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Business Matters

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TAXATION

Changes to Income Tax Rules for 2017

Be aware of changes to the income tax rules that will affect your 2017 filing.

For those already thinking about their 2017 income taxes, the following summarizes some of the changes from 2016.

Tax Credits

The child tax credit for arts and fitness is gone. Since this tax credit was capped at a maximum of $500 for fitness and $250 for arts per child in 2016, its removal will not likely have a major impact on most people's 2017 return.

Education

The tax credit for education and textbooks for full- or part-time students was eliminated effective December 31, 2016. Taxpayers with unused tax credits from 2016 or prior years will be able to carry them forward and apply them against future taxes.

The tuition tax credit is, however, still in effect.

In recognition of the need to support education in technical skills, the number of courses eligible for the tuition tax credit will be increased. Occupational courses provided by post-secondary institutions within Canada will be granted the tax credit. If a bursary is provided, the amount will likely qualify for either the full or basic scholarship exemption. Examination fees paid to take an occupational, trade, or professional examination to obtain a professional status recognized by federal or provincial statute, or to be licensed or certified as a tradesperson, to allow you to practise in Canada, may also be eligible for the tuition tax credit. However, if your fees were paid by your employer or the employer of one of your parents, or by a government program and not included in your income, you cannot claim the credit.

Labour-Sponsored Funds

Those who invested in labour-sponsored venture capital corporations will no longer be able to apply for the federal tax credit. Prior to 2017, a taxpayer would receive a federal tax credit of 15% of the investment up to a maximum of $750. Taxpayers should confer with their Chartered Professional Accountants (CPAs) to determine whether a provincial tax credit will be available in 2017 should they choose this investment vehicle.

Income splitting is gone.

Indexing

RRSP contributions, tax brackets, and various tax credits will increase in 2017 to reflect the adjustment for inflation as measured by the Consumer Price Index (CPI). The percentage increase for 2017 has been pegged at 1.4% (i.e., the 2017 personal exemption will increase to $11,635 from $11,474 in 2016). To capture information on the new levels for all tax credits and other deductions that have been indexed, you should visit the CRA website page: "Indexation adjustment for personal income tax and benefit amounts" http://www.cra-arc.gc.ca/tx/ndvdls/fq/ndxtn-eng.html

The notable exception to the inflationary increase is the Tax Free Savings Account that will continue to have a $5,500 per annum maximum contribution limit.

Work in Progress

Prior to March 22, 2017, unbilled work in progress was allowed to be deferred until billed to clients. This deferral allowed certain designated professionals (i.e., lawyers, dentists, doctors, and accountants) to delay the recognition of income until the year when the work was invoiced to clients. Effective March 22, 2017, this deferral of work in progress was eliminated, resulting in an immediate income inclusion of work in progress. A transitional relief will be available over a two-year period to help mitigate the tax impact of this change.

Caregiver Amounts

Prior to 2017, three credits were available for those in need of assistance:

- caregiver credit
- infirm dependant credit
- family caregiver tax credit.

To simplify the process and to recognize the need to provide financial support to caregivers, a new Canada caregiver credit will provide a 15% non-refundable tax credit maximizing at $6,883 of expenses for the care of parents, brothers and sisters, adult children and other specified relatives who have infirmities. An additional tax credit up to $2,150 on expenses is available for the care of a dependent spouse, a common-law partner, or a minor child with infirmities. The tax credit will be calculated using a formula that reduces the credit dollar for dollar once the dependant's net income exceeds $16,163.

Intangibles

Prior to 2017, any gain from the disposition of intangibles such as goodwill or trademarks, was treated as regular business income and was not subject to the capital cost allowance rules. Now, any gain from the disposition of goodwill and trademarks will become fully taxable as investment income. Companies will now be required to transfer the cumulative eligible capital pool as at December 31, 2016, to a new capital cost allowance class 14.1. This pool will be depreciated at 7% annually on the declining balance for the first 10 years, then at 5% annually thereafter. For the expenditures incurred after December 31, 2016, a 5% depreciation rate will apply.

T4s

Prior to 2017, employers were able to supply employees with their T4 information slips electronically if the employee gave permission. Effective 2017, the employer will not need permission. The employer must, however, have safeguards in place to ensure confidentiality and provide paper copies to former employees or employees on leave or upon request. Employees must ensure the information received is correct in order to avoid penalties and interest if they file an incorrect T1 tax form.

Possible Changes Ahead

While the changes noted in the 2017 Federal Budget were not as significant as those in the Liberals' first budget introduced in 2016, it signalled the government's intention to review the tax planning techniques that are currently available to the owners of private corporations. Specifically, the review will include the tax advantages provided to the business owners by:

- income sprinkling
- holding passive investments via a corporation
- converting regular income into capital gains.

Unfortunately, the budget did not include much detail. The government is expected to issue policy papers on this topic sometime during the summer of 2017, however. Any changes could impact the business owners significantly.

MANAGEMENT

The High Cost of Low Interest Rates

Even when interest rates are at historic lows, interest costs can be significant for businesses and owner-managers.

The Business

The significant rise in the cost of equipment, vehicles, real estate, and inventory has prompted many businesses to increase business debt. Low interest rates, combined with the ability to obtain larger loans with extended payment terms, have allowed businesses to operate in a "business as usual" mode with less consideration for the actual cost of borrowing.

To give some idea of the effect of even low interest rates on an owner-managed business, the following key elements of most businesses have been put forward as an example of the effect of interest costs on a business. The effect of domestic borrowing has been added to show the full impact of current interest rates on the owner-manager. Since lending rates vary widely depending on a variety of factors such as risk, item to be funded and the term, and are usually negotiated, **the interest rates used below have been chosen at random from Internet sources; calculations are approximate and for illustrative purposes only**. All loans have been made effective June 1, 2017.

- Commercial mortgage: $600,000 over 25 years at 3%
- Two work vehicles: $120,000 financed over five years at 6%
- Equipment loan: $200,000 financed over five years at 5%
- Operating line of credit: $50,000 at 3% a year
- Credit card debt: $10,000 at 15% a year on the outstanding balance

Commercial Mortgage

- Commercial mortgage amount: $600,000
- Interest for first year: $17,776
- Interest paid over first five years: $83,748
- Interest paid over the 25 years (300 months) of payment: $253,580
- Total commercial mortgage cost: $853,580

A sobering reality is that, when interest costs are factored in, the $600,000 building ends up costing $853,580. Assuming the interest is a deductible business expense, and assuming a 17% corporate tax rate, total interest would be reduced by $43,109, thus reducing the overall cost of purchasing to $810,471.

Work Vehicles

- Total purchase price of two vehicles: $120,000
- Interest for first year: $6,623
- Interest for five years: $19,196
- Total vehicle cost: $139,196

Equipment Loan

- Loan amount: $200,000
- Interest for first year: $9,179
- Interest for five years: $26,455
- Total loan cost: $226,455

Line of Credit

- Annual outstanding balance: $50,000
- Interest for one year: $1,500
- Interest for five years: $7,500

Credit Cards

- Average annual outstanding balance: $10,000
- Interest for one year: $1,500
- Interest for five years: $7,500

Over five years, the total interest cost to your business is $144,399. Even at a 17% corporate tax rate and a corresponding $24,548 reduction over five years, the cost of borrowing is still $119,851.

The hard truth is that interest costs even in times of low interest rates have a very negative impact on the bottom line.

Canadians are extending repayment periods.

On the Home Front

At the end of Q1 of 2017, the ratio of Canadian household debt to disposable income was 1.67:1 or $1.67 of debt for every $1 of disposable income. Canadians borrowed $27.5 million in the first quarter, of which mortgages accounted for $20.9 billion. Not only are Canadians borrowing a lot of money, they are extending the periods of repayment for some expensive items. Recent statistics indicate that in excess of 40% of all new vehicles purchased are financed from 61 to 72 months; loans extending from 73 to 84 months now make up almost 20% of new vehicle loans.

Home equity lines of credit (HELOCs) have increased as well. There are currently about three million HELOC accounts in Canada; the average outstanding balance in each account is estimated at $70,000.

For a moment, consider that the owner-manager, in addition to the business debt that has to be serviced, has the following personal debt with the same interest rates as the business.

Residential Mortgage

- Mortgage: $400,000 amortized over 25 years at 3%
- Interest for first year: $11,851
- Interest paid over five years: $55,833
- Interest paid over 25 years (300 months): $169,054
- Total mortgage cost over 25 years: $569,054

Vehicle Loans

- Two vehicles: $80,000 financed over five years at 2.7%
- Interest for first year: $1,974
- Interest for five years: $5,611
- Total vehicle cost: $85,611

HELOC

- Average annual outstanding balance: $70,000 for five years at 3.2%
- Interest for first year: $2,240
- Interest for five years: $11,200
- Total loan cost: $81,200

Total interest cost to service personal debt for five years is $72,644.

Given that the interest costs are in after-tax dollars and assuming the individual is in a 30% tax bracket, the taxpayer has effectively paid an additional $20,186 as well as the opportunity costs of not being able to purchase investments or other consumer goods.

Impact on Business

Interest costs affect owner-managers both at business and home. Business interest costs dictate the need to increase cash flow to service the debt and therefore drive the need to increase sales volumes or prices to maintain a sustainable profit.

Maintaining a lifestyle supported by debt increases the need to earn more money to service that debt. For the owner-manager, that means procuring a higher income from the business. This, in turn, creates additional pressure on the business to increase cash flow, sales volumes, or prices to satisfy the owner's personal needs. An added consternation is personal income tax. Not only will the additional income to the owner-manager create a higher personal income tax, but it may result in increased business expenses for other source deductions.

Risks of Low Interest Costs

The cost of borrowing, whether for business or for personal needs, has a significant impact on the owner-manager as well as on business operations. The service costs of debt are a major drag on cash flow, profits, and the future financial health of the business, even in periods of historically low rates such as we are living in right now. But merely making the monthly payments is not enough; the loan must eventually be repaid. With interest rates so low and the cost of borrowing so high, there is a serious risk that, when the bank rate starts to move up again, as it inevitably will, many owner-managers will be caught offside and unable to make even the monthly payments.

Don't let that owner-manager be you.

MANAGEMENT

Pricing Your Product or Service

Correct pricing can mean the difference between business success and failure.

Setting the price point for your product or service is not simply the process of determining the cost of production then adding a mark-up. It is more a matter of understanding the price the consumer will accept as the value of your product or service and keeping the costs of production to a level that will give you a profit at that price.

Consumers Buy for Value

Cost incorporates all the expenses incurred to bring a product or service to a customer or client. Costs include: parts, labour, production machinery, manufacturing space, administration, and transportation to the consumer. These are the true costs of production and a starting point for determining the price to the customer.

It is ultimately the consumer who decides the value of your product or service to them and thus what they are willing to pay. This will be the price that moves your product off the shelf.

Perception Is Everything

If a product is not moving and the price is reasonable given the cost of production and the price of competitive products, it may be that the seller has not provided enough information to the prospective purchaser to establish value. For example, consider the common incandescent 60-watt light bulb that traditionally sold for about 50 cents each. Newer LED light bulbs, providing the same lumens cost $5 to $6, and yet they sell. Why? Because consumers have been given information that persuades them that the newer product has value. Governments and manufacturers have persuaded environmentally aware consumers that long-life bulbs (LED bulbs are rated to last more than 50,000 hours, which is about 35 years if left on for only four hours per day, depending on the type of bulb) producing the same number of lumens at lower operating cost is a value worth paying for. Consumers are told the environmentally friendly LED bulbs will not only help to save the planet, but also save money through reduced electricity costs.

Pricing Strategy

Price is normally determined by cost plus mark-up or by estimating the perceived value of the product/service. Neither method will move your product/service if your competition is selling the same thing for less. Check prices by visiting your competitor's physical store or going online.

Shoppers are price sensitive. If your price is higher because of your costs, you must convince the consumer your products are better, your warranty is better, your service is better, or that you supply some other advantage. Setting a low price is not the best course of action for any business either. You may enjoy seeing your sales figures improve for a while, but you risk destroying your brand if consumers unconsciously reassign your product to a lower-priced brand category. If you constantly discount, you will eventually be seen as a discounter. Customers will just wait until you drop the price again. If the selling price does not cover all your costs, your business will ultimately fail.

Price Changes
Changing prices should be handled with care. Regular customers are familiar with your prices and if costs suddenly surge there may be a reduction in sales. If you have to change prices, remove the old price tags and relabel.

Customers look at price but see value.

Provide Comparison
Shoppers may be looking at prices, but they are seeing value. Offer products/services across a spectrum of values (i.e., extras cost more). The automotive industry provides a classic model of this merchandising approach: a base model with the price rising as features are added. This approach connects the purchaser to your value proposition. Power windows, heated seats and a high-end sound system are available on some models but does the consumer perceive them as having value *for them*?

Boutique Niche
Once in a while, you may have a unique or trendy product/service or perhaps you supply products/services associated with special holidays such as Christmas, Chanukah, Valentine’s Day, special events such as weddings, etc. These times may allow you to price on a value-added basis rather than cost-plus-markup because the clientele’s perception of what is needed gives them permission to spend more than they would if they were just making a simple everyday purchase.

Know Your Customer Base
Pricing products and services should not be a mechanical process. Owner-managers should examine their entire product line, determine their customer base and the product/services expected, and identify the special events that appeal to the environment they service. Knowing your customer base allows pricing to be in line with your market and customers’ expectations. This will ensure your business will be able to cover all operating costs and secure a profit sufficient to allow it to remain in business for many years to come.

TECHNOLOGY

The Heat Is On

A review of your HVAC system may show you how to improve your bottom line by saving on the cost of energy.

Because lighting, heating and cooling represent 19%-25% of the cost of operating a commercial business, control of energy costs is essential to improving profit margins. A reduction of even 10% in these costs can produce a significant improvement. But, because Canada is located in a part of the world where temperatures can range from 40C below zero to 35C above, it is inevitably expensive to keep internal temperatures at levels needed to maintain comfortable working conditions through the changing seasons.

Heating and Air Conditioning
The best means of controlling the temperature in the working environment is to install commercial programmable thermostats set to the workplace schedule. Thermostats can maintain comfortable temperatures during working hours, then be turned down or even off during nights, weekends, or holidays, when the workplace is not being used. Managing temperatures in this way can contribute significantly to the bottom line.

Smart thermostats have auto sensors that recognize when people enter or leave the work area. Once everyone has left for the day, the system automatically reverts to a lower setting to conserve energy; when the first worker arrives in the morning, the system will start up and return to the regular programmed schedule. When employees are absent for longer periods such as holiday weekends, the automatic system can be shut off completely. To prevent employees from tinkering with the temperature settings, smart thermostats incorporate a security code that must be entered before the temperature or other settings can be changed.

Most work locations have one central heating/cooling system that is fairly easy to manage. If, however, your building(s) have different areas that require self-contained heating/cooling systems, or if your business operates at more than one location, wireless smart systems enable remote control of individual thermostats through an app you can load onto your computer or smart phone.

Some systems record the history of heating/cooling adjustments. This data can be used to identify times and places of peak energy use, which, in turn, may identify the need to upgrade windows, doors or insulation.

If you install a smart system, have an HVAC technician make sure the new thermostats will communicate with the existing HVAC system.

Upgrade to multi-glazed windows with low-emissivity coatings.

Windows

Workplace windows should have at least two layers of glass with an inert gas (e.g., argon) sandwiched between the layers. Normal double-glazed windows have an R-value (i.e., the ability of material to resist the transfer of heat) of 2.0; triple-glazed windows provide an R-value of 6.0. These windows should have insulated edge spacers to reduce condensation, insulated frames, and low emissivity coatings that reduce heat loss from within and allow solar energy to enter. Multi-glazed windows not only prevent heat from escaping, they also prevent the entry of unwanted heat from the summer sun. Because of their thickness, multi-glazed windows reduce the effect of road noise and are harder to break than single-pane windows.

Maximize the return on your window investment by understanding the benchmark ratings established by the Canadian Standards Association (CSA). For instance, air tightness is measured from A1 to A3, water tightness rated from B1-B7, and wind load resistance from C1 to C5. The higher the number within each measurement category, the better the window.

Light-Blocking Curtains

To supplement new high-R and CSA-rated windows, you may be well advised to invest in curtains and blinds especially if your building has extreme window exposure to sun and cold winds. Curtains minimize the intrusion of heat from the sun and take pressure off the cooling system. During cold winter days, the curtains can be opened to allow the sun’s energy to augment the heating system or closed to retain the heat on cloudy days.

Reduce Your Carbon Footprint

Controlling the heating and cooling of your premises with smart thermostats and retrofitting of windows and window coverings are excellent ways of reducing the high cost of energy use while reducing your carbon footprint.

Most provinces have programs that help small businesses conserve energy and therefore reduce operating costs. Check with your provincial energy agency to save energy through appliance and equipment upgrades, building enhancements and by educating your employees about the need for proper maintenance and more efficient use of existing equipment or lighting.

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