

Small Business Income Tax

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Forms of Business



There are three forms a business can take;
sole proprietorship, partnership and corporation.

A sole proprietorship is an unincorporated business owned by a single person.

A partnership is when two or more individuals or corporations join together to carry on a trade or business. Each contributes money, skill, labour or property to the business and receives a share of the profits, which are divided according to the partnership agreement, in return.

A corporation is a separate legal entity that can enter into contracts and own property in its own name, separate from its owners.

Sole Proprietorship



The owner of the sole proprietorship does not have separate legal status from the business. That means that in the eyes of the government and Revenue Canada, the business and the person are the same entity.

Sole proprietors pay personal income tax on all earnings of the business. Your income tax return must include one of several forms outlining the earnings of your company. The most common form is T2124, Statement of Business Activities.

The fiscal year for a sole proprietorship usually ends on December 31st. The owner can choose a different year end by filing form T1139, Reconciliation of Business Income for Tax Purposes, however, you will pay more tax earlier.

If December 31 is the year-end, the owners personal tax return must be filed by June 15, although interest will be charged on taxes owed from April 30 (no penalties though).

Partnerships



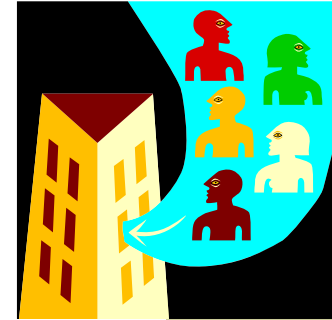
A partnership (including a limited partnership) does not file an income tax return itself. Instead, each partner includes a share of the income on his / her return by June 15 if December 31st is their year end.

Each partner files one of the forms mentioned above with his / her own tax return.

A partnership also has to file a partnership information return if it has six or more members or if one of the partners is a member of another partnership.

A partnership usually uses December 31st as its year end for tax purposes as well but it can also elect a different year end if all its members are individuals.

Corporations

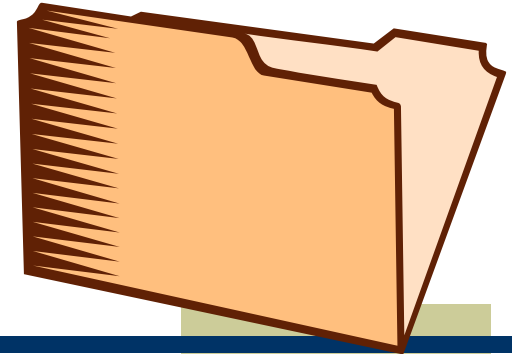


A corporation must file a corporate income tax return (T2) within six months of the end of every taxation year.

A complete set of financial statements must be included with its return, along with the appropriate schedules. Quicktax and other tax software can make this job much easier than in the past.

Its taxation year, or fiscal year, is chosen by the owners. It does not have to use December 31st as its year end. Usually an owner will choose a slow period (when inventory or sales are low) in order to close off the books.

Reasons for Keeping Good Records



- ◆ They can help you identify the sources of your income. This may help you prove that some sources of income are non-business or non-taxable.
- ◆ They can mean tax savings. They will make sure you do not forget some of the tax deductible expenses incurred by your business.
- ◆ They can prevent problems if your company is audited for income tax or GST. If incomplete records exist, auditors may have to use other methods, that may cost you money and time, to calculate taxes due. Expenses may be disallowed if not supported by records.
- ◆ You will be better informed about the financial position of your company. Records provide information to owners, allow for comparisons across years and assess the value of your company.
- ◆ They may help you get loans from banks and other creditors. Creditors can extract the information needed. Good records show the ability of management to properly run the company as well.

Legal Requirements



- ◆ Records must be kept in Canada unless you have permission from Revenue Canada to keep them outside. If they are kept outside they must be made available at Revenue Canada's request.
- ◆ They must be kept for 6 years after last use. This does not just mean after your income tax has been filed but six years after the records were required for any purpose. For example, let's say you bought some restaurant equipment in 1999 and sold it in 2001. The records relating to the purchase were created in 1999 but you need them to calculate the gain or loss on the sale in 2001. This means that the 1999 records must be kept until at least 2007, six years after the last times the records were used.
- ◆ They must allow you to determine how much tax you owe, or the tax, duties, or other amounts to be collected, withheld or deducted or any refund or rebate you may claim and be supported by vouchers.

Bringing Assets Into A Business



- ◆ Companies often need assets to operate. Owners may own assets that their companies can use. The assets can be transferred to the company to allow it to claim the expenses associated with that equipment, such as maintenance and depreciation.
- ◆ If you are a Sole Proprietorship, the Income Tax Act requires that you transfer the equipment at Fair Market Value (FMV). If that is more than what was paid for the equipment the person must claim the difference as a capital gain on their personal taxes.
- ◆ If you are transferring the asset to a corporation or a Canadian Partnership, you can do so at an elected amount. This amount can be different from the Fair Market Value as long as certain conditions are met.

Earnings, Expenses And Taxes

- ◆ Businesses must use the Accrual Method to record revenue and expenses unless your business is a farming or fishing business. That means that you must record revenue when you have delivered / completed the good or service, not when you are paid. It also means that expenses are recorded when you incur them, not when you pay for them.
- ◆ It's a good idea to keep expense and sales journals to record all transactions in addition to your deposit slips, cancelled cheques, bank statements and receipts.
- ◆ To be deductible, expenses must be incurred for the sole purpose of earning income. You must be able to back up your claim.

What is Business Income?

- ◆ Business Income can come from sources other than sales. If it relates to your business you have to record them as income.
- ◆ Business income includes money you earn from a profession, or trade, a manufacture or undertaking of any kind, an adventure or concern in the nature of trade, or any other activity you carry on for profit or with a reasonable expectation of profit.
- ◆ Employment income is not business income.



Examples of Other Business Income

- ◆ Recovery of Bad Debt – If items previously recorded as income were deemed uncollectible and expensed as a bad debt and later recovered, they must be reentered as income.
- ◆ Vacation trips or awards of any kind, as a result of business activities, must be recorded as income.
- ◆ Government grants and subsidies must be claimed as income or used to reduce an expense. If the grant was used to buy property that can be depreciated, you must reduce the capital cost of the property on your balance sheet and only depreciate the value that remains.
- ◆ Rental income can be income from property or income from business. There is a guide to help you determine which you might have and how to report it.
- ◆ If you barter, or trade, one good or service for another, the value of the good or service provided may be considered proceeds from a business operation. If you offer goods or services, normally provided as part of your business, in a barter transaction the value of the goods or service must be included in your income.
- ◆ If you sell a piece of capital property, such as land, for more than its cost you may have income to report.

Expenses



- ◆ The Cost of Goods Sold is an expense a business may have. To ensure the cost is accurate, inventory must be properly valued. Inventory is to be recorded at the lesser of cost or fair market value.
- ◆ If you are running a business from your home, you are able to deduct expenses for the business use of the work space if the space is either your principal place of business or you use the space only to earn business income, and you use it on a regular and ongoing basis to meet your clients or customers. If either is true you can deduct a reasonable portion of such costs as heating ,electricity, insurance, cleaning materials, property tax, mortgage interest, and depreciation. The percentage of the house used can be used to determine how much to expense.
- ◆ You cannot deduct personal living expenses that are not related to the earning of business income.
- ◆ Accounting and legal expenses are deductible.
- ◆ Advertising expenses are deductible, however, if a foreign broadcaster or non-Canadian magazine are used they may not be deductible.

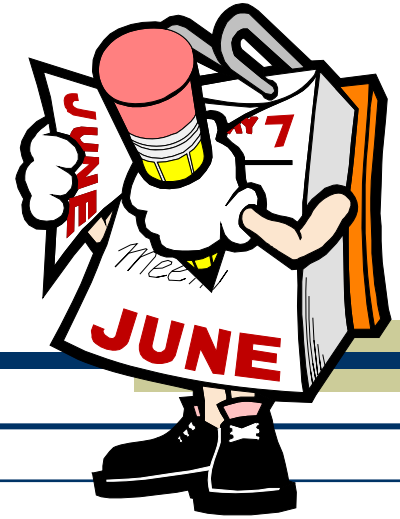
Expenses Continued...

- ◆ Business tax, fees, dues and licenses are deductible however some club fees may not be.
- ◆ Insurance on equipment used in the business is deductible.
- ◆ You can generally deduct interest on money you borrow for your business however there are limits on what you can deduct on passenger vehicles and vacant land.
- ◆ The cost of maintenance and repairs is deductible.
- ◆ 50% of the costs of meals and entertainment used to earn business income can be deducted.
- ◆ The vehicle expenses that can be deducted depend upon the type of vehicle you have. Most cars, vans, station wagons and some pickup trucks are considered passenger vehicles and there may be limits to how much depreciation, interest and leasing costs can be deducted. Vehicle expenses must be reasonable and complete records of your business travel should be kept. The types of expenses that can be deducted include; fuel & oil, maintenance and repairs, insurance, license and registration fees, depreciation, interest and leasing costs. If the vehicle is also used for non-business use only a portion of these costs can be deducted.
- ◆ Office expenses can be deducted.
- ◆ Salaries, including the employer's costs, can be deducted.
- ◆ Startup costs can be deducted only if you earned income in the year they were incurred so you must be very specific about the date your business started.

So What is Depreciation or Capital Cost Allowance?

- ◆ When a company purchases equipment, property or other items which do not get used up within one year, they cannot be expensed. For example, if you purchase a truck for your business, Revenue Canada does not let you claim the purchase price of the truck in the year it was purchased. They do let you deduct its cost over the estimated life of the truck. The amount you deduct each year is called Depreciation or Capital Cost Allowance. Costs related to the installation or setup of the equipment or additions to the property are also capitalized and not expensed. Land cannot be depreciated.
- ◆ Revenue Canada sets rates for each class of equipment. Other depreciation methods can be used for your financial statements if you wish but the CCA rates must be used for income tax purposes. The actual calculation of CCA is discussed in another workshop.

Important Dates



	Sole Proprietors / Partnerships	Corporations
15th of each month	Remit Payroll Deductions	Remit Payroll Deductions
End of February	T4 and T4A slips and summary	T4 and T4A slips and summary
Monthly		Installation on current year's taxes by the end of each month.
March 15th	First tax installment	
March 31st	Partnership Information Return if necessary	
April 30th	File personal tax return & pay tax owing (can wait until June 15 th)	
June 15th	Second tax installment & personal tax return	
September 15th	Third tax installment & personal tax return	
December 15th	Fourth tax installment & personal tax return	
Two / Three Months after Year-end		Remainder of Corporate Tax is due two months after year end unless claiming the small business deduction, in which case they are due three months after year end..
Six Months After Year End		Must file a T2 Corporate Income Tax Return within 6 months of year end.

Conclusion

Many small businesses succeed early, only to fail later because they failed to keep records and do proper tax filing. Plan for success and remember to keep a look ahead for tax time and you will make it through the business maze.

