Four reasons to pay attention to your company's balance sheet

Planning

Assets

Savings

If you've already incorporated your business, you are likely benefiting from some of the advantages of incorporation, including limited liability, tax deferral of funds reinvested in your business and the ability to initiate family planning. Your incorporated business may stand to benefit even further if it is considered a small business corporation.

Here are four reasons why you want to ensure your corporation attains and maintains its status as a small business corporation (SBC) or qualified small business corporation (QSBC):

1. The Lifetime Capital Gains Exemption
2. Avoiding the tax on split income (TOSI) on the sale of shares
3. Avoiding the punitive corporate attribution rule
4. Claiming an allowable business investment loss (ABIL)

What is a SBC/QSBC?

First, it is important to understand what the terms SBC and QSBC mean.

Small Business Corporation

To be considered a small business corporation (SBC), you must:

- be a Canadian-controlled private corporation (CCPC[1]); and
- use all, or substantially all (i.e., at least 90%), of the fair market value of the corporation's assets in an active business; and conduct business primarily in Canada.

A holding company can also qualify as an SBC if 90% or more of its assets are shares or debts in a corporation that is an SBC. This essentially provides access to the four benefits listed above to both the operating company and the holding company in a standard corporate structure.

Generally, if your corporation is a CCPC that uses all of the assets on its balance sheet in an active business, your corporation likely qualifies as a small business corporation. However, if some of the assets your company owns are not being used to earn active income, then the corporation may not qualify.

***Example:** your business has excess cash that it invests in long-term investments.*

Furthermore, since the 90% test is applied to the fair market value of assets rather than their cost or book value, you may require the services of a valuator to ensure you are using the correct values.

Qualified Small Business Corporation

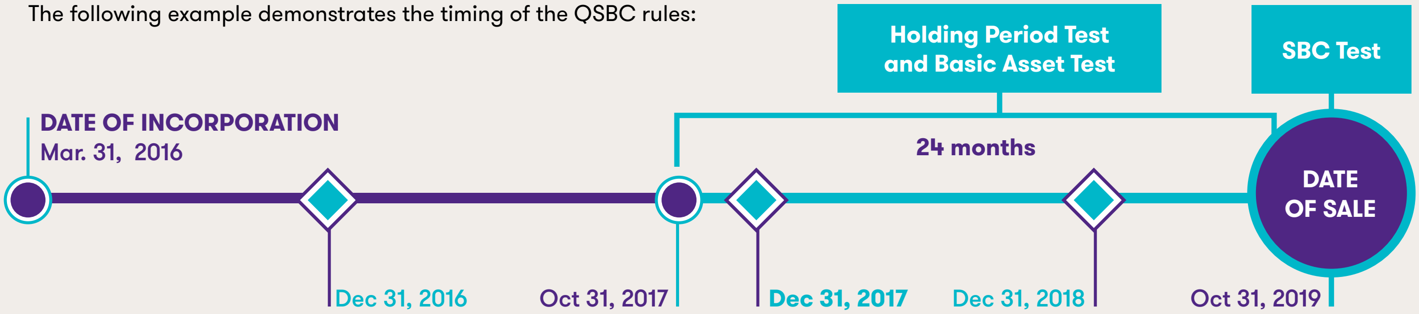
For shares to be considered qualified small business corporation (QSBC) shares, three tests need to be met:

The SBC test: The corporation must be an SBC at the "particular time"—that is, any point in time in which it is necessary to determine QSBC status (e.g., in a situation where shares are being sold, this would generally be the date of disposition);

The holding period test: The shares of the corporation must be owned by the individual, or a person or partnership related to the individual, throughout the 24 months prior to the particular time; and

The basic asset test: The corporation must be a CCPC throughout the 24 months prior to the particular time (and at least 50% of the assets must have been used principally in an active business in Canada).

The following example demonstrates the timing of the QSBC rules:



Pascal incorporated The North, Inc. (TNI) on March 31, 2016. TNI operates a sports gear retail business. Pascal was recently approached by a competitor who would like to purchase his shares of TNI. The proposed closing date for the sale is October 31, 2019. The following timeline illustrates the timing requirements of each of the three QSBC tests.

The top 4 reasons: What's in it for you?

Ensuring the shares of your company are considered QSBC/SBC shares is important because it may entitle you to beneficial tax treatment under certain circumstances. This discussion lists out four reasons why QSBC and SBC status are important for small business owners.

1 Capital Gain Exemption (CGE)

The CGE allows a Canadian resident individual to shelter gains on the disposition of QSBC shares. The cumulative amount that can be sheltered in a taxpayer's lifetime is

$866,912[2] up to 2019

If you own shares of a QSBC, it is an effective tool to reduce or eliminate your tax bill that would otherwise be payable upon the sale or succession of your company.

Sale of a Business

Although there are many ways to structure the sale of a business, one of the simplest ways is a sale of shares by the business owner to the purchaser. By selling the shares of the corporation, a business owner can benefit from the tax savings provided by the CGE.

The following example illustrates the potential tax savings in the province of Ontario:

Kyle has been approached by Nicki, who wants to buy his business. Nicki has offered Kyle $1,000,000 for the shares of his corporation, Hoops Inc. (HI). Kyle originally incorporated HI a decade ago for $100. Since his business is based in Ontario, Kyle's combined federal and provincial personal tax rate is 53.53%.

	SCENARIO 1: CGE applied	SCENARIO 2: no CGE
Sale proceeds	1,000,000	1,000,000
Cost of shares	100	100
Capital gain	999,900	999,900
Taxable portion (50%)	499,950	499,950
Less capital gain deduction[3]	(433,456)	-----
Net amount taxable	66,494	499,950
Tax @ 53.53%	35,594[4]	267,623

The potential income tax savings in this scenario is over $232,000. The results vary, depending on the province; regardless, the potential for savings is substantial.

Tax planning for you and your family

To avoid future uncertainties, some business owners may prefer to "lock-in" the benefit of the CGE at a time when they are certain that their companies meet the QSBC definition. This can be done through what is referred to as "Crystallization" of the CGE. The simplest way to do this is by transferring your QSBC shares of your operating company (Opco) to a holding company (Holdco) and electing to trigger a gain large enough to use your available CGE. The shares of Opco will now have a higher tax cost, which will reduce the capital gains on a future sale of the shares.

It may also be possible to multiply the benefit of the CGE by having other family members own shares in Opco, too. Under the right circumstances, this could result in a significant tax savings, as each individual family member would be able to exempt up to $866,912 of capital gains on their QSBC shares. For a family of four, that results in almost $3.5 million of capital gains exempt from tax. Strategies can also be implemented that use a trust in order to allow for flexibility and control in your tax planning. However, caution must be taken in having family members who are not active in the business owning shares in the corporation as this can result in negative tax consequences due to tax on split income rules (TOSI).

2 Avoiding TOSI

Although initially introduced in 1999, the tax on split income (TOSI) rules underwent major changes in 2017, requiring many taxpayers to revisit their small business ownership structures. The rules were extended to apply to the business owner's spouse (or common-law partner) and adult children, as well as most other individuals who are residents in Canada and related to the business owner. If the rules do apply, split income is taxed at the top personal marginal tax rate and is not eligible for any deductions or credits, except for the dividend tax credit and foreign tax credit.

As discussed in the Grant Thornton article, *Tax on split income and the effect on estate planning*, one of the major exceptions to TOSI is the exemption for gains incurred on the sale of QSBC shares, provided the gain is not incurred by a minor on a sale to a non-arm's length person[5]. Furthermore, there is no requirement to actually claim the CGE when disposing of the shares, which may allow for tax planning opportunities on such shares. For this reason, it is particularly important to maintain your company's QSBC status when you are considering estate planning or anticipating a sale in the near future. TOSI rules are punitive and complicated and getting expert help will allow you to mitigate the potential negative impacts of the new rules and explore potential tax planning opportunities.

3 Avoiding the corporate attribution rule

If your business is incorporated and you plan to add other family members as shareholders or implement an estate freeze, it is possible that the corporate attribution rules will apply. These rules are punitive in that they result in what is known as imputed interest, or "phantom income", being included in your income, whether or not you actually received any amount from the corporation[6].

For example, if you and your spouse each own 50% of your corporation and then you loan $1 million to the corporation, this could result in imputed interest being included in your personal income. Assuming the loan is outstanding from the beginning of the year, and the current prescribed rate[7] is 2%, this would result in a $20,000 interest income inclusion on your personal tax return.

Although there are several methods that can be used to alleviate the impact of these rules, the simplest one is ensuring that the corporation is an SBC. Meeting this requirement would allow for greater flexibility when deciding whether or not to transfer or loan property to the corporation.

4 Allowable business investment loss (ABIL)

If you have invested in a company by buying shares or lending money but your investment turns out to be a dud, there is the potential to write-off half of the loss on your investment as a tax deduction. This write-off—known as an allowable capital loss—has limited deductibility[8]. However, if the company you invested in is an SBC, the write-off could instead be considered an allowable business investment loss (ABIL), which allows for more opportunity to receive the benefit of the write-off sooner.

An ABIL is deductible against any source of income and, if no income is available in the current year, can be deducted against any income source in the three previous years or the next 10 years. After that time, it will still be available as a deduction, but in a more limited capacity. Therefore, the likelihood of receiving the benefit of the ABIL sooner rather than later is much higher than if it were not an ABIL.

How to maintain SBC/QSBC status

Now that you know the benefits of qualifying as an SBC or QSBC, it is critical to keep an eye on your balance sheet—and make sure your non-active business assets do not "taint" the status of your company.

Whether an asset is used in an active business or not can sometimes be subjective. One asset that can be difficult to assess is cash. Cash is considered to be used in active business if its withdrawal would destabilize the business. For example, if the cash is used as certificates of deposits required to be maintained by a supplier or the cash is anticipated to be used to purchase capital assets or repay debts, it will usually be considered as an active business asset. However, if your company has excess cash and you do not have plans to use it in your business operation, the cash will not be considered as an active business asset.

Other types of assets that may "taint" your company's status:

- **Investments:** (e.g., long-term bonds)
- **Rental property:** (e.g., a portion of the building is rented out to businesses other than associated[9] small business corporations)
- **Leased equipment** when a corporation is not in the equipment leasing business (e.g., equipment that is leased on a regular basis to businesses other than associated[9] small business corporations)
- **Vehicles:** (e.g., when it is used by employees or shareholders for personal use more than 50% of the time)

Fair market value vs. book value

It is important to note that the 90% test is applied to the fair market value of assets, not the book value. Some assets may even require a professional appraisal to determine their fair market value.

Examples

Land

FMV	=	$100,000
Book Value	=	$40,000
Use FMV of	=	$100,000

Goodwill

FMV	=	$1,000,000
Book Value	=	$0*
Use FMV of	=	$1,000,000

**Goodwill may not be included on a historical cost balance sheet. It may require an appraisal of the company to determine its value.*

Know what's on your balance sheet and plan ahead

If your corporation does not currently meet the definition of SBC or QSBC, there are ways to achieve this. Oftentimes, it is a matter of reviewing your balance sheet to determine what changes need to be made. For example, if you have a large cash balance, it may be necessary to evaluate the reason for the large balance and potentially determine ways to use the cash – for example, paying off liabilities or paying dividends to shareholders – to ensure you are meeting the requirements in the SBC definition.

Helping you reach your long-term financial goals is our priority at Grant Thornton. When done in advance, tax planning can both support and guide your decisions in a way that will maximize returns and help you avoid unexpected pitfalls. For more information, contact us.

1 Technically speaking, a CCPC is a corporation that is: (1) not listed on a stock exchange or controlled by a corporation listed on a stock exchange and (2) not controlled by non-residents. This second requirement generally means that a corporation can have up to 50% ownership by non-residents and still qualify as a CCPC, provided the first requirement is met (and the other 50%+ ownership is held by Canadian residents, of course).

2 The amount of the lifetime CGE is indexed to inflation and adjusted annually. The exemption is also available on "qualified farm property" and "qualified fishing property", on up to $1 million in gains.

3 Technically, the "capital gain deduction" is deducted from the "taxable capital gain" to determine the amount of the gain that is subject to tax. The "capital gain deduction" of $433,456 is 50% of the "capital gain exemption" of $866,912.

4 This does not include the alternative minimum tax (AMT), which would likely apply in this scenario. However, the AMT is refundable in future years upon payment of income tax. Even factoring in the AMT, there is still a substantial tax savings of over $70,000 available in the year that Kyle claims the CGE.

5 Generally, a "non-arm's length person" includes an individual related to the minor, and can also include a corporation or trust, if controlled by a person related to the minor.

6 The rules are punitive because an amount is included in the income of the shareholder, regardless of whether or not an amount was actually paid by the corporation, and there is no corresponding deduction to the corporation, resulting in double taxation.

7 The prescribed rate is essentially the average rate of three-month Government of Canada treasury bills for the previous quarter.

8 An allowable capital loss is only deductible against taxable capital gains in the year. If there are no taxable capital gains in the year, it can be deducted only against taxable capital gains in any of the three previous years or any future year.

9 Corporations can be "associated" in many ways, usually based on common control and minimum ownership requirements of two or more corporations by the same person or group of non-arm's length persons. The associated relationship is important for tax purposes for multiple reasons, including the allocation of the small business deduction and the determination of the nature of income between two or more corporations, as mentioned above.

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