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Canadian Overview

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New CRA Audit Project: Car Expenses

By Howard Wasserman, CPA, CA, CFP, TEP, Principal in Taxation, Segal LLP

It appears that the Canadian Revenue Agency (CRA) has a new project: corporate car expenses. This change comes as a surprise as previous correspondence from CRA was proposing to disallow personal car expenses for owner managers.

In CRA correspondence that we have seen of late, the focus is on those companies that had an expense in the vehicle expense line of the tax return. The standard letter is asking for the following items:

1. A detailed list of the general ledger transactions for vehicle expenses.

2. Invoices of the ten largest items in one month in the year.

3. A listing of the vehicles with clarification as to who owns the vehicles.

4. The make and model of the vehicles that the company leased.

5. The percentage allocation between personal use and business use as well as a copy of the log used to track the business and personal use.

6. An explanation of how the business and personal use is dealt with. For example, they are asking if expenses were reduced or reimbursed or if there is an employee benefit or standby charge.

They appear to be dealing with the years 2016 and 2017, which will shortly be statue barred.

One of the main issues being dealt with by accountants is that many clients do not keep very good travel logs. Additionally, there are clients who purchased cars in the owner's name and not the corporation's name, even though the corporation is deducting the expenses. Another issue is that the only backup for expenses are credit card statements and not the actual invoices or receipts. This could be a problem, as CRA has stated that they will not accept credit card statements because the statements do not provide sufficient detail. To date, we have not received correspondence from CRA that they will not accept the credit card statements, but we have reason to believe that this will be the case.

General Car Rules

In general, there are a set of rules depending on whether an individual or corporation owns the car. Where the company owns the car, there may be requirements for calculations on both the operating benefit and the standby charge. The operating benefit is a per kilometer benefit for every personal-use kilometer used ($0.28 per km). This amount should be included in the income of the individual who uses the corporate car. There is also the concept of a standby charge. If the car is corporate-owned, it is 2% of the original cost of the vehicle. If the car is corporate leased, it is 2/3 of the monthly lease cost. Both numbers are then multiplied by the number of months that the vehicle is available during the year. There is, however, a reduction of the standby charge where the car is used more than 50% business use and less than 20,000 km of personal use. In those cases, the standby charge is prorated based on the personal use versus the total use.

The challenge that many clients and taxpayers have is poor record keeping. One of the things to consider, in order to reduce the level of record keeping, is for the corporation to pay a "reasonable allowance". Based on CRA rules, a reasonable allowance is a per kilometer allowance of $0.58 for the first 5,000 kilometers and $0.52 for each kilometer thereafter. The record keeping required is to submit the number of business kilometers driven each month. In this way, receipts and other backup are not required for the actual operating expenses.

When a reasonable allowance is paid, it does not show up on an individual's T4 and the individual does not need to report it. The corporation deducts this expense as a car expense.

The key takeaway is to ensure that clients and taxpayers keep sufficient records to justify their business car expenses.

Pre-Employee Share Ownership Plans ("ESOP") - Key Valuation Considerations

By Andrew Dey, Mowbrey Gil

Developing an ESOP is new territory for both employer and employee. Many owners may already have a clear plan mapped out and have shared this plan with their employees, whilst others are less advanced in the ESOP process.

It is important for the business valuator engaged in the ESOP process to determine which end of the spectrum their client is on as this will have a bearing on the terms of the valuation engagement and the assistance required.

Irrespective of where your client is on their ESOP journey, the following key principles should be followed throughout all stages of the valuation process:

- Transparency – through an independent valuation;
- Communication – through regular updates to employees on the valuation process;
- Setting and Managing Expectations – communicating any changes to % ownership offered, price, terms, etc. in real time.

Engaging the Business Valuator – the "When and "Why"

When should you engage a Business Valuator? – It is never too early...

Early Planning Considerations from the Owner's Perspective:

- Purification of Company (for tax purposes) if the owner is selling their shares;
- Is a share freeze required if value of shares may be too high (expensive for employee to buy in;
- Corporate Reorganization – removal of non-operating assets from company;
- Adequacy of share structure – what if issued share capital is only 1 share?
- Early indication of value may help determine how employee is buying shares:
    - Purchase from Owner – can the employee afford the shares?
    - Purchase from Treasury – is there a need for a share freeze prior to buy -in?
- Potentially an early reality check on Value from owner's perspective.

Early Planning Considerations from the Employee's Perspective:

- The sooner in the process Value is established, the sooner the employee can determine:
    - Can they afford to buy in; and,
    - Do they want to buy in.
- It may also help determine how the shares are going to be purchased:
    - Purchase for Cash – employee savings, RSP's, TFSA's
    - Purchase in lieu of bonuses;
    - Purchase through payroll deductions;
    - Employer Financing or Corporate Guarantees to employees.

Why should you engage an Independent Business Valuator?

It is extremely important to get the initial valuation RIGHT as:

- It establishes the initial buy-in price for the employees;
- It sets the benchmark for measuring future growth and increase in share value.

Owners often resist or question the need for an independent valuation based on cost. So why is it so important?

- It IS Independent:
    - Eliminates owner bias as to Value;
    - Provides transparency to employees – it is not the owner's number!
    - The Business Valuator is available to provide independent information and analysis to both employer and employee without professional conflict.
    - Lends credibility to the determination of Value – important to employees as potential investors and to third party lenders.
- Independent Valuation establishes a credible basis for future valuations and a formula/methodology going forward.

Valuation Engagement Process

- Who is engaging and paying the Business Valuator? Irrespective of whom, the concept of independence must be clearly communicated.
- What Level of Report is required? A higher level of assurance may be more important to the employee than employer. Two most common types of Report:
    - Calculation of Value – basically uses owner's numbers with little or no corroboration;
    - Estimate of Value – independent assessment of business and economy – higher level of corroboration.
- Other Valuation Considerations:
    - Valuation Date – should be current;
    - What is being valued – 100% of shares (en bloc) of specific percentage;
    - Basis of Valuation – Fair Market Value, Fair Value, Net Book Value?

In conclusion, the valuation process will ultimately be driven by the circumstances in each specific situation, and the likelihood of a smoother process and positive outcome increases the earlier in the process the Business Valuator is engaged.

Shareholder Motivations for Liquidity

By Nathan Treitel, Segal LLP

In my previous article that appeared in June's edition of the Canadian Collaboration Newsletter, I discussed how best to prepare for a liquidity event. Proper preparation ensures a business is well positioned when encountering any unexpected events that may result in a liquidity event. It is recommended to give consideration to various liquidity alternatives in order to yield results that are optimal to shareholders and allow them to best meet their objectives.

Shareholder Motivations for Liquidity

- Business owners may desire to "take some money off the table" and reduce personal financial risk by diversifying their assets
- Business owners may be looking to take a step back from the business in order to pursue other interests or retire.
- A shareholder can elect to leave the business due to challenging interpersonal situations resulting from mutual ownership with other individuals with different personalities and / or visions for future growth of the business.
- An unexpected personal circumstance, such a death, deteriorating health or divorce, may require the division of family assets.

Liquidity Alternatives

Numerous liquidity alternatives exist that allow individual shareholders to realize their objectives. These alternatives include:

- Management /Employee-Led Buyouts:
  - A company is sold to its existing management or employees
- Recapitalizations and Financial Restructurings:
  - New capital is infused into a company to facilitate growth and the partial buyout of existing shareholders
- Divestitures:
  - Selling a company to a strategic or financial investor that is external to the business
- Raising Private Capital:
  - Raising debt and/or equity capital to facilitate growth or ease liquidity constraints

Characteristics of Liquidity Alternatives

The transaction alternatives, as noted above, each have certain characteristics which make it a better option for achieving the shareholder motivations and objectives. Some of these characteristics include:

- Confidentiality:
  - The ability to maintain a higher degree of confidentiality about the existence of the process and the fact that existing shareholders are looking for a buyer or investor
- Speed:
  - Certain of the alternatives have the advantage of being able to be executed more rapidly due to familiarity of the buyer / investor with the business and the fact that the required capital for the transaction is readily available.
- Growth & Upside:
  - Certain of the alternatives allow existing shareholders to continue to retain an interest in the company where they believe considerable future growth and upside potential exists. These alternatives involve partnering with experienced investors with access to tangible resources, experience and knowledge not available to the existing management and shareholders.
- Price:
  - By their nature, some of the alternatives will be directed to a broader pool of potential buyers/investors and a more formal auction process will likely be undertaken. Broad auction processes that target strategic investors are typically considered optimal from a price perspective.
- Use of Proceeds:
  - Certain of the alternatives, by design will result in existing ownership being diluted, taking chips off the table and diversifying their assets. Other alternatives do not necessarily (immediately) allow for these options.
- Ongoing ownership and management:
  - Certain of the alternatives result in existing ownership severing the relationship with the company immediately while others result I n continued ownership and possibly management roles going forward. One also needs to contemplate the various alternatives in light of the shareholder's com with having additional / new stakeholders at the table.

Conclusion

We often times find shareholders desiring a liquidity event fixated on a particular transaction alternative. Given the range of transaction alternatives available, it behooves business owners to carefully consider all the options so that they can identify the alternative objectives available to them.

Revenue Diversification by Non-Profit Organizations

Contributed By Marcil Lavallée

The Canadian Income Tax Act defines a non-profit organization as "a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit…."

On several occasions over recent years, the Canada Revenue Agency has had to issue interpretations on this subsection in order to offer its opinion on whether activities carried out by non-profit organizations, such as the rental of parking spaces, income generated through fiber optic networks or other similar activities, could have an impact on the tax status of such organizations. In any case, the CRA has deferred to the courts in each of its interpretative notes, in holding that the profit must be ancillary and in support of the organization's objectives.

Possible Changes to the Income Tax Act

During the presentation of the 2014 Federal Budget, the Minister of Finance made known his intention to reexamine the tax-exempt status of non-profit organizations. The review would be to determine whether such an exemption continued to be properly targeted and whether sufficient transparency and accountability provisions were in place. At the moment, it is still unclear if the liberal government, elected in 2015, will hold this review. In November 2016, the Minister of Finance stated that such a consultation remained possible but was not a priority at the time.

Case-law

The courts have clarified that a non-profit organization can diversify its income sources while still maintaining its tax-exempt status under the Income Tax Act. However, the courts have stated that, to avoid a change in tax status, the activities of the organization must be linked to its mission as well as be ancillary to it.

For some years now, the Canada Revenue Agency has taken the same stance as the courts. However, the CRA often takes a far more restrictive interpretation of what can be considered an ancillary activity with a link to the mission of the organization.

Conclusion

In our opinion, non-profit organizations should exercise a certain amount of caution before diversifying their activities. It would seem astute to first show that the new activities have a connection with their mission and that they are ancillary to those main activities. This would help ensure that your status as a non-profit organization will not be later disputed by the Canada Revenue Agency.