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Business Matters

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TAXATION

Consider the Taxes

Develop a strategy for distributing earnings and reducing corporate income taxes.

For most owner-managers, their goal is to create personal wealth through the operation of a successful business. Unfortunately, corporate and personal tax liabilities (among other things) stand in the way. Owner-managed businesses must struggle with tax on two fronts:

1. making a profit while minimizing the corporate tax liability
2. minimizing personal taxes while taking remuneration out of the company.

Have a Strategy

The first step to minimizing personal and corporate taxes is to put a tax strategy in place. Such a strategy depends on each individual owner's personal cash-flow needs. Because tax rates applicable to corporate income are often lower than to personal income and because this differential is only levied when the owner-manager withdraws the funds, taxes can be deferred to the extent such income is left in the corporation.

Often, this is not a realistic option since the owner-managers may need all or most of this business income for personal use. Then the owner-managers must remunerate themselves in the form of:

- salary
- dividends
- a combination thereof.

Deducting salary expenses reduces taxable income and lowers corporate income taxes. However, because dividend payments are not a deductible expenditure (i.e., it is a distribution of profits), personal taxes will be higher. Personal income taxes applicable on the dividends are lower than on salary to adjust for the difference (i.e., tax integration).

Tax integration works well for corporations earning active income under $500,000 as the "combined" (i.e., corporate and personal) tax rate differential is minimal (though it varies for different provinces). Therefore, employees are normally indifferent whether they receive salary or dividends, aside from how each affects CPP deductions or RRSP contribution room. However, this is not the case for corporations earning active income above $500,000 as the "combined" tax rate applicable to this layer of income is higher roughly by two-to-five percentage points depending on the provinces.

Avoiding High Tax Rates

Because profits in excess of $500,000 are not eligible for the small-business deduction, consideration must be given to declaring a salary that will drop the corporate taxable income below the $500,000 limit. By declaring a salary, taxpayers do not have to lose two to five percentage points.

After this decision is made, however, employees may find themselves in a higher personal income tax bracket because this remuneration must be added to the regular salary and other benefits received.

Once your personal taxable income exceeds predetermined thresholds, the rate on any excess amount rises significantly. For example, the rates in Ontario for tax year 2016 are scaled as follows for taxable income in excess of:

- $150,000 (47.97%)
- $200,000 (51.97%)
- $220,000 (53.53%).

Sometimes corporate taxpayers may want to be taxed at the higher corporate rate (i.e., decide not to pay the corporate income out in salaries) and leave the corporate income in excess of $500,000. Because the higher corporate rate still provides much lower "immediate" taxes, the corporate taxpayers may choose to pay the extra two-to-five percentage points if their rate of return on the deferral can exceed this eventual cost. Again, such strategy depends on the particular owner-manager's annual cash flow needs and circumstances.

Be careful when purchasing capital assets.

Purchasing Capital Assets To Save Corporate Taxes

Many owner-managers believe that purchasing capital assets will significantly reduce corporate taxable income. Certainly, purchasing assets will reduce taxable income, but not as significantly as one might believe. Two factors come into play:

1. The capital cost allowance permitted by the Canada Revenue Agency (CRA) is a percentage of the cost of the asset and not the entire cost.
2. The half-year rule usually comes into play in the year in which the asset is purchased, which restricts your percentage by another 50%.

Example:
Your business purchases equipment for $300,000, which is subject to the prescribed depreciation at the rate of 20%. Therefore, in the year of purchase, your business can deduct $30,000 (i.e., $300,000 × 20% × 50% half-year rule) which only represents 10% of the total purchase price. Assuming the 15% small business rate in Ontario, this provides a tax benefit of $4,500, which is minuscule compared to the actual spending.

The primary purpose of purchasing capital assets should be the need for the capital asset in the business; the tax savings should never be a main objective in arriving at this decision. The need to consider other aspects of purchasing, such as cash flow requirements to meet loan obligations as well as additional expenses for insurance, upkeep and operational costs, should be primary considerations in the decision-making process.

Family

To achieve tax effectiveness, owner-managers may consider bringing family members into the business. There may be benefits to distributing profits through salary or dividends to family members earning lower incomes. However, a caution must be given in both situations. For salary, the amounts paid to the family members must be reasonable and should be a fair consideration for their efforts. For dividends, the family member must own the shares and ensure there is no conferral of benefit when transferring the shares to them. Also, the owner-manager must consider any ownership and control issues consequent upon giving shares to family members.

Bringing family members into the business may also be useful as a long-term strategy in order to reduce or defer the overall impact of personal and “combined” taxes should the owner-manager suddenly die or decide to take early retirement.

Aside from tax objectives, succession planning is also essential should family members want to be part of your successful business. When there is more than one owner, bringing family members into the business needs to be discussed before any problems arise. Original owners will not only want to protect their percentage ownership in the business but will also want to ensure their remuneration is not impacted by distributions to others.

Tax and succession planning require careful review of everyone’s intentions and circumstances and are often technically complex. Your CPA and solicitor should be able to provide guidance as to how to structure ownership through different classes of shares that protect existing owners while providing new shareholders with the rewards of ownership. Such carefully restructured shareholdings can selectively distribute dividends so all shareholders can receive the rewards of ownership and tax savings without undue stress on corporate cash flow.

Plan Early

Because most tax-planning strategies cannot be put in place retroactively, leaving tax planning until the end of your fiscal year end is not a good idea.

Owner-managers should work with their CPA early in the development of the business to establish long-term goals. From then on, they should meet with their CPA annually to monitor whether the goals are being realized. Any adjustments necessary to ensure current financial needs are being met and that the long-term strategy required to build wealth for retirement or succession is on track can be made at these meetings.

MONEYSAVER

Rising Interest Rates

Start planning now for interest rate increases.

Historically low rates have encouraged borrowing for equipment, real estate, operating lines of credit and everyday purchases. How much longer interest rates will remain at these levels is an open question but now

is a good time to start thinking about the potential impact of higher rates on your business and personal life.

Potential Effects of Higher Interest Rates

Here are some of the effects higher rates could have on your business:

- Higher interest rates will drive up the cost of operations, manufacturing and delivery, which will force small businesses to either increase prices or face a smaller bottom line. If prices go up, consumers cut back their purchases if they need to borrow for vehicles and mortgages, or use lines of credit.

- Any resulting cash crunch may force customers to stretch payment time on their payables. This makes you your customers' banker.

- Payout periods of as much as eight years for equipment and vehicles have led many purchasers to believe that if they can make the monthly payments they can afford the asset. But, as the years pass, the warranty expires, the vehicle value plummets and repair bills mount. It may be difficult to finance a replacement if a significant amount is still owing.

- Personal finances are affected as well. A salary increase decreases company profit while increasing personal income taxes.

- Financial institutions become more selective. New companies without credit ratings may find it impossible to obtain a loan. Established companies may not be able to extend lines of credit.

Review income statements and balance sheets.

Proactive Planning

The following suggestions may help reduce the impact of rising interest rates on your business:

- Review your corporate income statements and balance sheets for the last five years because they reflect the lower cost of outstanding debt as well as the historical cost of your operating assets. Calculate the impact on the corporate bottom line if interest rates increase by two, three or more percentage points.

- Review your asset base. Determine what assets will need to be replaced within the next five years and estimate their replacement cost. If sales and expenses in the next five years remain the average of the last five years, would the increase in asset cost, combined with the need to borrow additional funds at higher interest rates, put undue stress on your operational capability?

- Review your personal debt at the same time as you review the corporate financials.

- Start building a cash reserve within your business.

- Consider reducing the long-term payouts on equipment and vehicles.

- Lock in existing secured loans.

- Lock in mortgages.

- Start incremental price increases to avoid a sudden and dramatic increase that may scare off clients if imposed later.

- Reduce the number of days outstanding for accounts receivable. Review your client base with the goal of reducing the lines of credit granted. Negotiate new payment terms with your long-term customers.

- Consider deposits on all jobs. Potential customers should understand that there are up-front costs that must be paid for, and that you are not a bank but a contractor.

- If your business has credit card balances or lines of credit with high interest rates, pay them off. If business credit cards are essential to your business, structure cash flow to pay off monthly balances.

- Use a percentage-of-completion method for payment on long-term contracts. If payment is not made as arranged, stop working. Better to walk away with a 20% loss then a 100% write off.

- Review all sources of company credit. Eliminate those with variable rates. Fledgling entrepreneurs should work to establish a line of credit with their financial institutions and increase it over time to ensure that in the future, that line of credit is still available.
- More established businesses should work to reduce the debt on their lines of credit in case a buffer is needed to meet short-term cash needs.

An Ounce of Prevention ...

Should interest rates start to rise, the trend is likely to continue upwards. Owner-managers should start now to model their business activity in potential future economic and credit conditions. Business plans derived from these models will help ensure the continued success of their business and family finances when the 2020 decade rolls around.

MANAGEMENT

Top Challenges

The more things change, the more they stay the same.

No matter what the economic conditions, some business worries never go away. Here are a few tips on how to handle some of these eternal problems.

Cash Flow

Customers will continue to extend payments over 90 days.

Understand your cash flow. At the end of each week, review accounts receivable, and accounts payable and make sure you know what you must pay in withholding taxes. Do not use your source deductions to pay suppliers unless those deductions are actually in the bank. Send requests for funds to suppliers before the end of the month.

Owner-Manager Fatigue

Overworked and underpaid will continue to be the mantra.

Learn to pace yourself. Work to make money not save money. Work at what you do best and delegate the rest. Consider that if you work 2,000 hours per year and your business has sales of $400,000, you are effectively generating $200 of revenue per hour. Ask yourself why you are trying to learn how to do something a subcontractor can do in a day.

Maintaining Customer Base

Maintaining clients while working to get new ones is going to be a challenge.

In tough times, even long-time customers may ask you to cut your costs or they may cut back their orders. Review the profit on your best customers, not just their sales volume. Visit the customer and find out their expectations for the coming year. Consider limiting services to marginally profitable customers.

Employers

Finding and keeping good employees is never easy.

Older employees may retire and good employees may leave. New, inexperienced employees do not solve short-term problems.

Happy employees are loyal and productive. Be approachable. Let employees tell you what they need. Employees always appreciate a bigger pay cheque, but a good working environment and feeling valued will also go a long way to keeping employees.

Overhead

The cost of everything will continue to rise.

Capital asset costs, fuel, property taxes, light, heat, power, insurance, and maintenance will continue to rise and put pressure on your cash flow. The same cost pressures will also affect the standard of living of your own family and the families of your employees.

Evaluate all aspects of business costs and perks. Look at discounts, value added and other incentives provided to clients. Review perks to employees and determine whether there are more economical solutions that will retain the good will of the employees but not put more pressure on your cash flow.

Technology and Changing Demands

Keeping up with new developments will be a challenge.

Changes in technology, process, or client needs require training and financing to transition from the tried and true. Budget for the inevitable or you risk being outflanked by the competition.

Social media is changing the entire marketing process.

Marketing and Advertising

Connecting with customers will continue to be a challenge.

Maximizing your brand is difficult at the best of times; unfortunately, social media is making the entire marketing process even more problematic. Analyze your market and decide whether the best way to reach potential customers is: one-to-one contact, social media, online advertising, television, radio, newspapers, or magazines. You may find that more and more dollars have to be spent to create a cross-media presence that provides the same information without any guarantee of a return on investment.

Consider a short-term contract with a marketing specialist to review your company and its client base to help determine the best combination of media to reach your target market. Then, develop a plan to deploy your advertising budget to the appropriate media.

Maintaining Control

Managing all sectors of the business will continue to be a challenge.

Managing sales, manufacturing, ordering, marketing, human resources and administration as well as dealing with the considerable number of regulatory agencies will continue to become more complex. Trying to do everything yourself will undoubtedly lead to failure in one or more areas.

Control your business by managing rather than doing. Find the best person to run each particular part of the business. Define their responsibilities with a detailed and accurate job description and schedule regular reports. This will enable you to understand what is happening within the organization, solve problems and improve operations. Have faith in your subordinates.

Regulations

Red tape is and will continue to be the nemesis of small business.

Research suggests that these compliance issues consume eight weeks of employee time per year.

Because collecting and providing information to governments and regulators cannot be avoided, owner-managers should institute in-house procedures and write manuals. Reduce the use of employee time and associated costs by purchasing reporting software. If you do not have in-house expertise, arrange for a third party to prepare regular reports. Filing reports correctly and on time eliminates the cost and stress that follows from non-compliance.

Plan Ahead

The size and complexity of these and similar issues will move forward in lockstep with the business. Analyzing each potential conflict area and developing a process to stave off potential problems is an excellent offensive tactic that will lessen the cost and uncertainty of moving forward for the balance of 2017 and beyond.

TECHNOLOGY

Password Management

Password manager software is an inexpensive way to secure all your passwords.

Our need for passwords to access everything in our life has become pervasive. Every agency, every computer, every credit card, every smartphone requires an exponential explosion of letters, numbers, and symbols to secure all information from hackers, whether it is personal data or corporate information.

To complicate matters, it is no longer permissible (or advisable) on many sites to use a simple password that is easy to remember, such as a word or name. Instead you must create a password with numbers, special characters, upper and lower case letters, and a minimum length.

One study suggests the average individual has at least 25 Internet-accessible accounts with passwords, while other sources suggest that number could be substantially higher. Is it any wonder that most individuals will, whenever possible, assign the same password to as many accounts as they can? Hackers know this and once they compromise one account, it often doesn't take long to gain access to your other accounts.

Use Different Passwords

The best means of protecting your personal information is to use a different, unguessable password for every account. Most password management software includes the ability to generate passwords, and then store them for you. The beauty of using a password manager is that you only have to remember one password to access all of the passwords you need to remember.

High-end password managers support multiple languages and are able to tie in passwords with hundreds of websites. Two-factor authentication is usually required (and should be!) to protect data in the event someone finds your password and logs in on your device or tries to log in on a new device that is not registered.

Set Up

Setting up a password management app generally requires you to download and install the software and add browser extensions for each browser you use. If you use multiple devices, you will need to load the app on each one. To set up an account, you will use your email address and will need to come up with a master password or passphrase (i.e., one long, hard-to-guess password to rule them all).

One primary password gives you access to all your passwords.

After creating the master password comes the arduous task of entering data about the various accounts or sites you need to access.

Some password managers will import your user names, auto fill standard information, and pull passwords from your existing browsers, although, if you haven't saved the passwords in the browser, the data will have to be entered manually. The password manager will typically assess the strength of your current password, and prompt you to generate a new, stronger password (typically at least 16 characters) for that site. Experts also suggest that you revisit your security questions and determine whether you want to change them as an added security measure.

Don't Forget Your Master Password

Unlike a typical website with a "forgot password?" feature, the master password is often not recoverable in that way. There are very few password manager systems that provide a "hint" to enable you to try to rebuild your password. For most, you will have to start all over and rebuild the passwords for every site and every account keystroke by keystroke. Commit your master password to memory; do not click "remember my password" for your master password; typing it often will help you to remember it.

Cost Factor

Most of the providers of password manager software provide free trial subscriptions; several offer a limited version of their software for free, with the ability to upgrade for additional features and support for an annual fee. Freebie options aside, password manager services typically range in price from $20 to $60 annually.

In Case of Emergency ...

If a person is incapacitated or dead it will be impossible for someone else to access the accounts. It is important to ensure that the software used provides the ability to set up an emergency contact to inherit your passwords. Some providers allow you to set a waiting period before a trusted individual can access the codes so that the accounts cannot be accessed while you are alive. If someone tries to access your accounts, you will be notified by email. Other providers allow you to designate specific accounts, such as the business account, that can be accessed by specific people, such as your business partner, or to designate personal accounts to a trusted relative or friend.

Large Benefit for Small Cost

Strong passwords are a necessity for everyone, and we all tend to use passwords that are easy to crack; this makes us easy targets for nefarious people looking to steal our information, money or identities. Using a password manager is an inexpensive way of ensuring access to the ever-growing number of sites we must access in our interconnected world while making it difficult for anyone else to gain access to our personal and financial information.

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