DJB CHARTERED PROFESSIONAL ACCOUNTANTS

DURWARD JONES BARKWELL & COMPANY LLP

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FORESIGHT

CONTEMPORARY IDEAS FOR BUSINESS MANAGEMENT SPRING/SUMMER 2020

The 7 Most Common HST Audit Issues

We have a specialized team at DJB that specializes in Commodity Tax. GST/HST can be complex and confusing if not dealt with by a knowledgeable professional. Oversights may trigger an audit and unnecessary penalties and interest assessed by the CRA.

We've compiled a list of the most common audit issues that we've seen to date. If you feel that you may need assistance with any of these HST areas, please contact us – we are happy to assist.

1. **Claiming Input Tax Credits** (ITCs) without proper documentation (see criteria table for specifics)
   - Ensure that the vendor's GST/HST number is always on the invoice, if not, ask for another to be prepared.
   - Do not used credit cards statements as your support. It is not considered acceptable proof for the CRA.
   - Also note, the CRA does not allow amendments where the sole purpose is to claim additional ITCs – any additions must be claimed on a future return.
2. **Invoices made out to the wrong company**
   - Holding company invoices cannot be claimed by the operating company
3. **Intercompany transactions – Section 156 elections and form RC4616**
   - Section 156 elections cannot be filed solely based on a controlling interest
   - Most situations required 90% ownership (parent/sub)
4. **Claiming ITCs when a portion of the related revenue is exempt**
   - Exempt income does not require GST/HST to be charged however no corresponding ITCs can be claimed on related expenses
5. **Self-assessment errors on acquisitions of real estate (two scenarios to be mindful of)**

   a. If the real estate acquisition is primarily used for taxable activities (e.g. commercial) – full ITCs can be claimed and the amount of HST owing would be nil. If a self-assessment is not completed, the CRA can reassess and add the HST due on the HST return. Thus, not having the ability to amend a return to add additional ITCs can result in significant cash flow issues and interest assessed by the CRA.

   b. If the real estate acquisition is used for exempt activities (e.g. long-term residential) than no ITCs can be claimed and HST would be owing. In this scenario, if a self-assessment is not completed, CRA can also reassess and include interest (same as scenario a).
6. **Claiming 100% ITCs on meals/ entertainment and passenger vehicles**
   - Meals/entertainment claims are only eligible at 50% of the ITCs.
   - Passenger vehicle ITCs are capped at the GST/HST on $30,000 capital cost (typically $3,900).
7. **Failure to charge/collect GST/HST on the sale of assets**
   - Commodity tax registrants are required to charge GST/HST when selling an asset used for commercial purposes.

Article written by: **Cory Prince,** CPA, CA

I Own a Small Business. Should I Incorporate?

I have a small business. Should I incorporate it? I often get this question. The answer depends on a number of factors.

LET'S FIRST LOOK AT SOME OF THE ADVANTAGES OF INCORPORATING

Limited Liability – Operating your business through a corporation provides some security against personal liability. It makes it more difficult for someone to go after your personal assets if the business defaults on its debts. If you operate your business as a proprietorship, your personal assets such as your home could be at risk. However, if your corporation applies for a business loan your banker may still require a personal guarantee in some circumstances.

Tax Savings and Deferral – In Ontario most Canadian controlled private corporations can earn up to $500,000 profit from their business and only pay a 12.5% tax rate on this income. This is considerably lower than personal tax rates. Therefore, there is more money left over to reinvest into the business such as purchase more equipment or hire more employees. You should note that the profits need to stay in the corporation. If taken out, they must be taxed as either a salary or a dividend to the individual. At that point, the tax deferral is lost.

Income Splitting – Income splitting can be a major reason for incorporating your small business. Dividends can be paid to other family members who have share ownership. However, this has changed significantly due to some new tax legislation. The ability to pay dividends to other family members depends now on the amount of share ownership and their involvement in the business. You need to consult a tax professional before making any decisions on share ownership where other family members are being considered.

Lifetime Capital Gains Exemption (LCGE) – The LCGE allows some incorporated businesses to be sold at a gain of up to $866,912 per individual without paying any tax. There are a few specific requirements that must be met before the LCGE can be claimed on the sale of an incorporated business, but with a successful business and proper planning the possibility is there.

Estate Planning – A corporation is a separate entity to you, so it continues to live on regardless of what happens to you. This can be helpful when planning to transfer your assets to others. It is much simpler to pass on to the next generation shares of your corporation rather than all of the assets that would be held by you directly if the corporation did not exist. If you accumulate significant wealth inside your corporation, you could freeze the value of your estate and thus tax bill on death and let future growth accrue to your children. In Ontario, you could draft a second will that deals with just your ownership in your corporation. This allows the shares of the company to pass to your beneficiaries without estate administration taxes (probate fees). These are just a few examples of how corporations provide more flexibility.

Canada Pension Plan (CPP) – If you are a self-employed proprietor and have business income at or above $57,400 in 2019, you will pay CPP of almost $5,500. If you transferred your business to a corporation and began paying yourself dividends you could eliminate this annual cost. However, a decision such as this needs to be part of an overall plan. There may be times you wish to remunerate yourself by way of dividends, and other times by way of a salary. A corporation gives you that flexibility.

LET'S LOOK AT THE DISADVANTAGES OF INCORPORATING YOUR BUSINESS

Administration – The main disadvantage of incorporation comes in the form of administration, which translates to additional costs. Since the corporation is a separate entity, it has to file its own income tax return. To do so you will need appropriate accounting records so you can produce annual financial statements, which include an income statement and a balance sheet. You should hire an accountant to look after this. You will also need to incur legal costs to incorporate the business and prepare the annual minutes and other filings required by the Business Incorporations Act.

Losses Are More Difficult to Use – It's not uncommon for start-up businesses to incur losses at first. When you operate a proprietorship and incur a loss, you can deduct that loss against your other personal income. If you were operating that same business through a corporation, the loss could not be applied to your personal income. Instead, the loss can be applied to another year's corporate tax return to reduce tax within the company only. The company could carry the loss backward up to three years to receive a refund of some previously paid taxes. Alternatively, the company can carry the loss forward up to twenty years to reduce taxable income on a future return.

I hope this article helps you if you are considering incorporating your business. If you have any questions please do not hesitate to reach out to me or another tax professional at DJB.

Article written by: **Don Knechtel**, CPA, CA

Annual Financial Statement Preparation - What are My Options?

All corporations, for-profit and not-for-profit, must prepare annual financial statements to accompany their tax filings with Canada Revenue Agency. However, determining the "type" of financial statements you engage your external accountant to prepare will vary depending on your organization's specific circumstances.

In the not-for-profit world the requirements for financial statement preparation are mandated by the enacted Not-for-profit Corporation's Acts, but directors and shareholders of for-profit corporations have much more flexibility and freedom when making their annual decision on the type of financial statements they wish to have their external accountant prepare.

There are three levels of work that can be performed on a set of annual financial statements. The level of work performed by the corporation's external accountant will vary depending on the shareholder's specific needs and if the financial statements will be relied upon or distributed to external users such as the bank or potential investors or purchasers. Generally, these external users will want to ensure sufficient work has been performed on the financial statements by your independent external accountant to obtain a level of confidence they are relying on accurate and complete information.

Notice to Reader Financial Statements

Notice to Reader, or Compilation, financial statements are generally prepared when there is no intention for the financial statements to be used or relied on by external parties (unless specifically allowed by your lenders/creditors). In these engagements, the external accountant simply takes the balances provided by the corporation's management and formats them into standard financial statement form. Minimal work is done by the external accountant to ensure the figures are accurate and there is no requirement

that the balances are reported based on any specific set of accounting rules or framework, such as Accounting Standards for Private Enterprises (ASPE) or International Financial Reporting Standards (IFRS). Since limited work to determine accuracy is performed by the external accountant and no assurance is given, fees for preparation of Notice to Reader financial statements are the lowest compared to the other two options.

When it makes sense for Notice to Reader financial statements:

- No external users
- Typically needed for tax compliance filing
- Desire to keep costs low
- No assurance required on balances reported

Review Engagement Financial Statements

The second type of financial statements provides users with limited assurance that nothing has come to the attention of the external accountant that causes them to believe that the financial statements do not present fairly, in all material respects, the financial position and results of the corporation. The external accountant is able to provide this limited assurance conclusion as the work they perform is more involved than when preparing Notice to Reader financial statements. This includes applying analytical procedures on reported balances and making inquiries of management and others within the entity to corroborate the reported balances. Generally, Review Engagement financial statements are prepared when there will be external users relying on the financial statements. This may be in situations where the corporation has moderate external financing and must report to the lender to ensure any financial covenants of the lending agreement are met. Review Engagement financial statements may also be requested by non-active shareholders to help give them some comfort on the results being reported by management. Unlike Notice to Reader financial statements, Review Engagement financial statements must follow an agreed upon accounting framework, such as ASPE, and will include additional disclosures not typically found in Notice to Reader financial statements. These disclosures give information to the users of the statements and allow them to further assess the reported balances. Additional disclosures would include a Statement of Cash Flows as well as Notes to the Financial Statements. The additional procedures performed by the external accountant along with the additional financial statement disclosures makes a Review Engagement financial statement a more expensive option than a Notice to Reader.

When it makes sense for Review Engagement Financial Statements:

- Statements to be distributed to external users
- Typically required with moderate debt levels
- Non-active shareholders
- Limited assurance on reported balances desired

Audited Financial Statements

An Audited Financial Statement provides users with an opinion that the financial statements present fairly, in all material respects, the financial position and results of the corporation for the period being reported on. In addition to the analytical procedures and inquiries of management performed in a Review Engagement, the external accountant plans and designs audit procedures to test areas where risks of material misstatements specific to the corporation and its industry are significant. Examples of these procedures would include physically inspecting assets and confirming reported balances with third-parties. The auditor also considers the design and implementation of the corporation's internal controls in order to design audit procedures that are appropriate in the circumstances. Similar to Review Engagement Statements, Audited Financial Statements must follow a specific accounting framework. Due to the extensive work required to give an audit opinion, the fees for Audited Financial Statements are the highest of the three options. Generally, owner-managed corporations do not require Audited Financial Statements unless requested by their lender.

When it makes sense for Audited Financial Statements:

- Statements to be distributed to external users
- Typically required with higher external debt levels
- Non-active shareholders
- Required by law or regulation

Determining the appropriate type of financial statement you need in any given year will depend on your specific circumstances. We recommend discussing this with your external accountant as early as possible to ensure appropriate planning steps are taken at/around your corporation's year end date to allow for a cost-effective financial statement preparation process.

Article written by: **Jeff McLean**, CPA, CA

Not Having a Will Can Be Risky Business: Make Sure You're Prepared

Executive summary

Most of us know that having a will is important, but statistics show that what we know about wills and the action we take with wills are very different. According to a survey conducted by CIBC in 2013, more than half of Canadians die without a will. If you die without a will in Canada it is referred to as dying in 'intestacy'. When you die intestate, it is up to government legislation to handle your affairs. Below are some points that should be seriously considered before deciding against a will and how you could expect the estate will be distributed according to the current rules of intestacy.

What you need to know

Anyone who has assets, debts, or dependents should have a will. Most everyone wants their family to be looked after when they die. By not leaving a legal will behind, your family may not be cared for appropriately. Death takes a huge emotional toll on a family and not leaving a valid will can make things a lot worse.

Below are some considerations for your estate if you do not have an up to date will. While this list is by no means exhaustive, these points should be carefully considered before deciding against a will:

- Depending on the province, common-law partners may not be entitled to the estate as per the rules of intestacy.
- There is no opportunity to select guardians for any minor children.
- When individuals die in intestacy, an application must be made to the courts in order to appoint an estate administrator. Therefore, the deceased forfeits the opportunity to appoint an executor of their choosing.
- Most provinces recognize posthumous birth under their intestate rules. Any children conceived before death and born after death are considered to have been alive during the deceased's lifetime.
- Even if you have a valid will, it is possible to die in 'partial intestate'. Dying in partial intestate means that for some reason your will does not deal with the whole estate or a segment of your will is considered invalid.
- Due to the laws of intestacy your spouse could end up with significantly less then intended, therefore they may not be able to maintain their lifestyle.
- While everyone likes to think that their family would peacefully and fairly distribute their assets, this is usually not the case. Money has a way of bringing out an ugly side in people. Having a will can prevent this conflict and ensure everyone is treated fairly.
- There will be no outlined plan for dealing with any taxes or capital gains that may arise from your death.
- Estate litigation can be very expensive for your family.
- There will be no opportunity for charitable giving at your death.

Distribution of your estate

If an individual chooses not to leave a will behind, then the estate is distributed according to regulations set forward by provincial legislation. Every province has its own legislation for their intestate rules. It is important to be familiar with the rules in your province. The distribution is dependent on a variety or marital/family situations. Typically, each scenario unfolds as follows:

1. **Surviving Spouse, No Children**
   - In situations where the deceased has a surviving spouse but no children, the entire estate is passed to the spouse.

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2. **Surviving Spouse, Surviving Children**

- **Preferential Shares** – When the deceased leaves behind both a spouse and one or more child, in most provinces, the notion of preferential shares come into play. Preferential shares dictate that a certain amount of the net estate is directed first towards the spouse. Depending on the province you reside in, the amount of the preferential share could range from $50,000 to $200,000. If the value of the estate is less than the dollar amount set out by the province, then the spouse receives the estate in its entirety. If the value of the estate exceeds the dollar amount set out by the province, then the preferential shares come into play. The spouse receives the preferential share amount and then the remainder of the estate is divided between the spouse and children.
- **Beyond Preferential Shares** – The net value of the estate that exceeds the preferential share amount is shared between the surviving spouse and children. This distribution is defined by provincial jurisdiction. Where there is just a spouse and one child, the majority of provinces distribute one half of the residual estate to the child and one half to the spouse. If the child has predeceased the parents, then their share is distributed down to their children (if they had any). This distribution is based on degrees of kinship, and is referred to as per stirpes.
- **What happens if you die without a Will?** – Where there is a surviving spouse and more than one child, the distribution differs by province. Generally one-half to one-third goes to the spouse, with the remainder being divided up equally among the children. In most provinces the children's shares are distributed per stirpes. If there is no surviving spouse then the estate is shared equally by the children.

**Provinces that do not recognize preferential shares include New Brunswick, Newfoundland, and PEI.*

3. **No Surviving Spouse, No Children**

- If the deceased leaves behind no spouse or children, then the estate is distributed to their heirs. In all provinces, except Quebec, if an individual dies without a spouse or children, the estate is passed to their parents in equal shares. If the individual is predeceased by their parents, then the estate passes equally to any brothers or sisters.
- If there are no surviving siblings, then the estate is then passed down to any nieces or nephews. In the case that there are no nieces or nephews, then the estate is distributed equally among the deceased's next of kin.

4. **No Heirs**

- If a person dies without any heirs, then each province has legislation that dictates the estate passing to the Crown in a process known as escheat.

The bottom line

Not having a will is risky business and there is virtually no benefit that comes from neglecting to have one created. The processes that go with dying intestate are complicated and may cause your family more grief then necessary when trying to cope with your death. A will is perhaps the most important part of any financial plan. No matter what stage of life you are in, it is never a bad time to contact your team of professionals and start developing a well thought out estate plan.

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