Owning and Managing a Small Business

IN FOCUS: TAX STRATEGIES

More Canadians own businesses today. As of December 2017, there were over 1.18 employer businesses, and 97.9% of these were small businesses. In fact, 95,000 new small to medium-sized enterprises were created every year between 2010 and 2015, but the bad news is that the average number of businesses that disappeared each year was high – 85,000. That means that only 10.5% successfully launched.[1]

It is important to receive financial advice before you start a small business to determine how the investment of time and effort in building a business will be funded and what the tax consequence will be when financial transactions occur.

From business structure to the acquisition of assets and the income and operating expenses the new venture will start to experience, there is likely a tax consequence for every financial step.

Learn more

Owning and Managing a Small Business - Tax Filing Rules

For Sole Proprietors

Sole proprietors do not have to file a separate tax return for the business, as incorporated owner-managers do. Instead, any business profit or losses must be included when you file your T1 general tax return. However, you need to be aware of the following:

Proprietorships: Filing Deadline and Balance Due Date

As a business owner, you have until June 15 of the following year to file your tax return – however, as with any other individual taxpayer, your Balance Due Date remains April 30. Any taxes owing must be paid by that date, or you will be subject to interest charges on the outstanding balance.

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[1] Key Small Business Statistics, January 2019, Innovation, Science and Economic Development Canada, Small Business Research Brach, Research and Analysis Directorate, wwww.ic.gc.ca/sbstatistics

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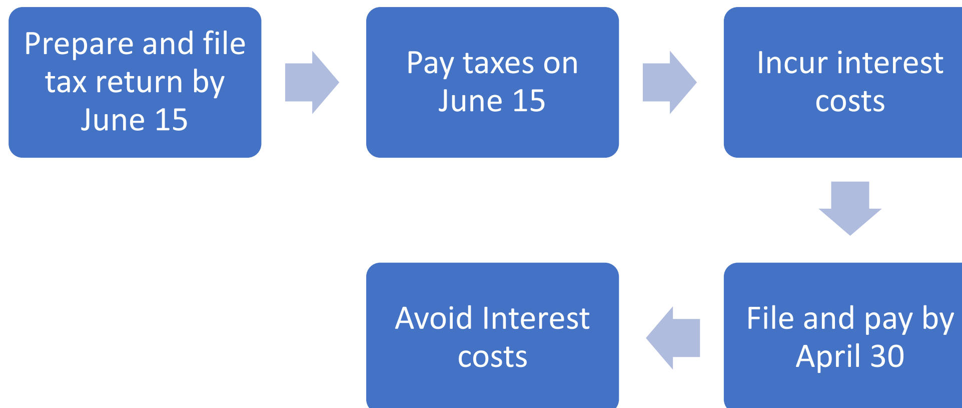

Tax Payment by Instalments

Another way to avoid interest costs on tax payment deficiencies at tax-filing time is to make quarterly tax instalment payments.

CRA requires that you pay tax by instalments on a quarterly basis – by March 15, June 15, September 15 and December 15 - if the amount you owe in tax in the current year or either of the previous two years exceeds $3,000.

Farmers and fishers can make one annual instalment on December 31.

The actual amount of income tax you pay for the year may end up being more or less than what you reported quarterly, but you will reconcile any discrepancies when you file your annual tax return.

Tax Tip: Ask your advisor to review your projected net business income as part of your year-end tax planning activities. An RRSP contribution may serve to reduce income enough to avoid the $3,000 payment threshold, resulting in more cash flow for spending or investing all year long next year.

For Partnerships

As an unincorporated partner, you are required to report your income (or loss) from the partnership on an annual basis. Partnership income or loss is determined at the partnership level; you then report your proportional share individually.

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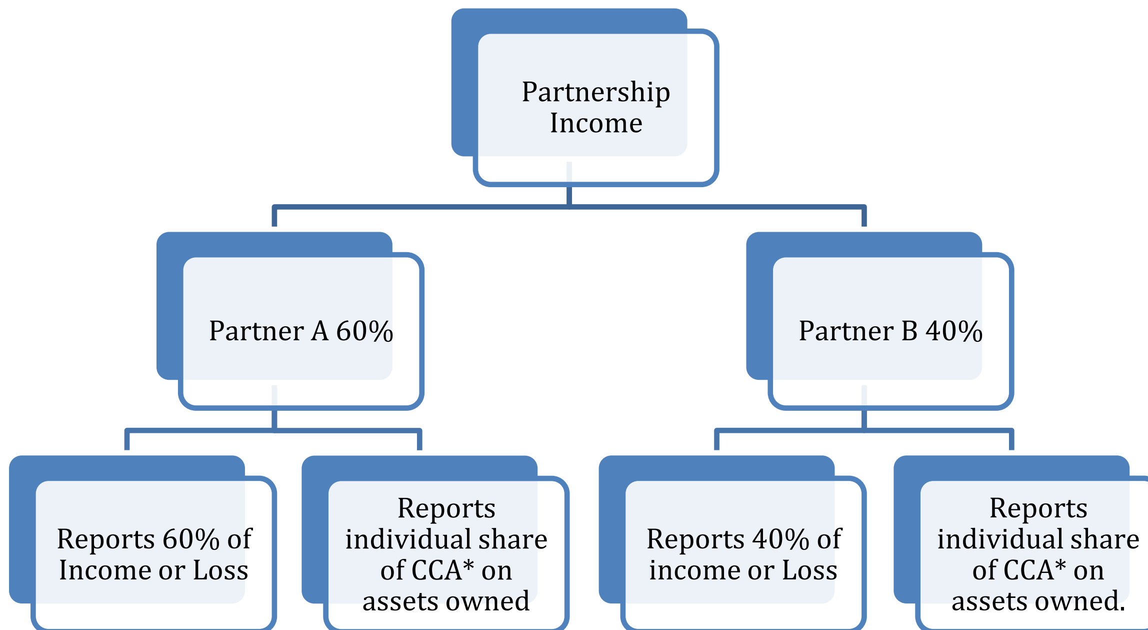

*CCA = Capital Cost Allowance on assets individually owned and used in the business.

Tax Filing Requirements.

The Canada Revenue Agency (CRA) requires that each partner file a copy of the annual statement of partnership income and expenses and include their share of the net partnership income on their annual tax return. Generally, the partnership does not have to file a tax return, but larger Partnerships may have to file Form T5013 *Statement of Partnership Income*. The tax filing due date to avoid late filing charges is the same as for proprietorships: June 15.

> **Tax tip:** File by April 30 to avoid interest charges on taxes due, unless you have prepaid enough taxes by instalment.

Like proprietors, partners have to pay tax by quarterly instalments if more than $3,000 is owed in taxes in both the current year and one of the previous two years. Any shortfall or overpayment will be recognized on your annual return.

Deductions at the Partnership Level

Some tax facts to discuss with your financial advisors:

- *Partners cannot be employees of a Partnership and, therefore, cannot be paid a 'salary.'*
- *Money paid to a Partner is viewed as a distribution of income and, as such, is not subject to source deductions like EI and CPP.*
- *Capital Cost Allowance (CCA) on depreciable assets owned by the partnership is taken at the Partnership level. For assets owned by individual partners and used in the partnership business, CCA is taken on the tax returns of the individual partners.*
- *Charitable donations and other payments eligible for tax credits are not taken at the Partnership level but are allocated to the individual Partners to be claimed on their own tax returns.*

Some tax facts to discuss with your financial advisors:

- Partners cannot be employees of a Partnership and, therefore, cannot be paid a 'salary.'
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- Charitable donations and other payments eligible for tax credits are not taken at the Partnership level but are allocated to the individual Partners to be claimed on their own tax returns.

For Incorporated Businesses

Legally, a corporation has a separate identity from the owners (shareholders) and, as such, is taxed separately as well. This has implications, many favourable, for the owners. As a separate entity, the corporation is required to file its own tax return (T2) and is required to pay tax on income earned. For the owners of private corporations, there are two main advantages:

The Small Business Deduction (SBD)

Ordinarily, corporate income is taxed federally at 38%. This will be reduced by 10% to reflect the tax applied by the provinces and territories. However, companies that qualify as Canadian Controlled Private Corporations (CCPCs) are allowed a further 19% tax reduction on 'Active Business Income' of up to $500,000 per year.

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This reduces the federal tax rate to 9%. Once the provincial/territorial taxes have been included, the corporate tax rate for CCPCs is in the 9 to 14% range. This is one of the most attractive tax features of owning and managing a private Corporation.

Note: April 19, 2021 Budget Proposal:

The Budget proposed a temporary reduction in the small business corporate tax rate for zero emission technology manufacturers, essentially cutting it in half for the next 8 years followed by an increase until the rates are returned to their current levels. This will obviously increase the amount of after-tax cash retained in small CCPCs allowing for entrepreneurs to reinvest those funds. The budget, however, did not propose changes to the dividend tax credit rates or the allocation of corporation income citing the targeted application and temporary nature of these changes. As such there should be an over-credit, at the personal tax level, with respect to (at least) non-eligible dividends. Integration, rarely works perfectly and for the next 10 years clearly is not a concern for this government. The decrease in rates will clearly lead to a decrease in government revenues.

- For CCPCs that have active business income that is subject both to the small business rate AND the general corporate tax rate, they will be able to choose to have their eligible income taxed at either a reduced rate of 4.5% for small business of a reduced general rate of 7.5%. The amount of income taxed at the 4.5% rate plus the amount of income taxed at the small business rate of 9% would not be allowed to exceed the business limit.
- Reduced rates would apply to taxation years that begin after 2021.
- The reduced rates would be phased out starting in taxation years that begin in 2029 and would be fully phased out for taxation year that begin after 2031.

Excerpted from Knowledge Bureau Report.

Understanding definitions. As noted, the SBD applies strictly to the 'Active Business Income' of a CCPC. The definitions for these terms are quite specific, but in general, are defined as follows:

- Canadian Controlled Private Corporation (CCPC)

  A CCPC is a Corporation that is not controlled, directly or non-directly, by a non-resident or a public Corporation or any combination of the two. As well, no class of shares of the Corporation can be listed on a stock exchange.

- Active Business Income

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Generally, Active Business Income (ABI) is the income earned from the regular activities of a company and does not include investment income, income from a holding company or income from a Specified Investment Business (one that derives its income from property – interest, dividends, rents and royalties)

Discuss with your advisors whether your corporation is eligible for the SBD.
Other questions:

Do you have an investment strategy for the money accumulating in your corporation?
Do you have a timing strategy for the removal of funds in the corporation to be taxed personally?

- *Have you set up your affairs to avoid Tax on Split Income when family members work in your corporation?*

Passive Investment Income Retained in a Corporation. Note that recent tax changes reduce the $500,000 small business limit for small businesses that earn more than $50,000 of investment income in a year. Be sure to discuss whether your portfolio should be focused on accumulating value rather than producing income for a better after-tax result.

Capital Gains Exemption (CGE)

This is the other attractive tax advantage that can be derived from owning/managing a private corporation: the Capital Gains Exemption. Upon the disposition (deemed or actual sale) of shares of Qualified Small Business Corporations, the tax on up to $883,384 of capital gains (the 2020 indexed figure) can be offset or eliminated. This figure is $913,630 in 2022.

The CGE can, therefore, play a significant role in retirement and estate planning.

Ask your financial advisors to provide you with more information about this provision and how to meet the eligibility requirements in your share structure for each of your family members to qualify for the CGE.

It is also possible to use a trust to multiply the CGE. Flowing inter-corporate dividends from an operating company (opco) through a trust to a holding company (holdco) may also provide a good way to purify the opco for the purposes of claiming the CGE and creditor-proof it. If properly structured, the inter-corporate dividend will not attract tax in the holdco. Future dividends distributed to individual shareholders, however, will. Ask your financial advisors to show you how this may benefit your family.

Source Deductions: Paying the Canada Pension Plan (CPP)

It is a requirement for employers to take certain statutory deductions from employees' gross pay and remit them to the Canada Revenue Agency. This includes income taxes, Employment Insurance (employers contribute 1.4% of required contributions) and the CPP, which has recently been the subject of a number of changes.

Employers and employees share the cost of CPP premiums equally. However, unincorporated business owners must pay both portions of the CPP at tax-filing time. This often results in an unexpected balance due, which can be over $5000 annually and rising. This is because, starting in 2019, annual CPP contribution rates started to rise over a seven-year period, which at approximately $55,000 of net income is estimated to be approximately $40 a month more than current rates.

The following table shows the projected premiums to the year 2025, adjusted for known pensionable earnings and indexing at 2.0% thereafter.

PROJECTED AMOUNTS:

Year	Regular CPP Rate	Max. Pens. Earn.	Max. Reg. Premiums	Additional Pens. Earn.	Max. Pens. Earn.	Add. Rate	Add. Prem.	Total Prem.	Max. SE Prem.
2018	4.95%	$55,900	$2,593.80		$55,900	0%		$2,593.80	$5,187.60
2019	5.10%	$57,400	$2,748.90		$57,400	0%		$2,748.90	$5,497.80
2020	5.25%	$58,700	$2,898.00		$58,700	0%		$2,898.00	$5,796.00
2021	5.45%	$61,600	$3,166.45		$61,600	0%		$3,166.45	$6,332.90
2022	5.70%	$62,800	$3,380.10		$62,800	0%		$3,380.10	$6,760.20
2023	5.95%	$64,100	$3,605.70		$64,100	0%		$3,605.70	$7,211.40
2024	5.95%	$65,400	$3,683.05	$4,800	$70,200	4.00%	$192.00	$3,875.05	$7,750.10
2025	5.95%	$66,700	$3,760.40	$10,200	$66,700	4.00%	$408.00	$4,168.40	$8,336.80

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Tax tip: Unincorporated business owners with net income levels over $60,000 will need to plan to tuck away money for the CPP, payable with the T1 return. The amounts due will over $6700 in 2022, just over $560 a month. This is expected to rise to almost $700 a month by 2025. (Just over 13% of net earnings).

Understanding CPP Benefits Payable

To help make the decision about whether to fund the CPP, it is helpful to know what the benefits payable will be in the future. The current rates are shown in the chart below.

However, consult the Retirement 101 White Paper for more information about planning retirement income with the CPP.

Canada Pension Plan Benefit Rates

Circumstances	2019	2020	2021	2022
Maximum monthly Retirement Pension (at age 65)	$1,154.58	$1,175.83	$1,203.75	$1,253.59
Maximum Post-Retirement Benefit	$28.86	$29.40	$30.09	$36.26
Maximum monthly Disability Pension	$1,362.30	$1,387.66	$1,413.66	$1,464.83
Monthly Disabled Contributor Child Benefit	$250.27	$255.03	$257.58	$264.53
Monthly Survivor's Pension under age 65	$626.63	$638.28	$650.72	$674.79
Monthly Survivor's Pension over age 65	$692.75	$705.50	$722.25	$752.15
Monthly Orphan's Benefit	$250.27	$255.03	$257.58	$264.53
Monthly Combined Retirement (age 65) & Survivor	$1,154.78	$1,175.83	$1,203.75	$1,257.13
Monthly Combined disability & Survivor	$1,362.30	$1,387.66	$1,413.66	$1,467.04
Maximum Death Benefit	$2,500.00	$2,500.00	$2,500.00	$2,500.00

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Tax Strategies to Consider:

- **Earn Dividends and invest in a TFSA instead of CPP**. As of January 1, 2019, the CPP death benefit is $2,500 regardless of CPP pension entitlement. But a major drawback is that the death benefit is not indexed to inflation. Taxpayers who forgo CPP contributions in favour of TFSA contributions that are made with tax-paid dividends will be able to pass all the TFSA accumulations to the spouse or heirs. That makes the TFSA a better alternative for estate planning.
- **Earn Salary to help preserve the Small Business Deduction** – Corporations eligible for the Small Business Deduction will generally want to keep taxable income below $500,000. Paying a salary or bonus results in a direct deduction from income and may serve to reduce income below the Small Business Deduction maximum.

This cannot be accomplished by making a dividend payment, which is a distribution of after-tax income and will not reduce corporate income.

- *Depending on the tax bracket, dividend income can be taxed at much lower tax rates than employment income on your personal tax return. Ask your financial advisors to work out how much tax will be payable on salary vs dividend income at various tax brackets.*

- **Paying Bonuses** – Receiving a bonus as employment compensation has the advantage of flexibility, so the amount can be varied to meet your needs. As well, tax law allows for the **deduction of a bonus in the year of declaration,** but the recipient will not be taxed until the money is received - provided it is not paid later than 180 days after the end of the year in which the bonus was declared.

Paying Taxable and Non-Taxable Benefits

The structure of a corporation as a separate legal entity from its shareholders provides opportunities for the owner/manager to receive certain benefits in a tax-efficient manner.

However, it is important to appreciate that the *Income Tax Act* provides many rules and regulations to ensure that the owner/Corporation does not abuse the ability to use the Corporation to receive "undue advantage," The following are some rules to observe:

Compensation and Benefits

One of the initial and ongoing issues in managing a business is how to get paid.

Sole Proprietorship

With a Sole Proprietorship, legally, the owner is indistinguishable from the business, and you have little choice on how to receive compensation. While you do submit a statement of

business income, it is net income or loss is reported on your personal tax return. This is the figure that Canada Pension Plan contributions are also computed on.

One of the advantages of this structure is that you can deduct business losses directly against other personal income to the extent of reducing these other sources of income to zero. **You can carry additional losses back three years and forward for 20 years.**

Partnership Income/Loss

A Partnership is not a separate legal entity like a corporation and does not file a tax return or pay tax itself. However, the overall income or loss is determined at the Partnership level, and then each Partner is apportioned his or her appropriate share, which is then reported by the Partner for tax purposes.

Deductions at the Partnership Level

Most business expenses are treated the same as other businesses, but there are some particular considerations:

- Partners cannot be employees of a Partnership and, as such, cannot be paid a 'salary.'
- Money paid to a Partner is deductible by the Partnership but is viewed as a distribution of income and, as such, is not subject to EI, CPP, etc.
- Capital Cost Allowance (CCA) on depreciable assets is taken at the Partnership level.
- Charitable donations are not taken at the Partnership level but by the Partners themselves.

Compensation – Corporate Structures

The corporate structure allows some latitude on how compensation is paid to an owner/manager. Since a corporation is a legal entity separate and apart from the owners (shareholders), those shareholders can be employed by the Corporation and paid a salary and/or taxable and tax-free benefits.

Alternatively, as an owner/manager, you can choose to receive your compensation in the form of corporate dividends paid on your shares in the Corporation.

The major difference in these two approaches is that salary or **employment income** is viewed as a deduction from corporate income **prior to tax**, whereas a **dividend** is paid from corporate **after-tax** income.

Tax Integration. When a shareholder reports dividend income, it is money that has already been taxed at the corporate level. The *Income Tax Act* provides measures that act to offset this double taxation effect, which is called tax integration.

However, due to tax differences in different provincial/territorial jurisdictions, tax integration does not work perfectly, and there can be some tax advantage in choosing one approach over the other.

Your financial advisors can provide you with additional information on the implications of personal/corporate tax integration and show you how to manage your taxable income with the right salary/dividend mix.

Tax and Investment Strategies. There are several additional considerations when choosing your method of compensation. It is important to understand the implications of earning salary, bonus and dividends and the advantages and disadvantages or each:

Tax Strategies:

1. **Earning Salary or Bonus**. Earning a salary or bonus will result in the receipt of a T4 slip. This is active income that qualifies for the purposes of making CPP and RRSP contributions. However, the employer (the corporation) must also deduct and remit withholdings for CPP, EI and Income Tax. Some planning considerations:
   - **Earned Income for RRSP contributions** –Dividends received from a corporation are not considered 'earned income' for RRSP purposes, whereas employment income is. If you want to create RRSP contribution room, at least some of your compensation should be in the form of a salary. RRSP contribution room is determined by earned income in the previous year.
   - **Contributory Earnings for CPP purposes**. Employment income is also used to calculate CPP Contributions. The contributions payable are rising over the next several years.

Some shareholders may wish to forego earning a salary and earn dividends instead to avoid making CPP contributions. Consider whether you wish to give up the survivor, disability, orphan and retirement benefits available down the line. See the table below for maximum benefits at the time of writing. Ask your financial advisor to help you with this decision-making.

Benefits - Proprietorships

Benefits are generally defined as benefits received as an employee in lieu of or in addition to the ordinary salary or wage.

As a Sole Proprietor, you cannot employ yourself, so access to employment benefits are, for the most part, not possible. However, Private Health Service Plans (PHSPs) may be

established to provide supplementary health care for the owner and his or her family, and employees in many cases. Ask your advisor about this.

Benefits - For Partnership

In a Partnership, income (or loss) is determined at the Partnership level and is then apportioned pro-rata as per the Partnership agreement subject to tax law. Partnership income is fully taxable. Consequently, there is not much latitude in realizing and reporting Partnership income, although certain measures can be taken at the Partnership level to adjust income, but the resulting amount must still be distributed pro rata to the Partners.

Since a Partner cannot be an employee of the Partnership, there are few benefits available.

Use of an Automobile

Where, as a Partner, you are provided with the use of an automobile by the Partnership, you must, like any other employee, include what is known as "standby charges" when calculating your income for taxation purposes.

Standby charges reflect the fact that you are receiving a benefit from the use of the automobile. If you are using your own automobile for Partnership business, you can deduct reasonable expenses as allowed under the Income Tax Act.

Retirement Benefit Plans

A Partnership may establish registered plans such as Pension Plans, Deferred Profit Sharing Plans (DPSPs), Group RRSPs, and Profit-Sharing Plans for employees. However, since Partners cannot be employees, they themselves cannot participate in these programs.

As partners can establish their own individual RRSPs as part of a comprehensive retirement plan, ask your financial advisor for help in computing contribution levels and investing in an RRSP.

For Incorporated Companies

One of the initial and ongoing issues in managing a business is how compensation will be paid and what benefits are available to the owner.

Taxable Benefits Received as an Employee

Although this is not an exhaustive list, here are some of the benefits received from a Corporation that must be included in income by the employee/shareholder:

Ask your financial advisors to help you develop a tax-efficient compensation plan that maximizes the opportunities for personal/corporate tax integration

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Home Workspace

There are many tax issues you may need to consider as a sole proprietor or unincorporated business owner. One of the first – and most common - is the establishment of a home office workspace. This is a great way to write off some of the costs of homeownership, but there are some tax traps to be aware of.

The Home Office

Certain tax rules allow proprietors to deduct a percentage of some household expenses from business income. Here are the general rules:

Determining the amount that can be deducted: The total area of your home used for business purposes determines the percent of household expenses you can deduct as business expenses. First, though, your home office must meet one of two tests:

*If you can answer yes to **either** of these questions, you will be eligible to make the claim. Speak to your financial advisors about deciphering these terms and how the rules will apply to your business.*

Eligible Expenses

In general, you can deduct a **prorated portion** of the following household expenses from your business income:

- **Mixed-Use Expenses**: personal expenses are never deductible. Note: **Telephone** – Unless you have a dedicated phone line, you can only claim business-related long distance charges.
- **Car** - if you are using your car for personal and business use, you must keep a log of how many kilometres you drive for business. Trips from the home office to get groceries are not deductible unless there is a business reason: the local post office where you pick up mail is there, or certain office supplies are picked up on the trip.
- **Capital Cost Allowance** – You can claim the CCA for an exclusive office space, but this is generally not recommended – doing so suggests a change in the use of your home space and would prevent you from making full use of the Principal Residence Exemption on the portion of your home used as a home workspace.

Restriction on the Home Workspace Deduction

The amount of deductible household expenses you can claim in a given tax year is restricted to the **net business income** you earn in that year. In other words, you cannot create a tax loss by making use of business-at-home deductions. However, any excess deductions you have can be carried forward and deducted against income from that business in succeeding years.

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Pandemic Support Provisions. In the 2020 tax year, the federal government introduced a simplified flat rate option for claiming home office expenses. At the time of writing further extensions of these special rules had not been introduced.

Help with Decision-making

Things for me to do:

- Collecting Information on a Small Business

Things for my advisors to do:

- Determine tax rules that will impact your business and business planning, such as employees and salaries, partnerships, CCA, and charitable donations.
- Determine whether your corporation is eligible for the Small Business Deduction.
- Advise you on the right time to declare a bonus to get the best personal tax deferral
- Calculate the standby charges on your owned or leased vehicle and explain whether it is better to own or lease for tax purposes.
- Compute contribution levels and investing in an RRSP.
- Help develop a tax-efficient compensation plan that maximizes the opportunities of personal/corporate tax integration.

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