming year. (Page 85)

**November**

- Review your instalment options for the upcoming final 2010 tax instalment. (Page 112)

**December**

- Fourth 2010 tax instalment due on the 15th. (Page 110)
- First and only tax instalment is due on the 31st for farmers and fisherman. (Page 110)
- Value your inventory and consider writing off obsolete or damaged inventory if you have a December year-end. (Page 136)
- Consider purchasing now, any major asset you’re planning to buy early next year if you have a December year-end. (Page 155)
- Consider delaying until next year the sale of any major asset if you have a December year-end. (Page 156)
- If you have a December year-end and can use the cash method of accounting, consider deferring tax by purchasing some of next year’s supplies this month. (Page 22)
- Record your odometer reading for calculating allowable automobile deductions by the end of the month. (Page 165)

# Preface

***B**eat the Taxman!* had its beginnings in the form of a “Lunch and Learn” seminar that we created for our clients. The seminars focused on easy tax-planning ideas for the individual investor and businessperson. Several of the ideas discussed in this book originated in those seminars. The main philosophy of the seminars also became the main philosophy of this book: That saving tax dollars involves doing a lot of little things right, throughout the year.

While it’s true that under the right circumstances significant tax dollars can be saved using complex structures and high-level tax plans, it is also important to realize that really effective tax planning starts with knowing the rules and doing a lot of little things correctly throughout the year. Tax planning doesn’t occur on April 30 when you file your tax return. It occurs when you’re planning to purchase that new vehicle, when you’re paying your teenage son or daughter that monthly allowance, and when you’re recording the revenue and expenses of the business. Tax planning is truly a 365-day-a-year fight. And this book is meant to help you win that fight.

In this book, tax savings is definitely the name of the game. My focus from the outset has been on how I can save you tax dollars. In order to accomplish this task, I have had to explain some of the tax legislation so that I can show you how to use it to your advantage. However, I have intentionally kept the tax explanations short, to the point, and not too complex. My objective is to save you tax, not teach you tax law.

I have also structured the book in an easy-to-understand question-and-answer format. This will allow you to quickly go to a section that relates to your business. For the most part, the chapters of the book, or what I refer to as “Rounds,” stand alone. That is to say, you do not have to read the book from start to finish in the order that I have laid out. If a section does not relate to your business, you can skip that section and move on. Where the rules interrelate I refer you to the sections where they are explained in more detail.

I do, however, recommend at least a cursory review of the sections of the book which you believe do not relate to your business. My experience has been that many taxpayers believe certain legislation does not apply to them until they obtain more information. You can save taxes by knowing the rules and acting on them.

> **TAX BEATER**
>
> Deduct the cost of this book and save.

Throughout the book I have highlighted important tax-planning ideas by summarizing them in the margins as “Tax Beaters.” In the body of the text that runs beside the Tax Beaters, I have explained in more detail how to use the technique to save tax dollars. For example, if you are in business or you are in receipt of commission income, you can deduct the cost of this book as a business expense. If you are in the highest personal income tax level of about 50%, this idea will save you approximately $13.50. As well, if your business is registered for GST, you will be eligible for an input tax credit of approximately $1.35 on the purchase of this book. This is a savings of approximately $14.85

depending on your province and tax level. In this way I have tried to make tax savings easy and time effective.

For quick reference, I have placed at the end of the book a summary of all 167 Tax Beaters plus three bonus tax tips.

## Some Words of Caution

It is impossible to predict every potential tax situation and include it in this book. And, as I mentioned earlier, my focus is on tax savings, not on tax education. I have made a concerted effort to provide an accurate summary of what I consider to be the more important areas in the tax law that was in effect at the time of writing this book, and as that law relates to small and home-based businesses. Many of the ideas in this book are very straightforward. However, there are several areas that are more complex and for which you may need assistance. You should always consider seeking the advice of an expert to ensure that a tax saving idea is right for you. This book is not intended to be a substitute for good professional tax advice.

It is also important to realize that what may make perfectly good sense from an income tax savings point-of-view, may make little sense when reviewed in your particular business situation. I have concentrated on ways to use the income tax legislation to your advantage. However, it is important for you to decide if the ideas make sense in your business. This is a personal assessment which only you and your tax advisor can make.

# Acknowledgements

**I** would like to thank Colin Chambers, CA, for his assistance in updating this year's edition of *Beat the Taxman!* Colin is a senior CA in our office and a graduate of the CICA In-Depth tax course. Colin's efforts were instrumental in ensuring that this year's edition happened. I want to thank him for his contributions.

# ROUND ONE

## Get Off to a Good Start

As with many things in life, starting off right in business can often make the difference between winning the match or getting knocked out before the first bell. Knowing where you stand with the Canada Revenue Agency (formerly Revenue Canada) and what the ground rules are going to be can pay dividends to you down the road. In this round, we will look at some of the key questions that are often asked when starting up a new business and how to turn these questions into tax-saving ideas.

## What Is a Business?

What is a business? This seems like a pretty straightforward question, one hardly worth spending any time on at all. But, in fact, it is absolutely the first question to ask when you’re starting up, and essential for getting started on the right foot.

You may find this statement surprising, but I have found that the Canada Revenue Agency and the typical Canadian taxpayer do not always agree! A key area of disagreement concerns the question “What is a business?” In fact, the Canada Revenue Agency (CRA), the courts and taxpayers have been arguing a lot about what is and what is not a business over the past few decades. What would seem to be a straightforward question has been a very difficult fundamental question to answer. And the problem has historically come about because CRA does not want to allow a taxpayer to deduct losses year over year in a questionable business. As a result, in the past, the tax department considered a business to be any activity that you conduct for a profit or a reasonable expectation of a profit. If the business could not demonstrate that it could become profitable, CRA would deny the losses.

On May 23, 2002, the Supreme Court of Canada ruled on two cases, Stewart v. The Queen and the Queen v. Walls, which changed all the rules. As a result of the Supreme Court of Canada's decision, CRA now only considers the concept of "reasonable expectation of profit" if there is a personal element with respect to your business. If there is no personal or hobby element and assuming of course your business is not a sham, then CRA will generally no longer question whether or not you are in fact in business.

If, however, there is a personal or hobby element in your business, then it must be determined if your business is carried on in a sufficiently commercial manner as to indicate that there would be a source of income, and therefore a business. In this case, CRA would look at whether or not there is a reasonable expectation of profit from your enterprise so that it may be considered a legitimate business.

It would appear, however, that the federal government was not entirely happy with the Supreme Court of Canada's decision in the Stewart and Walls cases, for on October 31, 2003 the Department of Finance released proposed amendments that would essentially reverse the court's decision and legislate the former CRA's assessing practices. That is, to deny business losses and other expenses unless there is a reasonable expectation of profit from that business or related activity. Originally, it was intended that if this proposed new section of the Income Tax Act became law, it would be effective for taxation years starting after 2004. What the Department of Finance found was that during the period of public consultation, many individuals and groups expressed serious concerns that a test to determine whether a reasonable expectation of profit exists may unintentionally limit a number of ordinary commercial expenses. As a result, the Department has decided to revise the legislation in order to address the concerns of the public while still achieving the Government's objectives. In the fall of 2005, the Department of Finance stated that its intention was to replace the concept of "reasonable expectation of profit" with a more modest concept, however, at the time of writing no further details had been provided. Since 2005, there has been no mention of this issue in any federal budget. So, for now, we must wait until the Department of Finance issues its alternate proposal for the public to comment on. Until new legislation actually comes into force, the Canada Revenue Agency has indicated that they are assessing based on the Stewart and Walls cases. Therefore, for now, it is best to understand CRA's current assessing practice.

Based on the Supreme Court of Canada's decision there is now a two-step process in deciding what is and what is not a business for tax purposes. If your business has no personal element involved, then it will normally be considered a business. If the business is not successful, the Canada Revenue Agency will normally allow the losses. In the very recent past, CRA would try to deny legitimate business losses on the premise that there was no reasonable expectation of profit, therefore no source of income or no business. Now, under their current assessing practises, if there is no personal or hobby element, CRA will generally have to allow the losses. This is a major win for the taxpayer as many legitimate businesses have lost over the years their right to claim losses from what amounted to bad business decisions.

However, if there is a personal or hobby element to your business then you have to move to step two in the process. In this step, it must be determined if your business is being carried on in a sufficiently commercial manner as to still qualify as a source of income and thereby qualify as a business. To determine whether or not your business is carried on sufficiently in a commercial manner, CRA will use among other tools, the concept of reasonable expectation of profit. But the anticipation of profit cannot be the only test used by CRA. The objective is to evaluate the commercial nature of your activity, not to judge your business acumen. Therefore, even though your business may not be profitable and there is a personal element involved, losses from the business can still be tax deductible if your business is operated in a sufficiently commercial nature.

Developing examples of how these rules would work is tricky, as CRA is just starting to announce how they plan to interpret the new rules. However, it is probably safe to go through some extreme examples to highlight how these concepts are likely to be interpreted. First of all, if your business is profitable, then you likely have very little to worry about. CRA is mostly concerned with taxpayers deducting business losses. Profitable businesses will normally be considered in business provided that your activity is not on account of capital. Income on account of capital is normally a single transaction that results in a gain. Instead, we are assuming your business has many transactions and therefore the income would be considered business income.

Now let’s say you have a ceramics business and the ceramics you make are for a local electronics manufacturer. The ceramics have no value, other than to your customer, as it is a component in the product they are making. You do no other types of ceramics. Despite your best efforts however you have not been able to turn a profit. It is hard to suggest that there would be any personal element in this business. Accordingly, we do not have to look at whether or not you will ever be profitable. You are operating a commercial activity and your business losses would be tax deductible.

Now let’s say you only make cute ceramic statues. You would like to sell them to the public but after three years you have only been successful in selling a couple to strangers and a few to family members. You on the other hand have a nice collection of the statues in your home. In this case you are most likely operating a hobby or at least there is a definite personal element to your business. So the question becomes have you been operating it in a sufficiently commercial nature as to suggest that your losses should be deductible as a business loss. To determine this you might look at your business plan, whether anything happened unexpectedly that caused your business to become unsuccessful and what effort did you make to correct the matter. If however, your business is really just a hobby, then your losses will not be tax deductible. Not so much because it was not profitable, but because you really never engaged the business in a sufficiently commercial manner.

The above represents the current assessing practices of CRA. However, as mentioned earlier, the government was proposing some changes to the legislation that many thought would dramatically affect the deductibility of losses and expenses in the future. The legislation that was being proposed would have only allowed the deduction of business losses and other expenses where it would have been reasonable to assume that you would realize a cumulative profit from the business during the time that you carried on the business or could reasonably be expected to have carried on the business. The concept of whether or not there is a personal element to your business would be gone. If you could expect to realize a cumulative profit, then you would be able to deduct the losses. If you did not, or could not, realize a cumulative profit then the losses would have been denied. For clarity, profit would not have included capital gains from the selling of the business or asset. So if you were intending on operating a business at a loss with the intention of selling the underlying assets for a gain a few years later, then your losses would likely not have been deductible because there would not have been a cumulative profit, given that the gain on the sale would not be considered as a part of the profit.

It is important to note that this test for reasonable expectation of profit would have been an annual test, one that if questioned you would have to defend to the Canada Revenue Agency. As an example, it is possible that the first few years of operation you managed your business at a loss but that it is sensible to consider that your business has a reasonable expectation of making a cumulative profit. However, say in year four, it is no longer reasonable to expect that the business can operate with a cumulative profit. Accordingly, in year four and subsequent years your losses would be denied. It becomes apparent from this that it would have been increasingly important to document exceptional events that prevented you from being profitable and to prepare and revise your business plan to support your reasonable expectation of profit.

**TAX BEATER**

Prepare and periodically revise your business plan to support any business losses.

Again, the important thing to remember is that this is how the legislation would have operated had it been passed. As was mentioned earlier, the Federal government is currently revising its proposed legislation in order to address the concerns that were raised. Until their revised legislation is made public, we won't know what the new rules will entail and how much of a compromise the government will make. However, by having an understanding of what the original legislation looked like we gain an idea of where the government is going.

As you can see, determining whether or not your business is in fact a business for tax purposes can be a difficult question to answer. The changes in the rules and interpretations continue to complicate an already difficult and sensitive area. In the end, if you truly believe your business is legitimate but is merely struggling, claim the losses and document as best you can the reasons why your business will be successful. If you are ever challenged by Canada Revenue Agency, seek a good tax coach and argue your position. This is a fight you will want to win.

## Should I Keep My Losses Low in the Start-Up Years?

Sometimes legitimate business operators fear that if they claim too great a loss or if they have too many years in a row with losses, that the Canada Revenue Agency will disallow the deduction of the loss. Some even fail to deduct expenses to reduce the loss or, even worse, generate income and pay tax on it to show an expectation of profit. This type of "tax planning" is totally unwarranted. If you are operating a legitimate business, always deduct all legitimate business expenses to reduce your tax liability. If challenged, with a good tax coach in your corner, you can often successfully argue your case and, by obtaining a favourable ruling, “Beat the Taxman.”

> **TAX BEATER**
>
> Report all legitimate business expenses even if you incur persistent losses.

If your business is continuing to incur losses, instead of not deducting legitimate expenses, look at your business to see what expenses can be reduced or eliminated that would make your business profitable. Can you, for example, pay down debt which will reduce your interest expense or reduce some office or other business expenses.

If your business has a personal element involved and is not profitable, then you may need to show that it has a reasonable expectation of profit or that it is being carried on in a sufficiently commercial manner. Often the best support to turn too for this is your business plan. I strongly recommend that you prepare a business plan complete with forecasts of revenues and expenses for your business regardless whether there is a personal element involved or not. The business plan will serve as the documentary proof that your business can be successful and that you embarked with full intentions of making a profit. If later your business is unsuccessful, you will have something to compare too to see what happened. If you can identify one or more “events” that happened or didn’t happen that resulted in losses to your business, then these “events” can be used to show to a tax official that at the time of starting the business there was a reasonable expectation of profit if not for these “events,” and that the losses should be deductible.

## When Did My Business Start?

In order to maximize your tax savings when starting a business, it is important to know when your business began. For example, did your business start when you made your first sale, or met with your first customer? Or did your business begin when you opened your new bank account, installed the separate telephone line, or purchased your first supplies?

**TAX BEATER**

Record all business-related expenses between startup and your first sale.

It can often be months after this start-up date before sales finally start happening. If you consider your business to have started only after your first sale, then you may lose out on some significant tax deductions.

**TAX BEATER**

Don’t spend money on your business before official startup.

There are no hard and fast rules on when a business starts. The beginning date is very much dependent on the facts of each particular case. Generally speaking, a business is considered to commence whenever some significant activity is started which is important for the operation of the business. For example, a business may be considered to have started when you begin applying for a licence necessary to operate your business, or when you make your first purchase of supplies or products to sell.

Any expenses made before the start of a business will not be tax deductible. So before you incur significant costs relating to your business, perform some event which will signify the beginning of your operation. This event may be the registering of your business name with the province or the Chamber of Commerce, or opening up a separate bank account. Whatever it is, do something that signifies the start of operations.

## What Types of Expenses Can I Deduct?

**TAX BEATER**

The general rule: All reason able business related expenses are tax deductible.

Generally speaking, any reasonable expense that relates to your business is tax deductible. From this basic rule, there are numerous restrictions which the government has legislated to reduce the tax deductions. These restrictions are discussed throughout the book. By knowing these restrictions you can plan around them and maximize your tax deductions.

## Am I Really Self-Employed or Still an Employee?

This is an important distinction. If you think you are self-employed but the Canada Revenue Agency later decides you are still an employee, then many of the expenses you have tried to deduct may be denied. Additionally, your employer will be required to pay Canada Pension Plan contributions and Employment Insurance and may be assessed interest and penalties for not remitting these payments along with the withholding tax on your “salary.”

In many cases it is obvious that you are self-employed: you have several different customers, you are your own boss, you supply your own tools, and you have the risk of losing money. However, there are many cases where this distinction is much more blurred. In today’s world of downsizing, many employers are laying off their staff and hiring contract workers. Often, an employee is given a retirement package and then asked to come back on a contract basis. If this has happened to you, are you an employee or self-employed?

The distinction between being an employee and being self-employed is based on the facts of each case. Over the years the courts have developed four tests that they use to determine if you are an employee or self-employed. These tests are:

1. The control test
2. The integration or organization test
3. The economic reality test
4. The specific results test

**The Control Test:** If one person holds considerable control over you, in the form of deciding what you will do, how you do it, when you do it, and where you do it, then they may be considered to be your employer. If, on the other hand, you have the liberty to perform the task as you choose, provided it is done within an agreed-upon time, then you may pass this test.

**TAX BEATER**

Know and follow the rules for self- employment.

**The Integration or Organization Test:** This test looks at whether or not you become an integral part of an organization. If your work is so closely tied to your customer's business that you act like any other employee, then you may also be considered to be an employee.

**The Economic Reality Test:** This is often the most clear-cut test. It looks at whether or not you own your own tools, have a chance to make a profit, or could be at risk of incurring a loss. Where an individual supplies no funds or tools, takes no financial risks and has no liability, the courts have considered the relationship to be employee and employer.

**The Specific Results Test:** This last test looks at whether or not you are performing a specific task with a distinct completion or whether your services are provided over an extended time frame, with no specific result contemplated. An employee is typically hired to perform various tasks as required on an ongoing basis. A self-employed person would be hired to perform a specific task, the completion of which would end the relationship.