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# The Small Business Deduction

For many years, the income eligible for the small business deduction remained at $200,000. However, during the period 2003 through 2005, this limit was incrementally increased to $300,000 for 2005 and subsequent tax years. The provinces have also increased their small business income limits over the past few years, some to amounts in excess of $300,000, to provide further tax breaks for small businesses.

The 2006 Federal Budget proposed to increase the $300,000 limit to $400,000 effective January 1, 2007. It also proposed reductions in the federal tax rate applicable to this income.

**An Incentive**

The special low rate of corporate tax provided by the small business deduction is an important incentive for qualified small businesses. The tax relief is particularly helpful during the first few years of operations, as it allows the business to accumulate more after-tax income for reinvestment and expansion.

The federal small business deduction is an annual tax credit calculated as 16% of the least of the following amounts:

- Active business income for the year;
- Taxable income, subject to certain adjustments; and
- $300,000 (per corporation or group of associated corporations).

This effectively reduces the corporation's income tax on the first $300,000 of active business income earned by the corporation or group of associated corporations to rates in the range of 15% to 21% depending on the province in which the business operates. In some provinces, these rates are scheduled to be reduced even further.

**Eligibility for the Small Business Deduction**

To be eligible for the small business deduction, your corporation must be a Canadian-controlled private corporation (CCPC). A Canadian-controlled private corporation is one which is not controlled directly or indirectly by one or more non-resident persons and/or public corporations. Where the corporation has many shareholders, ownership of shares owned by non-residents and public corporations is aggregated in determining who controls the company. The corporation also

cannot have any of its shares, such as non-voting or preferred shares, listed on a prescribed stock exchange.

In addition, the corporation must be a CCPC throughout the year to qualify for the small business deduction for that year.

As the small business deduction is intended to benefit only small corporations, a large corporation's access to the deduction is restricted on the basis of its taxable capital employed in Canada. Once taxable capital exceeds $10 million, the amount of income eligible for the small business deduction is reduced.

**Active Business, Active Business Income**

An active business is any business carried on by a corporation other than a specified investment business or a personal services business. Active businesses include most businesses in which the company takes an "active" part in generating the income, including manufacturing and processing, mining, construction and farming. Simply put, the business is "doing something" to earn income.

The income eligible for the small business deduction is the "active business income" of the corporation for the year. If the corporation carries on business through a partnership, the corporate partnership rules impose a limit on the amount of active business income earned by the partnership that is eligible for the small business deduction. This amount is allocated among all partners.

Generally, to calculate active business income from carrying on a business in Canada, the corporation must deduct from its net income, for income tax purposes, any of the following amounts that apply:

- Taxable capital gains minus allowable capital losses;
- Dividends that are deductible from income;
- Property income minus property losses;
- Property income from an interest in a trust;
- Foreign business income;
- Income from a specified investment business; and
- Income from a personal services business.

**Specified Investment Business**

A specified investment business is a business whose principal purpose is to generate income from property such as interest, dividends, rents or royalties.

Income from a specified investment business earned by a CCPC is generally not eligible for the small business deduction unless the corporation employs more than five full-time employees throughout the year. Instead, this income is subject to tax at the higher corporate rates applicable to investment income with a portion refundable when dividends are paid to the shareholders.

**Personal Service Business**

A personal service business is basically that of an incorporated employee. There is an exception if the corporation employs more than five full-time employees throughout the year.

A corporation carrying on a personal service business will pay tax at full corporate rates on that income. There are limited deductions, which may be claimed against this income, and it is not eligible for refundable tax treatment. As such, it may be unwise to set up a corporation that carries on a personal service business.

**The Corporation**

A corporation is considered to be a taxpayer separate from its shareholders. While personal income taxes are payable by shareholders when they receive dividends or salary from the corporation, these taxes are deferred until the distribution is made. This deferral is a good incentive for the CCPC to retain working capital to assist in the future success of the business.

For many small businesses, the small business deduction allows the corporation to accumulate income at low tax rates so that the owner/manager can defer personal tax until he or she removes the after-tax corporate profits from the corporation as a dividend. Through the dividend gross-up and tax credit mechanism, the owner-manager pays approximately the same amount of tax as would be paid had the income been distributed in the form of salary.

**Thinking about Incorporating?**

If you are starting a new business or operating your business as a sole proprietorship or partnership, should you incorporate? It depends. In addition to the significant tax benefit discussed above, there are other advantages to carrying on a business in the form of a corporation such as limited liability, prestige, greater access to capital, the ability to transfer ownership, and estate planning opportunities. But there are also disadvantages that need to be weighed in your decision.

If your small business is not presently incorporated, talk to your chartered accountant about the implications that incorporating may have on your business. ■

# Crisp and Quick Labels

Do you find printing labels with a desktop or network printer can sometimes be a time-consuming hassle? Are addresses on items to be mailed or shipped sometimes being handwritten?

If your company is not using a label printer, perhaps it is time to investigate this time and money saver.

Many label printers can print a standard address label in two or three seconds with a resolution of 300 DPI with images, custom text and barcodes. The super fast ones will print a label in one second and as many as 55 labels per minute.

Some label printers are so reasonably priced – and quiet – that a business could consider installing them at individual workstations. The footprint is often just a little larger than a two-hole punch so the printer takes up very little space on the work area.

As the labels are printed directly from your PC, you save time while avoiding the frustrations and wastage that can happen when loading label sheets into a standard laser or inkjet printer. What's more, these tiny, easy-to-use printers let you print a single label as easily as you can print a database of addresses.

Some models use thermal technology for printing, which eliminates the need for ribbons, toner or ink cartridges. The only supplies you need are the labels and the occasional cleaning card.

In addition to the standard self-adhesive labels for envelopes, there are many other types and sizes of labels you can create for file folders, shipping, name tags, disks and many other uses.

**Compatibility**

Label printers are compatible with both Windows and Mac applications and connect to USB or serial port for easy installation. The complete package usually includes USB and serial cables, a power adapter, the Windows and Macintosh software on CD, a start-up roll of labels and a User Guide (either Readme on the CD or in hard copy).

**Enhancements**

Label printers allow you to print the label text in various fonts and type sizes directly from Microsoft Word, WordPerfect, Outlook, QuickBooks, ACT!, GoldMine and other software programs. Further enhancements are also available, such as the ability to print high-resolution bar code symbologies, postal bar codes, graphics, your company logo and even black-and-white photos.

Another major advantage is that some models allow you to store frequently used names and addresses in a built-in list manager or the software can be integrated directly into the toolbars of your data management program.

Of course, the more features you need, the more you will pay. However, many label printers can easily be shared over a network.

**A Small Investment with a Big Payback**

The addition of a label printer to your system can help you:

- Enhance the professional appearance of your mail and shipping labels;
- Improve file management within the office and warehouse;
- Speed up the addressing, handling and processing of parcels and correspondence; and
- Ensure the accuracy of addresses for billing and payment purposes.

Label printers are not only becoming more affordable for businesses of any size but also increasingly versatile for meeting a wide range of labeling needs within an organization. ■

# What is Your Business Worth?

What is your business worth? While a figure may come to mind, generally your business is worth the amount you would obtain if you were to sell it on the open market. Of course, from a potential buyer's perspective, the value of the business lies in its ability to generate profits in the future.

Most owner/managers require an independent valuation of the shares and/or assets of their businesses at some point. The valuation may be required for estate and tax planning purposes or for a variety of other reasons such as shareholder litigation, divorce, the acquisition or sale of a part or all of the company or a deemed disposition on death. Valuations may also be a very important part of obtaining debt or equity financing or implementing a succession plan for a family-owned business.

**What is a Valuation?**

Valuations and appraisals are similar but they are not the same. The key difference is that an appraisal is used to determine the value of tangible or physical assets while a valuation considers both the tangible (physical assets such as inventory) and intangible assets (your company's goodwill and going-concern value, which is generally based on future cash flows).

Because business valuation is part art and part science, it is important that an experienced valuation practitioner be involved in the process. Improper values can lead to unsound plans and strategies, improper allocation of value and tax-related problems if values are not accepted by the CRA.

**The Valuation Report**

There are three types of valuation reports which can be prepared by a chartered business valuator (CBV) which provide increasing levels of assurance:

- A calculation valuation report.
- An estimate valuation report.
- A comprehensive valuation report.

The level of assurance required is dictated by the purpose of the valuation report, which can range from providing an indication of the value of a business for a selling shareholder to providing a comprehensive valuation report for litigation purposes.

**Valuation of Family-owned Private Companies**

Businesses are generally valued under either:

- A going-concern or earnings approach where the anticipated earnings substantiate a value in excess of the underlying assets; or
- An assets-based approach where the value of an entity is closely related to the value of the underlying assets (as in the case of a real estate holding company), or the anticipated earnings do not justify a value in excess of net assets.

When valuing family-owned private companies, the valuator will usually need to make adjustments to the reported financial information. The following discusses a few of the commonly encountered adjustments that the valuator will consider, and if applicable, reflect in the valuation conclusion.

**Income Statement Adjustments**

Assuming the valuator determines that a going-concern or earnings-based approach is appropriate for the valuation, the company's historical earnings for items which are not at economic amounts will need to be adjusted or normalized. Normalized earnings are used to determine the maintainable earnings the business is expected to earn in the future.

Examples of revenues or expenses which may require adjustment from financial statement figures are as follows:

- Related party compensation comprising salary, bonuses (including amounts to bonus down for income tax purposes) and personal expenses paid by the company (i.e., vehicles, meals, entertainment, travel).

  This is one of the most common adjustments. Economic compensation levels represent the remuneration which would be incurred to replace that individual with an arm's length third party who has comparable skills, training and experience to perform the same duties.

- Related party transactions such as real estate leases, equipment leases, material purchases and interest on related party loans.

- Discretionary expenses which may not be incurred in the future by an arm's length third party. These types of expenses – such as professional fees, charitable donations and promotion – frequently have a personal element associated with them.

The valuator may also make additional adjustments to normalize income for non-recurring items.

**Balance Sheet Adjustments**

Examples of balance sheet items which may require adjustment from financial statement figures include:

- Redundant assets, which are those assets not required for ongoing operations including real estate holdings, investments or excess cash retained in the company.
- Income tax consequences associated with redundant assets. There may be significant tax liabilities associated with redundant assets if they have appreciated. Depending on the circumstances, tax liabilities can be recognized at the full value, discounted value or not at all.
- Life insurance policies to reflect the cash surrender value as well as the policy's loan value, face value, conversion privileges, and the health and life expectancy of the insured.

Further adjustments may be required to the capital structure for excess/ insufficient leverage. These adjustments should be considered after the balance sheet adjustments are made.

To the extent that any balance sheet adjustments are made, it will be necessary to adjust normalized income to remove revenues or expenses associated with these items.

**Adjustments to Individual Shareholdings**

Once the income statement and the balance sheet are adjusted to arrive at the "en bloc" value of the company, it may then be necessary to value individual shareholdings.

The valuation of individual shareholdings takes into account the rights and privileges of the shares being valued including the type of shares (common or preferred), redemption, retraction or conversion privileges, dividend rates, participation privileges and voting rights. In addition, the shareholders' agreement is also reviewed for any provisions which may affect the value of the shares.

**Every Business is Unique**

These represent some of the more commonly encountered adjustments that may be required when valuing a family-owned business. Of course, because of the unique nature of each business, further adjustments will likely be required.

If you are planning a transaction or business transfer, ask your chartered accountant if professional business valuation services will be required. Consider also that knowing the value of your business could help you capitalize on actions to increase its value. ■

**TECHNOLOGY**

# Laptops on the Go

Undoubtedly, the portable computing power of a laptop can be an incredible productivity boost. When you are on the go, be sure to take steps to ensure the battery does not run low and your data is secure.

**Extend Battery Life**

Has your battery gone down in a place where electric outlets are not to be found? There are ways you can extend the life of your laptop's battery.

A laptop's LCD screen requires a lot of power. Lower the brightness to a level that is comfortable for viewing the screen. Better still, use black and white mode. Set the monitor to go off after five minutes of inactivity.

Remove unused devices and peripherals. Modems, USB devices, external drives and wireless LAN devices put an unnecessary burden on the laptop battery. Turning them off when you are not using them will result in a lower battery drain.

When you are not using a PC card, close all applications using the card and pop it part of the way out of the slot or remove it altogether to save power.

If you are not using the built-in Wi-Fi, turn it off.

Increase the laptop's memory (RAM). Memory requires less battery power than a hard disk drive, which requires disks to be spun at high speed.

Avoid running multiple programs and close all unused or unnecessary programs. This frees up some of the memory and the processor does not have to work as hard. Consider using smaller, simpler programs whenever possible such as WordPad instead of Word.

Reduce the frequency of background processes such as auto-save in your word processor and other software so that your system can shut down the hard drive for longer periods.

The hardware program Bios Setup that comes with a laptop computer allows you to view and set system parameters. Check the Bios to see if power management is enabled. Set it to maximum to save battery power.

Use standby when you are not actively using your laptop such as when you are taking a five minute break or talking on the telephone. Standby puts your system into a low-power state. When you will not be using your laptop for a longer period of time, use the hibernate or suspend mode. Hibernate puts the laptop into an even deeper sleep than standby but uses less power than shutting the system off and restarting it.

Make sure your battery is fully charged before you leave. Of course, the best tip is to buy an extra battery and keep it fully charged and ready to pack as a back-up.

**Take Steps to Prevent Theft**

Your laptop is vulnerable to theft whether you are taking it with you on the road or using it in your office.

Presumably your laptop is insured, so the more critical concern is that someone could access the personal, financial and private information that you have stored on its hard drive. The data could be of more value to a thief than the laptop itself and may indeed be the primary reason for the theft. Consider the rising incidences of identity theft.

The free built-ins found on many systems, such as passwords or operating system logons, are designed mainly to deter casual prying. All a thief has to do is remove the hard disk and install it in another PC as a secondary drive and the drive can then be read without a password.

You can protect the data stored on your laptop by using encryption software that codes your documents so only authorized users can read it. Some encryption programs use both a password and special USB tokens that resemble a memory stick.

Do not store highly sensitive information such as passwords, credit card numbers, the activation code to your home alarm system or your SIN or passport numbers on your laptop.

Back up your data on alternate media, such as a thumb drive, USB memory key or some other removable storage medium, all of which are relatively inexpensive. Set the automatic back-up feature of software such as your word processing and financial management applications so that these back-up files are also stored on the removable medium and not on your hard drive.

If possible, send the data to a remove data storage site. Once you have transferred the data, delete the files from the laptop and then make sure that you empty the recycle bin, trash or equivalent.

Do not compute sensitive information online while traveling unless absolutely necessary and you know the link is safe; for example, you are connected through virtual private network (VPN) software that requires an extra level of log-on passwords and encryption.

Carry your laptop in a bag that is not too obvious. For example, there are bags shaped like backpacks that are specifically designed to carry laptops and have the right padding.

If you leave your hotel room for the day, take your laptop with you or check it at the front desk.

The laptop provides for business-as-usual while you are on the go. A few preventative steps can help you maximize the use of your laptop while ensuring your data is secure. ■

BUSINESS MATTERS deals with a number of complex issues in a concise manner; it is recommended that accounting, legal or other appropriate professional advice should be sought before acting upon any of the information contained therein.

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