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Newsletter

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The CRA's Sector Audit Letter. Did you get one?

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A new and exciting way to get taxpayers to second guess their filed tax returns.

The CRA has been sending out letters to some real estate agents and taxpayers with rental income. The letter kindly reminds the taxpayer that:

- Canada's tax system is based on self-assessment.
- The CRA regularly identifies the most common errors on income tax returns in order to determine areas that require further clarification.
- **The CRA may be conducting audits in your sector.**
- If the CRA audits your tax records, their audit may not be restricted to the items identified in the letter.
- There is a Voluntary Disclosure Program that allows you to come forward, correct errors, and pay the taxes and interest with no penalties. (Note that the letter does not warn the taxpayer that there are specific rules to follow to qualify. See CRA's website http://www.cra-arc.gc.ca/gncy/nvstgtns/vdp-eng.html.)
- If you find any expenses that have not been claimed correctly, you can correct the error by filing the enclosed T1-Adjustment Request.

In some of the CRA letters, they have included a paragraph stating, "Taxpayers who knowingly or under circumstances amounting to gross negligence, have made or have participated in making a false statement or omission on a return, form, certificate, statement, or response are subject to penalties under subsection 163 (2) of the Income Tax Act." These penalties can add up to 50% of the unpaid taxes.

The CRA letter to the real estate agents listed a few expenses, such as advertising, motor vehicle, and rent. The CRA letter on rental property provided information on rental income, including cash payments and various expenses.

What should you do if you get a letter? First, do not panic; second, call your accountant. We recommend that you do not call CRA directly, or complete the enclosed T1 Adjustment Request. If you know you made a mistake, your accountant can help correct it. If there are no mistakes on your return, there is nothing else to do.

If you are audited and the CRA auditor disallows expenses or finds extra revenue, will they state, "We warned you in the letter to correct your errors, so we are assessing you penalties." The decision to assess penalties seems to go through a cycle at the CRA. It appears they are on the rise again. However, we hope they will not waste the taxpayer's time and money on differences of opinion and/or minor mistakes made by the taxpayer. Time will tell.

The CRA should educate taxpayers. Their website is an excellent reference tool which we refer to on a regular basis. Although I find the tone of the letter somewhat threatening, it is an interesting audit tool in a self-assessing system. **Do not** feel forced to self assess a change on your return when you believe you are complying with the rules of the Income Tax Act.

Inside this issue:

"Income tax returns are the most imaginative fiction being written today."
- Herman Wouk

Special points of interest:

- ***Maximum RRSP limits:***
  2009 - $21,000
  2010 - $22,000
- ***Deadline for making RRSP contributions for 2009 tax year is March 1, 2010.***
- ***The Harmonized Sales Tax (HST) comes into effect in Ontario and B.C. on July 1, 2010.***
- ***Personal tax instalments:***
  - March 15, 2010
  - June 15, 2010
  - September 15, 2010

Employer-Provided Scholarship Plans

Jeff Saunders, Tax Partner, Teed Saunders Doyle & Co.

Providing scholarship plans is one area where employers can distinguish themselves from their competitors. When structured properly, they can provide an incentive for retaining existing employees or they can be a powerful recruiting tool in searching for new talent.

Scholarships to Employees' Family Members for Post-Secondary Education

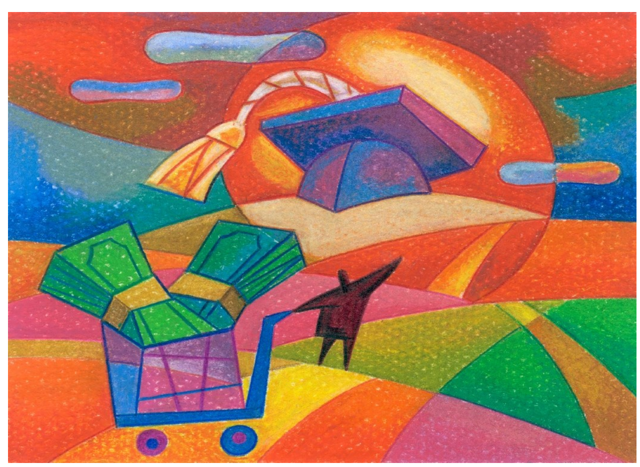
In recent years, as the result of various court cases, the CRA has revised its administrative position regarding the tax consequences of an employer providing scholarships to employees' family members for post-secondary education. Previously, if an employer paid for or reimbursed tuition fees, books, and supplies related to post-secondary education for an employee's family member, the payment was treated as a taxable benefit to the employee. For 2007 and subsequent taxation years, if the payment is made as part of a plan whereby scholarships are awarded on the basis of academic or other achievements or qualifications, the payment can now be treated as income to the family member and reported on a T4A slip in the family member's name, eliminating the taxable benefit to the employee.

For the family member, post-secondary education scholarships, fellowships, or bursaries are not taxable if they are received for enrolment in a program that entitles them to claim the education amount in 2007 or subsequent taxation years. The end result is that, in many cases, the cost of the scholarship is a deductible expense to the employer and it is not taxable to the employee's family member that receives it. Given this revised tax treatment, employers may want to consider setting up a scholarship plan for employees' family members.

Scholarships as a Recruiting Tool

Employers recruiting for new talent from amongst the ranks of students currently enrolled in post-secondary education may also want to consider using scholarships as a recruiting tool for future employees. A scholarship can have a significant tax advantage for the student when compared to other recruiting tools such as signing bonuses. The CRA's administrative position, as stated in *Interpretation Bulletin IT-75R4 – Scholarships, Fellowships, Bursaries, Prizes, and Research Grants*, is that, "If an employer-employee relationship has not yet been established and a student receives a scholarship or bursary in return for undertaking to enter the employment of the person granting the award upon completion of the studies or training, the payments received are considered to be scholarship income..." For many of these students, the scholarship will not be taxable. A tax-free cash payment can be an attractive incentive for a student who may be evaluating more than one offer of employment.

Employer-provided scholarship plans can be a unique and often overlooked method of attracting and retaining top talent. If you would like more information about how a plan could be structured to benefit your business, you should contact your tax advisors for assistance.



Providing scholarship plans is one area where employers can distinguish themselves from their competitors.

Salary vs. Dividends? The Impact on Your Bottom Line

Donna Ho, CA, Tax Manager, Ginsberg Gluzman Fage & Levitz, LLP

In the past, many owner-managers of Canadian -Controlled Private Corporations (CCPC) have chosen to pay themselves a salary or bonus to reduce their corporate taxable income. With corporate tax rates decreasing, dividends are becoming a more attractive alternative.

In most provinces, the tax rate on the first $500,000 of CCPC income is approximately 15%, and the tax rate on anything above $500,000 is approximately 30%.

For a CCPC, the table below compares the payment of a salary with taxing the income in the CCPC and then paying personal taxes on dividends (at the small business rate and the general rate).

As the table shows, for corporate income below $500,000, there is actually a tax savings of approximately 4% by paying a dividend instead of salary. For income above $500,000, there is an additional tax cost of 2%, but the taxes payable immediately are only 30%, compared with 45% under the salary alternative. The additional taxes aren't payable until the money is taken out of the company as a dividend.

So … salary or dividends?

If funds are not required immediately, after-tax corporate income can be left in the CCPC for use in the business or to invest. From the example below, on the first $500,000 of income, there is a deferral of 30% on taxable active income left in the corporation. The corporation can retain $30 by paying corporate tax and leaving the money in the company rather than paying it out as a salary or bonus. There is a deferral of 15% on taxable income above $500,000 left in the corporation.

Looking strictly at income taxes, paying dividends is becoming a more attractive option. However, there are other factors to consider, including:

- Paying a salary will create RRSP contribution room for an individual, while dividends do not.
- Money retained in the corporation is subject to risk of creditors.
- There are additional payroll costs for salaries, including the employer's portion of Canada Pension Plan (CPP), Employment Insurance (EI) (if applicable), workers' safety premiums, and other payroll related costs.
- A salary or bonus must be reasonable for shareholders that are not active in the business. A dividend can be paid to any shareholder and the dividend amount is not subject to the same reasonableness tests.
- To qualify for CPP benefits in the future, payment of a salary or bonus is required.
- If there is too much inactive cash and/or investments in the corporation, the corporation could lose its Qualified Small Business Corporation (QSBC) status, meaning that it is ineligible for the $750,000 capital gains exemption if shares of the company are sold.
- Source deductions must be withheld on salary and bonus payments.
- The timing of the payment of eligible dividends.

	Salary	Non-Eligible Dividends (CCPC active income below $500,000)	Eligible Dividends (CCPC active income above $500,000)
Corporate Taxable Income	$0	$100	$100
Corporate Tax	$0	$15	$30
After-Tax Income = salary/dividend amount	$100	$85	$70
Personal Tax on salary/dividend	$45	$26	$17
Total Taxes Paid	$45	$41	$47
% Total Taxes Paid	45.0%	41.0%	47.0%

Getting More Out of Your Financial Reporting - Income Statements

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In our technology driven society, many businesses use software to prepare their accounting records. Accountants encourage this, as it makes their lives easier when compiling the year-end financial statements and preparing the tax returns. Accountants also analyse the success of a business based on these records. The downfall is that, for many businesses, this may only happen once a year. What do you do for the rest of the year?

Most accounting software packages have the ability to provide a great deal of relevant business information, but many business owners don't use the software to its fullest potential. For example, in QuickBooks 2010, there are at least 20 report suggestions on the main page of the Report Centre. This can be overwhelming and confusing if you have never used them before.

The Profit & Loss statements contain many iterations of your income and expenses. This allows you to look at your net income compared to a previous year, or even just for the same month of the previous year. If your business is cyclical, examining your income and expenses month by month can improve your understanding of cash flows in your business. If you compare your net income to date to that of the entire prior year, you will be able to determine how much more income you will have to generate to meet or exceed the prior year.

If you have more than one type of income stream, you should consider using classes or departments. This feature lets you match expenses to each type of income; therefore, allowing you to view your net income by each business line and assess whether it is profitable, as well as determine how to improve your profitability.

For those who need to track expenses by job, most software packages will generate a Profit & Loss report for each job in a given time period. This requires a more sophisticated record-keeping system that can track income and expenditures by job number.

Our Spring Newsletter will include my next article, where I will discuss the Balance Sheet.