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### Take time to do tax homework

New businesses need to pay special attention tax rules. Kristin Goff gets the details from expert Evelyn Jacks.

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When you get cash back you see it as?

- A bonus - more spending money
- Expected income
- Repayment of an interest free loan to the government

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**Evelyn Jacks**

The Ottawa Citizen

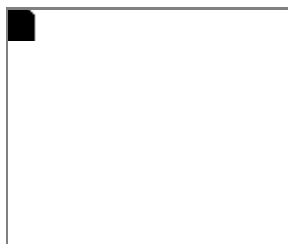
*Sunday, March 10, 2002*

As surely as rough economic times give birth to layoffs and hiring freezes, they also produce a bumper crop of new businesses as many people, by choice or necessity, decide to create their own jobs.

That can be exciting and rewarding. And the prospect of being able to write off the cost of everything from computers to travel as you follow your dreams, only adds to the allure.

But eager entrepreneurs should be aware they are taking on a new business "partner" -- Canada Customs and Revenue Agency (CCRA) -- formerly known as Revenue Canada -- when they open their doors.

Tax rules for businesses are more flexible than those for



**The Ottawa Citizen**  
**Evelyn Jacks' latest book, Make Sure It's Deductible, offers many hints to new small business owners about audit-proofing your business.**



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more flexible than those for employees, but they don't offer carte blanche. In fact, for the unwary, there are pitfalls that could doom your enterprise from the start.

## Raging Rivers.

"The day you decided to open your business is the day you stepped up to the plate to play ball with CCRA," says Evelyn Jacks, author of *Make Sure It's Deductible*, (McGraw-Hill Ryerson) and other books on making the most of your taxes.

Knowing the rules and using them to your best advantage should be a key part of planning your business right from the start, she says. So should the record keeping required to support your claims.

"One of the biggest mistakes you can make is to view your taxes, one year at a time," said Ms. Jacks in a recent interview. Unincorporated business, run as proprietorships, may be able to carry operating losses they incur in their early years back for three years or forward for seven, if they can't be used to offset income in the current year. That could generate tax refunds from past years when your employment income was higher or lower taxes on your business in the future when it becomes more profitable.

That alone could help provide a little relief in the difficult startup period for a business. But it means entrepreneurs need to spend time understanding the often complex rules that apply to businesses.

Unlike rules for employees, which spell out quite clearly what deductions are allowed, rules for businesses contain a number of grey areas. That means even such basic issues as what qualifies as a business, could be open for dispute.

Since entrepreneurs are far more likely to be audited than employees, Ms. Jacks says new businesses need to set up a record-keeping system that will, in effect, "audit-proof" their business, allowing them to document easily all the income and deductions they claim, if CCRA should come calling.

She also recommends businesses seek professional advice on some tax and legal issues.

The following is a look at some common issues faced by would-be entrepreneurs in the early stages of starting a business.

### Severance Packages

It's common for people who get substantial severance pay when they lose their job to look at it as the seed money to use to start a business.

But that's often the wrong thing to do, both because it means you are "putting all your eggs in one basket" and because there are more tax-efficient ways to go, says Ms. Jacks.

If the severance amount is large, it could not only push you into a higher tax bracket in the year you receive it, but also trigger a clawback of employment insurance benefits if your income exceeds the threshold of \$48,750 in the year.

In many cases, it is better to put as much as possible into a tax-sheltered RRSP (subject to roll-over rules and your maximum contribution limit). If you need to, you can withdraw it in subsequent years when your income

is low.

Interest on loans (even personal lines of credit or home equity loans) can be deducted as a business expense. If you can do it, borrowing is a more tax-efficient way to start a business.

#### What Is a Business?

Since many people logically start businesses based on interests and activities with which they have experience, CCRA could question whether you are running a business or simply pursuing a hobby.

What matters here is not the type of activity. Dog walking or leading nature walks can qualify. You can also pursue a business part-time while holding another job.

The test is whether you can satisfy CCRA that you are involved in an enterprise with "a reasonable expectation of profit" and have a plan to make money, even if you aren't profitable at first. There isn't any specific limit on how long it should take a business to become profitable, but CCRA may start to question an enterprise that continues to write off losses after operating for some time.

Your best defence is to have records of your activities and a business plan that show what you are doing to build your business towards a profit.

#### When Does a Business Start?

A business doesn't necessarily begin when you start researching it. If you are simply flying around the country to scout possible locations for a business, that may not be deductible as a business expense.

You'll need to show a specific concept for a business and have begun a process to start driving income for that business.

Ms. Jacks concedes that this could be a "grey area" but if you have records showing, for example, the registration of a business name or that you have done some advertising or consulted professionals for your business plan, that will help substantiate that your business has begun.

Tax rules also require that expense deductions be "reasonable in the circumstances" -- leaving the onus on you to meet that test.

#### For the Record

Here's a look at some key records worth keeping to help audit-proof your business, based on advice in Evelyn Jacks' book, *Make Sure It's Deductible*.

- Always keep business and personal finances separate. Have a separate business bank account, credit card, line of credit. This will help support the accuracy of both the income you report and the expenses you claim.
- Write a business plan for at least five years with specific plans, including startup costs, marketing strategy and targets, for when you expect to be profitable. Review and update it regularly.
- Keep receipts of all expenses. Make notations on back, if necessary, to explain the purchase. Separately record capital and operating expenses in income and expense records.
- Maintain an auto log that records all mileage. To deduct auto expenses,

you'll be required to show what proportion of your total automobile use was for business.

- If you use a separate part of your home as your primary office or to regularly see clients, you may be able to deduct a portion of your overall expenses, including utility costs, maintenance, mortgage interest and property taxes. Keep a sketch with your business records of the overall space in your home and what proportion of that the office represents. (Deducting the principal portion of your mortgage payment is usually not a good idea since it could affect the capital gains exemption for your personal residence when you sell your home.)


- Keep a daily business journal, recording all activities that relate to your business, including who you see or talk with, research activities, mileage driven and every hour worked on a project. Keep every business card you collect at networking events.

This can be invaluable if you are challenged on the various "grey" areas that apply to small business owners, such showing when your activities reached the point where your business started, and what you are doing to pursue a profit, even if you continue to lose money. It can also help show expenses were "reasonable" for your circumstances.

- Set up formal records, including time sheets, for any employees, including family members.

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