TAX NEWSLETTER

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DFK An Independent Member Firm of DFK Canada Inc. and DFK International

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Special points of interest:

- *Maximum CPP contribution for 2013 is $2,356.20. Maximum employee portion of EI is $891.12.*
- *CRA's prescribed interest rate on shareholder loans remains unchanged at 1% for the 4th quarter.*
- *Personal tax instalments:*
  - *December 15, 2012*
  - *March 15, 2013*
  - *June 15, 2013*
  - *September 15, 2013*

Snowbirds beware: Your holiday in the sun may have US tax consequences

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Canadian residents who escape the winter chill by temporarily migrating to warmer climates in the US are often referred to as "snowbirds". If you are spending significant time in the US, you should be aware of potential US tax consequences, including filing a US tax return or other tax filings.

There is a common misconception that if you spend less than 183 days a year in the US, you would not be considered a US resident and would not have US tax filing obligations. The reality is that the Internal Revenue Service (IRS) uses a "substantial presence test" to determine residency for tax purposes. This test, which only applies to individuals present in the US for more than 31 days in the current year, considers the total number of days spent in the US over a three-year period, and is calculated based on the following formula:

- 100 per cent of days in the current year; plus
- 1/3 of days in the prior year; plus
- 1/6 of days in the second prior year.

Individuals who were physically present in the US for 31 days in the current year, and the above formula results in a total of 183 days or more, will be deemed a US resident for tax purposes and will likely need to file a US tax return. It's important to note that a "day" in the US includes any part of a 24-hour period that an individual is on US soil.

If the substantial presence test is met, there are a few options to consider:

1. **Filing Form 8840 - "Closer Connection Exception Statement for Aliens"** – This form is for individuals who were physically present in the US for fewer than 183 days in the current year, maintained a "tax home" in a foreign country during the year, and can establish that they have a closer connection to a foreign country than to the US.

2. **Filing a US tax return claiming tax treaty benefits** – Individuals who were present in the US for more than 183 days in the current year (therefore not eligible to file Form 8840) can file a non-resident US tax return claiming tax treaty benefits to avoid being considered a US resident. This return must be filed along with Form 8833 — "Treaty-Based Return Position Disclosure."

3. **Do nothing** – Although the IRS would not approve of this alternative, to date they have not been aggressive about pursuing snowbirds who choose not to file. We are unaware of clients who have had significant issues with this approach, but there is no guarantee that this will continue to be the case.

Both Form 8840 and Form 8833 are required to be filed by June 15 in the year following the applicable tax year.

So, the next time you pack your bags for a trip to the US, be sure to count the days you will be in the US, and contact your DFK advisor to discuss the potential tax consequences of your travel plans.

Are you getting the information you need to manage your business?

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When you started your company, you had intimate, hands-on knowledge and were fully immersed in each of the projects your company secured. As time passed, your focus shifted. More often than not, you now find yourself delegating more responsibility to your management team. As a function of these successes, your time and attention is now spent on the business administration side of the company and you no longer have the time to continue with the hands-on approach. This begs the question as to whether or not you are getting the right information to ensure the continued success of your company.

As with every other area of your business, your accounting software and processes need to be reviewed and appropriately managed as you go through periods of growth. An accounting system needs to be set up in a way that provides meaningful information when you need it; however, the common feeling among business owners is that if something is not broken, it does not need to be fixed.

To ensure that new projects continue to be profitable for the company, timely and relevant financial information needs to be made available and presented in a way that's useful to those who will decipher it. Business owners need to ensure that any new project bids can continue to cover their direct costs as well as all workforce and overhead or burden costs.

What you need to know

Tracking costs from past projects can provide a good basis for creating bids on new projects. Comparing a project's actual incurred costs against its original budget can provide valuable insight on what areas should be looked at more closely prior to submitting the next bid. There may be room for efficiencies in some areas, whereas others may benefit from additional resources.

We have all heard the saying that time is money. Investing the time and effort to understand the outcomes from past activities can improve a company's financial results in the future. The key is to analyze the appropriate information. The good news is that it's all available in your financial records.

First, take a look at the financial information that you are able to review on a project-by-project basis. Next, look at the financial information that is available to you on a monthly basis. Is this all of the information that you need to manage your business? Is it possible that the accounting system that was established when you started the company needs to be modified? If you find yourself searching for extra information that falls outside of the project-by-project or monthly reports, the answer is likely a resounding yes.

A good accounting software package has project costing modules built in. The time it takes to acquire the training to use these models effectively is well worth it. If you are tracking the financial information for each project on a spreadsheet external to the accounting system that's expressly built for this purpose, you may be duplicating work within the company. When correctly set up, most accounting software packages allow purchases and payroll costs to be assigned to a given project with only a few extra key strokes.

The last word

Reliable, accurate and timely financial information is vital to the continued success of your company. Take the time to evaluate your financial reporting needs and processes. Establishing strong internal controls that look after purchasing, costing and contract oversight become more important as your company grows.

Over time, the pre-existing policies and procedures are often not updated to reflect the new realities that accompany growth. Financial practices that were established when the company was laying its original foundation may no longer be enough to support the thriving venture it's become.

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Is incorporation right for your business?

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Over the last several years, the process of incorporating a business has become easier and easier. What once involved accountants and lawyers and cost a great deal of time and money has now evolved into a process that can be mastered with the click of a button. There are countless websites outlining a step-by-step process to incorporating your business, sometimes for as low as $99! It becomes a tough sell for the professionals out there trying to pitch the value of using their services when the cost savings are so significant.

What's lost in the online, do-it-yourself process is one significant advantage: advice. Sure there are tips along the way, but these come from a computer, not someone experienced in the varying and specific details of business owners' situations that allow for setting up the corporate structure in a tax-efficient manner that permits optimal long-term planning. Even before getting to the structure, an accountant can ask you the questions you need to answer to see if incorporating your business is actually right for you in the first place.

The increasing ease of the incorporation process has resulted in a lot of sole proprietors doing it. With the apparent advantages and low cost, it's become a fairly rash decision. Unfortunately the key word is rash. There are countless situations where people either incorporate who should not, or would benefit from incorporation but don't set up the structure effectively.

Among others, there are two significant benefits to incorporating a business: tax deferral and tax savings. The tax deferral arises from being able to leave excess profits in the company, where they are taxed at a much lower rate than if they had been earned personally. Yes, there is another level of tax to be paid when the owner takes these after-tax profits out of the company, but that may not be for many years, at which point the owner could be in a lower income tax bracket. In the meantime, the company can put the excess profits back into operations or other investments. For the extravagant business owner, this tax deferral benefit is lost because all of the business profits are being spent.

For tax savings to work, multiple taxpayers must be in the picture. If the business owner has a spouse or adult children in a lower income tax bracket, there are opportunities to split the income. Through paying a reasonable salary to family members or distributing the after-tax corporate profits as dividends to adult family members, taxes can be saved. If the business owner is single, or if there is a spouse but the spouse's income is in a similar tax bracket as the business owner, these tax savings benefits disappear.

Although the potential tax deferral and tax savings are two of the possible benefits from incorporation, they are among the biggest. If you're spending all the money you make and you don't have family members to split the income with, you may be well-advised to skip the whole process.

If these opportunities are of potential benefit to you, that's great, but don't jump the gun on incorporation. Once the decision is a go, it's even more important to sit down with a professional. Accountants and lawyers with experience in setting up corporate structures will work with you to implement a strategy that meets your goals around tax-planning, both in the present and down the road. In addition, business succession options and estate planning matters are considered up front to keep exit strategies open and to be prepared for the inevitable. Setting up holding companies and family trusts are a few of the tools often used, and doing so at the time of incorporation is significantly easier and more advantageous than at a later date in the corporation's existence.

The decision of whether or not to incorporate is not to be made lightly. There are several considerations to be made to determine if it's right for you and your business. And if the only reason you can think of is "everyone else is doing it", you might want to reconsider!

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Making interest tax-deductible

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A line of credit is similar to a variable rate mortgage or credit card with a low interest rate, that can be paid down at any time penalty-free, unlike a restricted mortgage. Individuals can borrow against a line of credit; but must keep in mind, if interest rates go up, the interest charge will also go up.

Making interest tax deductible reduces the cost of borrowing money. Anyone who has debt should review their situation to see if the interest can be deducted for income tax purposes.

Many people have a single line of credit that has been used partially both for investment purposes and for personal expenditures. The Canada Revenue Agency only considers interest on the investment portion tax deductible.

We recommend individuals have their line of credit divided into two or three segments, for the following purposes:

1. Items that are clearly tax deductible, such as borrowing to purchase non-registered investments.
2. Personal expenses, that are not deductible for tax purposes.
3. Items that are partially deductible, such as a vehicle.

When you have excess funds available to pay down a line of credit, you should pay off the debt in the following order: the non-deductible segment first, the partially-deductible segment next, and the fully tax-deductible segment last.

It is sometimes possible for people with a non-registered investment portfolio and line of credit with non-deductible interest to make the interest deductible by:

- Selling off the investments in the non-registered investment portfolio (this may create capital gains).
- Paying off the line of credit that has non-deductible interest.
- Establishing a new line of credit to be used strictly for investment purposes.
- Buying the same income-producing non-registered investment portfolio with funds from the line of credit (be sure to wait at least 30 days for any investments sold at a loss).

The interest would now be tax deductible, which cuts the borrowing cost in half for high-income taxpayers.