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Tax Evasion and Avoidance and the Impact on Your Business



How Businesses Reduce Taxes Paid

Even though it might be tempting to think of taxes as a fixed amount that must be paid each cycle, business owners actually have a fair amount of leeway in determining how much their business owes in taxes. Businesses engage in tax planning and can reduce taxes in two broad ways. These are known as tax avoidance and tax evasion. Tax avoidance is quite legal and is practiced by businesses interested in tax planning. Tax evasion on the other hand, is not legal, and is considered a crime.

Tax Avoidance vs. Tax Evasion

The general definition of tax avoidance is taking lengths to reduce one's tax burdens within the constraints of the law while also complying with tax regulations. Tax evasion, on the other hand, is defined as not reporting all of a business's income to the tax authorities.

Tax Evasion Examples (i.e. What Not To Do)

Tax evasion can occur in a number of ways, so be sure to avoid these pitfalls when determining your business's payable taxes.

- Deliberately omitting or under-reporting income.
- Keeping two sets of books, or engaging in fraudulent accounting activities.
- Claiming false or overstated deductions on a return.
- Over-stating charitable deductions or misrepresenting travel costs.
- Claiming personal expenses as business expenses.

These are all examples of tax evasion that business owners should be aware of so as to not be charged criminally.



Tax Avoidance Requires Skillful Tax Planning

Strategies for skillful tax avoidance usually encompass one or more of these strategies: minimizing taxable income, maximizing tax deductions and tax credits, and controlling the timing of income and deductions. In order to use these strategies, it is very important to have income and asset projections for your business, going at least several years into the future. Although this may seem like a difficult endeavor, it is critical to at least have some idea of how much cash your business will be generating.

Claiming Deductions and Credits Minimizes Your Business's Tax Bill

Accounting software can be complicated and it's nice if someone else can make the decision as to what would work best for your business. By outsourcing, you gain access to a team of professionals who are already knowledgeable about the best accounting software available. Furthermore, since your accountants already know the software inside and out, they will be able to identify plugins or additional modules that you can consider adding to help tailor the software to your business.

Decrease Your Risk

It is important to know which expenses are deductible to your business and which are not. Deductible expenses include meals and entertainment expenses, automobile expenses, and business travel. Be cautious about deducting the entire amount of a business expense in the first year that it is incurred. If you anticipate your business's income rising over the next several years, you may want to spread the cost over into the future (for example, in the form of amortization).

Tax credits are a very valuable and useful tool in tax avoidance. Unlike deductions, which reduce your taxable income, credits reduce your total taxes paid, giving you tax relief in a direct and tangible manner. Some tax credits that you may want to investigate include the SR&ED Tax Incentive Program, the Co-operative Education Tax Credit, the hiring credit for small business and charitable donation credits.



Optimizing Your Marginal Tax Rate and Postponing Income Generated

Individuals and their businesses are taxed differently depending on which tax bracket they are in. One key to successful tax avoidance is optimizing which bracket you and your business fall into. This might mean postponing income that you could receive now to future years so as to reduce the amount of current income and thereby reducing your current taxes. You could also structure a transaction so that it becomes a capital gain instead of an income transaction. Finally, shifting which taxpayer receives the income within your organization will affect taxable income. For instance, you can hire your children and shift income to them, thereby advantageously modifying the structure of your taxable income.

The Downside of Tax Avoidance

The downside to tax avoidance is that it can be a very lengthy, time-consuming, and resource-intensive process. Accountants and lawyers are often required and their costs must be offset against any benefits accrued. However, when the benefits outweigh these costs, tax avoidance strategies are highly beneficial.

Increasing Tax Avoidance and Decreasing Tax Evasion

Tax avoidance and tax evasion tend to increase as the marginal tax rate increases for any individual. There is more at stake for individuals in higher tax brackets than those in lower ones.

Reducing this problem is complex but one suggestion is to simplify the tax code. This has been predicted to decrease the amount of avoidance/evasion practiced by individuals earning income. Increasing legal penalties will also result in decreased tax evasion. The same is true for increased auditing and monitoring by tax authorities. Not only are people



more likely to tax evade as marginal tax rates rise, studies have shown that they are also more likely to change employment to jobs that are more conducive to evasion. The degree of tax evasion depends on the ease of evasion as set by tax laws, including expected penalties. The vast majority of employed individuals in Canada correctly report their salary income. However, those who are self-employed are much less likely to correctly report income, as they know there is no central record of their wage incomes.

Understanding the strategies of tax avoidance can be highly beneficial to the individual business owner, as total taxes paid can be minimized, leaving more income for use in other areas. But make sure you avoid evasion tactics at the same time!

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