How to Design and Support a Deductible Expense

Tax Relief Strategies the Experts use for Their Own Returns

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The Magic of the Right Attitude

Are you completely certain you are doing all you can to save taxes? When was the last time you really took a close informed look? It's amazing what many businesses and professionals leave on the table at the end of the year to be lost in taxes. It goes without saying that for many of us there are critical aspects of claiming expenses that require another careful scrutiny. Although it's important to have an attitude that is hell bent for claiming everything one thinks should be deductible, it's more important to be informed on how to arrange your expenditures to make them deductible-one way or the other. That's the secret. That's the key. And that is what you will get in this report. And your tax savings may be dramatic enough to change your lifestyle.

Getting in the mode for maximum benefit

You are relaxed. You are expecting some good results. But there is something else that would help. Please switch off your conservative nature and ignore any debilitating brainwashing you may have picked from CRA or even your accountants. For now, ignore all preconceptions you have about how you can legitimately claim expenses. You must think for yourself. You deserve the best tax treatment you can arrange for yourself. You have the legal right. The countless, unrelenting, underpaid hours operating your business or practice-the horror, the thrill, the money, the incredible expenses- has an outcome that is taxed. Those taxes are where the treasure is.
Treasure/ Shovel.

It's time to ask yourself a simple question. Ask this one question every time you spend a dollar for your business. "If I did not have the business, would I be spending this money? If the answer is yes – it's probably a totally personal expense and not tax deductible. If the answer is no – deduct it! You are subject only to specific restrictions that apply to your situation).

The Challenge is the Proof

It's easy to initially claim your expenses – because they are processed automatically once your financial statements or forms are completed and entered by CRA for your initial assessment. That assessment does not mean the expenses are allowed. Here, the prime directive is to satisfactorily support the expenses you have claimed should CRA come calling.

We rarely spend money for no reason. If the reason is the business here are the ways to ensure your deduction is validated and allowable. Every payment has a tax consequence. We don't promise CRA is going to agree with everything with you claim but we will show you that there is very little downside and a huge upside if you do it right.

The Theory of Allowable Expenses

Let's start with the theory. This is a critical part of this exercise so don't skip it.

Remember. You don't have to think the way anybody else does.

STEP 1: THE THEORY CRA GOES BY

The general rule is simple because even CRA cannot list every conceivable situation. The gospel:

"Income Tax Act (ITA) 18(1)(a) *No deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."*

What does this essentially mean to the theory of tax deductions?

It is not essential to demonstrate expenditures were incurred to produce actual income, only that there was an intention and a "reasonable expectation of profit (REOP). We will discuss this in detail later.

You must eliminate the personal element which is that costs incurred will be considered personal except when they are made in connection with a business and REOP. ITA 18(1) (h) and 248(1)

It appears, short of outright fragrant claims for obviously personal items, CRA and the courts will listen to your position and if well supported, allow expenses that are not restricted (see later) even if the business reason is rather inconclusive. OK, well, the simplicity can't last forever. Now it's time for the next step.

STEP 2: DEVELOPING YOUR OWN THEORY

First build the foundation. Supporting your expenses to the inquisitive tax auditor should portray **all** of the these requirements in a positive light;

1. Is the entity an active business or property?
2. Does the expense pay the business purpose test (see step 1)
3. Are the expenses properly matched against related gross income, if possible?
4. Have you ensured there are no restrictions in the ITA?

Restrictions are a matter of fact. See 'Designing a Deductible Expense', and 'Restricted Expenses' (below). You now have a legitimate, supportable expense – in theory. The boring part is over – let us now ensure you can make the most of these expenses.

Remember the ITA requires a taxpayer to:

- make fine distinctions
- provide clarity of the filing position

- be factual and specific.
- do it all at once

Self –assessing is a good approach, and it works best if you are not shy about it. Four words to emphasize that would be, “CRA is not shy”.

We have barely scratched the surface. It's time to start looking at the details.

Expenses Factors You Can Control to Maximize Tax Savings for Claimed

Here is a checklist of how expenses should be recorded and declared. These are not the same thing. You always record an expense on your records. Whether you declare them as tax deductions is subject to accounting rules and special provisions of the ITA for some items.
(Reference ITA 9(1), 12(1), 18(1) and s. 67.

<u>The Timing Factor</u>
At which time would you classify an expenditure an expense for tax purposes – if at all? Questions to ask include the following.

- Are the expenses recurring (running)? If yes, you probably have to deduct them in the year incurred.

- Is the expense singular? It is not repetitive or it has a special purpose. If yes, you have the option to either expense the outlay or match revenues. An example of that would be using prepaid work in progress or inventory matching to revenue as billed.

Please note that the matching principle according to Generally Accepted Accounting Principles (GAAP) is not a concluding factor in tax courts (GAAP is not always recognized as a last line of defense). Each situation is a question of fact.

- Timing differences will also depend on how you characterize the expenses. For example, is it a repair (restoration) or capital (betterment) item? See list of ‘Restricted Expenses’.

- Does the expense represent an actual commitment to pay by another party? The matching (to income) accounting principle vs. CRA’s insistence expenses not paid are allowable (as payables) only if there is an actual legal liability. No real consistency here. Use your judgment and obtain legal advice about contract law and legal obligations (see ‘Designing a Deductible Expense’).

<u>The Year End Factor</u>
This represents the adjustments you can make on financial statements to establish when you recognize gross revenue and/or record an expense. Your control of the

following documentation and activities define in which fiscal year you will declare an income and related expenses. Of course you want to cut-off at year-end for your benefit

- Issuing sales invoices for contract work. As soon as you issue an invoice, the profit component increases your taxable income in the period the invoice was dated.

- Issuing multiple, staged billings for services or delaying transfer of ownership (delivery) of goods results in different amounts of income being recorded in the period you desire. The rush for favorable fiscal results is a phenomenon that is often counterproductive to being tax-wise.

- Recording what cost components are included in inventory and inventory write-downs for obsolete goods or lowering inventory using 'net realizable' valuations. Hint – What 'net' means is that you can also deduct estimated direct costs to complete the transaction to an ultimate sale-such as shipping costs. This is an industry specific 'net value' determination but it pays to do some research of tax precedents and theory of inventory valuation because many taxpayers do not calculate the 'net' amount of inventory resale value for tax purposes. They must be consistent to prior years for similar items.

From your inventory at cost, calculate the net realizable value. Net and realizable being the key words because net is net of direct costs and realizable is cost value actually realized after direct costs that must be paid.

- 'Phantom' commitments that are possible tax deductions when reconciling income per financial statements to taxable income. These are enforceable liabilities according to agreements (recognizing guarantees, penalties, price adjustments, bonuses, employee commitments such as vacation pay).

- Accruing interest, professional fees, estimated bills not yet received (bills to you dated after the year end but still for services, goods before the year end – e.g. utilities and tenant operating costs…many more possibilities for losing money – I mean tax deductions). The better you know your business and its financing arrangements, all the deals it has made and activities on the go, the more you can add to accrued liabilities or costs to complete, which add to your current liabilities and expenses at year end. These are quantified activities or commitments not yet billed to you by a supplier at year-end. Like your accounting fee for example.

Other examples of what factors you can control that can affect year end taxable income are:

- selling or abandoning investments or projects
- controlling when closings of sales contracts take place
- income or losses from joint ventures whose year-end falls within your fiscal period

- deciding when assets are purchased
- deciding when discretionary expenses are to incurred

The Reconciliation Factor

Reconciling Financial Statement Income to Taxable Income.

ITA recognizes expenses for tax purposes differently that they are recognized for reporting on financial statements.

Differences between financial income on your 'normal' financial statements and income for income tax purposes must be reconciled on the tax return – e.g. depreciation vs. capital cost allowance. If you are just preparing statements for tax purposes this reconciliation exercise is unnecessary.

These are usually some timing differences in recognizing inclusions or exclusions of specific items from financial statement income to arrive at taxable income. These differences are quite effective in changing your tax payable and will definitely prove how valuable your accountant really is. One only has to book at a typical T2S (1) schedule for corporations - see Reconciling Items for Taxable Income.

Remember

Some key items to remember that can be different for tax purposes are unearned income reserves, doubtful accounts receivable or bad loans, depreciations v. Capital Cost Allowance (CCA-the tax term for depreciation and amortization), and recognition of additions and deletions to capital cost that can be different for tax purposes.

Elections especially designed by CRA to test your clairvoyant talents include capitalizing interest, trader vs. casual investor and excluding work in progress from income for certain specified professions are important to research.

Opportunity

There is no statutory rule that expressly governs the timing of deductions of a current expense. What in tarnation does that mean? It means it's a self assessing system. But remember -If you provide the tar CRA will bring the feathers.

The Best Professional Tax Advice You Will Ever Get!

If you do not willfully or ignorantly contravene obvious tax rules, and you can honestly support the legal and technical aspects of your tax position by your intentions and documentation – the worst that can happen is the expense is arbitrarily disallowed by CRA (in full or partially). You then pay non-deductible interest on any re-assessment. You will not be penalized and will be almost in the same position as if you had not claimed it.

Just remember to always spend the effort to document your intentions, do the research and engage professional advice to support your position for material transactions.

What Else May be Affected by the Way You Claim Expenses?

Since the principle of objectivity never allows any accountant to admit they work from the bottom line up (net income before tax) to finalize the profit and loss statements or tax returns, here are some other ideas and implications you should consider to maximize the difference between the net income (before tax on the financial statements) and income for tax purposes.

Why are you trying to increase your net income by reducing your tax? Any resulting tax savings will increase your net income after tax as disclosed on your financial statements which could have important positive consequences regarding:

- Compliance with covenants of loan agreements with financial institutions and terms of security agreements - because most covenants have equity ratios and working capital definitions and requirements. These are all affected by how much tax you pay and how much tax you still owe.

- Corporate law regarding paying dividends when cumulative losses in excess of profits arise.

- Penalties for late filing if taxes remain payable on taxable income.

- The current year situation if businesses trends are reversing. Filing prior year tax returns with lots of taxable income when you are currently losing money is an important decision. A tax loss for the present year can be carried back but if you don't file the prior year on time, are the cost of late filing penalties to be paid later worth not having the collection calls from CRA? Can subsequent events affect the decisions that produced the prior year financial statements so you can restate the tax returns? (Normally subsequent events should not affect judgment of prior year's activities – but then again, when exactly is the cut-off date? Is the error (if not corrected) misleading enough to distort income and justify an amended tax position and the hassle of third parties, including CRA, to amend? Capital cost allowance can be amended under certain circumstances as well).

- Any expected windfalls or large expenses on the horizon that could alleviate your current tax position.

- The application of unpaid amounts rules, deemed realizations, present or changing tax assessment treatments of CRA for uncertain tax situations you are presenting. New interpretations, administration positioning or rulings of CRA – can they be applied retroactively? Not until you try-they say.

- Tax is a cash drain (hence the expression 'Down the Drain'. Can you manage the cash flow requirements of paying income taxes as they normally come due? Really? CRA can be approached to make accommodations for late payments. Be proactive so CRA won't be reactive.

- Objections to re-assessments that postpone taxes re-assessed (does not apply for GST).

Key Issue – CRA will apply tax payments to interest first, arrears of tax next, and current tax last – so ensure you indicate how your payments (including installments) are to be applied and fight to apply payments to the principal owing first, so interest is reduced. Interest on interest is charged so the way to reduce interest is to reduce the 'oldest principal' the interest is calculated on – that's the way CRA interest calculations work.

Eight Frequently Missed Opportunities for Claiming Expenses for Your Business

The exercise of claiming expenses is surprisingly subjective. Here are some common occurrences that are frequently missed when claiming expenses.

Joint Ownership

Joint ownership (project, real estate) and partnerships can change the % of allocation of losses/gains among co-owners for any period at any time. So if the partners agree (more common in close relationships) and the partnership agreement allows (change the agreement if it does not), split the net income/losses as would benefit each partners' tax position in line with their contribution of money and effort to the business or property. This also affects each other partner's entitlements to profits/losses but in many instances the tax benefits make the argument a no-brainer.

Taxable Employee Benefits

For corporations, watch for expenses paid by the company that create taxable employee benefits (especially to shareholders). It is an exercise in itself to minimize tax on employee benefits. Typical and costly taxable employee benefits items are standby charges and GST on standby charges for corporate owned vehicles, deemed interest and tax on ineligible loans, stock options, personal portion of re-imbursement of expenses like travel or tuition fees and club dues if 50% of activities are not business related. There are many more benefits to review for tax consequences. See our tax strategy paper titled, 'Employee Benefits', for

Personal Expenses Incurred for Business

Deduct business expenses paid personally from net income of partnerships or co-mingled activities that don't reimburse your additional business expenses. Professional fees, dues, home office, travel, insurance vehicle, promotion expenses come to mind.

Corporate Vehicle

Instead of having a corporate vehicle resulting in CCA restrictions and standby charges, own the vehicle personally and have the company pay you a tax fee (if allowance reasonable) car allowance for business use.

Computer Software
Deduct computer system software 100% (split the cost of hardware to capitalize and software to expense).

GST and Other Fines and Penalties
Fines and penalties, including those levied on GST are more commonly deductible (except for those related to income tax) on many of life's neglects, purposeful or otherwise. See the new IT 104R3, issued by CRA in 2002. It does not mention GST interest and penalties are deductible but the court case was conclusive in this regard and by omission from exceptions in this IT, CRA has regretfully conceded GST interest, fines and penalties are deductible. Nice to know since we spend a heck of a lot of time collecting their money for them.)

Little Gems That Add Up
Some expenses don't need to be prorated to comply with CRA regulations (e.g. parking for business use, minor expenses like coffee and donuts that are not meals etc…). More to come on these little gems in updates to taxwise.ca

Charges and Re-imbursements
Review those charges to shareholder accounts or personal re-imbursements to the company for expenses not allowed by company policy. Some may be deductible.

Don't think the expenses on CRA forms T2125 (self-employed income and expenses) or the GIFFI statements (on corporate tax returns) are the only ones allowed.

Keys to Remember When Designing Your Deductible Expense

Are you still uncertain that the support of your deductions is not turning you into a comedian? If you are talking about any large sum of money it's worth the research to accommodate your concerns, bolster your confidence and strengthen your position for future disputes, if any, with CRA. Here are some 'tips' of the 'trade'.

- Find a tax case (DTC) that closely resembles your situation and the outcome you want. Read the judge's comments carefully and research references to other cases usually included in the judge's justification of their decisions. You will find something positive. Judges are quite reasonable, objective and at times surprisingly arbitrary. Visit the Federal Tax Court (on line). Don't expect CRA to be worried about any tax case or even follow court directions exactly, but it is worth the effort because it supports your position.

- Many sites publishing tax articles are out of date (tax publishers excepted). Find out what is happening currently. Call CRA (appeals officers are the best) for theoretical advice.

- Don't bet all or nothing. For situations that could reasonably be considered personal or rather one-sided (not your best side), take a reasonable % for business use.

- Since CRA states very clearly and repeatedly that do not bind themselves to being consistent with each taxpayer with each situation (let alone consistent assessing policies across Canada), don't think just because you treat a transaction one way, doesn't mean you can't treat it another way at another time. It is rare that singular expenses are even identical. As CRA states – "It is a question of facts".

- Keep you tax planning memos and correspondence close to the vest. Really close. Refuse to provide these smoking guns to CRA unless ordered to do so (obtain legal advice) by a "requirement to provide information". Read carefully the letter from CRA. Is it a 'Request' or 'Requirement'? Obtain copies of all third party working papers (especially from your public accountant) and memos and ask your lawyer about protecting these documents via legal client privilege.

- Determine what tax treatment other involved parties have taken, especially your partners and vendors, Contrary positions to yours are undesirable but may be more flexible than you assume. Timing of transactions, characterization and allocations of dollar amounts to components of contracts (repairs or betterments), software vs. hardware, and conditions such as payment discounts or buy-backs should be considered. (Ensure the invoice you receive provides a break-down of each major component of the supply you are being charged for.)

Important - over 90% of the outcome of tax disputes are not revealed by any court case (informal court or otherwise). Negotiated outcomes of re-assessments and appeals of others, and GST rulings are not public knowledge-except to CRA. You are at a disadvantage. Call all the industry associations and members you can to see how others treated the situation and the results they had.

What to Avoid Unless Your Want Trouble from CRA

Nothing is better than well documented intentions (even if the intention is to save tax – you are still onside) and positions that are supportable. But just in case you wondered here are situation you want to avoid.

CRA will react with deadly force to the following conduct:

- Arrangements or claims that are offensive. Syndications or third party transactions that have no reason other than saving or postponing an audacious amount of tax by distorted valuations, unwarranted fees, outright factual fabrications or criminal activity will pressure CRA into action.

- Not declaring income obviously belonging to the taxpayer.

- Any lies, misrepresentation, falsifying of documents.
- Claiming expenses that are obviously personal.
- Flaunting a lifestyle or assets not justified by reported income.
- Non-compliance to obvious and traditional requirements (non-filing of required returns, 'habitually delinquent' actions).

Ignorance is no excuse and any of the above actions will lower your credibility to unrecoverable depths. Oh – and if you ignore their requirements and don't communicate – expect notional assessments of outrageous amounts – way higher than your darkest nightmare. This is CRA's answer to intolerable behavior.

Samples of Restricted Business Expenses

This list is only a superficial example of some of important restrictions imposed by the ITA. Professional advice should be obtained for material transactions to ensure all restrictions are considered and to plan alternatives.

For more details refer to ITA, Section 18 and the references mentioned below.

- Capital nature (claim of capital cost allowance is optional).
- Personal component (but don't assume all or nothing – allocate on reasonable basis).
- Life insurance premiums (exceptions applicable).
- Entertainment and meals – 50%. ITA 67.1(1)
- Recreational and club dues – prohibited but some exceptions.
- Interest and fines related to income tax. Recent changes are more generous for other fines and interest, including GST.
- Some legal and accounting fees.
- Vehicles have cost or lease payment limits
- Personal services business (be careful, incorporating to service one client could restrict all expenses).
- Interest and property taxes on vacant land.
- Number of conventions per year if proprietorship or partnership (not for

corporations)

- Foreign media advertising. ITA 19(1)
- Home office expenses (loss creation restrictions).
- Financing expenses (have to be amortized) for major refinancing projects.

Also watch for inadequate consideration to recipient for non-arms length transactions including appropriations by shareholders ITA 69.4.