Top 10 Tax Mistakes All (or most) Small Business Owners Make

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1. Poor recordkeeping

• Three aspects
  • No receipts
    • Or no explanation of context of receipts
  • No documents for key business items/relationships
    • ie. employment/independent contractor arrangements
    • issuance of shares
  • Ignoring distinction between business and personal transactions
2. Not incorporating

- Very favorable tax rates for small to mid-sized Canadian-controlled active business corporations
- In most cases it will be a “no brainer” to incorporate
- Exception – very early start-ups, where investors/owners want to deduct losses generated by the business
- Many advantages to incorporating in addition to the rate advantage
  - Creditor protection
  - Income splitting/capital gains exemption utilization/estate planning

3. Missing Deadlines

- Life is “easier” for taxpayers with a good compliance history with CRA
- Common problems:
  - Not registering for HST on time
  - Missing tax return filing deadlines
  - Late payment on year-end taxes and instalment payments
  - Late payment on payroll and HST remittances
  - Late filing of tax information slips (T4 slips for employees; T5 slips for dividends, etc.)
4. Missing (or incorrect) deductions/credits/incentives

- Missing Deductions
  - Capital cost allowance/amortization of purchased intangibles
- Incorrect Deductions
  - Meals & entertainment
  - Motor vehicle
  - Convention

4 (cont’d). Missing credits

You may be surprised to find that your business qualifies for available tax credits:
- Federal investment tax credit - applies to new buildings/equipment – in specific industries (manufacturing, etc.)
- Scientific Research Tax Credits (“SRED”)
- Apprenticeship job creation tax credit
- Provincial tax credits
4 (cont’d). Not taking advantage of available incentives

- Federal hiring credit for small business
- RRSPs as a source of investment capital
- Provincial equity tax credits for investors
- Federal grants/loans (ACOA, NRC IRAP)
- Provincial grants/loans

5. Losing the Small Business Deduction

- Low rate of tax applies to the first $500,000 of active business income
- The $500,000 limit is shared by “associated” companies
- Companies are “associated” if they have the same owners or related ownership groups
- Related companies can be structured not to be associated
- For example, a husband owns 100% of one company, and a wife owns 100% of a second company – both get the $500,000 deduction – if they each own 50% of each company – they have to share the $500,000 deduction between the companies
- Trap for discretionary family trust as shareholder – for purposes of the association rules, each beneficiary is deemed to own 100% of the shares of the company owned by the trust
- “Bonus down” each year to the $500,000 limit (or consider not bonusing, pay high rate tax but get a higher personal credit on “eligible dividends”)
6. Ignoring (or botching) income splitting opportunities

- Each family member is taxed at their own marginal rates
- Family members can acquire shares of the family company for a nominal price (at incorporation, or later, after the value of the company has been “frozen” into preferred shares)
- Allows dividends to be paid to each family member and taxed at their low rates – family members don’t have to work in the business
- Family members can own shares directly, or through a discretionary family trust
- Must be structured carefully to avoid “attribution rules” – CRA cares about the fine details

7. Not planning for the worst

- Directors of a corporation are personally liable to CRA for unremitted payroll source deductions (ie. tax, EI and CPP) and for unremitted GST
  - There is a due diligence defense
  - There is a two year limitation period after the director resigns
- The director’s liability can in some circumstances be traced to other family members who receive assets from the director at below fair value
- Tempting to let remittances slide when cash flow is tight – but the risk of personal liability is high – and CRA is aggressive in collecting
7 (cont’d). Not planning for ABILs

- An investor can deduct a loss on an investment, provided the investor can show an income earning purpose and a reasonable expectation of profit
- The loss will typically be capital – can only be applied to reduce capital gains
- But if the loss is an “Allowable Business Investment Loss” or “ABIL” then it is fully deductible against ordinary income
- To be an ABIL must be a loss on shares or debt of a private Canadian company that carried on an active business

8. Not planning for success

- On the sale of a company’s shares, or on the death of a shareholder, a capital gain is triggered
- If the shares are “Qualified Small Business Corporation” shares, then the gain qualifies for an $800,000 lifetime capital gains exemption
- Only applies on a sale of shares – an asset sale does not qualify
- Only applies to shareholders that are individuals – holding companies don’t qualify
- The company must have 90% or more active business assets
- Strict rules and limitations can deny the exemption if not planned for
9. Not planning for business succession

- Business owners need to plan their exit strategy, i.e., sale, transfer to the next generation of the family, etc.
- Early tax planning can minimize the tax cost of the exit:
  - Estate freeze – to defer or reduce tax
  - Family trust – to involve family members in ownership without losing control of the business
  - Voting control shares – to maintain control when ownership is transferred to the next generation
  - Shareholder agreements – to govern family ownership in the next generation

10. Believing tax myths / “urban legends”

- The chance of getting audited is very low
- I can deduct all of my car expenses, including travel from home to work (and I don't need a mileage log)
- I can move my investments “offshore” and avoid tax in Canada
- If I get audited, I can cut a deal with CRA and not have to pay all my taxes, interest and penalties
- I can buy and flip houses, and not pay taxes because of the principal residence exemption
- I can day trade in stocks, and only pay capital gain tax rates on any profits I make
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