

# Tax Planning for Business Owners: 2017-18



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 are certainly 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 a period of 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 for 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 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 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.

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 specialist before being taken.

## 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 (CCPC) the rate is 10.5%, in 2017, on the first \$500,000 of active business income. (Finance has announced this tax rate will be reduced to 10% effective January 1, 2018 and 9% effective January 1, 2019). The small business rate begins to be phased out once the corporation's capital exceeds \$10 million. Meanwhile, many provinces have also have reduced rates for small businesses with potential tax rates generally ranging between 2% and 8%.

### *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 would 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**. 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 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. 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 specialist 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. You could then pay dividends that may be taxed at a lower rate than if you earned the income directly. This ability to pay dividends to family members is often referred to as "**income sprinkling**".

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

A Notice of Ways and Means was released by Finance on October 24, 2017, implementing reductions in the small business tax rate and the dividend gross-up rates for non-eligible dividends.

The small business tax rate stands at 10.5%. It will be reduced to 10% on January 1, 2018, and to 9% on January 1, 2019.

The gross-up for non-eligible dividends as well as corresponding dividend tax credit are to be reduced. Therefore you might consider paying dividends out in 2017.

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". It should be noted this type of income splitting is under scrutiny by the Department of Finance.

The Department of Finance intends to introduce reasonableness tests for adult children between 18 and 24 years of age, as well as those 25 and over. In short, any salary paid to them must be commensurate with the value of the labour they provide for the company.

Moreover, Finance has set out that 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

Draft legislation is expected in the coming months, with proposed rules to come into effect for 2018.

If you have: that have established a family trust that owns shares in a private corporation; who have a private corporation that pays dividends to family members; who are planning a reorganization of their corporation, and are considering an estate freeze.

These clients could consider:

1. Maximizing income splitting in 2017 such as paying reasonable dividends or salaries to your spouse/partner and children.
2. Using a prescribed rate loan where the circumstances are appropriate.
3. Proceeds of non-arm's length sales considered to be split income will be taxed as non-eligible dividends after 2017 (2018 onward).
4. Ensure work provided by family members is clearly documented.

These corporations are also being scrutinized for the amount of **passive income** kept within them, and can act as a tax deferral vehicle. For many private corporation owners, this can be an alternate way of saving for retirement. However, the Department of Finance states that wealthy individuals who can set up private corporations should not have unlimited tax assisted savings beyond the registered plan (e.g., Registered Retirement Savings Plan) limits available to everyone else. Therefore, the tax treatment rules for passive private corporation income are now under review.

In its initial July proposals, Finance referred to the "apportionment method" where varying tax rates would be applied to different types of passive income. For example, passive income earned as small business income, passive income earned as corporate-rate income, and passive income earned from assets contributed to the corporation by individual shareholders. The new measures are not supposed to apply to past investments and future income earned from them.

Finance announced in October that \$50,000 of passive income will be annually exempt.

These measures are to apply on a go-forward basis. Draft legislation with new tax rules for passive income may be included in the 2018 federal budget.

**The measures described above give rise to opportunities for income splitting and dividend tax planning before the end of 2017. Consider speaking with your tax advisor about tax planning strategies that are appropriate to you and your corporation.**

## Consider:

**Have you been claiming allowable business expenses on your tax return? Are you keeping proper records of your business expenses to back up your claims? Are you ensuring that your capital costs are being claimed for properly? Do you have a home office? Have you considered incorporating your business? Would incorporating provided added business and tax benefits? Have you reviewed how the recent private corporation tax proposals will affect your company? Speak to your TD advisor, legal and tax specialist when reviewing any of these strategies as part of your goal-based planning.**



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