

Making the leap from employee to owner: some tax considerations

Jamie Golombek

Managing Director, Tax & Estate Planning, CIBC Financial Planning and Advice

If you're making the leap from employee to business owner, you're in good company – there are more than four million Canadian businesses, which include self-employed individuals. It's important to consider how you will structure your business, since choosing to operate as a sole proprietorship, corporation or partnership can impact the taxes you will pay. When a business is owned personally, whether by a sole proprietor or an owner-manager of a corporation, business and personal expenses may become comingled, so it's particularly important to use separate accounts to track tax-deductible business expenses.

Introduction

Small businesses, which include self-employed individuals, make up the vast majority of Canadian enterprises. In 2017, there were 1,271,000 employer businesses in Canada and 98% of these were small businesses, defined as businesses with fewer than 100 employees.¹ A further 2,778,000 businesses were not employers² and are believed to be individual owners with family members or contract workers. Together, these make up 99% of the four million Canadian businesses.

Businesses are generally easy to start. If you have an idea or a skill set and the basic tools to make it happen, you can start a business. Startup businesses often need little funding and, where funding is required, government programs such as the Canada Small Business Financing program can sometimes provide assistance. Here's an introduction to some of the tax considerations you will want to keep in mind as you start your own business.

Business structures and business income (loss)

The Canada Revenue Agency (CRA) defines a business as an activity that you intend to carry on for profit where there is evidence to support that intention.³ This would include a profession, a trade, or a manufacturing operation.

For income tax purposes, the net business income (or loss) is calculated by totaling the income from the business and deducting eligible expenses. Income would include revenue from the sale of goods or the provision of services.

Many expenses that are deductible for accounting purposes may also be deducted when computing taxable income. For example, employee salaries can be deducted.

For capital expenditures, such as equipment purchases, deductions are generally taken over time by claiming an annual capital cost allowance, which is similar to accounting depreciation.

If business expenses exceed income in a year, there is a net loss for tax purposes. This non-capital loss generally may be deducted against all sources of income in the current year or carried over and deducted against income from any of the previous three taxation years or any of the following twenty taxation years.

The three most common types of business structures are sole proprietorships, corporations and partnerships, and income is taxed differently for each.

Sole proprietorship

In a sole proprietorship, an individual (the “sole proprietor”) owns the business and is personally entitled to all the business profits. As a sole proprietor, you can operate the business under your own name, or under a registered business name. The sole proprietor is considered to be “self-employed” but can certainly hire employees to work in the business.

Calculation of business income or loss follows the principles outlined earlier. Business income is reported on your T1 personal tax return. Net business income is added to your other taxable income, such as net income from investments, to determine the total amount of your taxable income. Business losses can be deducted against all sources of income in the current year or may be carried back or forward, as discussed above. It is often advantageous to run a business as a sole proprietorship at first because, if losses are anticipated in the early years, they can be deducted from your other personal income.

Tax is levied on your net taxable income, including business income, at combined federal / provincial marginal tax rates ranging from about 20% to 54% in 2018, depending on your province of residence.

Corporation

A corporation is a separate legal entity that is owned by one or more shareholders who are entitled to the profits of the business.

If you start a business as a sole proprietorship, you can incorporate the business at a later date by setting up a corporation and transferring the business assets to it. You can generally transfer assets to the corporation at the tax cost of the assets, so that there is no capital gain at the time of transfer. This is referred to as a “rollover” of assets to the corporation.

Since a corporation is a separate entity, net business income is calculated at the corporate level and reported on a T2 corporate tax return. A Canadian-controlled private corporation (CCPC) pays tax on business income at rates ranging from 10% to 31% in 2018, depending on the province in which it is earned and qualification for the small business deduction.

Salary can be paid to employees, including the owner / shareholder of the corporation. Alternatively, after-tax income from the corporation can be distributed to shareholders as a dividend, which is reported on the shareholder’s T1 personal tax return. Since income is taxed both at the corporate and shareholder levels when dividends (rather than salary) are paid, the dividend tax credit mechanism helps to ensure that the total taxes paid by the corporation and shareholder approximately equals the amount that would have been paid had the individual earned the income directly.

Note that personal tax is not payable by an individual shareholder until the shareholder receives the dividend. Consequently, personal taxes can be deferred until a later date by delaying the dividend payment if funds are not needed immediately by the shareholder, leaving additional funds to be reinvested within the corporation in the interim.⁴

Partnership

In a partnership, two or more parties (such as individuals or corporations) join together to carry on a business. Each partner is entitled to a share of the business profits.

Net business income is calculated at the partnership level and is allocated to the partners in accordance with the partnership agreement. The partners report their share of the business income as they otherwise would. For example, an individual partner includes the business income and expense items on a personal tax return, while a corporate partner reports these on a corporate tax return.

Summary of structures and reporting of business losses

As you can see, each type of business reports income differently. There can be advantages with each type of structure from a tax perspective. For example, business income from a sole proprietorship or partnership is reported along with other personal income, so it is easy to administer, and if losses are realized, they can be deducted against other personal income. On the other hand, structuring your business through a corporation may provide a significant tax deferral opportunity when funds are not needed immediately by the business owner and can be left in the corporation. The tax deferral advantage will be higher if the corporation is taxed at the lower small business deduction rate on its business income.⁵

Keeping it separate

When a business is owned personally, whether by a sole proprietor or an owner-manager of a corporation, business and personal expenses may become commingled. It is important to be able to separate clearly which charges are for business purposes, since these can be deducted on a tax

return, and which charges are non-deductible personal expenses. If personal and non-personal charges are commingled in the same account, it can cause problems later on when they have to be sorted out.

One of the easiest and best ways to distinguish business from personal expenses is to have two separate bank accounts: a personal account and a business banking account. It's also a good idea to have two credit cards, one for personal spending and the other for business use.

Most banks will require separate bank and credit accounts for a corporation since it has its own legal identity. It is just as important for sole proprietors to separate their accounts, and most banks do not allow businesses to operate through personal accounts. Having a separate bank account and credit card for any business will make tax time a lot easier when it comes to segregating business and personal expenses and can also come in handy in the case of a CRA business expense audit down the road.

Conclusion

The taxation of businesses is quite complex and these are just a few of the tax matters to be considered. There are also a number of non-tax factors in determining the appropriate structure for your business, such as legal matters. You should, therefore, consult with the appropriate advisors, including tax and legal professionals, prior to implementing your business.

Your CIBC financial advisor can help you to understand the financial solutions that are available for your business.

Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Financial Planning and Advice in Toronto.

- ¹ CANSIM Table 552-0007 - Canadian business counts, location counts with employees, by employment size, December 2017, Statistics Canada, which is available online at <http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=5520007>.
- ² Canadian business counts, December 2017, Statistics Canada, which is available online at <https://www.statcan.gc.ca/daily-quotidien/180208/dq180208b-eng.htm>.
- ³ <http://www.cra-arc.gc.ca/tx/bsnss/sm/stng/menu-eng.html>
- ⁴ For a full discussion of the tax savings (or cost) and the tax deferral (or prepayment) from having corporate income taxed and retained in a corporation, please see, “Bye-bye Bonus! Why business owners may prefer dividends over a bonus” at https://www.cibc.com/content/dam/personal_banking/advice_centre/tax-savings/jg-dividends-bonus-en.pdf.
- ⁵ The 2018 Federal Budget contained proposed amendments that would limit access to the small business rate, for taxation years beginning after 2018, where more than \$50,000 of passive investment income is earned by the corporation in the prior tax year.



Disclaimer:

As with all planning strategies, you should seek the advice of a qualified tax advisor.

This report is published by CIBC with information that is believed to be accurate at the time of publishing. CIBC and its subsidiaries and affiliates are not liable for any errors or omissions. This report is intended to provide general information and should not be construed as specific legal, lending, or tax advice. Individual circumstances and current events are critical to sound planning; anyone wishing to act on the information in this report should consult with his or her financial advisor and tax specialist.

CIBC Cube Design is a trademark of CIBC.