

# THE Quarterly Dividend

Vol. 25 No. 1 Your guide to income tax & financial planning

## FAST TRACK



### Loneliest Man in Town

Every year we consider the "loneliest man in town", not by singling out anyone in particular but by pointing out one aspect of the life of the small businessman in the hope that readers will understand what it takes to be an owner/manager in the 21st century.

Much is written about how an entrepreneur might go into business. The various issues he will have to address before getting started, the movement into and the establishment of

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## Making Payments to the CRA

It is likely that you will have to make a payment to the Canada Revenue Agency some time this year. When that time comes you will have to decide how to get the money over to them.

Here is a list of the different ways taxpayers can remit their amounts due. It's bad enough you have to pay them at all. So make the whole exercise as painless as possible by picking the option that is easiest for you:

- (a) pay at the bank by using a pre-printed remittance form issued by the Agency;
- (b) if this is going to be ongoing, register an online banking account with the CRA designated as a registered payee. Arrange for your financial institution to provide a confirmation number as the payments are made;
- (c) set up a My Payment account at the CRA. It is an electronic payment

service that uses Interac Online to make payments directly; (d) arrange for preauthorized amounts to be withdrawn from your bank account on pre-determined date(s) for specified sums; (e) although not very common, the CRA will accept Plastiq credit card payments. There is a 2.5% service charge levied on each transaction; and (f) mail your payment via Canada Post.

In all cases, payments are only credited to your account when they are actually posted, so it is wise to allow two or three days for processing. Always make sure that you are sending the money to the "proper" account. There are so many different accounts with similar sounding names and numbers. It is easy to get confused!!



## Reliability of Financial Information

It is clear that there are many significant differences between financial statements that have been audited or reviewed and those that have been prepared as a compilation engagement. The most important one is the overall stated valuation of corporate assets and liabilities. The dollar value placed on the company's year-end inventory, for example, will spell the difference between "income" or "loss" for many a company.

In the first two sets of statements, the accountant is under a professional obligation to inform the reader about the inventory, usually within the notes to the financials. He will tell the user how the inventory was valued and whether it is

primarily in saleable condition.

The preparer of the compilation financial statements is under no such obligation, and is often guided by management as to the valuation to be presented in the statements.

As an example, consider a company that purchases its materials outside Canada. If the transaction takes place in \$US, the exchange rate at the time will determine the exact number of \$Can required to complete the deal. With the \$Can hovering around 75 cents American, a difference of only a few points either way, can influence the profitability of an order when it comes into the country and is eventually sold to Canadian consumers.

Compliments of

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routine that will define the enterprise and the myriad of problems and opportunities that will present themselves over time.

Not much is written about the time when the entrepreneur realizes that his career is winding down, and his best days are fewer and further between. The time comes when the dreaded "r" word is mentioned more and more often in his presence, and his family, friends and business associates, all well-meaning, are asking him what he plans to do when he can no longer put in fourteen hour days, six days a week at the "office".

The one issue that most entrepreneurs do not want to talk about is retirement. They have heard all the stories of how some people have been able to cope very well, developing a balance in their lives that they were unable to achieve during the time they were in business.

But they have also heard stories from others who express regret in having "given up the business" too soon. They have trouble adjusting to their new lives and hate having to find ways of "keeping busy", filling in the hours between the time they get up in the morning (which is probably the same time it was when they were still working) and the 11:00pm evening news.

Even though it is normal to realize that "nothing goes on forever", many entrepreneurs bargain with themselves to be allowed one more "season" of

But at least the price the company paid for the product can be easily verified. The company purchased the product from an independent supplier who charged it a negotiated price depending on a multitude of variables. And the amount paid is also easy to ascertain. The purchase invoice is paid at the prevailing \$US exchange rate.

But what happens if the company purchases the same product from a purportedly independent company but in reality has family or business ties to its owners or managers? Here, the company will pay a purchase price that reflects the particular needs of the parties and the amount of influence one has over the other. The price that is selected need not be equal to the "going" price that the same company negotiates with other

customers and the terms of payment may be more generous than those offered others.

Once again, financial statements prepared by accountants under an audit or review engagement should contain that extra but essentials information that allows the user to be better informed from the information presented than he would be if only considering financial statements prepared on the basis of a compilation.

The accompanying table shows financial statement items that the reader/user of financial statements should consider as "open to question" whenever presented with compiled financial statements. Review engagement financial statements are thought to be more reliable and those that are audited even more so.

This table shows individual financial statement captions and the "hard" questions that need to be asked, relating to them. The reader/investor cannot get this information. The company has the information and the accountant/auditor must "drill down" to obtain the details he needs to satisfy himself that the numbers shown on the statements can be supported.

**F/S Category**

**Area of possible concern**

Cash/Bank overdraft	did the bank accounts reconcile?
Short and long-term Investments	valuation issues, terms
Accounts receivable	valuation, cut-off, collectable? bad debts?
Inventory	existence, valuation
Prepaid expenses	determination
Property, plant and equipment	existence, ownership, valuation, length of use
Goodwill	existence, valuation
Accounts payable	valuation, cut off?
Short and Long-term debt	valuation issues, terms
Amounts due to/from shareholders	valuation
Revenue items	existence, valuation, cut-off
Expense items	existence, valuation, cut-off
Other issues - (a) foreign exchange transactions (b) related party transactions (c) income and sales taxes (d) outstanding litigation	

In the absolutely worst case, where readers of the financial statements have been provided with false and misleading information that they have relied upon to their detriment, the best recourse for recouping their losses is through the courts. The company is responsible for attempting to pass off fraudulent information, but they likely only did so once they realized just how disparate

their situation had become. Suing them, even if successful, would not guarantee enforcement of a judgment. Better to sue the party with "deep pockets". That would be the accountants who didn't adhere to their responsibilities and who are covered by insurance.





## The Offside Taxpayer

activity, one more contract to service, one more year to complete unfinished business that they want to see through to the end.

Having been in business for themselves for so long, they have earned the right to decide when to go and on what terms. If they had worked for others, this might have been denied them, but isn't this one of the few perks the entrepreneur has reserved for himself?

Ideally, planning and preparation should commence at least two or more years prior to retirement. This allows the entrepreneur to reconcile himself both physically and mentally to what will come next. A structured transition will be good for both himself and the party who will be taking over.

But sometimes this is just not possible. Life gets in the way of even the best laid out plans. And so the entrepreneur should strive to be prepared to move at a much faster pace if circumstances warrant. The development of an exit strategy, at least conceived of well in advance of having to be implemented, may pay off handsomely should that day arrive without much notice.

Business owners should take the time to develop a retirement plan, even if they cannot foresee the day that they will ever "hang up their hat". They should consult professionals for legal and income tax issues and experienced transition intermediaries to make the process easier.

For the last ten years taxable dividends paid by Canadian corporations have been classified as either "eligible" or "other" taxable dividends. Historically, the former have enjoyed an "enhanced" dividend tax credit and so demand less tax in the hands of individual shareholders. In the past few years, however, the gap between the two has narrowed significantly.

The mechanism is a little complicated, but essentially the cash dividend is "grossed up" by a factor and then allowed a "dividend tax credit" on this larger amount.

In 2014, for example, an eligible dividend of \$50000 was "grossed up" and taxed as if the shareholder had received \$69000 in income. The dividend tax credit was determined as \$10363. The same "other than eligible" \$50000 taxable dividend was taxed as \$59000 and allowed a dividend tax credit of \$6500.

Since all eligible dividends are paid out of a company's retained earnings, the only thing separating the two classifications is whether the company (1) paid taxes at the general corporate tax rate or (2) qualified for the small business deduction on active business income or refundable dividend treatment of aggregate investment income.

Although you may not realize it, every year, when your corporation income tax return is filed with the Canada Revenue Agency, they are keeping track of not only the amounts of income

declared (if any) but also the "kind" of income reported and how it was taxed.

They do this by allocating a corporation's taxable income into one of two separate categories. They are termed: (a) the General Rate Income Pool (GRIP) and (b) the Low Rate Income Pool (LRIP).

Basically, (a) includes income from investments that is taxed at the "full" rate, while (b) includes "active business income" that qualifies for preferential income tax treatment.

If a company with \$100000 taxable income falls under (a) its federal corporate tax rate is 34.66% and if under (b) 11% in 2015. Corporations paying tax under (a) will receive a partial refund of the taxes it has previously paid of 33.33% of the amount of dividends it declares.

Up until now, we have seen there are two types of dividends (eligible and "other") and two types of corporations (those taxed at the "full rate" and those at lower rates). We have also seen that the Canada Revenue Agency is keeping track of what kinds of income are being reported and how they are taxed.

The Agency is "happy" when a corporation that has been paying taxes at the "full" rate distributes an "eligible" dividend to its shareholders. Since the corporation has paid its full freight all along, the shareholders can benefit from an enhanced dividend tax credit.

Let's crunch some numbers:	Invest Inc \$	Active Inc \$	Offside Taxpayer \$
Taxable income	100000	100000	100000
Federal Corp Tax	34660	11000	11000
Dividend refund	-16660		
Corporation Tax (a)	18000	11000	11000
Shareholder (with other income)	20000	20000	20000
Dividend from corporation			
\$50,000	69000	59000	69000
	89000	79000	89000
Federal income tax (b)	4513	6133	4513
Combined income taxes (a) + (b)	22513	17133	15513



Unfortunately, entrepreneurs have a history of "doing things their own way". They have followed their own instincts for so long that the issue of retirement is just another of the many episodes in their lives that will have to be addressed when the time comes. Besides, no one else can understand their special circumstances and their particular situation.

The truth of the matter is, however, these entrepreneurs will one day have to face reality. They will no longer be able to put off the inevitable.

They will have to recognize the big picture and get used to the idea that the world will no longer revolve around them.

They will need to practice patience, perseverance, flexibility, compromise and humility. Fortunately, these are the same traits they exhibited throughout their working lives. But this time they will need them in spades, if they are ever going to transition into retirement without driving both themselves and those around them crazy.

**Thanks for Your Referrals**

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The Agency is also "happy" when a corporation that has been paying taxes at the lower rate distributes an "other than eligible" dividend to its shareholders. Since the corporation has benefited all along with its tax rate, the shareholders will only be entitled to "regular" tax treatment on the dividends they receive.

However, the Agency is not "happy" when a corporation paying taxes at the lower rate issues an "eligible" dividend thereby allowing its shareholders the enhanced dividend tax credit. To show their "disapproval" they levy a special surtax on the corporation when it issues these

dividends. The amount of the tax is 20% of the dividends declared.

The combined income tax bill for the corporation and its shareholder is \$22513 if the income is from investments and \$17133 if from an active business (see table on page 3).

The Offside Taxpayer will try to get the best of both worlds and pay \$15513. The Canada Revenue Agency will apply a 20% surtax on the misrepresented dividend that totals \$10000. This will discourage the Offside Taxpayer from going through with his scheme (see table on page 3).

## New Year's Resolution

We all have a lot on our plates and sometimes our immediate goal is just getting through today, let tomorrow take care of itself.

Here is a schematic of the human brain. It has been divided it into ten sections, each representing an aspect of everyday life that may go unnoticed in our sub-conscious.

Each section is important in and of itself but cannot work without the others. Together, they create the real "you". Let 2016 be the year that you become the person who can put it all together!!



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