

Income from Business

What is Business Income?

Net Income for Tax Purposes

- Net Employment Income
- Net Business Income
- Net Property Income
- Capital Gains and Losses
- Other Income
- Other Deductions
- Current Year Losses – Capital or Non-Capital
- = Net Income For Tax Purposes

Differences so far

- Net Employment Income
 - Can only be earned by individuals
 - Taxed on the cash basis
- Net Business Income
- Net Property Income
- Capital Gains and Losses
 - Can be reported by any taxable entity (corporation, trust, individual)
 - Taxed on the accrual basis

Income Over Time

- Important Reminder:
 - This determination occurs on the income that is earned over time. Business vs. Property income on property that is held.
- Why is this important?
 - Individuals – Only important in determining what deductions are available against the income.
 - Corporations – Property income is taxed as a significantly higher rate within a corporation.

Business vs. Property

- Property Income

- Less effort to earn
- “Passive” income
- No large commitment of time, labour or attention

- Business Income

- Actively Earned
- “An adventure in the nature of trade”
- Not employment income

Business vs. Property

- Property Income
 - Interest
 - Dividends
 - Rental Income
 - Royalties

- Business Income
 - Plumbing business
 - Starbucks Franchise
 - Providing legal consultations

Business vs. Property - Example

- An individual operates a 2 unit rental building (duplex) and has no employees. Would these rents be considered business or property income?

This income would be considered property, no significant commitment of time is required to earn income from a duplex unit.

- An individual operates a 50 unit rental building (complex) and has 8 employees to do bookkeeping, perform maintenance, and sit at reception. Would these rents be considered business or property income?

This income would be considered business income. Managing 8 employees for this number of units would require active work

Business vs. Property - Example

- An individual investments \$20,000 in GIC's which bear interest at 6% annually. Is this interest business or property income?

This income would be considered property. Passive income that involves only holding the GIC until interest is paid.

- An individual invests \$300,000 in a McDonald's franchise and regularly checks in on the progress of the manager to make sure things are on track. Would income earned be business or property income?

This income would be considered business income. The individual is monitoring and regularly managing their business. (Management Fees)

Gain on Sale

(business/cap gains)

(inventory/capital property)

- Important Reminder:
 - This determination occurs when an asset is sold.
 - Why is this important?
 - Because capital gains are only 50% taxable, can be incentive to argue that income is capital and not business income.
 - Because capital losses are restricted and only 50% claimable, can be incentive to argue that losses are business losses and not capital

Business vs. Capital Gains

- Tests for Capital vs. Inventory
 - Did you buy the item to resell?
 - Length of ownership period (2 weeks vs. 5 years)
 - Is your normal business buying & reselling?
 - Number & frequency of transactions
 - Supplemental work on the property
- Capital Assets - Acquired to earn income through their use. Capital Gain on sale
- Inventory – Acquired to be resold for profit. Business Income on sale

Business vs. Capital Gains

- Inclusion Rate
 - **Business income** included in taxable income 100%
 - Dispose of an investment:
 - $\$10 \text{ FMV} - \$5 \text{ cost} = \$5 \text{ gain} \times 100\% = \5.00 taxable
 - **Capital Gains** included in income 50%
 - Dispose of an investment:
 - $\$10 \text{ FMV} - \$5 \text{ cost} = \$5 \text{ gain} \times 50\% = \2.50 taxable
- Application
 - Capital losses only deductible against capital gains

Business vs. Capital Gains

- Regularly performing an activity with a view to profit can result in business income, where it might otherwise be considered property income.
- Example:
- House Flippers Vs. Selling the Family Cottage

Ordinarily, the sale of a cottage is considered capital gains. It is not purchased to earn income and occurs over a long period of time. However, house flippers buy homes with the intent to improve and resell them. The trades occur frequently. This recharacterizes the gains on sale as business income.

Business vs. Capital Gains

- Regularly performing an activity with a view to profit can result in business income, where it might otherwise be considered property income.
- Example:
- Day Trading Vs. Passive Investing

Ordinarily, the sale of investments is considered capital gains. Generally, investments are purchased with the intent that their value will increase over time. However, day traders intend to make profits over a very short period of time. They purchase stocks with the intent to resell them shortly at a profit. This changes their nature to business income.

Examples:



Ostrich Producers of Ontario, 2012

Business Income Calculation

Calculation of Business Income

START	Income for Accounting Purposes	\$100,000
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Adjust for items restricted in the act

Adjust for items permitted in the act

Example:

Amortization (not deductible for tax)	\$20,000
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CCA (not included in accounting income)	<u>(16,000)</u>
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Business Income for Tax	\$104,000
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Calculating Business Income

- Start with Accounting Income (Financial Statements)
 - Add Items Back
 - Accounting Depreciation
 - Accounting losses
 - Taxable Capital Gains
 - Income Tax Expense
 - Interest & Penalties on Taxes
 - 50% of meals & entertainment
 - Current year financing fees
 - Non-deductibles (Yacht, Golf)
 - Unreasonable expenses (high income to spouse)

Calculating Business Income

- Less Items
 - Capital Cost Allowance (CCA-Tax depreciation)
 - Financing Costs (over 5 years)
 - Accounting Gains
 - Landscaping Costs (if capitalized for accounting)

=Net Income for Tax Purposes

Calculating Business Income

- Adjusting Items
 - Accounting Gains removed, Capital Gains added
 - Example, sale of land purchased for \$10, sold for \$30.
 - Accounting gain = \$20 (\$30-\$10)
 - Taxable Capital Gain = \$10 $((30-10) \times 50\%)$

Adjusting accounting income to taxable income

Deduct: accounting gain	(20)
Add: taxable capital gain	<u>10</u>
Adjusted Income	(10)

Calculating Business Income

- Adjusting Items
 - Unreasonable Expenses
 - Amounts paid to related entities must be reasonable to be deductible
 - Salary for wife who does bookkeeping \$150,000
 - Arms length individual would be paid \$40,000

Adjusting accounting income to taxable income

Add: unreasonable amount	150,000
Deduct: reasonable amount	<u>(40,000)</u>
Adjusted Income	110,000

Calculating Business Income

Meals & Entertainment

- 50% Deductible in ordinary circumstances
- 80% Deductible for long haul truck drivers traveling away from home at least 24 hours.
- No restriction if:
 - Meals provided to customers (hotels, airlines)
 - Meals for a charitable fundraising event
 - When reported as a taxable benefit
 - When for meals in a remote work site
 - **When made available to all employees (office meetings or Holiday parties).**
 - Meals billed to clients who reimburse

Calculating Business Income

- Adjusting Items
 - Meals
 - Example assumes ordinary 50% meals of \$1,000

Adjusting accounting income to taxable income

Add: 50% of meals	500
Deduct: no offset	<u>0</u>
Adjusted Income	500

Calculating Business Income

- Adjusting Items
 - Financing Fees
 - Costs of refinancing debt.
 - Deductible over 5 years – straight line
 - Assume current year fee paid of \$1,000

Adjusting accounting income to taxable income

Add: any current year fee	1,000
Deduct: 1/5 of current year	<u>(200)</u>
Adjusted Income	800

Income reduction in year 2, 3, 4, 5 = \$200 in each year

Calculating Business Income

- Adjusting Items
 - Reorganization Fees
 - Legal and accounting fees paid to perform a reorganization or incorporation
 - Non-deductible but then added to Class 14.1

Adjusting accounting income to taxable income

Add: accounting deduction	1,500
Deduct: no offset	<u>(0)</u>
Adjusted Income	1,500

CCA deduction calculated separately. And CCA deduction taken.

Calculating Business Income

- Adjusting Items
 - Landscaping Fees
 - Landscaping fees are capitalized to the cost of land for accounting purposes
 - They are deductible for tax purposes

Adjusting accounting income to taxable income

Add: no offset

0

Deduct: landscaping fees

(2,000)

Adjusted Income

(2,000)

Calculating Business Income

- Adjusting Items
 - Interest & Penalties
 - Can't deduct interest and penalties owing because of the tax act (on late filing, late payment, late installments, etc.)
 - Must add it back to calculate business income
 - Taxes Owing per Financial Statements
 - Financial Statement income is ordinarily shown net of tax (tax already deducted).
 - Must add it back to calculate the business income we want to apply tax to.

Business Income Inclusions

Business Income Inclusions

- Damages
 - For example, a subcontractor defaults on the contract and you are awarded damages
- Gambling Profits
 - Only when earning it constitutes a business (a professional gambler). Otherwise, gambling and lottery winnings are tax free.
- Inducement Payments
 - For example, receipt of a lease inducement from tenant who wants special terms included in a lease.

Business Income Inclusions

- Profits from Illegal Businesses
 - Drugs, Bribery, and Prostitution Income is Taxable
- Government Assistance
 - When received to purchase capital assets, it reduces the cost of the assets.
 - When received for an income earning purpose, it is included in taxable income.
- Restrictive Covenants
 - Includes non-compete clauses received other than by employment. Example, from the person who purchases your business

Restrictions on Business Deductions

Business Deduction Restrictions

- Capital Costs
 - Non-deductible, only CCA can be taken.
 - If deducted for accounting, must be added back.
- Personal or living expenses
 - Personal housing, travel, meals, clothing, etc.
- Must be Incurred to Earn Taxable Income
 - Expenses to earn exempt income aren't deductible
 - Must be incurred with the intent to earn income

Business Deduction Restrictions

- Interest & Property Taxes on Vacant Land
 - Since not technically incurred to earn income it isn't deductible. These amounts are capitalized to the cost of the land.
- Illegal Payments
 - Bribes, Fines, Tickets
- Political Donations
 - Not deductible but able to receive a credit for them.

Business Deduction Restrictions

- Yacht, Camp, Lodge, or Golf Dues
 - Never deductible to businesses
- Expenses of Personal Services Business
 - What is a PSB? Acting as an employee through a corp.
 - Restricted to employment expenses

Business Deduction Restrictions

- Life Insurance
 - Cannot be deducted unless:
 - Required by the lender
 - Lender is a financial institution (bank)
 - Used as collateral for a loan
 - Interest on that loan is deductible

Life Insurance Example:

Andy borrows \$50,000 from the bank to buy new vending machines for his snack business. He's getting on in years so the bank asks for life insurance against the balance of the loan. Andy thought he'd probably like extra life insurance too so bought a policy for \$150,000.

The annual premiums were \$6,000

Can Andy deduct the life insurance against business income?

Yes – it is a requirement of lending

How much can he deduct?

\$2,000 the proportion the premiums are to the required insurance
\$6,000 premiums x (\$50,000 required / \$150,000 obtained)

Comprehensive Examples

Example A:

Financial Statements of Harpco:

Revenues from sale of widgets	\$60,000
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Salaries	\$10,000
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Depreciation/Amortization (CCA \$10k)	\$6,000
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Legal fees	\$2,000
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Accounting fees	\$2,000
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Meals & Entertainment	\$1,800
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Interest (\$100 from CRA)	\$1,500
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Parking Tickets	<u>\$200</u>
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Net Income before tax	\$36,500
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Tax Expense	<u>\$5,840</u>
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Net Income	<u>\$30,660</u>
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Example A: Solution

Accounting Income	30,660
Tax Expense for Accounting	5,840
Salary (no adjust if reasonable)	-
Accounting Amortization	6,000
CCA (assumed)	(10,000)
Legal (no adjust if not reorg/finance)	-
Accounting (no adjust if not reorg/finance)	-
Meals (50% deductible)	900
Interest & penalties from CRA	100
Parking Tickets (illegal)	<u>200</u>

Net income for tax purposes: **33,700**

Example B:

Financial Statements of Harpco:

Revenues from sale of widgets \$500,000

Salaries \$170,000

Depreciation 4,000

Financing Fees 2,000

Life Insurance (no debt) 3,000

Net Income before tax \$321,000

Tax Expense \$50,000

Net Income \$271,000

CCA \$6,000 & Bribes accepted \$3,000 (unreported)

Plays the lottery once a week at work, and won \$50,000 (unreported)

Husband earns \$130,000 as bookkeeper, would cost \$40,000 to replace.

Example B: Solution

Accounting Income **\$271,000**

Tax Expense (Added back to calc pre-tax income)	50,000
Salaries (add unreasonable)	\$130,000
Salaries (deduct reasonable)	(40,000)
Depreciation (add accounting)	4,000
CCA (deduct for tax)	(6,000)
Financing Fees (deductible over 5 yrs)	2000
Financing Fees (Deduct year 1)	(400)
Life Insurance (deductible if required for debt)	3,000
Bribes not included in accounting income	3,000
Lottery winnings (not business income)	-

Net income for tax purposes: **416,600**

Example C:

Jim operates a welding business. He doesn't maintain records but wants you to calculate his taxable income. He believes he earned \$50,000 from sale of his services and received \$15,000 in government grants to get started. He paid his employees \$7,000 in salaries (unrelated to Jim) and paid for \$400 in meals while they were on the job. He used some welding profits to pay for a new lawn mower which cost \$500.

Calculate Jim's Net Income for Tax Purposes from Business Income.

Example C: Solution

Accounting Income (N/A)

Revenue	50,000
Government Assistance	15,000
Salaries (all reasonable)	(7,000)
Meals (no exceptions-50% deductible)	(200)
Lawn mower (personal)	-
Net income for tax purposes:	57,800