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Your guide to income tax & financial planning

FAST TRACK

Leadership

Every business school in the country assumes the mandate to teach its students the art of managing a business enterprise. Thus they concentrate their efforts on such topics as finance - how to arrange the business' affairs to have the necessary funds to begin and maintain operations; marketing - how to procure and maintain a client base; and accounting - how to "keep score" as to

In this Issue:

Observations from the 2012 Income Tax Season

The 2012 "income tax season" is now behind us and it would be worthwhile to go back and review a few lessons that were learned over that period:

(i) sometimes it is better to treat an expenditure as a "non-refundable tax credit" rather than as a deductible expense

(a) consider the Jones family who have two children. Mr. Jones, with an income of $50000 plus the Universal Child Care Benefit of $100/month or $1200 for the year, is the spouse with the lower net income. In the course of interviewing them prior to filling out the income tax forms, the tax preparer is told that the family sends their children, aged ten and four, to the local religious school at a cost of $11000 year. The school has provided them with qualifying child care expense receipts. These receipts, however, also have imprinted upon them the school's charitable donation number as provided by the Canada Revenue Agency.

The income tax preparer can choose between using the receipt as an expense for child care or as a charitable donation on Mr. Jones' income tax return.

The accompanying table will demonstrate the alternatives. Under scenario (1) since one of the children is less than seven years of age, Mr. Jones is allowed to deduct up to $7000 in allowable child care expenditures made on his/her behalf. The second child is older than seven years of age and under seventeen years of age. This allows Mr. Jones to claim up to $4000 on his/her behalf.

Since Mr. Jones gave the religious school $11000, he can deduct the full amount against his income and arrive at a taxable income of $40200.

Alternatively, under scenario (b), Mr. Jones may choose to treat the $11000 he gave the school as a charitable donation. His taxable income will be $51200 and he will receive a "non-refundable tax credit" for the $11000 expenditure.

The difference is significant and the income tax preparer should choose scenario (2).

(b) consider the situation of Ms. White, a single mother of two children, whose children are the same ages as those of Mr. Jones above. She receives the Universal Child Care Benefit of $100/month or $1200 for the year for her second child.

The income tax preparer can include this amount as income of Ms. White herself thereby increasing her taxable income for the year (scenario 3). Alternatively, the preparer can claim the $1200 as "income" of her younger child. This has the effect of reducing the amount she is allowed to claim for him/her as her "amount for eligible dependant" in her calculation of non-refundable income tax credits (scenario 4).

The difference is significant and the income tax preparer should choose scenario (4).

(ii) sometimes it is better to treat an expenditure as a deductible expense rather than as a "non-refundable tax credit"

(c) consider Mr. Brown, a widower, who has one child aged ten whom he enrols in the YMCA for an annual fee of $500. The "Y" has graciously given Mr. Brown a receipt that he can claim toward his child care expenses or alternatively be applied toward his allowable "children's fitness amount", a "non-refundable tax credit" on his income tax and benefit return.

Let's see how these scenarios "play out":

Intuitively, we would expect the "value" of the child care expense (scenario 5) to be greater than that of the non-refundable credit (scenario 6). This is because the deduction directly reduces taxable

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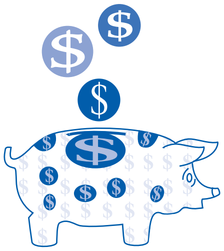


whether the business is succeeding or falling behind.

Unfortunately they do not teach (and It may be something that might well be impossible to instruct anyway) leadership.

What qualities must a leader possess? Here are some: (a) he must be "close" to his people so that he understands their needs and desires; (b) he must have the power to calm his people, either through word or deed, so that situations that come up will be dealt with rationally; (c) he must be able to resolve complexity, to see how what appears to be insurmountable can be approached one step at a time; (d) he must have the ability to attract a following either through "charisma" of ideas or personality and (e) he must have the desire to lead, understanding that without his guidance the desired outcome will never be achieved.

There appears to be two leadership styles. The first is overly centralized and can be compared to a

income at the taxpayer's marginal income tax rate while the credit is a flat 15% of its nominal value. In this case the amount in question is only $500 and what we instinctively thought would be the case is indeed borne out.

Surprisingly perhaps, should Mr. Brown's income become more modest, approximately $30000 or less, the difference between the two alternatives is completely eliminated.

Finally, the situation that applies to the "children's fitness amount" above will also apply to the "children's arts amount" as well.

(iii) splitting medical expenses and/or charitable donations

(d) consider Mr. and Mrs. Wong who have incurred extensive medical expenses in the past year. They are debating whether the expenses should be divided up so that Mr. Wong claims some of them and his wife claims the remainder.

Scenario 7 outlines their total income tax bill if the medical expenses are claimed on one return while scenario 8 shows the result if the medical expenses are split between the spouses. You will note that the result is more income tax effective if all the medical expenditures are claimed on one income tax return (7(a) is less than 8(a)).

If the incomes are increased or one spouse has more income than the other, the same result will occur. It is always better to have one spouse claim all the medicals rather than split them between the two. The reason for this is that you will notice that the medical expenses are reduced by a factor of 3% of net income (which is often equal to taxable income as in this illustration) to a maximum of $2052 in 2011. This has the effect of reducing the non-refundable income tax credit associated with the medical claim. Should each of the spouses share the medical expenditures, the reduction in non-refundable income tax credits occurs twice. And this causes the family as a whole to lose out.

Although not demonstrated here, the same thinking applies when considering splitting charitable donations between spouses. In this case, charitable donations are subject to a two-tier calculation when they are applied to the non-refundable income tax credits. The first $200 of donations is allowed at the rate of 15% federally while any amount over this threshold is allowed at 29%.

Consequently, non-refundable income tax credits are reduced for the family when each of the spouses has to go back to the beginning and claim the lower rate on the first $200 when this would not be the case if all the donations were applied to just one spouse.

(iv) application of fair or market values to revenue and expense items

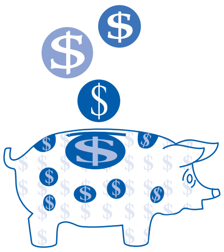
One income tax strategy that has been around for several years involves the purchasing of a rental property by an adult child of the family and "renting out" the premises to the parents. The child is looking for long-term capital appreciation of his investment. He knows that his tenants will treat the residence "gently" and not selfishly abuse the property.

As an added bonus, he will claim the income or loss from the rental property on his income tax return. Typically the goal is to show a loss for income tax purposes. This can be achieved by charging the parents a rent that is below market value for the area in which the house is situated. Normal operating expenses are applied against this revenue and a loss is "generated" (scenario 9).

Alternatively, the parents are charged "fair value" rents. When normal operating costs are applied, the investment shows a "profit". In order to create a loss, the taxpayer arranges to have his spouse (or some other family member with lower income) draw a salary out of the investment (scenario 10). This effectively splits the rental income among family members. One spouse/sibling has a loss for income tax purposes while the second spouse/sibling has salary income against which he can contribute to the Canada Pension Plan or make contributions to a Registered Retirement Savings Plan.

Of the two choices the second alternative is preferred. This is because the Income Tax Act states that both revenues and expenses in non-arm's length transactions must be reported in amounts that approximate fair or market values. Clearly the act of charging your parents below market rents in a property that you control will be difficult if not impossible to justify.

Showing market rents and reporting rental income as it should be calculated or splitting the income with another family member both keep you "on side" with the income tax authorities and prevent nasty surprises should that same CRA auditor call you to look into your reporting of rental income.



parent of young children. The leader must be capable of "doing it all", the doer, the problem solver, all knowing and totally competent. If something needs to be done, it is for the leader to do it.

The trouble with this leadership style is that if the leader is a parent, the followers remain children. They are totally dependent upon him, do not develop skills of their own, acquire a sense of responsibility or the self-confidence that comes from exercising it.

The second style is much more decentralized. It is about diffused responsibility, making each individual count, building cohesive teams on the basis of a shared vision, educating people to seek out ways of reaching their full potential and valuing honest discussion while tolerating dissent.

This calls for leaders who inspire others with their vision, delegate authority and empower them. It means giving them guidance, encouragement and the space in which to operate.

There is Often More Than One Way to Prepare An Income Return

	1	**2**
Employment income	50,000.00	50,000.00
Univ Child Care Bene	1,200.00	1,200.00
	51,200.00	51,200.00
Child care expense	11,000.00	
Taxable income	40,200.00	51,200.00
Charitable donations		11,000.00
Income tax payable	5,809.06	4,914.50

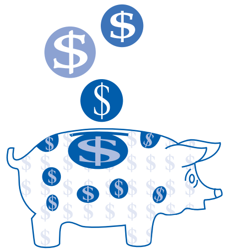
	3	**4**
Employment income	50,000.00	50,000.00
Univ Child Care Bene	1,200.00	
Taxable income	51,200.00	50,000.00
Non refund tax credits		
Basic personal amt	10,527.00	10,527.00
Eligible dependant	10,527.00	9,327.00
2 children	4,262.00	4,262.00
CPP/EI/ Employ amt	4,069.36	4,069.36
	29,385.36	28,185.36
Income tax payable	6,683.16	6,510.93

	5	**6**
Employment income	50,000.00	50,000.00
Child care expense	500.00	
Taxable income	49,500.00	50,000.00
Non refund tax credits		
Basic personal amt	10,527.00	10,527.00
Eligible dependant	9,327.00	9,327.00
1 child	2,131.00	2,131.00
CPP/EI/ Employ amt	4,069.36	4,069.36
Child fitness credit		500.00
	26,054.36	26,554.36
Income tax payable	6,674.83	6,705.58

	7		**7(a)**
	Mr. Wong	Mrs. Wong	
Employment income	20,000.00	20,000.00	
Taxable income	20,000.00	20,000.00	
Medical expenses	$6305 (no splitting)		
Non refund tax credits			
Basic personal amt	10,527.00	10,527.00	
CPP/EI/Employ amt	2,237.75	2,237.75	
Medical expenses	6,305.00		
Less: 3% net income	- 600.00		
	18,469.75	12,764.75	
Income tax payable	229.54	1,416.23	1,645.77

	8		**8(a)**
	Mr. Wong	Mrs. Wong	
Employment income	20,000.00	20,000.00	
Taxable income	20,000.00	20,000.00	
Medical expenses	$6305 (with splitting)		
Non refund tax credits			
Basic personal amt	10,527.00	10,527.00	
CPP/EI/Employ amt	2,237.75	2,237.75	
Medical expenses	3,305.00	3,000.00	
Less: 3% net income	- 600.00	- 600.00	
	15,469.75	15,164.75	
Income tax payable	679.54	1,056.23	1,735.77

	9	**10**
	Chavez Family	Wellington Family
Rental revenue	5,000.00	19,500.00
Expenses		
Property taxes	3,777.00	3,042.00
Mtge interest	2,670.00	4,916.00
Repairs/mtce	2,343.00	1,474.00
Utilities	2,214.00	3,902.00
Insurance	474.00	172.00
Salaries		12,000.00
	11,478.00	25,506.00
Rental loss	(6,478.00)	(6,006.00)



How Will You Fund Your Retirement?

	Established by	Funded by	Contribution limit
(a) Registered Pension Plans	business	employer and employee	18% pensionable earnings
(b) Registered Retirement Savings Plans	individual	individual	18% pensionable earnings
(c) Pooled Retirement Pension Plans	business and/or individual	employer and employee	maximum $10500/year
(d) Tax Free Savings Accounts	individual	individual	maximum $5000/year
(e) Deferred Profit Sharing Plans	business	business	18% pensionable earnings
(f) Canada Pension Plan	business individual	employer and employee	annually set by govt
(g) Personal svgs/investments (unregistered) accts	individual	individual	not-applicable

Canadians of all ages are facing a"perfect storm": as a nation, we are living longer lives but increasingly have less savings "put away" for our retirement years.

This has created two classes of retirees: (i) those who worked for large corporations or government and participated in their employer pension plans; and (ii) those who were self-employed or worked for companies that did not offer a pension plan.

The above chart looks at the established vehicles available for saving for retirement and who is funding the contributions. More important than this, however, may be who "has a say" in how the accumulated pool of money is being invested and who is managing the inflows and outflows on a regular basis. Those participating in (b) and (d) have the most influence in where and how their contibutions will be treated. Members of (a), (c) and (e) depend on who is providing and administering their plans.

All Canadians covered by (f) have their contributions administered by a government agency.

Included in all groups are Canadians who have managed to save money throughout the years. They are represented in (g).

Factoring

Cash flow is the lifeblood of any business and the most important part of any discussion about cash flow is the collection of the company's accounts receivable.

One little known strategy of which most small business owners are unaware is the possibility of selling their accounts receivable for cash. This is called factoring.

It works as follows: Your company contracts with the "factor" to collect your accounts receivable on your behalf. In most cases, your customers need not know that they are dealing with a factor rather than you.

The amount of "up-front" money you will receive from the factor depends upon the value of the receivables, the number of customers involved and their credit worthiness. The percentage is typically ninety percent, but could be lower depending upon whether the factor requires you to "make good" on any receivables he fails to collect and upon which he has advanced you funds.

In the end, the cost of factoring is often higher than traditional bank financing, but there may be savings in that the lender will not require any security and the paperwork involved will be minimal.

Great leaders do not create followers, they create other leaders. They share their inspiration, give of themselves and treat others as adults who can be taught to take individual and collective responsibility for their own futures.

Neither leadership style is correct in all situations. Sometimes the first is needed as it is "more efficient" and will provide results in a shorter period of time. Sometimes the second should be selected if the longer-term is appreciated.

Perhaps that is the greatest leadership quality of all…knowing when and how to apply the appropriate style as circumstances dictate.

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