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### STARTING A HOME BUSINESS

Are you considering starting a home business? Here are some planning issues, tax rules and tips to keep in mind.

#### Incorporation

Many people are not clear on the difference between a business and a corporation, but the difference is extremely important, for both tax purposes and liability purposes.

You can carry on business without creating a corporation. Although you may give your business a name, it is simply you carrying on the business. You are a “sole proprietor”.

If you create a corporation, it will have “Limited”, “Inc.” or “Corporation”

as part of its name. The corporation is a **legally separate person** from you, and the corporation, not you, carries on the business. Although you control the corporation, the business is legally not “your” business. This means that you are **normally not liable for the corporation’s debts**. (However, if the corporation needs to borrow money from a bank, the bank will insist on a personal guarantee from you, so in practice you will be liable if the corporation cannot repay the bank loan. Also, as a director, you are liable for certain obligations of the corporation, such as an assessment of GST/HST or employee payroll deductions that the corporation fails to remit.)

If you create a corporation, then the corporation will have to file annual T2 corporate income tax returns and pay tax on its profits. Your corporation will normally be a “Canadian-controlled private corporation” (CCPC), which pays a special low rate of tax on its first \$500,000 each year of active business income (somewhere around 12%, depending on the province). This “small business deduction” rate is subject to many complex rules, however. Note also that *investment* income earned by a CCPC is usually subject to a very *high* tax rate, with much of the tax refunded once the corporation pays out dividends to you.

Normally the corporation must pay monthly instalments to the CRA after its first year of operations, so that it will not have a large tax debt at year-end.

Of course, if the corporation is profitable, you want to be able to enjoy those profits. However, **you should not simply take the corporation’s**

**money for yourself.** To extract profits from the corporation, you should either have the corporation pay you **salary or bonus** (which the corporation can deduct and is taxable to you as employment income), or have it pay you **dividends** (which are not deductible to the corporation but are taxed to you at a lower rate, due to the dividend tax credit). These steps require certain paperwork, and it is important to document properly what you are doing; otherwise the tax consequences can be serious if you or the corporation are audited. The corporation can also repay to you any money you have loaned to it, with no tax consequences.

### **Sole Proprietorship**

In many cases, a home business is simply carried on as a sole proprietorship. There are no legal requirements for doing this (other than the requirements noted below); you are not required to have a separate business name, though you may wish to create one in order to appear more professional to your customers. (If your business will be visible, such as with customers regularly visiting you, then you should check whether you may run afoul of local zoning bylaws, or condominium or apartment rules if you live in a building.)

If you pick a business name that is not simply your own name (or perhaps your own name plus something like “Consulting Services”), then when you are paid by your customers, you will need a business account into which to deposit cheques. For this purpose, your bank will normally require that you obtain a **business name registration** from the province. This is usually a simple matter that requires a modest fee.

### **GST or HST**

Once your total sales exceed \$30,000 per year (combined with the sales of any corporation you control), you must register for

and collect the GST and HST. Until your sales top the \$30,000 mark over four consecutive calendar quarters, you do not have to register or charge GST/HST. (Generally you charge 5% GST to customers in non-HST provinces, 13% HST to those in Ontario and 15% HST to those in the Atlantic provinces; but the rules vary depending on the type of business, and in some cases depend on where you are providing services, or other factors.)

Even if you are under \$30,000 in sales, if your sales are to businesses rather than consumers, you may wish to register. You will then need to collect GST/HST from your customers, but they generally will not care since most businesses get back all GST or HST they pay. You in turn will be able to recover all GST/HST that you pay on your business expenses. (Or you may be able to profit from the “Quick Method” of filing, which can allow you to make a little money out of the GST/HST if you have relatively few taxable expenses.)

You may need to register for and collect provincial sales tax as well, depending on the nature of the goods and services you provide, and your province of residence.

(The same rules apply to any corporation that you own: it may have to register for and charge GST/HST.)

### **Reporting Your Income**

When you are carrying on a sole proprietorship, any income earned by the business is reported on your tax return under “Business income” (or Professional, Farming or Fishing income if you are engaged in one of those kinds of businesses).

The tax return requires you to show both gross revenues (total sales) and business income (after expenses). You will also need to file an income statement showing the details of your revenues and expenses (broken down by category – e.g., Advertising expenses, Office supplies, Meals & entertainment [which are only half deductible], Utilities, etc.).

This is normally done on Form T2125 but is not required to be.

Your net business income is combined with your other sources of income on your return, like employment income and investment income, to reach “total income”.

## Deducting Business Expenses

When calculating your (net) business income, you can deduct the expenses of carrying on business. Here are some things to make sure you do not miss:

- **Office supplies.** This would include computer paper, toner cartridges, USB sticks, pens, and similar items that you buy for use in the business. It may also include publications such as business magazines and journals. Keep your receipts! If you buy supplies for a combination of personal and business use, estimate the business proportion.
- **Telephone.** If you have a separate business line, the cost is fully deductible. If you are using a personal line partly for business purposes, it probably falls within the “Home office expenses” category in the next heading. And don’t forget to deduct your monthly Internet connection service fees, and cell phone costs to the extent you use your cell phone for your business.
- **Equipment.** For expensive, long-lasting “capital” items like computers and furniture, you cannot deduct the expense immediately. Rather, you can claim depreciation, called “**capital cost allowance**” (CCA), applied to a declining (depreciating) balance over many years. The CCA rate depends on the kind of equipment; for example, it is 55% for computers and 20% for furniture. In most cases you combine all assets of the same “class” into one pool and claim CCA on the pool. For the year in which you acquire an asset, only 1/2 of the normal rate

of CCA can be claimed for that asset. After that, you claim the regular rate based on the balance left in the pool after the previous year’s claim. But there are incentives encouraging purchases of capital equipment by giving fast writeoffs. For example, for 2022-24 (2021-2023 for corporations), there is a rule allowing “immediate expensing” of up to \$1.5 million of many capital purchases.

CCA claims are optional in that you can “save” the amount claimable (the “undepreciated” capital cost) and claim it in a later year if you want to use up losses or have another reason to not want to claim the expense. However, if you don’t claim an amount you could have claimed, the CRA will not let you amend your return later to claim it, if they think you are doing “retroactive tax planning”. (See the article “Around the Courts” below.)

- **Automobile expenses.** You will need to track your business use of your car as opposed to your personal use. It is advisable to keep a daily logbook recording business use and note the odometer reading at beginning and end of the year. You can then figure out your business use proportion, and deduct that percentage of your gas, insurance, licence, car washes, maintenance, and repair costs. You can also deduct that percentage of capital cost allowance (which is 30% per year for cars). However, there is a dollar limit on a car’s cost that can be used as your base for claiming CCA. The limit was \$30,000 for many years beginning 2001, but has been increased to \$34,000 for cars purchased in 2022 or later. (For a “zero-emission” vehicle such as an electric car, the limit is now \$59,000.)
- **Meals and entertainment.** You can claim restaurant meals and tickets to sports events, shows, etc. where the expense was required for your business – e.g., you take a prospective client

to lunch or a hockey game. However, you can only claim 50% of the cost as a business expense (long-haul truck drivers can claim 80% of meals).

### Home office expenses

Home office expenses are deductible only if you fall into one of two categories:

- Your home is your principal place of business – that is, you do not have an office elsewhere. Note that even if you have a major client that provides you with an office on its premises, it is still the client’s premises and it will not disentitle you to your claim for a home office.

or

- The home office is used exclusively for your business, and is used “on a regular and continuous basis for meeting clients, customers or patients”.

You can only claim the expenses against your income from the business. You therefore cannot use home office expenses to produce an overall business loss that is applied against other income.

However, losses disallowed because of this rule can be carried forward and used in any later year against income generated from the same business (you will need to bring them in on each year’s return to carry them forward).

The allowable expenses will normally be based on the fraction of the home that is used for your office. When making this calculation, you can normally exclude common areas, such as hallways and bathrooms, from both the numerator and the denominator. You can choose any calculation that is reasonable; calculations based on square footage or number of rooms are usually considered reasonable.

The expenses you can claim include:

- rent, if your home is rented
- mortgage interest (but not the principal portion of blended mortgage payments)
- home insurance
- property taxes
- utilities: electricity, heat, water, gas
- telephone, if your personal line is used partly for business
- home maintenance and repairs, as well as supplies (e.g., light bulbs).

You may also claim CCA (at 4% of the declining balance of the cost of the building) on the appropriate fraction of your home, but this is often not advisable. If you claim CCA, then when you sell the home you may lose part of the principal-residence exemption which applies to exempt you from tax on capital gains on a home. As well, any CCA you claimed can be “recaptured” into income when you sell your home. However, if you bought your home at the top of the housing market and do not expect to recover your costs when you sell, claiming CCA is likely a good idea.

## DO YOU HAVE A BANK ACCOUNT IN ANOTHER COUNTRY?

If you have a bank account, or a brokerage or other financial account in a country outside Canada, and you have not been reporting the account or income from it on your income tax returns, you need to know about the “**Common Reporting Standard**” (CRS) rules, which have now been in force for five years.

The CRS represents an **unprecedented level of cooperation among tax administrations** worldwide. It was developed by the Organisation for Economic Cooperation and Development (OECD) for **automatic information exchange between countries** to reduce tax evasion.

The CRS works as follows. In each participating country, banks and other financial institutions must **collect information about accounts owned by residents of other countries**, following “due diligence” rules, and must report this information to the local tax authority. There are thresholds below which these rules may not apply (e.g., accounts under US\$250,000), but the rules can vary by country and can change over time.

The tax authority then splits up the information by country of residence and will **automatically provide that information to each foreign country**, without needing a request from that country.

So, suppose you immigrated from Italy, are now resident in Canada, and you kept an account at an Italian bank branch, which now has EUR 300,000 in it. The Italian bank will report your name, address, the amount of the account and other identifying information to the Agenzia delle Entrate (the Italian tax authority). The Agenzia will then send this information to the CRA, along with that of other Canadian residents with accounts in Italy. If the CRA finds that you haven't been reporting the income from this account or haven't reported the account as “foreign property”, you will be in serious trouble. In addition to being assessed tax, interest, and penalties for many years, you may be prosecuted and could be sent to prison.

If you are in this situation, you may wish to make a **Voluntary Disclosure** to the CRA as soon as possible. The CRA's Information Circular 00-1R6 changed the rules for voluntary disclosures,

as of March 2018. **If the CRA already has information identifying you**, such as from the Agenzia delle Entrate in the above example, you **will not qualify for a Voluntary Disclosure** even if the CRA has not yet told you it has this information. (See the third bullet in para. 29 of the Circular.)

If your disclosure is accepted as a Voluntary Disclosure, the CRA will not prosecute criminally and will not impose the 50% gross-negligence/fraud penalty. However, you will have to pay the tax up front to qualify, and will be subject to interest and other penalties, such as penalties for unpaid instalments and penalties for not reporting foreign property.

So, if you are in this situation, you may wish to act now in the hope that the CRA has not yet received information identifying you and your foreign bank account.

## MAKE MONEY VOLUNTEERING FOR A CHARITY

If you volunteer for a charity, you may be able to make a little money at no cost to the charity.

The charity cannot give you a donation receipt for services that you provide for free. A valid donation receipt for tax purposes can only be issued for a donation of money or property.

However, suppose the charity **pays you for your services and you donate the money back?**

If you are not in a fairly high tax bracket (taxable income, after all deductions, over \$155,625 in 2022), this can pay off. Donations over \$200 per year will give you a 29% federal credit plus a provincial credit, for a total savings of about 40-45% depending on the province. If you are in a lower bracket, the income you report from the charity



will be taxed at a lower rate than the credit you receive. The lower your tax bracket, the higher the differential and thus the more profitable it will be to have the charity pay you.

If you are in **Alberta or Nova Scotia**, the benefit is even larger. Both of these provinces provide a special 21% provincial tax credit for charitable donations over \$200. This makes the total federal/provincial credit worth 50%, even for someone paying a much lower marginal rate of tax.

Of course, the amount the charity pays you for your services must be reasonable, or the charity can run into problems if it is audited by the CRA. Also, if you are a director of the charity (or related to a director), you may not be permitted to be paid by the charity for your services. There are numerous rules, both federal and provincial, that govern charities and their activities.

Note also that if you are GST/HST-registered, or your revenues from self-employment exceed \$30,000 per year, you will be required to charge the charity GST or HST on your services (unless you are working for it as an employee, in which case it needs to withhold payroll deductions on your pay). The charity will be entitled to a rebate for a substantial fraction of this GST/HST, however.

## AROUND THE COURTS

### Changing past CCA claims not allowed

As discussed in the first article in this Letter, capital cost allowance (CCA) claims are optional. In a given year a business may choose to not claim CCA, or to claim less than is available, so as to use up losses or otherwise cause business income to be higher than it has to be.

Usually, the CRA allows changes to past returns if a deduction has been overlooked. However, the CRA will deny requests to change past CCA claims, if the purpose is considered to be “retroactive tax planning”, because you have later determined that you did or didn’t want to claim CCA in a particular year.

This is what happened in the *St. Benedict Catholic Secondary School Trust* case, decided recently by the Federal Court of Appeal. The Trust had claimed certain business losses that the CRA denied because they had expired. To fix this problem, the Trust wanted to retroactively reduce its CCA claims for its 1997-2003 years, so that it would have a higher “terminal loss” when it disposed of a property in 2013. The CRA refused and the Trust appealed to the Tax Court of Canada, and then to the Federal Court of Appeal.

Both the Tax Court and the Federal Court of Appeal ruled against the Trust. As the Court of Appeal put it, a taxpayer has no right to “amend a tax return that had been previously filed to change the amount of CCA that was claimed for a particular year”. Even though CRA administrative policy often allows changes to past returns, that policy is not law and was not binding on the CRA.

### Boat costs allowed as a business expense

In the recent *Jackman* case, the Tax Court of Canada held that a business used a boat primarily for marketing purposes, and not as a personal benefit to its shareholders.

The business operated a marina in Port McNeill on Vancouver Island and sold fuel and provisions to boaters. The owners, Bruce and Nancy Jackman, ran the business together. They used their boat, the *Port McNeill Explorer*, to market the business at boat shows and to meet potential customers visiting the area. They also used it for business deliveries at times.

The Jackmans made only occasional personal use of the boat (maybe 5% of the time), and they paid \$18,000 a year to the company to reflect this use. Nevertheless, the CRA assessed them for personal benefits on the basis that they had use of the boat.

On appeal, the Tax Court listened carefully to the Jackmans' evidence and believed their explanations. The boat really was for business use and not personal use. As a result, the amount they had paid the company was sufficient, and they had no further personal benefit on which to pay income tax.

As you can see, sometimes it's possible to disagree with a CRA assessment and appeal successfully to the Tax Court.

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*This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.*



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