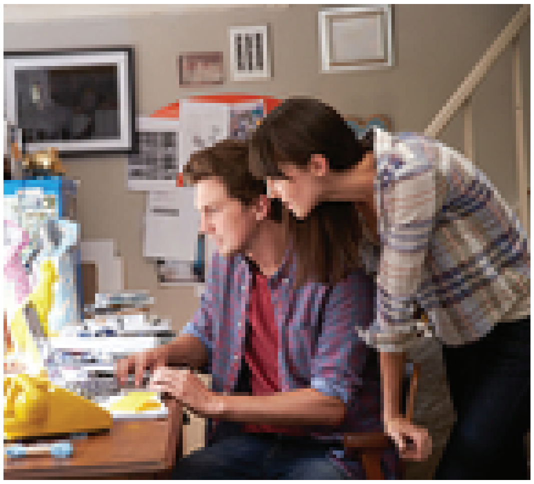
Tax Benefits For The Self Employed

There are many tax advantages for self-employed Canadians who work from home and hire family members in their business.

If you are self-employed, you may want to consider incorporating home and family into your business to create tax benefits for both the business and the family. Consider the following opportunities to reduce your taxable income and thus increase the amount of money left over to support your family.

Individuals in a 40% tax bracket save $40 on every $100 spent.



Hiring Family Members

If your business needs employees, why not hire your children or your spouse? Of course, the job must correspond to their abilities and the pay reasonable in terms of the going market rate for such skills. It is usually more beneficial for a sole proprietor to pay family members rather than a third party for the same work. Suppose, for example, you pay one of your children or your spouse $5,000 per year for performing a task and they have no other income. Because the $5,000 is less than their personal exemption ($11,327 for 2015) they will not have to pay any income tax on the earned amount. Further, the payment is deductible from your self-employed income. If, as sole proprietor, you are in a 40% tax bracket, the $5,000 paid to the family member effectively saves $2,000 on your self-employed income while providing $5,000 of tax-free income to the family member.

If, for example, you are paying $5,000 per year for your child's tuition and the child was not paid from your business, you are effectively paying in after-tax dollars. That means you will have to earn $8,350 (40% of $8,350 = $3,340) in order to clear the $5,000 ($8,350 - $3,340 = $5,010) needed to pay for your child's education.

Home Office

You are allowed to deduct at-home expenses if you meet one of the following conditions:

1. You do more than 50% of your work at home.
2. The work space is used only to earn income and for meeting customers or clients. You cannot deduct at-home expenses if you are just using your kitchen table to do the work.

Home Maintenance Expenses

You can write off a portion of your home maintenance expenses such as heating, home insurance, electricity and cleaning supplies. A percentage of property taxes and mortgage interest can also be deducted.

Capital Cost Allowance (Tax term for depreciation)

CRA also allows the deduction of a percentage of the capital cost allowance on the cost of the house or outbuildings. However, since there are tax consequences after the principal residence is sold, discuss this option with us before claiming this expense.

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You are also allowed to write-off the cost of other capital items bought to use in the business, eg desk, computer, etc. There are specific rules which tell you the maximum amount you may deduct each year.

Allowable Write-Off for "Business Use of Home Expenses"

The method of determining the percentage of allowable write-off must be determined on the basis of the space used by each particular business. Some sole proprietorships may only need a 10 x 10 office to conduct their business; others may need a larger office or perhaps even outbuildings for additional office space or storage. The most common calculation method, however, is to take the square footage of used space as a percentage of the total usable space.

Losses

If, for instance, profit before the application of home expenses was $7,000 and the at-home expenses were $8,000, you cannot claim a $1,000 loss. Your taxable income from the business will be nil but the $1,000 that was not applied can be carried forward to the following taxation year and applied against that year's income. If your business has a loss of $8,000, you cannot increase the loss by the application of at-home expenses. These losses would be carried forward from year to year as well.

To claim business expenses, retain all receipts.

Business Expenses

The expenses listed below are normally common to all businesses. In order to claim any of these, however, make sure they are incurred to earn income, are "reasonable in the circumstances" and that all receipts are retained:

- accounting and legal fees
- advertising expenses
- business taxes, fees, licences and dues
- insurance expenses
- interest and bank charges
- maintenance and repairs
- meals and entertainment
- office expenses
- salaries, including employer's contributions
- motor vehicle expenses

There may be limitations to deductibility within each category. Seek our advice before making any claims, and be sure to give us the gross amounts. For examples, meals are only 50% deductible. If you take 50%, and then we take another 50% - then you didn't get the full deduction you were entitled to.

Credit Cards

Interest on credit card balances incurred for business expenses is deductible. But, if business purchases are made with a personal credit card, the CRA will most likely disallow the interest expense because the interest applicable to outstanding business balances cannot be separated from the interest charged on personal balances.

Business Bank Accounts and Business Loans

Business bank accounts allow bank charges to be easily identified as business expenses; deposits and withdrawals can be more readily traced back to suppliers, customers or owner's withdrawals or contributions. Separating business accounts from personal accounts minimizes the confusion when processing year-end tax information or when preparing for a CRA audit.

Loan Interest

Loan interest for vehicles and equipment is also a deductible expense. Make sure the transaction is transparent so you can establish that the principal went into a business bank account. If the loan is from relatives, make sure proper documentation establishes the date of the loan, the interest rate and the repayment terms.

Mortgages

Should you need to increase your mortgage to provide operational funds for the business, separate clearly in your records the mortgage for the principal residence from the funds for your business. The date the additional funds are deposited into the business account establishes the break. We can then calculate separately the loan interest attributable to the business and that attributable to your personal residence.

Salary or Dividends ?

The way a bonus is paid has a significant effect on corporate and personal after-tax income.

You are an owner-manager and you've just had a really good year. Profits are up significantly and you want to reward your employee shareholders with a bonus. But how? Salary or dividends? The answer to this age-old question is not as simple as it seems. It is even possible to receive remuneration that is a combination of salary and dividends. However, because every company and its shareholders have different needs, a "one size fits all" approach to remuneration is not prudent.

Salary and dividends differ with respect to taxation. A dividend is a per-share payout of retained earnings and is therefore not an expense and thus does not reduce pre-tax income. A salary bonus differs from a dividend in that it is an expense and thus reduces pre-tax income. Corporations, trusts, charities and a wide variety of other entities can also receive dividends.

Different Tax Effects

Distributing a salary bonus effectively reduces pre-tax income by the amount paid. Thus, if a company pays out 100% of pre-tax earnings in the form of a salary bonus, the corporation may not be subject to income tax expense. On the other hand, if a company wishes to distribute the same dollar amount of earnings by declaring a dividend, the company must first pay corporate income tax. Assuming after-tax earnings of $100,000 and a tax rate of 15.5%, the cash outlay would be $118,343 (i.e., the distribution of the $100,000 of earnings in the form of a dividend bonus plus the $18,343 in income tax on those earnings in order to net $100,000 for the dividend payment).

Dividends are often cited as the best means of providing remuneration to the owner-manager since they do not attract as much personal income tax as salary. For example, a salary of $100,000 for a single individual would create a combined federal and provincial tax of $26,466 (Ontario), whereas an eligible dividend of $100,000 from an owner-managed business would generate a personal tax of $9,802; personal tax from an other than eligible dividend would be $16,693.

At first blush, an owner may be tempted to simply pay out all profits by dividend because of the significant personal tax savings. However, since dividends are paid from after-tax earnings, the combined tax in the case of an eligible dividend would amount to $28,145 ($18,343 + $9,802) and in the case of an other than eligible dividend the combined tax would be $35,036 ($18,343 + $16,693). Certainly there are other factors that come into play both on a corporate and personal level, but the example establishes that one should carefully consider the approach to be taken.

Additional Considerations

There are additional considerations that must be factored into the decision as to whether to pay dividends or salary.

• Because dividends are not earned income, they cannot be used to create any RRSP contribution room.

• Because dividends are not earned income, they do not create any requirement for a contribution to the Canada Pension Plan by either the owner-manager or the employee.

• Financial institutions often lend on the basis of earned income believing that salary is the only way to judge an individual's ability to pay. Attitudes in this area are certainly changing, but income based on corporate dividends may impact your ability to obtain personal mortgages or lines of credit.

• If the employee is unable to work because of an accident or some other event, a wage replacement amount may be difficult to calculate because dividends are not earned income.

• Income splitting that is possible by paying salary to family members employed in the business will be hampered if the family members are not shareholders since dividends are paid to shareholders on a pro rata basis.

• Insurance companies may not be willing to support benefit or disability programs if dividends paid to an organization's owner cannot be included in their definition of earned income.

• Receipt of dividends instead of salary may nullify other personal income tax deductions such as child care expense.

• Various provincial bodies may include dividends when calculating the employer's Workplace Safety and Insurance Board (WSIB) or Employer Health Tax liability.

An employee can receive three types of dividends.

Three Types of Dividends

A business must be aware that there are three types of dividends an employee can receive from your corporation:

1. **"eligible" dividend:** (i.e., subject to a dividend gross-up of 38% and a federal dividend tax credit equal to 20.73% of the cash dividend) — as noted above, eligible dividends provide a more beneficial tax rate

2. **regular dividend:** (or an other than eligible dividend) subject to an 18% dividend gross-up and a federal dividend tax credit equal to 13% of the cash dividend — provinces may have their own dividend tax credit rates (Check the rate in your province.)

3. **capital dividend:** (capital dividends are received tax free) — this dividend is paid from the company's capital dividend account, which includes the non-taxable portion of capital gains, life insurance proceeds, and capital dividends received from other corporations

Other Concerns

Eligible dividends cannot exceed the balance in the General Rate Income Pool (GRIP). Excess payments from the GRIP can result in penalties.

Talk to US First

Given the complexity of the decision as to whether salary, dividends or a mix of both is the best way to proceed, astute owners should meet with Allan or Marcia to discuss corporate and personal needs before a decision is made. We understand the share structure of your company, the company's viability, and the overall remuneration needs of the shareholders. This insight, plus knowledge of the tax regulations and the tax software that can be used to simulate various scenarios, enables us to assist you in making the right decisions as to the appropriate mix of salary or dividends.

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Metamorphosis

"A change would do you good." — Sheryl Crow

The software industry is in the midst of a revolutionary change. Change is sometimes considered a constant in the world of IT; however, the model of the industry itself has only shifted a few times and each shift has changed the way people work with technology.

Early programmable computers were huge and expensive – what we may now think of as mainframes. By modern standards, these early machines were difficult to use and their resources were not easily shared by large numbers of people. The next major era in computing was the transition to stand-alone, personal computers (PCs); everyone could have one on their desk for productivity-boosting applications such as word processing and spreadsheets. The ability to network PCs together led to the client-server era; computing work was split between the PC as client and centralized servers. Email, the "killer app" of the networked PC, revolutionized the way people communicate at the office.

The Cloud

The next step, Cloud computing, is not substantially different from the client-server model we've come to know, save for a key detail: ownership. Infrastructure, platforms, and applications are changing from something that was once purchased and installed to a service, with a monthly or annual fee instead. In the Cloud-based model, computing is a utility, much like hydro, water or the Internet.

Pros and Cons

Pros:

Based on your business needs, the Cloud model may have some compelling advantages:

• increased productivity: simplified processes and easy sharing of information

• lower capital costs: infrastructure, hardware, and software costs are all shifted to the cloud provider(s)

• reduced overhead: easy information sharing and "accessible anywhere" architecture means your workforce could log on from Trois-Rivières or Tahiti just as easily as they could from their desk in Toronto

• expanded hiring pool: knowledgeable people are all over the globe; Cloud-based technology provides the opportunity to tap into this expertise without the costs associated with relocating workers and family members to a central location

• improved knowledge sharing: even if your staff are all located within the same office, they may benefit from the quick accessibility of Cloud-based software that's always up to date

• more time: day-to-day minutiae such as running the servers and backing up data are handled by someone else as part of the package.

Cons:

The Cloud is not a magic bullet and has some potential

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disadvantages to consider:

• geographical implications: servers are physically located elsewhere; your data may be subject to the laws of the country in which it is stored, and this may not be the same country in which you or your business operate

• loss of control: a vendor manages the system, its functionality, and your data

• potential security risk: online applications, regardless of whether hosted under your desk or in a data centre by a Cloud provider, are always "on" and theoretically could be hacked.

Things to Consider

Financial Information Management

Cloud-based accounting services allow multiple users to enter financial data such as expenses, sales and deposits, anytime, from anywhere, and from almost any device. From a management point of view, it is important to ensure that every transaction can be traced to the individual who made the entry. Without this safeguard, accountability could go out the window.

The ability to connect your financial platform to your bank removes barriers; the ability to create invoices from literally anywhere, and enable customers to pay them seamlessly and instantly simplifies billing. Easy collaboration is another big advantage that allows your accountant or bookkeeper access to your books remotely.

Get to know conventional records management practices.

Record Retention

Modern financial systems may allow or even encourage storing digital versions of documents. Businesses must be sure they are following CRA and other regulatory authorities' retention policies. Get to know conventional records management practices so you will understand which documents must be kept in original paper format, for example, or the length of time digital and/or physical records must be retained. Redundancy is also essential. Most Cloud-based servers back up the data to other sites. If you need to keep an in-house backup copy of your data, make sure your Cloud provider has this ability.

Integrity of Data

Consider what happens if you decide to change your Cloud-based service:
• Will you be able to transfer the data from one provider to another?
• Do you retain ownership of your data?
• In what country is the data stored?
• Can I make backup copies on my own server?
• Can I recover my files if I decide to terminate the servic and what is the cost?

Hiring, Communication and Collaboration

Communication and collaboration can be difficult in any company. In a digital world without physical boundaries, whether you are working together in the office or with your team at a distance, modern collaboration tools offer more features than mere meeting facilitation through screen, document, and digital whiteboard sharing, and more than simple chat, such as web, telephone, and video conferencing. There are even some collaboration tools that encompass all of these features, and more!

Understand and Adapt

The availability of Cloud-based applications and platforms will require owner-managers to adapt their businesses to embrace the virtual world. As with many other technological advances, however, the previous foundational technology never went away. We're seeing the beginning of a trend: client-server-based computing is giving way to a Cloud-based model. Stand-alone and client-server applications will continue to become more and more specialized, serving niche markets, as Cloud-based computing

Let's Incorporate

The incorporation process is relatively simple whether you incorporate provincially or federally.

As a sole proprietor, you may be looking back at last year's results and ahead to the time you have to pay your taxes, and wondering whether you might not be better off incorporating to control the income tax expense on earned income. In Canada, a company may be incorporated provincially or federally. Federal incorporation has some advantages:

• You can carry on business in any provincial jurisdiction using the federally approved name.

• The head office can be in any province.

• Books and records can be maintained in any province.

• Annual meetings can be held in any province or territory.

• If you are incorporated provincially and wish, for example, to move your business from Alberta to Manitoba, it would be necessary to dissolve the Alberta corporation and reregister in Manitoba or apply for a discontinuance in Alberta and apply for a continuance in Manitoba. If your business is incorporated federally, you need only file Articles of Amendment indicating the head office is moving and register an extra-provincial corporation in its new home province.

Whether you are thinking of incorporating provincially or federally, the following are a few areas to consider:

Naming the Company

The corporation can have a name company or a number. If you incorporate using a number, you may also use a name (i.e., 1234567 Ontario Ltd. could also register itself as "Able's Horse Stable".) This name becomes "attached" to the registered number.

When conducting business using the trade name, you must still identify the company by its registered name. For instance, sales invoices could show "Able's Horse Stable" but should indicate that the actual incorporation name is 1234567 Ontario Ltd.

The name chosen cannot be either identical or deceptively similar to existing registrants in the province. The name or number must be identified as a corporation by using the French or English forms of "limited" or "incorporated".

Location

The head office of a provincially incorporated company must be located in the province of incorporation. The head office is usually at the same location as the operations but, if there is more than one operating location, a choice can be made.

Ownership and control are determined by the number of shares held.

Ownership

Shares must be issued in order for the company to be owned. The owners must decide among themselves the minimum number of shares that will be owned by each shareholder. The shares provide the owners with voting rights. Whether the corporation issues 10,000 or only 50 common shares with voting rights, the degree of ownership and control are determined by the proportion held by each individual. The value of each share is decided at the time of issue. If share value was set at $10 per share, then the holder of, say, 5,000 shares would have to remit $50,000 to the corporation to purchase ownership.

Private corporations may not have more than 50 shareholders. The residential addresses of all shareholder(s) must be provided for notification purposes.

Directors

All corporations must appoint at least one Canadian resident as a director. If four or more directors are appointed, 25% must be Canadian residents. The residential address of the directors must be provided along with the residency status.

Officers

In owner-managed businesses, it is not unusual for the shareholder(s), director(s) and officer(s) to be one and the same. It is not a requirement for officers to own shares or be directors of the corporation. However, in that officers manage the operations of the company, they are held to a high standard of stewardship and thus the appointments should not be taken lightly. The residential addresses of the officers must be provided.

Year-End Date

You will have to determine a fiscal year-end date for the corporation. Depending upon the date of incorporation and the business cycle, you may choose a year end other than the calendar year end. It is advisable to speak to us about the best month end for your type of business and to maximize tax-deferral possibilities.

Auditor or Accountant?

Provincial acts of incorporation may require audits of financial statements. This requirement can be waived for non-publicly traded companies as long as all of the shareholders agree to waive the audit provision. Consent to waive an audit is required each year. Most business owners, their banks and creditors do not require audited financial statements; waiving audit provisions in favour of reports provided by a CPA/ CA is an acceptable alternative.

Even though the appointment of an auditor may not be required, it is wise to consider appointing a CPA/ CA as part of the incorporation process to assist in setting up the required books and records, tax accounts, business number, WSIB, employee payroll remittance accounts, HST accounts and all the other regulatory registrations that may be specific to your business.

Seek Professional Advice

Incorporation requirements vary from province to province. The guidelines above are provided as general consideration as to what is normally required. Entrepreneurs considering incorporation should seek professional assistance in their jurisdiction to ensure the appropriate steps and documentation meet the requirements under their provincial incorporation act

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