TAX NEWSLETTER

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Inside this issue:

Special points of interest:

- *Personal tax instalments:*
  - ► *June 15, 2015*
  - ► *September 15, 2015*
  - ► *December 15, 2015*
  - ► *March 15, 2016*
- *The deadline for filing tax returns for self-employed is June 15, 2015.*
- *Tax-free Savings Account annual contribution limit increased from $5,000 to $10,000 as of January 1, 2015.*

ITC Allocation Method—Back to Where We Started

Martin Goguen, CPA, CA, Tax Recovery Services, MRSB Group, DFK Affiliate Firm

The Excise Tax Act generally allows taxpayers to recover tax incurred for the purpose of making taxable supplies. As tax professionals we are often asked to review the apportionment method used to allocate input tax credits between commercial and non-commercial activities. The ETA requires that the apportionment method used be fair and reasonable and used consistently throughout the year. The Act, however, does not prescribe any particular method for allocation, leaving it up to the registrant to determine how to allocate between these two activities. Moreover, the courts have held that the registrant can choose any method that is "fair and reasonable", even if another method might be more fair or more reasonable.

The issue of apportionment has always been contentious as a small change in the allocation can result in large reassessments or refunds. During the 2006 CICA Commodity Tax Symposium, the CRA announced it would no longer allow ITCs for past reporting periods based on a change in allocation method, much to the surprise of the attending tax professionals. The CRA's policy was that unless an error had been made, once a fair and reasonable allocation method had been applied to a particular year, the taxpayer could not retroactively change that method for another, more favourable method and claim additional ITCs.

When the CRA disallowed the $1 million ITC claimed by CIBC World Markets (CWM) after a retroactive adjustment to an allocation method, the matter eventually found itself in front of the Tax Court of Canada. The Court agreed with the CRA's position, stating that if the initial claim was fair and reasonable, it would be "perverse" and detrimental for "fiscal certainty" if a registrant retroactively changed its allocation method.

This decision would ultimately prove irrelevant for financial institution like CWM. In July 2010, a new section of the ETA was enacted to require financial institutions to use CRA approved apportionment methods that cannot be changed without written consent of the Minister. It is somewhat ironic that these new rules were enacted retroactively to 2007.

Nevertheless, CWM appealed the decision to the Federal Court of Appeal in 2011. The FCA reversed the lower court's decision and allowed the retroactive ITCs. The court stated that the CRA's policy would essentially turn the act of filing a tax return into one of making an "irrevocable election" to use a particular method, and if such a result was intended, the legislation would clearly say so. Furthermore, the FCA stated that the ETA required only consistency throughout the year and does not prevent the apportionment method from being changed from one year to the next but rather from one period to another with the same fiscal year.

We still occasionally encounter clients who, either as a result of a ruling, audit or reassessment received between 2006 and 2011, are unaware of this policy change. This strong FCA court decision however confirms that taxpayers who are in the business of making both taxable and exempt supplies, other than financial Institutions, are indeed entitled to review their ITC allocation method annually, and if an improvement can be made, claim additional ITCs retroactively provided that they are made within the normal limitation period of 4 years. In the end, we are back to where we started.

How Will You be Affected by the 2015 Federal Budget?

Adrienne Barclay, CPA, CA, Tax Manager, Taylor Leibow, Hamilton, ON, DFK Affiliate Firm

The following is a list of some of the more significant changes announced in the April 21, 2015 Federal Budget. For a complete list of Budget changes, contact your accountant.

Personal Tax Measures

Tax-Free Savings Account (TFSA)

- The annual contribution limit has increased from $5,500 to $10,000, effective January 1, 2015.

Registered Retirement Income Fund (RRIF)

- Starting in 2015, there is a reduction of the minimum amount that seniors must withdraw each year from their RRIF.
- Since the budget was not announced until April, RRIF holders who withdraw more than the reduced 2015 minimum amount during 2015 will be able to re-contribute the excess to their RRIF up to February 29, 2016. The amounts re-contributed will be deductible from taxable income for the 2015 taxation year.

Tax Rate on Non-Eligible Dividends

- The gross-up percentage on non-eligible dividends will decrease from 18% to 17% for 2016 and 2017, 16% for 2018, and 15% for 2019 and thereafter.
- The dividend tax credit on non-eligible dividends will also decrease from 11.017% to 10.522% in 2016, 10.021% in 2017, 9.512% in 2018 and 9.030% in 2019 and thereafter.

Repeated Failure to Report Income Penalty

- Currently, there is a 10% penalty imposed where a taxpayer fails to report all of their income in their tax return for a taxation year and has also failed to report an amount of income in any of their prior three taxation years.
- The budget amends the penalty calculation and also will only apply it where a taxpayer fails to report at least $500 of income in the year and in any of the three prior taxation years.
- The penalty will be the lesser of:
  1) 10% of the unreported income; or
  2) 50% of the difference of the additional tax less the tax withheld.

T1135 "Foreign Income Verification Statement" – Streamlined Reporting

- Currently, taxpayers that own foreign property with a cost of more than $100,000 are required to report detailed information on that property on Form T1135 annually.
- The budget is introducing a more simplified streamlined reporting form for taxpayers with foreign property with a total cost of up to $250,000.

Business Income Tax Measures

Decreased Small Business Tax Rate

- The federal small business income tax rate that applies to the first $500,000 of qualifying active business income of a Canadian-controlled private corporation will decrease from 11% to 9% gradually. It will be phased in: 10.5% starting January 1, 2016, 10.0% starting January 1, 2017, 9.5% starting January 1, 2018, and 9.0% starting January 1, 2019 onwards.

Accelerated Capital Cost Allowance (CCA) for Manufacturing and Processing Machinery and Equipment

- Certain qualifying equipment purchased after 2015 and before 2026 will be eligible to be included in a new Class 53 which provides for a CCA rate of 50% per year on a declining balance basis, subject to the half-year rule in the first year of purchase.

When is the Right Time to Sell Your Business?

Craig Maloney, MBA, CA, CBV, Partner, WBLI Chartered Accountants, Halifax, NS, DFK Affiliate Firm

For the past five years (or more), we have anticipated a flood of business owners exiting their businesses. According to a 2012 Canadian Federation of Independent Business (CFIB) study, close to half of small and medium sized enterprise (SME) owners planned to exit their business in the next five years; a dramatic increase from the 2006 CFIB survey when one-third of businesses were in the same position.

Another study shows similar statistics: 6 in 10 private companies in Canada will change ownership structures within the next decade. (CICA/RBC Business Monitor Survey, 2010) Despite these promising stats, there has been an underwhelming absence of actual buy and sell activities among SMEs over the past several years.

The flood is coming, as baby boomers are approaching 70…

According to Industry Canada, baby boomers, or those born between 1946 and 1966, accounted for approximately 7 out of 10 SME business owners in 2004. In 2010, more than 60% of SMEs were controlled by an owner aged 50 or older; thus, the number of business owners seeking an exit option is very likely to increase in the near future. ("The State of Entrepreneurship in Canada" Industry Canada. February, 2010.)

A few reasons for the lack of business transitions in the past few years include the following:

- the economic downturn of 2008-09 delayed the exit date of many SME owners, as their personal RRSP / investment portfolios were hit, business valuations were down, and lending was tougher to access;
- SME owners are not clear on how to begin the process of transitioning their businesses. People generally know how to sell a house; but selling a business is a much more complex process.
- Business owners are struggling to identify successors who will maintain the legacy of the business and the culture. In many cases, the business owner has operated the business for 20 plus years - transitioning such a business can give rise to protective sentiments akin to those felt when considering an appropriate spouse for your offspring.
- Understanding what the business is worth and knowing what to do after retirement / the sale of the business. Some owners will confuse 'what they need to retire' vs. 'what the business is worth'. It is important to have realistic expectations of the value of a business.

While businesses are changing hands quietly and confidentially in Canada via transitions to family members, management buyouts, and private company transactions, the level of transactions has not neared the 'flood level' … yet. The data shows that a mass transition of businesses should be occurring in the next few years.

What are your exit options?

Business owners need to transition their business in some form, at some point. There are four real options to exit:

1. **Winding up the business** is not an attractive alternative in most cases. Drastic events, such as health issues or death aside, proper planning should mitigate the need to windup a business.

2. **Transitioning to family members** is occurring, but it is less common. Fewer family members are stepping up to continue the family business. Generally speaking, the children of baby boomers are less likely to take over the family business, and they face less pressure from their parents to do so. <u>Only one-third of family businesses are successfully transferred to the next generation, and a mere 13% are passed on to the third generation.</u> (Family Firm Institute Inc.)

3. **Transitioning to a management team** is a good, viable option for many companies. A few factors are key to a successful MBO:
   - the business has to be big enough to employ a capable management team;
   - the knowledge and relationships should be shared with the management team;
   - management should actually purchase as much as feasible in order to have 'skin in the game.'

When is the Right Time to Sell Your Business? Cont'd

Craig Maloney, MBA, CA, CBV, Partner, WBLI Chartered Accountants, Halifax, NS, DFK Affiliate Firm

4. **Selling to an outside party.** The greatest number of buyers exists within the 'outside party' group which includes entrepreneurs, other companies, and private equity groups. For owners, selling to an outside party is a very feasible and attractive alternative for quality businesses. Some owners will consider partial sale options that allow them to retain some ownership during a transition period (this can be an easier pill to swallow than simply 'handing their child over').

There is a potential downside to the expected course of events over the next several years: the vastly increased supply of SME businesses available might lead to a dramatic increase in companies for sale which would likely drive down valuations and give new leverage to buyers.

Succession Planning is a Process, not an Event

Business owners are generally responsible, organized and forward looking people; planning for the succession of their business should be high on their list of things to do. However, according to a 2012 CFIB survey, less than 10% of SME owners have a formalized business succession plan.

It is important to plan the transition process. An effective succession plan is put in place one to five years before the eventual transition of ownership. It is too late to capture value or appropriately plan when a significant health issue or significant business issue occurs.

Each transaction and business valuation is unique. Having good advisors can simplify the process. Name can help you prepare for an eventual transition and help make your business more attractive to prospective buyers. We have the knowledge and skillset to identify your business' key value drivers and will provide you with a roadmap of how to leverage those drivers.