SMALL-BUSINESS TAXES

AUDITS

You're about to be audited. Now what?

An audit can happen for a reason, or randomly. Either way, this is what a business owner needs to know

KIRA VERMOND

For many small business owners, the fear of being audited by Canada Revenue Agency ranks up there with the fear of heights, spiders and public speaking.

Even if the company's bookkeepers believe they've done everything right – such as kept detailed notes and filed away receipts – will the auditor feel the same way, or will there be a hefty penalty to pay? Make no mistake, there are definitely horror stories of small businesses going through an audit only to be charged thousands or even hundreds of thousands in back taxes, fees and penalties for non-compliance. But many other audits go smoothly and without dropping financial bombshells.

Dale Barrett, a Toronto tax lawyer and author of *Tax Survival for Canadians: Stand up to the CRA*, says small-businesses owners often hire him simply because they can't deal with the stress of an audit.

"A lot of people get freaked out and they get crippled. They're not able to do anything but just sit and think about it. They fixate on the audit," he says.

In reality, the anxiety can be worse than the audit itself, and with some preparation, your business can get through the process without paying significant tax dollars. Here are five tips to ensure a smooth ride if you have somehow popped up on CRA's radar.

Chartered professional accountant Kate Amangoulova of Langley, B.C., says not all audits are the result of CRA seeing red flags. 'Sometimes it's just a draw and you've been randomly selected.' JEFF VINNICK FOR THE GLOBE AND MAIL

Know why you've been audited in the first place

In some cases, audits are nerve-racking because it's not known why the small business was chosen in the first place. There's a sense of being caught – without actually knowing why it's in the wrong.

"But you can get selected for various reasons," says Kate Amangoulova, a chartered professional accountant in Langley, B.C., who works primarily with small businesses.

Although in some cases there is a red flag that gets CRA's attention – the business shows financial losses for years, for example – "Sometimes it's just a draw and you've been randomly selected," she explains.

Or sometimes your business seems to be out of whack with others in the same industry. If you're blowing through 23 per cent of your revenue on office space, but your competition only spends 8 per cent, that discrepancy could be enough to trigger an audit. "Understand that the CRA's computers are getting better, bigger and faster," says Mr. Barrett. "They match and they compare absolutely everything to everything else."

Hit the deadlines

Although you're required to keep your records for six years from the time you file your tax returns, the government has up to three years from the time of issuing your assessment notice to audit your business.

Once the assessment letter lands in your mailbox (and your accountant's, if you use one) you will be given 30 days to respond to the auditor so you can arrange a date, time and place for the audit.

Ms. Amangoulova says that she receives a call first before the letter arrives when clients are being audited for a specific reason – not randomly selected.

The letter will give you a list of documents the auditor wants to see and gives a deadline to pull them together. In some cases you can ask for an extension if the timing is bad.

It's reasonable for a retailer to ask for one if the deadline is two weeks before Christmas, or in the middle of tax season for the accountant.

Don't get chatty

In some cases the auditor will ask for a desk audit – you simply drop off or send the documents in question.

But when an auditor wants to do a field audit, be prepared to have the person come to your place of work.

Field audits can be tricky, however, says Mr. Barrett. People have been known to get chummy with a friendly auditor and reveal all kinds of things about themselves that could raise questions down the road.

"They are not your friends," he explains. "They'll talk to you about your summer trip to Hawaii – and meanwhile they're adding up numbers in the back of their head. What may just seem like simple dialogue and friendly chatter could actually be a fishing expedition."

So be courteous and polite, but zip it.

Always be prepared

To avoid any last minute scrambling, the very best way to prep for an audit is to keep the best records possible all year round.

That means keeping a detailed automobile log if you use your car for business and for schlepping the kids around after school. It can be as simple as keeping a little book in the glove compartment and writing down how many kilometres you travelled and where you went each and every time you get behind the wheel.

A pain? Absolutely. But automobile expense is the number one flashpoint for small businesses at audit time.

"Keeping accurate records of everything is really tough," agrees Mr. Kelly, president and chief executive officer of the Canadian Federation of Independent Business in Toronto. "But you've got to do it. It's important and can save your butt when times are bad."

Know you can appeal

Think the auditor made a mistake and you're now being overcharged? Fortunately, you have options.

For starters, if there are going to be any changes to your tax returns, ask the auditor to explain each and every proposed change. Then take the list to your accountant or a tax lawyer to run the numbers again. Try to work with the auditor or his or her superior first, but know tax court could be in your future if you can't come to an agreement at the lower level.

But being persistent and refusing to back down can pay off. Mr. Barrett recently managed to get an $800,000 tax bill down to $25,000 in a case of supposed undeclared revenue.

"We have a great system," Ms. Amangoulova adds.

Special to The Globe and Mail

ADVICE THREE TOP TAX TIPS

It's no secret that small-business owners put in long hours. A typical day can include anything from hiring new employees to overseeing marketing campaigns and even cleaning out a rank staff room fridge.

With so many responsibilities gobbling up an entrepreneur's time, no wonder Statistics Canada data shows that more than 40 per cent of owners work 50 or more hours a week – while just 6 per cent of employees work that amount.

But many owners would gladly take the fuzzy fridge over dealing with befuddling tax matters any day. In 2013, 79 per cent of small businesses answered a Canadian Federation of Independent Business (CFIB) survey listing their tax burden as the biggest challenge they faced.

"I can say quite authoritatively that almost every business in Canada is not fully [tax] compliant – and in 99 per cent of those cases it's because the rules are so incredibly complicated. Implementing them perfectly is near impossible," says Dan Kelly, president and chief executive officer of the CFIB.

To help make tax filing a little less taxing this year, here are some tips, tricks and good-to-know facts so you can focus on what you know best: your business.

Get it in writing

If you have a small-business tax question for CRA, rather than phoning up the call centre, use the My Business Account online service instead. A CRA agent will respond to your question in writing. That's helpful if you want to have a record of advice and information provided by CRA in case there are problems later.

To register for an account, visit cra-arc.gc.ca/mybusinessaccount.

Keep your records

In most cases, you need to hold on to all those receipts and records and supporting documents for a period of six years from the end of your tax year. But if you file your income tax return late, keep your records for six years from the date you file the return.

While CRA auditors will generally ask to see records that are less than three years old, if they suspect problems or inconsistencies, they may ask to examine your older records, too.

Accountant or lawyer?

You're being audited. Do you turn to your accountant or tax lawyer to help you through the process? That depends. An accountant's job is to understand what files and records CRA needs and can speak the lingo to get the job done, while a tax lawyer's main concern is protecting the client.

"An accountant may not get suspicious when the auditors seem to be asking questions that have a criminal tone to them," says Dale Barrett, a tax lawyer with Barrett Tax Law in Toronto.

Kira Vermond

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SMALL-BUSINESS TAXES

HOSPITALITY

A tip for restaurants: Keep your hands off the gratuities

To avoid tax implications, it's best for owners to let staff handle and divide tips, experts advise

JOSH O'KANE

Paul S. Hewitt has the same piece of advice for all restaurants he works with: The less you control the tips, the better.

As soon as an establishment has "control" over tips – by including them as a mandatory service charge, by determining how they're split among service staff, or by simply counting them as business income – they can count toward an employee's official remuneration, and therefore become subject to income-related charges such as Canada Pension Plan deductions and employment insurance premiums.

"The key is not to co-mingle the [tip] money with your restaurant's revenues," says Mr. Hewitt, a Toronto-based chartered professional accountant who ran restaurants for nearly 15 years and now advises a number of service-industry clients on tax and audit issues.

The unwritten rules around tipping are confusing, cumbersome and often inequitable, to the point that there's a growing movement to kill tips altogether. That doesn't mean they're going away any time soon. And the way establishments handle tips for tax purposes can have an impact on how much they wind up paying the government.

Because "it's easier to call us than Canada Revenue Agency," says James Rilett, Ontario vice-president of Restaurants Canada, the food-service industry group fields questions about tips constantly. "It's actually one of the most frequent questions I have from newer members."

Canada Revenue Agency distinguishes between two different kinds of tips for most of the country: direct and controlled. Direct tips are those that flow straight from the customer to the employee, such as cash tips and debit or credit-card tips that are passed back to service staff in cash. Those aren't eligible for CPP contributions or Employment Insurance premiums. (In Quebec, however, tax legislation requires employees to declare direct tips to their employers.)

If an establishment interferes with tips' distribution, though – like determining how they're spread among service staff or through adding an auto-gratuity – the tips can be considered controlled, and therefore company income, which can lead to deductions for both employer and employee.

If a restaurant interferes with tips' distribution, such as determining how they're spread among service staff, the tips can be considered controlled, and therefore company income. MATTHEW SHERWOOD FOR THE GLOBE AND MAIL

> **There are no laws in Canada about restaurateurs or operators being responsible for tracking and accounting for employee tips.**
>
> **Douglas Fisher**
> *President of FHG International*

In the simplest terms, Mr. Rilett says, "If it's only handled by the server, then the restaurant has no responsibility."

When it comes to cash, it's easy for non-Quebec employers to keep their hands off tips and let their serving staff distribute tips among themselves. But it can be more complicated than that when debit and credit is used and point-of-sale machines get involved.

Any tips that come attached to service staffs' regular paycheques is eligible for tax deductions, so businesses generally make sure the money stays separate. It's best to let employees handle everything themselves: When Mr. Hewitt advises restaurants and bars, he tells them to cash electronic tips out as soon as possible and give it to employees. If they pool it to distribute between different service staff – cooks, for instance, don't get the client-facing perks that servers do – it's best to make sure the employees decide among themselves how to divide the tip pool.

When asked to clarify if there are time limits on distributing credit- and debit-originated tips, a CRA spokesperson said in an e-mail, "If an employer, for cash flow reasons, delays paying out the tips to the workers, the employer is merely a conduit for the tip from the client to the worker and the tip would still be considered to be direct and would not be subject to CPP and EI deductions."

Auto-gratuities – like those charged to large groups of, say, six or more – are considered "controlled" tips by CRA, too, and eligible for taxation. Mr. Hewitt says it's possible to get around the taxes involved with those by writing them onto the bill by hand, skipping the point-of-sale machine entirely.

The notion of what tips should and shouldn't get taxed is an "extremely grey" area, says David Hopkins, president of Fifteen Group, a Toronto-based restaurant consultancy. So, he says, it's implicit in much of the industry that management shouldn't touch any tips. "At the end of the day, as far as we're concerned, and the restaurants we work with are concerned, they don't control any tip distribution." (It's a touchy subject – numerous restaurants that The Globe contacted for this story either declined to speak or avoided comment altogether.)

"There are no laws in Canada about restaurateurs or operators being responsible for tracking and accounting for employee tips," says Douglas Fisher, president of FHG International food-service consultants, "unlike in the U.S., where employers must record and file tip information."

For service staff, direct tips aren't eligible for CPP contributions or EI premiums. Still, it's extremely common for employees in the service industry to declare either none or very little for their taxes. To avoid audits, Mr. Fisher says, "a lot of restaurant employees come together at tax time and decide what they declare as a group, so no one stands out."

Jane, a bartender in Toronto with 15 years experience, said that she knows people who claim nothing, but "generally the rule of thumb is 10 per cent." Point-of-sales systems can create a paper trail, she says. "I don't know anyone who keeps an extra copy of that piece of paper."

Even in Quebec, where tips are significantly more regulated, cash tips can go untraced. One Montreal server, whose previous employer would tabulate tips at the end of every shift, says in her current role, "I don't declare cash tips."

But as technology makes transactions easier to trace, tips are harder to conceal. New legislation in Ontario has made it illegal for employers to take a cut of tips, too, shining a light on how the service industry operates. And a recent court decision in Ontario regarding tips received and distributed by Andrew Peller Ltd. found that when a company goes to great lengths to account for and distribute tips, "It appears that the courts would rule that the employer is the one that is paying the tips," Mr. Hewitt says.

So for now, he says, "Under the current state of the law, I advise my clients not to take any control over tips."

EXITING

Deadline looms for businesses looking to sell

Taxes on asset sales are going to increase significantly come January

BRENDA BOUW

Private companies pondering whether to sell their businesses are being forced off the fence becaue of a change in the latest federal budget that would see them pay more tax on a sale starting next year.

The revision is around taxation of intangible assets, such as goodwill and licences, at the time of sale.

Tax experts says the move, which is intended to simplify the tax system, is inspiring some business owners readying for a sale to finally pull the trigger, with a goal of closing the deal before the new tax rules kick in on Jan. 1.

"It's driving a lot of discussion about M&A [mergers and acquisitions]," says Dov Begun, a partner in the tax group at Osler, Hoskin & Harcourt LLP, who works with many entrepreneurs and startups in Canada.

"There are a lot of meetings, a lot of phone calls and a lot of interest" since the change was introduced in the federal budget on March 22, he says.

The clause can be found in the "eligible capital property" section of the budget document, which includes "intangible property such as goodwill and licences, franchises and quotas of indeterminate duration, as well as certain other rights."

The change affects all companies, but has a significant impact on owners of private companies that sell the assets of the business, and not the company shares, says Matthew Mammola, a senior manager at consulting firm Ernst & Young's transaction tax practice.

He said the key difference is that a company selling intangible assets will have them taxed as a capital gain starting in 2017, which attracts a higher tax rate for Canadian-controlled private corporations. Under the current system, those assets are taxed as business income.

Matthew Mammola of Ernst & Young suggests business owners who are contemplating selling their assets should begin the process now if they want to beat the deadline, when taxes go up. JENNIFER ROBERTS FOR THE GLOBE AND MAIL

> **You never do something simply for tax purposes. You look at the business deal first and foremost. If there is a deal on the horizon … then there may be some motivation here to accelerate that transaction and consummate it before year end.**
>
> **Dino Infanti**
> *A tax partner and national leader at KPMG LLP*

For example, today, goodwill gains are taxed as business income at a rate of between about 13 and 15.5 per cent, depending on the province a business operates in, Mr. Mammola says. Starting next year, the rate will range between 25 and 27 per cent, when taxed as a capital gain under the new system.

Put another way, if a company were to sell its goodwill for $5-million, for example, the tax would be about $700,000 in 2016. Under the new system starting in 2017, the tax would be about $1.3-million, or nearly double.

The change could also be an incentive for owners of private companies to sell their shares, instead of the assets. That way, they may also qualify for the lifetime capital gains exemption, which is $824,176 in 2016, which is not possible for an asset sale.

However, that may be more challenging since buyers often prefer asset deals because of certain tax deductions they can't get on a share deal, Mr. Mammola says. Plus, an asset sale is less risky for the buyer.

"If they buy the shares of the company they're inheriting its tax history and any skeletons in the closet that now become theirs," such as litigation, he says.

For business owners thinking of selling their assets, Mr. Mammola recommends they start the process soon if they want it done under the current, more favourable tax system.

That is because it can take up to six months or more to complete a deal.

"A typical transaction can take longer than most people think," Mr. Mammola says. "If they wait until the last couple of months of the year, they could run out of runway."

Mr. Begun at Osler is expecting inquires from potential sellers to pick up over the summer, as the end of the year draws closer.

However, he doesn't expect owners, who had no plan to sell prior to the budget change, to suddenly make a decision to find a buyer.

"It's more for people already in negotiations, with a term sheet, thinking about a sale or who have been approached about a sale – and are thinking about the best way to structure it," Mr. Begun said.

Dino Infanti, a tax partner and national leader at KPMG LLP, says his firm is getting more calls from private companies looking to sell before the end of the year, or to simply better understand the tax implications of staying put for a few more years if they are not ready.

"Where someone has been thinking about selling their business … then it would be useful to have a discussion now to entertain a transaction, before the new tax regime comes into place," Mr. Infanti says.

That said, he also doesn't expect business owners to decide to sell simply to beat the taxman.

"You never do something simply for tax purposes," says Mr. Infanti. "You look at the business deal first and foremost. If there is a deal on the horizon … then there may be some motivation here to accelerate that transaction and consummate it before year end."

Special to The Globe and Mail

HST AND GST

Render unto Caesar, or face CRA

Collecting taxes on behalf of the government flummoxes small-business owners, especially if they have cash-flow problems

AUGUSTA DWYER

For most small-business owners it's probably safe to say that collecting taxes on behalf of the government can be a nuisance.

"These are in the category that are called 'trust monies,'" said Dale Barrett, of Toronto-based Barrett Tax Law, "and the Canada Revenue Agency goes crazy over trust monies."

What's more, the legislation related to the harmonized sales tax and the goods and services tax is complex, and it's easy to make costly mistakes. Here are the seven most common HST/GST errors.

Small-business owners have to register with Canada Revenue Agency and begin collecting HST from customers once their revenue passes $30,000. ISTOCKPHOTO

Not registering with the CRA

For Kristin Li, owner of Tax911Now.com, the top HST/GST error she sees is small-business owners not registering. "They have no clue that once they pass $30,000 in billings, they have to register for GST or HST," she said. One of her clients, she recalls, had already made $70,000 and hadn't thought to register.

Companies that hit the $30,000 mark within one year have until the end of the month following the crossing of that threshold to register and start collecting tax.

"But if you hit it within one quarter alone then you have to register at the time your invoice puts you over $30,000," said Paul McVean, tax partner at Anklesaria McVean Professional Corp. in Toronto, and start collecting immediately on that invoice.

New business owners in particular make this mistake, he says. And whether they charged their customers or not, they still have to pay CRA what they should have collected.

Not paying on time

Sometimes a small business owner with cash-flow problems will hold onto the tax money, Mr. Barrett said. "A lot of people will say, 'Well, I will just meet the payroll with the HST money I have now, and when business gets better we will pay back the government.'"

That can get them into a lot of trouble with the CRA, he added. "You can get yourself into a position where they can become very aggressive with the collection."

Not getting a new account when incorporating

Companies often assume they can keep using the same HST number and account when they incorporate, said Mr. McVean. "Of course that number is really attached to them as a sole proprietor."

Ms. Li said this often happens to contractors and other small business people. "Usually they start small and later become big and have to incorporate. They often forget that they can't use the old GST number any more."

If a small-business owner has already gone through the incorporation process but neglected to update their records with CRA, it can lead to a paperwork nightmare.

Charging when they don't have an account

Some businesses do the reverse, collecting HST before they have registered, Mr. McVean said. "The problem with that is, if the people who are then paying the HST go through an audit, and the auditor matches up HST numbers, they could determine that there was no registrant with an HST number at that time period."

By collecting tax money before it has registered, the business has not only created a problem for its clients but broken the law as well.

Messing up when doing business in another province

Adding to the HST/GST confusion, provinces charge varying amounts of tax. "Businesses selling products or services in other provinces need to charge the sales taxes applicable to the place of consumption," Ms. Li explained. So if an Ontario-based business is selling a product or service in Alberta, for example, only the 5-per-cent federal portion can be charged.

On goods, moreover, "it can get a little bit trickier," said Mr. McVean, "because it depends on where the customer is considered to have actually acquired that purchase, and that has to do with whether it is shipped freight-on-board or not."

Business owners can check rates for all the provinces and territories on the CRA website.

Not paying HST/GST on their employees' taxable benefits

"We see that missed all the time," said Mr. McVean. He admitted, however, that this can be complicated "because you're not actually paying or collecting any HST as part of those transactions and have to calculate a kind of notional amount.

"Essentially you have to figure out what would have been the HST had you paid a third party, and then alter your HST return accordingly," he said.

Not documenting input-tax credits properly

Businesses pay taxes on their own purchases and can deduct them as expenses. "That," said Mr. McVean, "is where they don't get it right a lot of the time."

When claiming the input-tax credit, or ITC, he said, business owners might have the receipts but not the breakdown showing the HST or GST component.

What's more, company owners need to remember that only the business portion of such expenses can be claimed.

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