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Canadian Overview

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The quarterly Canadian Overview is a newsletter produced by the Canadian member firms of Moore North America. These articles are meant to inspire conversation and collaboration throughout Canada and beyond.

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TIPS FOR PLANNING YOUR YEAR-END

BY GREG SHAGALOVICH, CPA, CA, FROM SEGAL LLP

The new year brings new changes and new ideas; if you're planning on incorporating or starting a business as a sole proprietor here is some advice to consider for planning an effective year-end.

Plan in Accordance with Your Highs and Lows

If your business is seasonal or cyclical, you'll ideally want to establish a year-end that coincides with the end of your busiest period. The downtime following year-end will allow you to catchup on record keeping and will give you a clearer idea of how well your business has done. As an example, a landscaping business generally peaks over the summer season and may favour a September 30 year-end.

The year-end of a business that is structured as a sole proprietorship is always calendar year-end. The activity of your sole proprietorship is recorded on your personal tax return on a specific form. As a tax filer with a sole proprietorship, your return is due by June 15th instead of the usual April 30th due date. If there is a balance owing, it must be paid by April 30th.

Type of Business

Independent: A sole proprietorship or a taxpayer that is self-employed must use a December 31 fiscal year-end. It's important to remember, a sole proprietorship is still subject to collect and remit HST if the revenue exceeds $30,000 in the year. Furthermore, a sole proprietorship needs to file all T-slips (i.e. T4s, T5s) depending on the extent of its operations.

Incorporated: If your business is incorporated, you have the option to choose any year-end if its within 365 days of incorporation. As previously stated, when selecting your year-end, you should consider your industry and choose the end of the busiest time for your fiscal year-end. Another bit of information that is important to note is that some year-ends are fixed for some industries, so be sure to check if yours is among those.

Changing a Fiscal Year

If you've come to realize your fiscal year is not the best fit as it currently stands, you do have the option to change it. The process is to first correspond with the Canadian Revenue Agency (CRA). You cannot change your year end for just any reason. It must be something substantial that the CRA will likely acknowledge as a valid reason. For example, if you opened your business and then realized that you're busy in one season but not another, it would make fiscal sense to change your year end.

Pursuing a tax advantage simply for convenience (IE. You have a vacation that you would like to plan around) is not a reason that will likely be accepted.

NEW STOCK OPTION RULES

BY HOWARD WASSERMAN, CPA, CA, CFP, TEP, FROM SEGAL LLP

Initially, there was going to be a new set of rules for any stock options issued after December 31, 2019, effective January 1, 2020. However, the Department of Finance recently released a statement that the effective date of the new rules will be disclosed in a future communication- likely the budget released in March or April of 2020. Under this new regime, a portion of the stock option benefit may no longer be eligible for the stock option deduction.

Under the current rules, applicable to a non-Canadian Controlled Private Corporation (CCPC), an individual may be able to claim a stock option benefit deduction if the exercise price is greater than or equal to the fair market value of the underlying share at the time the option was granted. The deduction is 50% of the benefit.

Under the new rules, there is a calculation to determine whether or not the value of the options that vest in the year have a value that exceeds of $200,000. That is, all the values of shares for options that vest in a year must be considered to determine if their value at the time of the grant exceeds $200,000. Of this amount exceeds $200,000, a portion of the stock option benefit will not be eligible for the stock option benefit deduction. This means that even though, economically, an individual has received the same amount on the exercise of options as in previous years, the tax will increase.

Where an individual can stagger the vesting of options, so that the vesting amount is less that $200,000 in a year, it would save taxes for that individual. However, there must be a consideration of whether the individual could lose those stock options because they are not vesting as quickly as they would otherwise.

The other major change in the new rules is that corporations may be able to deduct that portion of the stock option benefit that the individuals cannot deduct. There are notification rules that the corporation must adhere to, for both the individual and CRA, in order for this to be allowed. Additionally, it is only the direct employer of the individual who can claim the deduction. This could be an issue if the actual stock option is being issued by a foreign parent company and not the actual employer of the individual.

These rules can become quite complex. It would be best to consult your local tax expert for advice on how to best navigate these changes for you and/or your business.

MANAGING BIAS IN THE VALUATION PROCESS

BY MICHAEL FROST, CPA, CA, CBV, FROM MOWBREY GIL

A valuation is often viewed as a number crunching exercise with readily available inputs and assumptions available, but it typically involves many subjective assessments, choices and assumptions that are prone to bias in a valuation. That is often driven by the underlying purpose for the valuation and if not managed properly, can give a result that may be limited in its usefulness.

Common Sources of Bias

Forecasting. A forecast or projection of future cash flows from a business is a key input to a valuation model based on future cash flows. In preparing as a forecast, there are many sources of potential bias. For example, there can be too much reliance on personal experience, intuition instead of independent information and data in estimating revenue growth rates and profitability metrics. Even if objective information is utilized, confirmation bias can result in more weight in the analysis being given to information that confirms existing optimistic beliefs that may be optimistic or pessimistic. When estimating the profitability of a business, the historical performance is often given significant weight, but those historical results are often subject to adjustments intended to normalize the results which can be selectively included or excluded.

Valuation Inputs. Beyond the forecast assumptions, there are various other inputs assumed in a valuation model related to working capital and capital expenditure requirements, identification of redundant assets, discount rates and terminal value adjustments. For example, discount rates should reflect the risk of achieving the future cash flows forecasted but there are several choices among alternatives in building the discount rates that are subject to bias. Any one of these inputs, if misapplied or selected without any objective basis, can result in significant variations in valuation conclusions.

Valuation Multiples. Market participants may rely on a relative valuation or market approach as the primary valuation approach or as a secondary approach. Obtaining relevant data from truly comparable companies that are publicly traded can be difficult and there may be a temptation to use companies that are not comparable due to size, product mix, end markets, etc. In selecting valuation multiples from open market transactions, transactions may be selected that are too old or not relevant for many of the same reasons related to publicly traded companies. Also, certain valuation multiples from comparable companies can included or omitted to achieve the objectives of the valuation and minimize those that conflict with the objectives.

Application of Discounts or Premiums. The use of discounts such as illiquidity and minority discounts or a premium for control are more typical in private company valuations for shareholder disputes, income taxes and other disputes. Since there is limited objective information on discounts and premiums, a valuation conclusion can be subjectively decreased or increased by using subjective adjustments for various situations.

Responses to Bias

Corroborate Forecast Inputs. When estimating growth rates in revenues, factors like industry growth rates and market share should be considered. Independent information that conflicts should not be dismissed but rather used to stress test the forecasts. For example, a business may be expected to grow faster than industry average during the short to medium term but over the long-term, businesses tend to revert to the average in the longer term. To address bias in normalized financial results or where there is a limited history of operations, to the extent possible, the historical profit margins as a percentage of revenues should be corroborated with independent industry evidence for reasonability.

Corroborate Valuation Inputs. To the extent possible, other valuation inputs that have a material impact on the valuation should be based on objective verifiable information. This includes historical information related to inputs such as working capital and capital expenditure requirements and market-based information related to calculation and selection of discount rates. While historical data specific to the company is usually strong evidence for inputs such as working capital and capital expenditures, industry data should also be utilized where there is limited historical evidence or data available in an early stage business.

Cross Check the Results. Where possible, a secondary valuation approach should be used to ensure the valuation conclusions from the primary valuation (typically a cash flow based method) approach are reasonable and consistent lending further support to the inputs and assumptions used in the primary valuation approach. This typically involves comparing the valuation multiples of a businesses with those of other comparable companies or to prior transactions in the shares of the subject company and if properly carried out, such an analysis can help stress-test the primary valuation method.

Valuation Range. Any value that is obtained for a business is first and foremost an estimate and as accordingly should be quantified as a range of estimates to accommodate the inherent margin for error. This can be based on application of multiple scenarios and or presentation of a best-case (high) and worst-case (low) estimates of value. The output that is presented should reflect the estimates of value and the inherent uncertainty of those values.

Conclusion

Bias in valuations cannot be eliminated as there will always be inherent estimation uncertainty from the forward-looking nature and many assumptions used. However, building better valuation models that effectively use available objective and independent information is an effective way of addressing the bias and the uncertainty arising from macroeconomic, industry and company specific conditions.

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THE WAYFAIR DECISION: A YEAR AFTER

BY BENOIT VALLÉE, CPA, CGA, FROM DEMERS BEAULNE

More than a year has passed since the U.S. Supreme Court rendered its decision in the case of South Dakota v. Wayfair Inc. States can now require an out-of-state seller to register for their Sales and Use Tax ("SUT") and collect it even if this seller doesn't have a physical presence in the state. The creation of the Economic Nexus has been one of the most important changes in matters of sales tax in the U.S. these past few years.

Today, most states have adopted the Economic Nexus legislation. However, each has its own set of rules which differs from one state to the next.

States Which Have Adopted Economic Nexus Rules

As of August 1st, 2019, 43 out of the 45 states that impose a SUT had adopted the Economic Nexus, each having different effective dates and rules. Florida and Missouri are the only two states that haven't followed suit.

Economic Nexus Threshold

South Dakota established that out-of-state sellers with more than $100 000 in sales or 200 transactions on their territory meet the Economic Nexus and are therefore required to register for SUT purposes. Most states adopted this threshold while others opted for a higher threshold (between $250 000 and $500 000).

Many states do not require a certain number of transactions. Other states, such as New York, requires that both criteria be met (sales and transactions). As for Kansas, the very first taxable sale generates the Economic Nexus.

Sales Included in the Threshold

Sales included in the threshold differ from one state to another. Most states use gross sales to establish if the Economic Nexus is met, while other states, like Illinois, only take into consideration retail sales. Pennsylvania, for its part, only considers taxable sales.

Impacts and Changes for Your Company

Canadian companies doing business in the United States of America without a physical presence should review and update their SUT analysis and register themselves in some states, if required.

Our team at Demers Beaulne can help you identify in which states your company meets the Economic Nexus and if it is required to register for SUT purposes.

Should you wish to learn more about the Economic Nexus rules, do not hesitate to contact our tax specialists.