SUMMER 2015

THE Quarterly Dividend

Vol. 24 No. 3 Your guide to income tax & financial planning

FAST TRACK

Advice to Small Business Owners That You Will Not Find Anywhere Else!!

At no time in history has it ever been easier to go into business for yourself. Most industries that you might consider have very few "barriers to entry" and bank restrictions on lending to "first-time entrepreneurs" have been relaxed to the point where some start-up capital can be had at relatively low interest rates. It sometimes has been

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Deferral of Capital Gains

The Income Tax Act lays out certain benefits to individuals owing shares of "qualified small business corporations". Among these are (a) the ability to take advantage of the $800000 capital gains exemption when the shares are disposed of for a "profit"; (b) the ability to deduct allowable capital losses against "ordinary income" rather than from realized capital gains only; and (c) a capital gain deferral that is often overlooked by individuals and their advisors alike. Here is how it works:

Disposal of currently owned shares

What: shares of Canadian-controlled private corporations, which at the time of disposition, use at least 90% of the fair market value of their assets in an active business carried on in Canada;

When: the shares must have been owned by the taxpayer for a minimum of two years prior to disposition. During this twenty-four month period at least fifty percent of the corporation's assets must have been used in an active business. However, if the corporation is a holding company used to finance a connected active business, the percentage increases to ninety percent throughout the period;

Common examples: (i) an entrepreneur who carries on business as a sole proprietor can "roll over" the assets of his business into an existing incorporated company that satisfies the twenty-four month rule stated above and be able to access the benefits immediately; and (ii) a shareholder of a company that previously qualified but became "off-side" when the corporation went "public" and listed on a Canadian stock exchange. These shareholders typically elect to dispose of their shares immediately prior to the listing on the exchange and buy them back when the listing has been completed, thus allowing them to benefit from the increased market value of their shares generated by the initial public offering and the benefits indicated above right to "the end".

Calculation of the Gain

The general rule is that a capital gain or loss is determined as (a) the amount received as proceeds of disposition for the property less (b) the property's adjusted cost base less (c) costs incurred in realizing the transaction. From time to time, (a) and (b) have adjustments attached to them that make their determination less than straight-forward and costs associated with the disposition may be interpreted liberally. However, once all the technicalities have been ironed out the gain can be determined.

Decision Time

Erin realized a $400000 capital gain in 2015 from the disposition of qualified small business shares. She must now decide whether to (a) include the gain as income on her 2015 personal income tax return and take advantage of whatever amounts she has available as an exemption to offset it; or (b) take the $400000 in cash and re-invest it in one or more qualifying small business corporations. If she does this the cost base of the new investment will be reduced by $400000. Any taxes from the original disposition will be deferred until such time that the new investment has been liquidated (or until an even later date if these provisions are invoked when they are sold as well).

If Erin chooses (b) she should probably have had some idea beforehand that this was going to be the case. Although there are no set time guidelines outlined in the Act as to the series of transactions that are being contemplated by the taxpayer (sale of shares in Corp One, realization of capital gain, purchase of shares in Corp Two) it is important the funds generated in the initial sale be able to be "identified" and perhaps kept segregated until the second sale has been consummated. This will allow Erin to stay "on-side" throughout the entire series of transactions.

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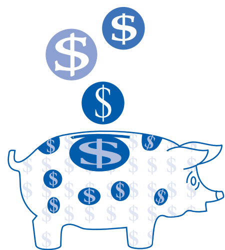


known to happen that prospective business operators can choose between several competing banks who are anxious for their accounts.

The only problem is the entrepreneur himself. He has to come to the meetings with the bankers having done his "homework". He has to be able to demonstrate the existence of a viable market for the project he is pitching, a working technological model of the product he will taking to market, and enough capital behind him to last awhile longer than he thinks he will need to get his business off the ground.

If the entrepreneur goes to the banker and states categorically that his business only needs to borrow three months' capital because his research has indicated that customers in his industry will leave their existing suppliers and flock to his newly-formed company, the banker will be just as adamant that his prospective client is either overly optimistic or naïve. He will be unlikely to approve the loan.

Transferring Your Mortgage Mid-Contract (Part One)

One of the decisions facing home owners with mortgages is what strategies they should pursue when their current loan comes up for renewal. But what happens if a "terrific" deal presents itself in the middle of the term and the home owner must decide between keeping the current mortgage or getting out of it early and re-financing somewhere else?

Here is an example: Harvey is currently party to a five-year fixed term mortgage for $100000 bearing interest at the rate of 7% per annum. His local bank has run a promotion seeking new customers to leave their old arrangements and come with them for a mortgage bearing interest at the rate of 5%. Harvey is intrigued and considering making the switch.

Here is his analysis of the 7% mortgage. The required payments are $700/month and the balance remaining on the mortgage is $91053 after five years.

Year	O/S	Princ Repay	Int Pymt	Combined	PV Factor	Pres Value
1	100,000	1,552	6,853	8,405	0.9346	7,855
2	98,448	1,662	6,743	8,405	0.8734	7,341
3	**96,786**	1,781	6,624	8,405	0.8163	6,861
4	95,005	1,908	6,497	8,405	0.7629	6,412
5	93,097	2,044	6,361	8,405	0.7130	5,993
	91,053					34,462

Here is his analysis of the 5% mortgage. The required payments are $582/month and the balance remaining on the mortgage is $88514 after five years.

Year	O/S	Princ Repay	Int Pymt	Combined	PV Factor	Pres Value
1	100,000	2,076	4,903	6,979	0.9524	6,647
2	97,924	2,181	4,798	6,979	0.9070	6,330
3	95,743	2,292	4,687	6,979	0.8638	6,028
4	93,451	2,408	4,571	6,979	0.8227	5,742
5	91,043	2,529	4,450	6,979	0.7835	5,468
	88,514					30,215

In order to truly compare the two mortgages he must "present value" all payments required over their respective terms. This means recognizing that $6979 in mortgage payments made in 2015 are not the same as $6979 in mortgage payments made in 2020. The difference is the Present Value factor.

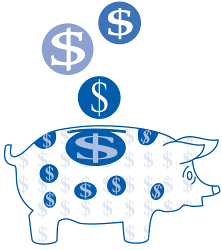
You will notice that even in the current year, the full amount of the payments are reduced below their nominal values to reflect one year's worth of adjustment because the analysis is presented as at December 31 of the year in question using the stated rate of the mortgage.

The amounts on the above tables show the PV of five years' payments for the 5% mortgage to be $30215 and $34462 for the 7% mortgage. This means it will cost Harvey 34462 2015 dollars over the next five years to service his current debt but only 30215 2015 dollars to service the alternative debt. The difference is $4247.

It would seem that transfering the mortgage is a "no-brainer" and the present value analysis only confirmed what we would have figured all along.

However, there are two additional points that Harvey did not notice in the "fine print". That could raise some doubt as to how to proceed. It seems that he will be "on the hook" for an "early termination fee" imposed by his current lender should he opt out of his mortgage before the end of its term. And he will be responsible for any legal fees incurred in the leaving of one mortgage and the taking on of the second.

In some cases, the new mortgagor may assume these legal bills as an added incentive to customers to make the switch. But they are unlikely to cover



The entrepreneur has to approach the banker with a sense of humility. He cannot behave as if he is doing the banker a favour by borrowing funds from him. He must recognize that even though the bank appears to have funds available to lend, banking is a business too, and they will only lend to prospective clients with whom they feel comfortable. He should be courteous at all times and attempt to answer whatever questions he is posed. He should also not be surprised if the bank asks for collateral on the funds they are about to lend while seeking credit and background checks on the principals who will be operating the business.

Once the loan has been approved and the funds advanced, the entrepreneur should be open to the provision of quarterly or semi-annual financial statements to the banker to keep him informed as to how the business is doing. Many entrepreneurs look at these reporting requirements as a "waste of time". They consider them costly if they have to pay someone to produce them and time consuming if they have to prepare them themselves.

the "early termination fee". This why the original mortgagor wrote them into the contract in the first place.

See accompanying table that shows how "early termination fees" are calculated.

As long as these additional costs are less than $4247 Harvey should conceivably consider transferring his mortgage. By doing so today, he will lock into the 5% rate for the next five years. On the other hand, he will be risking that mortgage rates might drop even further and might be below 5% when his original mortgage comes due.

In this example, the amount of the penalty will make or break Harvey's decision. If the mortgagor uses (i) then all of Harvey's so-called savings will be eaten away. The same is true of legal costs which may be an additional $500. If the mortgagor uses (ii) Harvey will come out ahead, even including the legal costs.

It is interesting to note that the reasons initially identified as favouring the 5% mortgage: the lower monthly payment and the resulting additional amount of principal repayment, by themselves, might have resulted in an incorrect decision had Harvey not prepared a present value analysis considering all costs to be incurred in the switch.

It is important to look at all the facts when making a decision, particularly the "fine print".

Transferring Your Mortgage Mid-Contract (Part Two)

The mortgagor holding the 7% mortgage can command up to $5800 in transfer fees, depending upon the contract. He wants to make-up for the amount of interest he will "lose" when the mortgagee goes somewhere else.

The formula will probably be written in the mortgage agreement. These are the two most common methods. If there is no set provision, the mortgagor will claim the right to determine the penalty in the way he sees fit.

(i) interest differential method

(a) existing mortgage interest rate:	7%
(b) competitor's mortgage interest rate:	5%
(c) difference:	2%
(d) amount of mortgage to be discharged (say end of second year):	$96,786
(e) (c) times (d):	$1,936
(f) number of months remaining on existing contract:	36
(g) (e) times (f):	$69,688
(h) (g) divided by 12:	$5,807.34

(ii) 3 months interest penalty

(a) existing mortgage interest rate:	7%
(b) amount to be discharged:	$96,786
(c) (a) times (b):	$6,775.23
(d) (c) divided by 4:	$1,693.81

Home Purchase Loans

Most businesses have a certain seasonality where they are uncommonly busy for a particular period of the year and relatively slow during others. This is especially true of retailers, depending upon what they are selling. While there may be a steady, year-round demand for cellular telephones and other consumer products, most retailers look forward to the months of November and December as the time of year where they can expect their customers to visit and see what they have to offer.

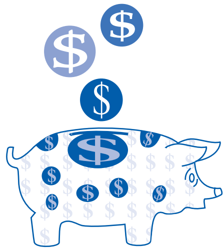
Once the rush is over, and the company has more cash on hand than it has had at any other time during the previous ten months, it is often too "easy" or tempting for the owner to withdraw "excess" funds, in cash, from the business. He sees the company as his own personal piggy bank, allowing him access to money that he feels is rightfully his as a reward for his business acumen and the long hours of work he has put in during the previous months.

As long as he is certain that he will not be draining the business of cash, leaving it exposed to undue risk in the months ahead, the sole proprietor need not worry about the taxes he will pay on his withdrawals. The earnings from the business will be taxed as an extension of the owner who is running it. The amount of income tax he will pay will be determined only on the results of the operations of the company and not by how much he withdrew from it.

Not so the owner/manager who conducts his business affairs through a corporation.

While the business owner, conducting his operations through a corporation, will be just as tempted as the sole proprietor to withdraw as much cash as he can from the business, he will have to understand the double taxation that pertains to his situation.

The earnings generated these past few months and throughout the rest of the year belong to the corporation as an entity completely separate from the shareholder who owns and operates it. The



The truth is that these reports can "force" the entrepreneur to keep an eye on his business that might not have otherwise occurred. It is easy for the small business owner to become so concerned with sales and revenue generation that he loses focus on the myriad of other factors that are needed to operate successfully.

The benefit of preparing these reports, and if they are done "honestly" and not just to show the banker some numbers so that "he will leave me alone", is that they can be used as a record of what has happened in the last period and where things stand today. They can point out areas that need improvement and allow the owner to plan ahead to where he would like to be in the foreseeable future.

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corporation itself will be subject to an income tax levy on the earnings it has generated. For "successful" corporations this will be at a much lower rate than the rate than the sole proprietor will pay for similar earnings.

However, in addition, any money withdrawn from the corporation by the shareholder will be taxable in the form of a salary or a dividend. The income tax rate on these earnings will be identical to what the sole proprietor will be paying on similar amounts.

This double taxation makes it very attractive for a shareholder to arrange his affairs in such a way that the withdrawals can be "tax-free" or at least "tax-deferred".

One such way is when the shareholder takes money from his company to purchase a personal residence.

In these situations, the shareholder(s) may take $25000 completely interest and tax-free from the corporation. It will, however, be recorded as a loan receivable on the books of the company.

Any amounts over $25000 can still be withdrawn, but the shareholder will be charged a "taxable benefit" to be included as income on his personal income tax return. The amount is calculated as the lower of (a) the Canada Revenue Agency prescribed rate of interest when the funds were advanced, and (b) the Canada Revenue Agency prescribed rate of interest determined every three months on a calendar year basis over the term of the loan. These loans are theoretically for five years but they are renewable for as long as the shareholder desires.

Since (a) has been set at 1% these past few years and is likely to remain constant for awhile yet, this strategy may be viable for many shareholders and their corporations.

Jack and Sandy are equal shareholders of a corporation which just happens to have "excess cash" at a time they are thinking about changing their personal residence. If they each draw out $250000 on January 1, 2015 as a Home Relocation Loan, they will receive the first $25000 without any income tax consequences. And since the prescribed rate of interest was 1% at the time of loan, each will include $2250 on their personal income tax returns for 2015 and every future year until the loan has been repaid. The amount of the taxable benefit will be adjusted, however, as they pay back their loans.

But, before going through with the loans, Jack and Sandy must recognize that withdrawing $500000 from their corporation may have a serious impact on their future business operations. The bank or any other potential lender will not consider these loans as assets of the corporation against which they can draw as collateral. Should their business suddenly need cash, they may find themselves having to take out a mortgage on their residence to allow them the funds they require. They will then put this money back into the corporation and be back to where they were in the first place.

What, me worry?

There is a great amount of stress being in business today and one way that it is exacerbated is by the owner/manager of a company worrying about decisions made and implemented in the past and trying to undo them. Hindsight is 20 - 20 and to the extent you can put whatever has been done behind you and just concentrate on tomorrow, the more productive you will be today and in the future.

While worry is a part of everyday life, it has been suggested that ninety percent of what is troubling you, will never come to pass. Your financial advisor is well meaning when he suggests saving and investing for the future so that "you will never outlive your money". But, seriously, is this really a concern when you have so many more pressing current things to look after?

How about Canada Revenue Agency audits? Sure they are a concern and no one would suggest taking a cavalier attitude in the filing of your taxes. But the CRA hammers the same deductions year-in and year-out. If you claim automobile and promotion expenses, expect to be asked to supply receipts sooner rather than later. The same goes for rental losses and self-employment.

But if you claim rent, telephone, professional dues, etc., these are so straightforward that they can be examined through a "desk audit". If questioned, you simply provide the receipts that back-up your claim and the whole process is completed in short order, more often than not confirming the amount that was originally claimed.

In the final analysis, there is no point in worrying about issues and situations over which you have no control. Whatever will be, will be. Just concern yourself with issues and situations in which you have input. Go out and try to do something about them.

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