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Your guide to income tax & financial planning

FAST TRACK

A New Style of CRA Audit

You would think that when the Canada Revenue Agency wanted to conduct an audit on a taxpayer's personal or corporate tax return they would go about it in a professional manner.

<u>Here is what you would like to think happens, and does in most cases:</u>

(a) contact the taxpayer to inform him of the upcoming audit and its particular focus. The audit could concentrate on say the tax-

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Corporate vs. Individual Reponsibility

Here is a topic that is rarely discussed.

Company A is in the construction business, mostly doing work for insurance companies who are attending to claims from their clients who have experienced damages to their properties.

The company does not recruit its employees/sub-contractors directly but depends on a "word of-mouth network" to bring individuals with the necessary skills to the attention of management. These individuals are interviewed and then hired as needed.

All employees/sub-contractors, without exception, like working for the company. It pays the "going hourly rate". It is reliable and fair.

Over the years, as the company has grown, the number of employee/sub-contractors has increased substantially. And the pool of "referrals" now includes some illegal immigrants to Canada who have come to our country without being registered by the authorities. All workers are paid in exactly the same manner so the amounts they earn are similar to those with "valid" papers.

The company encourages all employees/sub-contractors to register as sole proprietorships or corporations. It does not pay HST unless the recipient informs the company that it has a HST number, at which time their pay includes the 13% levy.

The company, in the interviewing process, does not screen potential employees/sub-contractors for how they came to Canada, why they are here and their immigration status. It feels that it is hiring the individual to work alongside others on a specific job site. It is none of their business to ask too many personal questions and as long the worker performs his duties satisfactorily, that is all that can be asked of them.

By now the company must surely know that some of its employees are "illegals" and others have come to Canada through proper channels. They can easily ask the one question that can separate workers into the two separate categories.

But the company is blunt about their hiring practices. They prefer "new-comers" to Canada rather than those who have been here for awhile. They like their "work ethic" and willingness to put in extra time as required. Should they not have the ability to hire whom they want and whom they feel will work best for them?

The question that arises is one of responsibility. Is the company acting correctly by not asking "too many questions" and insisting that all employees/sub-contractors be set up as small businesses?

Some might argue that by hiring illegal residents, the company cannot be sure that they are paying taxes on the money they have earned. But why should the onus be on the construction company to "police" its employees/sub-contractors concerning these matters? Running a successful business operation is difficult enough without adding these extras "duties" to the mix.

Finally, is it the company's concern how the employees/sub-contractors handle their personal affairs when away from the company's premises or job sites? Don't the employees/sub-contractors have responsibilities of their own concerning how they live their lives in Canada or elsewhere?

There are no simple answers to these questions. The company needs employees/ sub-contractors and perhaps should be "encouraged" to hire bona fide Canadians first. But they should not be under any obligation to do so, if the employee/sub-contractor who presents himself at their door has the skill set needed to perform the duties required by the company and is eager to work

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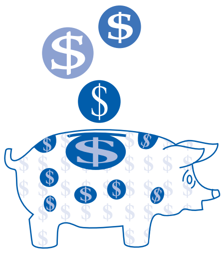


payer's business payroll account, for example, or maybe its collection and remission of the Harmonized Sales Tax. In some situations, the Agency might concentrate on a certain expense account, usually auto and travel or business promotion;

(b) inform the taxpayer as to whether the audit will be a "desk audit" whereby he will be asked to submit his receipts by fax or mail to the CRA office where the auditor is located or whether the auditor will visit his place of business in person;

(c) give the taxpayer particulars of what period is being considered, when he expects the taxpayer's documents to be submitted and whether he will be “dealing" with the taxpayer himself or a representative he has appointed;

(d) await for the taxpayer to submit the information or have it available for him to examine should he be coming to see the taxpayer or his representative in person;

(e) work with the taxpayer or his representative on an "ongoing basis". As issues come up, and they always do, show professional courtesy to each other. It often happens that when an auditor examines one piece

Sell of Assets vs Sale of Shares

There are two ways to sell a company. The first is that the corporation sells its assets to the purchaser and it becomes a "shell" company compared to what it was before. The entity continues to exist, but depending on the extent of the sale, might be left with cash as its only asset once the proceeds of the sale have been realized.

This cash is needed to pay the taxes owing to the government on the sale transaction. Once this has been disbursed, the company can distribute the funds to the shareholders or re-invest them in a new project.

The second option is for the purchaser to pay the shareholders the negotiated price for their shares. At that time the original shareholders give up all title to the corporation they once owned and it becomes the property of the new owners who assume its assets and debts.

The question then becomes, which is the preferable way to sell your company? The usual rule of thumb is that sellers like to sale shares (for reasons we'll see later) and purchasers like to buy assets because they are fearful of any "hidden" issues attached to the shares that have not been disclosed to them, and that may impair the company they have just purchased.

Therefore it is not uncommon for purchasers to be willing to pay a premium to the sellers to structure the deal as an "asset sale" rather than as a "share sale".

The decision then falls upon the sellers to determine whether the proposed sale of assets will leave them with at least as much money at the end of the day as they would have realized on a sale of shares. They have to go through the exercise of considering both options and then choosing the one that is in their best interest.

Let's look at an example where the prospective purchasers have offered the shareholders of a company $2.5 million to purchase assets or $1.9 million to purchase shares. This is a sizable premium for the purchase of the assets and the shareholders may be tempted to go for the larger amount of cash. But, of course, that is not the decision making criterion they should be considering.

They should only look at the amount of dollars they will be "left with" once the transaction has been completed, the corporate taxes have been paid, and a full distribution of remaining corporate funds has been made. For there will be personal income tax consequences that have to be considered before any final decision on the structure of the deal can be determined.

Sale of Shares

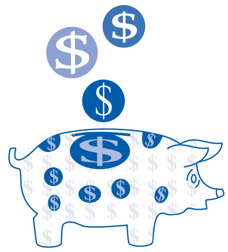
The first thing to consider is the Balance Sheet of the company being sold from an accounting point of view and an income tax perspective.

	Accounting Fin Stmts $	Inc Tax Fin Stmts $
ASSETS		
Cash and A/R	**150000**	
Inventory	**50000**	
Net Capital Assets	**25000 (a)**	**100000**
Goodwill	**75000 (b)**	**75000**
	300000	
LIABILITIES		
Current Liabilities	**70000**	
Bank Loan	**100000**	
Due to Shareholders	**30000**	
	200000	
SHAREHOLDERS EQUITY		
Share Capital	**100**	
Retained Earnings	**99900**	
	100000	
	300000	

(a) the acquisition cost of the capital assets was $125000 but over the years the company has taken capital cost allowance at identical amounts to those claimed for accounting purposes. This means that the company will have to recognize "recapture" of the $100000 previously deducted for income tax purposes.

(b) a similar situation exists in regard to goodwill. The current $75000 valuation has been determined after years of claiming amortization in similar amounts for both accounting and income tax purposes. The original "cost" of goodwill was $200000, but since only 75% is considered as its base for tax purposes, the recapture in this case is $75000.

The corporate taxes due on the sale then become:



of documentation it invariably leads to another and from there another. While the taxpayer would obviously like the trail to end quickly, once it has been opened, the auditor will likely see it through to its logical conclusion and the taxpayer will just have to "wait him out";

(f) keep in contact with the taxpayer throughout the process, ask questions to clarify "findings" and use the time to educate the taxpayer how he might want to do things differently;

(g) issue the assessment in a timely manner. By this time, both parties have a good idea as to how the audit "went". Each knows the other's position on the issues that were raised. The taxpayer may not yet realize the financial impact but he will soon enough.

Here is what happens from time to time:

(a) auditor sends taxpayer Notice of Assessment based upon an "audit" he has conducted on his own without notifying taxpayer;

(b) taxpayer is allowed thirty days to reply to auditor expressing his agreement or disagreement with auditor's findings;

(c) since taxpayer has been "blind-sided" he hardly knows where to start and must contact auditor for information behind the

Proceeds of sale		**2500000**	
Recapture (a)	**100000**		
Recapture (b)	**75000**	**175000**	**(c)**
Goodwill		**23250009**	**(d)**

Business income (c)	**175000**	**15%**	**26250**
Capital gain (d)	**2325000**	**25%**	**581250**
			607500

Proceeds of sale		**2500000**
Corporate taxes	**-**	**607500**
Available for distribution		**1892500**

50% of the cap gain can be distributed to the shareholders tax-free termed "Capital dividend"	**1162500**
Shareholder loan	**30000**
Taxable Distribution	**700000**
	1892500

This distribution can be spread over several years but typically most shareholders want to cash out immediately and usually by dividend. This would mean a tax cost of $284550 and net realized amount of $415450.

So how much did the shareholder realize at the end of the day?

50% of corporate capital gain	**1162500**
Shareholder loan	**30,000**
After-tax distribution	**415,450**
	1607950

And how much did the government realize?

Corporation taxes	**607500**
Personal taxes	**284550**
	892050

Sale of Shares

Proceeds of sale		**1900000**
Share Capital	**-**	**100**
Capital gain		**1899900**
Taxable capital gain 50% (c)		**949950**
Personal taxes		**252626 (e)**

So how much did the shareholder realize at the end of the day?

Proceeds of sale		**1900000**
Personal income taxes	**-**	**252626 (e)**
		1647374

And how much did the government realize?

Personal income taxes	**252626 (e)**

Conclusion

The shareholder will be $39424 better off by selling the shares for $1.9 million rather than the assets for $2.5 million. The break-even price where the seller would be indifferent between the structure of the deal is the sale of shares for $1.9 million or the sale of assets for $2.655 million.

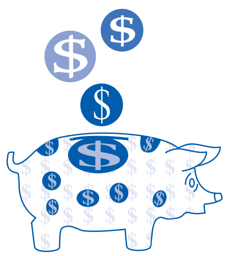
How Should You Receive Investment Income?

We are used to personal income tax rates remaining fairly constant from year to year with only the income tax "brackets" changing slightly to reflect changes in the rate of inflation. The government now concentrates on changing what they will or will not allow as deductions and tax credits. These are easier to "sell" to the average Canadian taxpayer who may not even know whether the change will affect them personally or not.

Changes in corporate income tax rates have also been few and far between. Except for 2016 where the rate changed from 15.5% to 15%. This may not sound like much, but is significant because corporate incomes tend to be many times higher than personal incomes.

When there are changes, it is time to revisit certain income tax situations to see how, if any, the new rules play out The following analysis looks at a taxpayer earning $30000 from employment and investment income of $20000. As always, the makeup of the investments is of utmost importance.

The discussion at hand is whether he should hold these investments in a corporation or personally, in his own name. As always, the makeup of the investments (between those that generate interest and those that pay out dividends) will lead to very



numbers he has come up with;

(d) taxpayer must now work feverously to discredit the figures arrived at by the auditor and if time permits put forth a case to the auditor showing where he has gone wrong;

(e) failing to get through to the auditor almost guarantees the taxpayer will have to go through the Appeals process if he is to have any chance of having his position considered fairly.

It would seem obvious that the conduct of an income tax audit cannot be "one sided" and without the knowledge and co-operation of the taxpayer. Unfortunately, the Canada Revenue Agency sometimes forgets this and tries to do an "end-run" around the taxpayer. This results in more anxiety for the taxpayer than necessary and strained relations for all concerned.

different tax positions for the taxpayer.

Facts: Taxpayer has salary income of $30000 and an investment portfolio of $20000 which he holds through a corporation. He wishes to withdraw his earnings each year from the corporation.

Question: What form should the portfolio take to give the greatest amount of "take home" earnings to the taxpayer?

Scenario #1: Taxpayer has interest income from his investment portfolio of $20000. After personal taxes have been paid, the taxpayer/investor has a "take home" amount of $40687.

Scenario #2: Taxpayer has dividend income from his investment portfolio of $20000. After personal taxes have been paid, the taxpayer/investor has a "take home" amount of $43921.

Scenario #3: Taxpayer has portfolio investment income made up of $10000 in dividends and interest of $10000. After personal taxes have been paid, the taxpayer/investor has a "take home" amount of $42346.

1st Result: The all dividend paying portfolio allows the taxpayer the largest "take home" amount.

Follow-up Question: What happens if the taxpayer decides to hold the portfolio personally?

	Taxpayer "take home" $
Scenario #1	41545
Scenario #2	43379
Scenario #3	42464

2nd Result: Once again, the all dividend paying portfolio gives the taxpayer the largest "take home" amount.

Conclusion: The best returns for the taxpayer are generated when he holds a 100% dividend paying portfolio either in a corporation or personally. However, it is also the portfolio with the most risk. If he wants a diversified portfolio or one that is very conservative and "all interest" he should own them personally and not through a corporation

Foreign Income Verification Statement

For the past twenty years the Canada Revenue Agency has required both individuals and corporations to disclose any holdings of "specified foreign property" that has a minimum aggregate cost of $100000. Let's take a look at what is involved:

What holdings are included? (i) money deposited in or outside Canada in foreign currency denominated bank accounts; (ii) shares or debt of non-Canadian corporations; (iii) tangible property located outside Canada when it is not being used to earn active business income or exclusively for personal use.

How is cost determined? The Act requires the "tax values" of the assets involved. In most cases this is the actual cost paid for the assets, in Canadian dollars, when purchased. However the "value" of these assets often fluctuate over time. Shares, for example, whose cost was, say $105000 but are currently trading at a valuation of $95000 are still to be reported at the figure of $105000

Are there any exceptions? Yes!! When a taxpayer holds shares or debt in a registered security dealer or trust company, the amounts reported are not the actual costs of the shares/debt themselves but the fair market values of these investments. In these cases, two amounts are reported. The first is the fair market value of the investor's portfolio at the end of the year. The second is the "highest" value of this portfolio attained within the year. Although each is subject to a minimum valuation of $100000, it is possible that one disclosure may be greater than $100000 and the other less than $100000.

