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CESTNICK

TAX MATTERS

How good records can keep your business out of tax court

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Maybe you've heard the story of the business owner who had a booth at a trade show. A woman walked by and he said: "Excuse me, could I interest you in buying a microscope?" "No thanks, I don't have a use for one," she replied. "Well, here's my business card if you ever change your mind" he insisted. She looked at his card and said: "This is so small, I can't read it." He smiled and announced, "I've got just the product for you!"

Selling in business is hard enough. Dealing with a tax audit is even harder. Here's a story all business owners can learn from.

The story

A woman owned a trucking business and ended up in court battling the Canada Revenue Agency. Her husband drove the truck and most work was provided to one trucking company. The tax dispute covered the 2014, 2015, 2017 and 2018 tax years, when the CRA questioned expenses claimed. The matter ended up in court.

In many of these cases, the court questions whether a legitimate business existed. Section 18 of our tax law allows expenses to be deducted when incurred for the purpose of gaining or producing income from a business. In the woman's case, the CRA and the court had no concern that her business was legitimate. That wasn't the issue. The real problem was whether there was sufficient evidence for the expenses she claimed in each year.

The judge described her supporting documents as "muddled, ersatz, and unorganized." Some receipts were so faint they couldn't be read. Other documents arrived gradually, in four volumes, while the case was under way. That's a bad look.

The case stretched more than two years. In a judgment handed down in April, the court allowed $138,744 of additional expenses, but the woman was lucky to be treated as well as she was. Even the judge said the expenses conceded by the CRA were more generous than the court would have allowed after its lengthy review of the evidence.

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One change saved Canadians nearly a quarter million calls to CRA this tax season

The lessons

If you're a business owner, there are a few things we can learn from this case.

Lesson 1: Maintain clear support for your expenses. Set aside the evidence when you spend the money, not years later when the CRA asks for it. Scan or photograph every receipt before it fades, making sure the image shows the vendor, date, amount and what was purchased. Add a brief note explaining the business purpose. For meals, record who attended and what was discussed.

It's best to keep receipts electronically. Give every document a consistent file name – the date and supplier work well – and store it in folders by year and expense category. Cloud bookkeeping tools can attach the image directly to the transaction – and keep a backup.

Lesson 2: Use a separate bank account and credit card. Set these up solely for use in your business. It's tough to convince the taxman that an expense was for business when it appears on a statement surrounded by personal expenses. A receipt may show what was bought, while a bank or credit-card statement helps show it was paid. Together, they create a strong trail. In the woman's case, certain interest and bank charges were denied when statements weren't provided, but accepted when statements supported them.

Lesson 3: Reconcile your accounts monthly. Match each transaction to a receipt, invoice or contract, then place it in the correct expense category. In this case, the court sorted out amounts claimed, amounts disallowed and items placed in the wrong category. No wonder the case went on for two years. Your bookkeeping system should make that unnecessary.

Lesson 4: Connect your expenses to your business. Pay special attention to those with both business and personal elements. For a vehicle, keep a log showing the date, destination, purpose and kilometres for each business trip. For telephone, internet or home-office costs, document how you calculated the business portion. The CRA generally requires records to be kept for six years after the end of the year they relate to. Electronic storage makes this easy.

Opinion: Taxes are important, but asset allocation comes first

The audit

If the CRA comes knocking, don't send a shoebox – physical or digital. Make the auditor's job easy. Summarize expenses by category, list transactions and attach supporting documents. If documents are missing, reconstruct the file right away. Ask suppliers for duplicate invoices, download bank and credit-card statements, and collect contracts, customer statements, calendars, e-mails and mileage records connecting expenses to the business. Evidence created now carries more weight than an explanation assembled years later.

Finally, involve your accountant early and consider a tax lawyer if amounts are denied. A professional can identify gaps, present evidence clearly and prevent disagreements from escalating. The woman won – but only after years of hearings and document reviews. Good records take some time each month, but poor records can cost you a lot more.

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