

When is a Business *in* Business?

Entrepreneurs excited by the prospect of starting a new business and anticipating a quick startup often purchase assets or make other expenditures far in advance of actual registration or incorporation. The questions then arises: "Are expenses incurred before registration chargeable against revenues?"

The answer to this apparently simple question is complicated by a number of factors involving the Income Tax Act and the subjectivity of timing. It should be noted, however, that, because the Act does not provide specific rules dealing expressly with start-up costs, the tax planner must be aware of both the administrative practices of the CRA and the guidance provided in this area by the courts.

The Act indicates that an expense is deductible only if incurred for the purpose of earning income. Thus, if money were spent to earn income, these expenditures are deductible only if it can be shown that the taxpayer was carrying on business in the fiscal period. This means the taxpayer will have to establish the date the business began and be able to show the expenditures were made as a first step to the start of normal operations.

When Does Business Commence? Establishing the moment when a contemplated business actually becomes a functioning business is a matter of judgment, since "the moment" depends on the determination of when normal operations begin.

It may be fair to assume that a restaurant, for example, has started business before the doors opened, if the lease arrangements are in place, capital assets are being installed, or the owners are running ads and interviewing for staff. In such a case, the Canada Revenue Agency would want to determine that significant organizational indicators were already in place to support a planned opening date.

If, on the other hand, the aspiring restaurateur spent money only researching the potential of a restaurant at a certain location, it is likely the CRA would consider the expenditures not connected closely enough with actual business operations to be deductible.

Significant Tax Impact

Determining whether expenditures are made in anticipation of an actual business is significant for taxation purposes.

After a business has started, all expenditures fall into two classes:

- Current expenses to be offset against current revenue;
- Capital expenditures to be amortized over the useful life of each capital asset.

Amortization is charged as a non-cash expense against the current and future revenue generated by the use of the capital asset. Certain expenditures, such as lawyer's and architect's fees etc., that would otherwise be treated as operating expenses, may be classified as capital expenditures, if they occur before operations commence and are related to the settlement of capital asset issues. They are normally added to the specific capital item and offset along with the original capital cost of the asset against current and future revenue.

The CRA's position is that operating expenses deemed to have been made before the start of business will not be available to reduce taxable income for the operational year. Further, if these expenditures result in a business or non-capital loss, the loss will not be available to apply forward against subsequent years' taxable income. Thus, the entrepreneur may make expenditures in what are, in effect, after-tax dollars from which neither the business nor the entrepreneur can receive a benefit.

Similarly, if capital expenditures are determined to have been made before the start of business, they might not be viewed as expenditures for the purpose of generating income. Thus, if the business fails before it begins, the entrepreneur will have a loss that may not provide any taxable benefit.

As noted, when a business begins is a matter of judgment. Probably no single factor can be used to establish the inaugural moment. As a result, whether expenditures made before registration or actual commencement of operations should be included as a capital or operating transaction is a subjective decision.

Evidence of intent assists in clarifying not only the time when operations begin but also the timing and allocation of expenditures for financial- and tax-reporting purposes.

Entrepreneurs should meet with us even if merely contemplating a new start-up business to determine:

- The reasonableness of the anticipated time likely to elapse between expenditures and business commencement;
- The possibility of timing expenditures to fall within the same fiscal period as the revenue generated;
- Capital assets are purchased only for the site and/or business contemplated;
- All fees, licenses, and permits are dated, receipted and specific to the site or the industry;
- Agreements, or letters of intent are in place for leases, franchises, and/or capital asset expenditures;
- Registration is completed within a reasonable time of commencement; and
- Necessary expenditures such as site-insurance, building permits, etc., are documented and receipted to assist in the allocation to either income or capital.

Plan, Plan, and Plan Again

Responsible planning when starting a business will ensure that the entrepreneur can take advantage of the maximum deductible expenses permitted by the CRA while at the same time satisfying investors and creditors.

This article only provides a cursory overview of this complicated topic. If you are even considering starting your own business, we encourage you to meet with us before proceeding.

This 'n That at Logan Katz...

Fond Farewell

The partners and staff of Logan Katz bid a fond farewell to Judy Mulder. During her more than five years with us, clients and colleagues alike benefited from Judy's uncompromising dedication to quality and care. She will be missed and we wish her all the very best in her future endeavors.

Will Planning and Charity Seminar

Denis Chainé spoke to an audience of gift-giving individuals at a Will Planning and Charity forum organized by eight local and national charitable organizations. The more than 100 guests at this annual event benefited from valuable information in regards to estate planning and the related benefits of charitable giving.

New at Our Reception

Next time you visit our offices, you will have the pleasure of being greeted by our newest professional administrator/receptionist, Michelle Gibbons. Michelle started with Logan Katz this past July and is eager to get to know our clients. We are proud to have Michelle be the first person you'll meet when you walk into our offices. Enjoy her company during your next visit!

