

## Be Your Own Boss — Save on Taxes

*Starting your own business, while still gainfully employed, may offer many tax benefits.*

Assume one of the following scenarios:

1. You have a good job, make decent money but the rumblings in the workplace suggest there may be layoffs and you start to wonder if it is time to strike out on your own.
2. You have always had the desire to start your own business.
3. You are a few years from retirement and are looking for new challenges.

*How about becoming a Sole-Proprietor While Still Employed?*

To understand the advantages of becoming a sole proprietor while you are still employed, you must first understand the basic 2011 tax brackets and rates. (Only federal, Ontario, and Quebec rates are provided for ease of explanation.)

*2011 Tax Brackets; Federal and Provincial Tax Rates*

### Federal Rates

- 15% on first \$41,544 of taxable income, +
- 22% on next \$41,544 of taxable income (on the portion of taxable income between \$41,544 and \$83,088), +
- 26% on next \$45,712 of taxable income (on the portion of taxable income between \$83,088 and \$128,800), +
- 29% of taxable income over \$128,800.

### Ontario Rates

- 5.05% on first \$37,774 of taxable income, +
- 9.15% on next \$37,776 of taxable income (on the portion of taxable income between \$37,774 and \$75,550), +
- 11.16% of taxable income over \$75,500.

### Quebec Rates

- 16% on first \$39,060 of taxable income, +
- 20% on next \$39,060 of taxable income (on the portion of taxable income between \$39,060 and \$78,120), +
- 24% of taxable income over \$78,120.

As is evident, the progressive tax scale requires the taxpayer to pay a higher percentage of tax on the portion of taxable income over a certain dollar amount.

If a taxpayer earns \$42,544, the additional \$1,000 earnings will attract the base amount of federal tax of \$6,232 (15% @ 41,544) less the savings due to tax credits, plus an additional 22% or \$220 when the taxpayer moves into the higher tax bracket. This \$220 liability is 7%, or \$70, higher than it would have been had the income been taxed in the lowest bracket, excluding provincial taxes.



### *Losses*

Most individuals start a business with a reasonable expectation of making a profit; however, as is the case in most start-up businesses, many individuals experience losses for a period of time until they are fully established. Fortunately, the *Income Tax Act* permits losses from self-employed ventures to reduce the income earned from employment income, thereby potentially dropping the taxpayer into a lower tax bracket. Self-employed individuals are often entitled to many deductions not available to salaried employees.

### *How Losses Work*

The type of business will determine the eligible deductions that can be offset against revenue earned within the business and, therefore, will have an impact on the amount of business loss available to offset against salaried income. The following are some of the allowable deductions (while similar deductions may be available to employees, these are generally more restricted):

- All purchases of material and supplies consumed in the making of a product.
- All purchases of machinery, equipment, furniture, electronic devices and all other capital items used in the business are deductible within guidelines established in the income tax regulations. Deductions are allowed against expenses over a period of time as set out under capital cost allowance rates.

- Place-of-residence deductions are claimable expenses if incurred to earn income. Property taxes, mortgage interest, utilities, as well as repairs and maintenance, are all legitimate deductions when based on usage attributed to the business. Taxpayers would do well to consult with their Chartered Accountant to ensure that the at-home expenses are allowable and reasonable given the business conducted and the portion of their home used to conduct business operations.

- Vehicle expenses: keep detailed records of the kilometres driven in pursuit of business income, especially if the vehicle is used to drive to your regular place of work.

- Interest and other charges on business loans and credit cards, and bank charges, if incurred in the pursuit of profit. It is normally advisable to have separate business bank accounts and credit cards to establish that expenses were not incurred for personal benefit.

Working-age children and spouses can be paid a reasonable amount for work performed in earning income for the business.

The taxpayer's objective is, of course, to find a tax bracket that is the lowest possible based upon the progressive scale shown. Starting your own business may allow you to reduce your taxable income by offsetting losses from self-employment against income earned from regular employment.

If annual revenue from sales and services amounted to \$20,000 and expenses, such as the ones above, totalled \$35,000, the taxpayer would sustain a business loss of \$15,000.

If the taxpayer's income from all sources before the application of the business loss was \$50,000, the wage earner could expect to pay federal income taxes of 15% on the first \$41,544 (\$6,216) (before considering federal tax credits), plus 22% or \$1,860 on the remaining \$8,456, for a total federal tax payable of \$8,076.

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The taxpayer should also expect to pay provincial tax. In Ontario, the taxpayer would pay Ontario income taxes of 5.05% on the first \$37,774 (\$1,908) (before considering provincial tax credits), plus 9.15% or \$1,119 on the remaining \$12,226 for total Ontario tax payable of \$3,027. Combined with the federal tax payable, the taxpayer would pay total tax of approximately \$11,000.

A Quebec taxpayer would pay Quebec income taxes of 16% on the first \$39,060 (\$6,250) (before considering provincial tax credits), plus 20% or \$2,188 on the remaining \$10,940, for total Quebec tax payable of \$8,438. In this example, a Quebec taxpayer could pay combined federal and Quebec tax of approximately \$16,000.

In that the *Income Tax Act* permits the self-employed taxpayer to offset the business loss against earned income, the \$15,000 loss would reduce the taxable income to \$35,000 (\$50,000 – \$15,000). The taxpayer would then be taxed in the lower tax bracket of \$35,000.

Referring to the previous scenario, if the taxpayer resides in Ontario, the personal federal and provincial income taxes would now be approx \$7,018 (before considering tax credits), an income tax reduction of approximately \$4,000.

Similarly, if the taxpayer resides in Quebec, the personal federal and provincial income taxes would now be approximately \$10,850, an income tax reduction of approximately \$5,700.

### Tax Loss Benefits

Self-employment losses, when offset against regular employment income, will provide tax benefits in that the income tax deducted by your employer will be refunded to you, in part, as your taxable income is reduced by the losses incurred in your business. Nevertheless, do not run your business simply to incur losses that *may* be offset against earned income since even at the highest tax rate you only receive a percentage of the overall loss as a tax refund.

Furthermore, if you never turn a profit, all your losses could conceivably, in some circumstances, be denied by the CRA, using hindsight, on the basis that the business is a hobby with no expectation of profit.

### Questions to Ask

Significant questions to consider in the decision to start your own business while you are employed:

- Will my current employment allow the time and effort required?
- Is there a term in my employment contract that prohibits me from carrying on another business?
- Is there sufficient cash flow or lines of credit to get a good start?
- Is there sufficient space at home or will another location be required?
- Is it possible to hire members of my immediate family?
- Will the business support my lifestyle should employment income disappear?

### A Word from the Wise

As in any new venture, an individual should seek the advice of those who have gone before. Talk with people who started a business while still employed. Their insight may be invaluable.

Naturally, your Chartered Accountant can help with advice concerning record keeping, government forms and regulations, deductions that will be allowable, and the impact of those deductions on your current taxable position. Further, your CA can apply various loss and profit figures against your earned income to show the combined impact of both federal and provincial income tax on various “what if” scenarios. This will allow tax planning strategies to be envisioned for your benefit.

### Weigh the Benefits

In the final analysis, the foray into self-employment while still gainfully employed offers:

1. The ability to take a risk without the fear of losing everything,

2. The opportunity to prepare for the day when you may not have regular full-time employment,
3. The time required to learn about your new venture while enjoying a secure source of income,
4. The experience needed to determine whether the route taken is one to pursue after your regular employment ends, and
5. A reduction of income taxes during the earning years instead of accumulating non-capital losses that may not provide personal income tax benefits should the business never make a profit.

### This'n That at Logan Katz

#### LK News

Gary Katz and David Logan have just returned from Istanbul, Turkey, where they attended the annual World Congress with other members of AGN International, our global affiliation.

Our very own Aron Mak has received admission to membership with the Institute of Chartered Accountants of Ontario. Congratulations, Aron, on receiving your Chartered Accountant designation!

#### LK in the Community

Logan Katz, as a Gold Sponsor of the University of Ottawa's Telfer School of Management Accounting Club, attended the 21st Annual C.A. Wine & Cheese at the National Arts Centre on September 21st. It was a true pleasure to meet and chat with so many bright, professional and talented students!

We were also a major sponsor at the 20th annual golf tournament hosted by the AISO – The Social Integration Association of Ottawa and for Espresso Uno at their recent ladies charity golf tournament.

LK has signed up TWO TEAMS this year for the Juvenile Diabetes Research Foundation's - Ottawa 2011 Ride. Last year, Logan Katz was the third highest single team fundraiser in the Ottawa event! If you'd be interested in sponsoring our teams for this incredibly worthwhile event, please give us a call or go to <https://jdrfca.donordrive.com/>. We would REALLY appreciate your support!