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Your guide to income tax & financial planning

FAST TRACK

Best Practices

The professions of medicine and law employ the term "best practice" as an everyday phrase to describe solid, reputable, "state-of-the-art" work. The idea being that even if the final outcome of the treatment or the judgement is not as desired for the patients or clients as they would have liked, they and their families can take solace in the fact that a "professional job" was performed on their behalf.

A doctor who does not follow contemporary standards runs

In this Issue:

Principal Residence Exemption

One of the "features" of the Canadian income tax regulations is the manner in which the sale of capital property is treated for income tax purposes. The vendor must compare the amount received upon disposition with the amount he paid for it when it was acquired. And subject to some limited allowable transactional outlays, record the difference as a "capital gain".

Two items of note must be mentioned here: (a) only one-half of the capital gain is taxable in the year, termed the "taxable capital gain" and (b) capital gains on the sales of "principal residences", typically the familial homes belong to taxpayers, are exempt from the tax.

It is not uncommon today for a family to purchase a home and live in it for awhile before deciding to use the equity built up in it to re-invest in a new residence for themselves.

They can choose to sell the original home free of tax and apply the proceeds to the new house, or they can turn the original residence into an "investment property", which when ultimately sold will be subject to the capital gain provisions outlined above.

In these latter cases, the owners of the rental property do not record the capital gain as the difference between the amount realized today and the original cost of the dwelling. They must allow for the period of "tax-free" time they lived in the house as their principal residence and recognize the "value" of the property when they changed its status perhaps many years ago.

If the taxpayers had thought about it, they might have obtained a real estate appraisal of the value of the property when they converted it from their primary residence to a rental property. They would then have good evidence as to the value of the house as at the date of change. This figure could then be used as a basis for calculating the capital gain realized on the ultimate sale of the property many years later.

But what happens if you didn't have the foresight to obtain the appraisal which would now come in so handy for income tax purposes? The CRA is way ahead of you and have devised a formula to help you. But just like any "assistance" offered by the government, beware of its source. Continue to try and find other reasonable benchmarks to use as your cost at the time of conversion of the property. There will be many times when the number you determine will be more accurate than the one arrived at by the CRA formula and, probably, higher too, thus saving you income taxes in the year of sale.

Consider this example:

Nancy bought her home in 1988 and lived there with her family until 1991, at which time she changed its status to a "rental property". She continued to own the house until 2015 when she sold it.

Nancy wants to determine the amount of the capital gain but realizes that she did not obtain a real estate appraisal in 1991 ascertaining the value of the property at that time.

If she is resourceful, she might be able to access copies of deeds in the City archives giving her some idea of the transactions taking place around the time she bought her second home. To the extent that the information can be extrapolated to her situation, she might be able to use this information if ever asked to justify the amount she will put down as her "cost" of the property she

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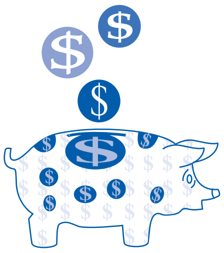


the risk of criticism if the case he has been following turns out badly. We have all heard the expression "the operation was a success but the patient died". This is simply a restating of the maxim that he did all he could for the patient, but in the end things did not turn out as he would have wanted.

In the best of all worlds, the diagnosis of the patient's ailment is correct and the appropriate treatment plan is determined. The patient is given the required medications and advised to change his lifestyle due to his condition. Nature takes its course and hopefully everything works out "the way it should". The patient "recovers" as well as can be expected and goes on to live many more years.

All of this is predicated on the fact that the patient's condition was diagnosed "early" enough and treatment commenced shortly thereafter.

Clearly a lawyer must be conversant with the statutes and precedents concerning the case at hand. His "job" is to tie together the evidence as it has been explained to him with the laws that would apply in that situation. Sometimes he can argue convincingly on his client's behalf, but there will be times when his client is simply "guilty" and all the eloquence he can muster will

sold in 2015. As long as she can justify a figure in excess of ($280040 + $42850) or $322890 she will "beat" the CRA number.

Alternatively, there is the CRA formula for the Principal Residence Exemption which can be used at least as a starting point (see accompanying table):

(a) the number of years the property served as a "principal residence" (1988-91)	4		
(b) the number of years the taxpayer owned the property (1988-2015)	28		
Proceeds of disposition		$520,000	
Less: Purchase price, legal fees, improvements to property 1988 through 1991		$280,040	
Capital gain before Principal Residence Exemption		$239,960	(i)
Number of years as Principal Residence plus 1 (allowed by law) 5			
Multiply (i) by 5	$1,199,800		(ii)
Principal Residence Exempt - Divide (ii) by number of years property owned (28)		$42,850	
Capital Gain		$197,110	
Taxable Capital Gain		$98,555	

Is Your Business Sustainable?

Viability and sustainability are not the same thing. A company can be viable as a business entity but it may not be sustainable because its current management does not have the necessary "smarts" to keep it going.

Here is a checklist of things owner-managers must address if they are to maintain the sustainability of their businesses:

(a) ability to meet business obligations as they come due. These include employees, the various government agencies regarding payroll taxes, HST, corporate income taxes and suppliers;

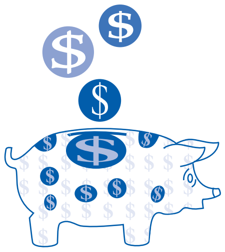
(b) ability to meet loan obligations on a timely basis. Contrary to what some financial analysts would have you believe there is nothing wrong for a company to incur debt when first starting out or when undertaking a new project. If the company had to wait until it had accumulated sufficient cash resources before embarking on expansion, it would stay stagnant for a very long time and probably never accomplish anything of value;

(c) ability to work with customers and grow with them: the story is often told of a company that was approached by a customer to pursue an idea that seemed so far-fetched that it was dismissed out of hand immediately. The customer naturally took their project to another company who was more receptive and willing to work with them. The product was "Tang" a fruit flavoured drink often associated with the American manned space flight program, and a consumer product for over forty years;

(d) the ability to stay current in all facets of your industry, never allowing technology to dictate how you do business but adapting it to your needs and ways of doing things. Just because things were done that way "historically", does not mean that is the only way things should be done. Keep up with current trends and innovations so that customers do not look at you as some relic of the past;

(e) the ability to develop a wide-ranging set of tools when dealing with customers. Do not have only one template that forces all customers' situations to be analyzed in only one fashion. You must have a "bag of tricks" that allows you to be creative and resourceful. Certainly, have one way of doing things for the routine items that cross your desk each day. But be on the lookout for situations that require you to understand when the customer at hand does not fit the common mould and is calling out for your unique expertise and experience;

(f) the ability to "stay out of trouble". Always strive to keep a "low profile" and not project an image to outsiders that you are the best and the brightest in what you do and that yours is the final word on any topic under discussion. There will



not be enough to make the judge see otherwise.

In the best of all worlds, the client discloses accurate and complete information to the lawyer not glossing over "unfortunate" facts and circumstances. This allows him to prepare an explanation of his client's behaviour in the circumstances early on.

However, as we have all learned over the years, there are two sides to every story.

Evidence that was not initially deemed to be important, gains in value as a more complete pictrure comes into focus. This usually happens when the "other side" gives their version of the same set of events and details that were "left out" by theclient come to light.

At this stage the lawyer can only put the best "spin" he can on his client's actions and present his case to the best of his ability.

But what about accountants? There are clients who may not obtain their desired outcomes in taxation and other matters where a professional account-ant has been called upon to assist. The client may not receive the income tax ruling he wished, even when represented professionally. The bank may not agree to the lending of funds requested or a prospective purchaser may not agree to buy based on the financial statements prepared

always be someone "out there" with more knowledge or experience than you. You can learn something from everyone so do not become haughty;

(g) the ability to capitalize on the company's established reputation in the industry. Companies, particularly owner-managed ones have founders who would love to see their businesses passed along to their sons or daughters. Studies show that very few companies survive into the second generation and the third generation today is almost unheard of. The owner-manager must come to terms with the fact that he is not building an empire. The best he can hope for is sustainability of the company throughout his watch. And then passing it along to someone else when he chooses to retire.

THREATS TO SUSTAINABILITY

These are more than just the mirror-image as to their positive counterparts. They are areas of concern to any owner/manager worried that his business continue over the long term. They include:

(a) corporate inertia - being too conservative and set in your ways to the point of paralysis. Unable to commit to anything for fear of failure;

(b) maintaining the philosophy that doing things "this way" got us to where we are today and there is no reason to change from what has worked in the past;

(c) internalizing your own sales pitches and literature intended for customers to the point where you think you are infallible and pursue new business opportunities that are far from your area of expertise;

(d) failure to have an "exit strategy" for the day when you will no longer be able to run the business as you have in the past. This can arrive suddenly due to illness, incapacity or death.

(e) inability to admit that actions taken may have been incorrect and that the company had been "wrong" in pursuing a course of action, dealing with a customer or supplier, or employee. In and of itself it may not be so terrible, but it does reflect a certain form of hubris. This can start off "small" but end up being a major source of trouble down the road.

When Is a Capital Loss Not a Capital Loss?

Most taxpayers know that capital losses incurred in one taxation year can only have these losses applied against capital gains, either in the current year, those realized during the past three years, or those to be realized at some future date.

However, there is one exemption to this rule that comes into play from time to time. This pertains to rental properties.

Joel bought a house in December, 2005 for $275000. He lived in it for awhile and "converted" it into a rental in July, 2012 when the fair market value of the property was $381000. He sold the property in November, 2015 for $355000.

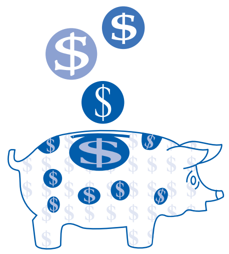
Here are the income tax implications:

(a) Joel will consider the house to be his "principal residence" for the time he lived in it between, December, 2005 and July, 2012. The appreciation of the property from $275000 to $381000 occurred while he was still living there, but no capital gain need be recognized;

(b) during the period from July, 2012 to November, 2015 the rental income earned and the expenses incurred are declared as net rental income or loss for the 2012, 2013, 2014 and 2015 taxation years;

(c) for simplicity, let's assume that no capital cost allowance was taken in any of the taxation years listed above;

(d) Joel sells the property in November, 2015 for $355000 and realizes a capital loss of $26000. Because this loss was in regard to a rental property, the full $26000 loss can be claimed as a "terminal loss" on his 2015 personal income tax return. This is in stark contrast to what many taxpayers might have believed to be the case. And they would have missed out on several $1000's of income tax savings.



Statements of Adjustments

When a home or business is sold, the lawyer prepares a "Statement of Adjustments" reconciling certain on-going expenses that are split between the purchaser and the vendor as at the date of the closing of the "deal".

Here are two sample sales transactions where such a statement is prepared. You will notice the similarity between the two.

STATEMENT OF ADJUSTMENTS -PURCHASE/SALE OF HOME

	Purchaser $	Vendor $	
Sale price		384,142.00	
Deposits paid to date	111,879.00		
Extras payable on occupancy	9,993.00		
Adjust re realty taxes		702.00	(a)
Adjust re utilities	358.00		(b)
	122,230.00	384,844.00	
Balance due on closing	262,614.00		(c)
	384,844.00	384,844.00	

(a) vendor had paid municipal realty taxes for the entire year and is now being "paid back" for the part of year still remaining after the date of sale

(b) vendor still owed some money regarding hydro at the date of sale and this amount will be included in the purchaser's payment to the utility company when he pays it after the date of sale

(c) amount owing to vendor to close the transaction

STATEMENT OF ADJUSTMENTS -PURCHASE/SALE OF BUSINESS

	Purchaser $	Vendor $	
Sale price		750,000.00	
Deposits paid to date	10,000.00		
Inventory		40,000.00	
Adjust re realty taxes		702.00	(a)
Adjust re utilities	358.00		(b)
	10,358.00	790,702.00	
Balance due on closing	780,344.00		(c)
	790,702.00	790,702.00	

(a), (b) and (c) similar to above

Note: This statement would only be prepared when the purchaser is buying the assets of the company. It would not be prepared when the purchaser is buying the shares of the vendor's corporation.

and presented.

In most cases, professional accountants and auditors inform their clients to the reality that the disciplines of accounting and income tax are not "exact sciences". There are many areas open to "professional judgment", particularly in the valuation of assets and liabilities. While the accountant strives to put "his best foot forward" on the financial statements at hand or the income tax "problem" under consideration, the ultimate decision maker, be it the bank, prospective purchaser or CRA has the final word as to whether the information presented will be accepted.

Like the doctor and lawyer, qualified accountants take oaths upon certification to uphold the highest standards of professionalism on behalf of their clients. They swear to maintain "best practices" just like the others.

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