Tax Planning for Business Owners 2018-19

If you make your daily bread in the business world as a self-employed person or corporate business owner, you have many opportunities to consider when it comes to tax planning. However, the tax rules which apply to you can be more complex than those which apply to an employee.

Self-Employed Individuals

You can be in business without having an incorporated company. And you can take advantage of tax planning strategies to lower your tax bill, and help improve your bottom line.

One of the key issues involves how your **business expenses** are treated. Some expenses must be written off over several years, and consequently lower your tax over that period.

This is particularly true for capital expenses such as buildings, furniture, computers, etc. You can claim depreciation of these assets, known as **capital cost allowance** (CCA) for tax purposes at rates provided under tax law. Generally, you group similar assets in a pool or class, and CCA can be claimed against each asset class. Various rates apply for varying type or class of assets.

Typically, the maximum CCA you can claim in the first year of owning an asset is one-half of the amount otherwise allowable. In order to claim a deduction for CCA the assets must also be available for use in your business and not simply purchased to sit on your books and used to claim CCA.

You can choose to claim less CCA than you are entitled to. For example, if you have other non-capital losses available to be applied, you may wish to claim less CCA to utilize these non-capital losses first.

Travel expenses are a common deduction for many businesses. You can generally claim any reasonable expense related to travel for business. The Canada Revenue Agency (CRA) requires strict record-keeping to facilitate this write-off. You cannot claim for travel (e.g., motor vehicle, taxi, or public transportation) from your home to your principal place of business.

Meals and entertainment costs incurred in the course of doing business may be deductible. The amount which may be deducted is limited to 50% of the actual expense incurred. This limitation recognizes the personal benefit realized by the taxpayer in respect of the meals and entertainment while also facilitating meetings with clients with the expectation of creating business opportunities for them. As with travel expenses, expect the CRA to be vigilant in reviewing these claims should you be audited. It's good practice to write the attendees and business purpose of the claim on the back of the receipt for future reference.

You may have set up a **home office** to conduct business. As a general rule, the amount of expense you can claim is equal to the ratio of space your office takes up in your home. You can apply this ratio to write off a variety of related home office expenses: rent, mortgage, property tax, utilities, and home insurance. Again, proper receipts should be kept. Keep in mind, you can make this claim only against your business income. Further, your home office should be your principal place of business. Please note that the proportion you use as an office will be deducted from a claim that you make for the principal residence exemption. These claims as well as others should be discussed with your tax advisor before being taken.

You can claim **business losses** as long as the loss is connected to a legitimate business activity — in pursuit of profit, rather than a hobby. Business losses which are "non-capital losses" must first be applied in the year they are incurred. These losses can be carried back three years or carried forward for up to 20 years.

Corporate Business Owners

If you own a corporation, it is a separate legal entity from you personally. Even if you are the only shareholder, you are limited in the way funds can be taken from the corporation, and have to follow specific rules related to the taxation of a corporation.

The federal corporate tax rate is 15% for active business income. For Canadian-controlled private corporations (CCPCs) the rate is 10% in 2018, on the first $500,000 of active business income. The rate will be reduced to 9% effective January 1, 2019. The provinces also have their own respective small business tax rates.

The small business rate begins to be phased out once the corporation's (and any associated corporation's) capital exceeds $10 million. Beginning in 2019, the small business rate will also be phased out where the corporation (any associated corporations) generate more than $50,000 of passive investment income at a ratio of $5 to $1.

Potential **planning opportunities** to discuss with your tax advisor include:

- Reducing your corporation(s) net investment income.
- Reviewing the types of passive investments held inside your corporation (and its associated corporations, if any).
- Generating expenses which may help reduce gross investment income such as interest expense. (For more, ask your TD advisor for our infographic: *Earning Passive Investment Income Inside Your Company*)

Extracting funds from your corporation

There are several ways to take money out of your corporation. Perhaps you **loaned money** to the corporation to get it started. The corporation can repay you without tax consequences — to you or the corporation. This assumes the corporation has the cash flow to pay you back. If not, it

may have to sell off investments, in which case there may be tax on any capital gains realized.

Another method of receiving money from your corporation is to have the corporation pay out dividends. The total tax paid by the corporation, and you, on receipt of **dividends** should, theoretically, be equal to the total tax you would have paid if you had earned the income directly outside of the company. To apply this theoretical "integration" you would include a "gross up" for any dividends you received in calculating your taxable income and then an offsetting dividend tax credit (both federally and provincially) is available to be claimed against your tax otherwise payable.

Private corporations have a notional account called the **capital dividend account (CDA)**. The CDA allows for amounts which would otherwise be received tax-free if received directly by you to maintain their tax-free status when distributed to you from the corporation in the form of a capital dividend. Among the most common amounts included in the capital dividend account would be capital gains. Where the corporation realizes capital gains, only 50% of the gains are taxed (similar to individual capital gains rules). The untaxed portion of the gain is added to this notional CDA account. Similarly, capital losses incurred by the corporation will decrease the CDA account by 50% of the loss. If there is a positive balance in the CDA a tax-free capital dividend can be distributed to all shareholders.

The corporation could pay you a **salary** in addition to repayment of loans and dividends. Similar to working for an employer, the salary is deductible to the corporation and taxable to you as an individual. A significant salary is allowable by the CRA as compensation for your owner-manager effort. Some key benefit of the corporation paying you a salary are that it creates Registered Retirement Savings Plan (RRSP) contribution room for you; will enable you to claim the Canada employment credit; and requires you to make Canada Pension Plan contributions, which in turn will facilitate your receipt of CPP retirement benefits. Of course, your corporation would be required to make matching CPP contributions on your behalf.

Determining the optimal mix of salary and dividends that is right for you involves complex calculations. An assessment of several factors is required. Here are some examples:

- What are the corporation's cash flow needs?
- What do you need in retirement income? Canada Pension Plan benefits?
- The needs of any other shareholders
- Other sources of personal income

It's advisable for you to speak with your TD advisor and tax advisor to aim for the balance that meets your and your company's financial goals.

Deciding how to extract funds from your corporation and minimize your corporate and personal income tax bills is a complex task. You should consider speaking with legal, accounting and tax advisors to learn what strategies will be effective, and how you should put them into practice.

Private Corporations

Private corporations may allow you to income-split with your family. One strategy is to make your spouse/common-law partner and children shareholders of your corporation when you incorporate. If you sell your business and the shares are treated as qualified small business corporation (QSBC) shares, you and your family members may be able to benefit from the lifetime capital gains exemption (LCGE).

> **Private corporations** may allow you to income-split with your family.

Another form of income splitting is to pay salaries to family members. The income paid to your spouse/partner and adult children must be "reasonable". Any salary paid to them must be commensurate with the value of the labour they provide for the company.

Moreover, any adult children receiving income from the corporation must be active in one or more of the following ways:

- Labour contribution
- Capital or equity contributions to the business
- Taken/taking on financial risks of the business, such as co-signing a loan or other debt
- Past contributions in respect to previous labour, capital or risks

Consider

A self-employed person or corporate business owner may have complex issues that are difficult to contend with. This year, new tax rules for private corporations have resulted in new planning challenges. No matter what type of business you own, consider speaking with your tax advisor to aim at making your company operate tax-efficiently.

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