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## TAXATION

### But I'm Single!

**L**iving together as single people may be great but be careful. The CRA may see you as a married couple.

One of the most contentious issues faced by tax preparers when completing clients' personal income tax returns is whether a couple is simply living together — or living together in a manner treated by the Canada Revenue Agency (CRA) as "married". This delicate area of personal beliefs can generate legal and income tax problems with a long-term impact on the individuals in the relationship.

The source of the problems is usually the belief by the parties in the relationship that they cannot be treated as married if they do not have a signed marriage certificate. In Canada, it is true that there is no such thing as common-law marriage; no relationship matures into marriage merely by the passage of time, as some people believe. In Ontario, a couple must have "cohabited" for three years, which means they must satisfy certain conditions other than merely living together before they are classified as common-law spouses; periods in other provinces vary between two and three years. Cohabitation is defined by the following seven factors established in *Moldowich v Penttinen*:



- 1. Shelter:** Was accommodation shared by the unmarried couple?
- 2. Sexual and Personal Behaviour:** Was the relationship intimate and perceived to be so by others?
- 3. Services:** Did the couple share the traditional functions of a family?
- 4. Social:** Did partners present themselves as a couple to the outside world?
- 5. Societal:** How was the couple treated by their community?
- 6. Economic Support:** Were the unmarried parties economically interdependent?
- 7. Children:** Did the couple see children as part of their home and interact as parents with each others' children?

## How the CRA Sees It

Couples who have cohabited for more than 12 months but less than the statutory period that would establish them as common-law spouses in their province of residence are often surprised to find the CRA has categorized them as “common-law partners” and thus treats them as “married” for tax purposes. The CRA’s website defines common-law partners as follows:

*“A common-law partner applies to a person who is not your spouse with whom you are living in a conjugal relationship, and to whom at least one of the following situations applies. He or she:*

- a) has been living with you in a conjugal relationship for at least 12 continuous months;*
- b) is the parent of your child by birth or adoption; or*
- c) has custody and control of your child (or had custody and control immediately before the child turned 19 years of age) and your child is wholly dependent on that person for support.”*

This is essentially a summary of the definition found in the Income Tax Act.

Individuals living together and wishing to establish that they are not married or living common law must establish that they are not living in a conjugal, i.e., sexual, relationship. If such a relationship has continued for 12 consecutive months (not necessarily beginning in the particular year), the CRA recognizes it as a common-law relationship. Individuals who live together for financial, physical or emotional reasons, especially if points (b) and (c) are in play but do not want to be categorized as common law for tax purposes should be aware that if the relationship becomes conjugal it would become a common-law relationship in the eyes of the CRA.

## Common Law Changes Tax Status

The significance of retaining “single” taxpayer status should not be dismissed lightly. Putting aside other legal issues, consider the following tax issues, both positive and negative, regarding common-law relationships for tax purposes:

- RRSP contributions may be made by one person for the benefit of another in a common-law relationship; the contributor is allowed the tax deduction. The same would not be true for individuals not in a common law relationship contributing to each other’s RRSP.
- When an individual within a common-law relationship dies, for the most part investments and RRSP amounts transfer to the survivor without immediate tax consequences. When an individual dies without a common law survivor, the estate of the deceased is taxable on the value of the RRSP at death.
- Medical expense receipts and charitable donations are creditable to the individual who incurs them. In many instances the expenses and/or donations do not aggregate to a total that is useable by the single taxpayer. Within a common-law relationship such expenditures are transferable from one taxpayer to the other to allow some income tax relief.
- An individual who earns income from investments, whether interest or dividends, must claim 100% of the amount for tax purposes. Assuming that a common-law couple shares the investments, the total income earned could be split between the investors if proper arrangements are made.
- Similarly with capital gains or losses, both taxpayers within a common-law relationship should be able to use the gains or losses to mutual benefit depending, of course, upon other investment gains or losses within their individual portfolios. Individuals within a common-law relationship must be aware that superficial loss rules apply to them as a couple in the same manner as the loss rules apply to an individual. That is, if an investment is sold at a loss to apply against gains but the other spouse repurchases the stock within 30 days of the original sale, the loss would not be permitted.
- If one partner dies while employed, an employer may allocate a \$10,000 death benefit to the common-law partner. This amount would be tax free in the hands of the recipient. A tax free benefit is not allowed to others unless the recipient is a child of the deceased.
- In addition to the specific areas covered above there are many other related income tax, goods and services tax, and tax-credit issues (both federally and provincially) that change when individuals decide to live common law.
- A single parent can claim child care expenses. In a common-law relationship the person with the lower income must claim child care expenses.
- A single parent can claim equivalent to spouse for their child. In a common-law relationship this is not possible.
- A common-law couple can only have one principal residence per family unit. Thus, if each individual owns a residence before union, one of the principal residences could incur tax on capital gains when one of the properties is sold.

### Consider:

- The universal child care benefit transfers as taxable income to the spouse with the lowest income.
- The Canada Child Tax Benefit paid to eligible families for children under 18 will transfer to the individual that is primarily responsible for maintaining care of the child. Thus, individuals with a child who earn less than \$40,726 will receive \$100 of non-taxable income. Live common law and have a combined income in excess of \$40,726 and the non-taxable benefit will be reduced by 2% for one child and 4% for two or more children for net family income exceeding the \$40,726.
- Individuals who receive the GST amount because they fall below an earnings threshold may find the amount starts to diminish when their combined family income is greater than the individual threshold.
- Similarly the National Child Benefit supplement payable will start to erode as the combined family net income starts to exceed the current threshold of \$23,710. By way of explanation:

If each single parent earned \$23,710 income individually, they would receive \$278 per month on the NCB program. Should the relationship become common law the combined income earned would double to \$47,420 and the supplement would drop to \$93 per month. (It should be noted that the Province of Alberta provides child benefit supplements that differ from the National program).

### An Audit May Change Your Status

There are undoubtedly taxpayers who are living in a conjugal relationship but still file as individuals. Many will receive benefits and tax credits they would not be permitted if their relationship were classified as common law. Taxpayers should be aware that should an audit determine they are living common-law, the taxpayers will undoubtedly be required to repay the taxable benefits received because they filed as single. Should the taxpayer decide to object to the audit findings it will be up to the taxpayer(s) to prove that they were not in a common-law relationship.

### Know Where You Stand

There are many tax issues associated with living common law versus living separately. There are equally as many legal issues, and most are more expensive than the tax benefits or losses resulting from going from single to common-law status with CRA. Thus, regardless of personal convictions, taxpayers contemplating living together either as a common-law couple or as a support mechanism for each other would be well advised to seek both tax and legal advice as to the best means of avoiding future conflict with each other and with the CRA. ■

## MANAGEMENT

# Director by Default

**A** director's lot is not always a happy one but a lot of care plus some insurance can protect against the worst.

If you are an owner/manager of an incorporated business, you are almost certainly also a director. As a director you should be aware of your legal responsibilities and liabilities, which may not always be as obvious as you might think.

### The Incorporation Process

There are three methods of business incorporation in Canada. Nova Scotia retains the registration system, Quebec and Prince Edward Island incorporate through letters patent, and the rest of the provinces and the federal government use the articles of incorporation method.



No matter what the jurisdiction of incorporation, all corporations are required to have at least one director. The board of directors occupies the middle ground between the stockholders and the corporation and has a responsibility to both. To be a director, one must have reached the age of majority, be of sound mind, have never been a bankrupt or (in some jurisdictions) have ever been convicted of a crime involving fraud. Except for British Columbia, which has removed the requirement, foreign subsidiaries are required to have a portion of their directors resident in Canada.

## Director's Duties

A director's common-law duty to be careful used to be minimal and only became an issue where gross carelessness was involved. Today a director is expected to exercise the care, diligence, and skill of a "reasonably prudent person." In law a reasonably prudent person is not an average person but one who has the knowledge and capacity to foresee the risk inherent in his or her actions, calculate its magnitude and likelihood of occurrence, and recognize any alternative less risky actions, if any. Such a duty of care can expose directors to significant liability for negligence.

Directors also have a fiduciary duty. The Supreme Court of Canada clarified this responsibility in *Peoples Department Stores Inc. (Trustee of) v. Wise* when it wrote: "At all times, they [the directors] owe their fiduciary obligations to the corporation, and the corporations' interests are not to be confused with the interests of the creditors or those of any other stakeholder." In other words, although the directors are elected by the shareholders to look after shareholder interests in the direction of the company, the primary fiduciary duty of the directors is to the corporation itself.

Fiduciary duty requires directors to avoid conflicts of interest and act honestly and in good faith toward the corporation. Thus, if a director were to lend corporate funds to a relative for reasons that were not in the best interest of the company, the director could be liable for any losses to the Company resulting from the failure to act in the best interest of the company.

If you are a director of a corporation care must be taken to ensure that:

- a) you do not take advantage of your position as director and receive benefits not normally available to other employees, officers or customers of the corporation;
- b) your personal interest does not conflict with the best interest and goals of the company. (For example, if your relative is one of the bidders in a contract to provide goods or services to the company.);
- c) you indicate the conflict of interest and refrain from participating in discussions concerning the project and definitely refrain from voting;
- d) you maintain corporate confidentiality on all aspects of business;
- e) all decisions are made in the best interest of the company and its shareholders.

## Informed Decisions

To ensure the standards of care, diligence and skill are met the director has a duty to be informed before making decisions. This may mean refusing to make a decision until sufficient information concerning proposals and their (potential) impact on the company are received and analyzed to the director's satisfaction. Such advice may be required in complicated legal, accounting or technical areas outside the director's expertise. In these circumstances the director must ensure that the chosen professionals have the required expertise and experience and that both the professionals and the project or issue they are evaluating are independent from board members. Directors cannot ignore their own knowledge of the facts or fail to exercise responsible judgment. In the end, directors' decisions can be supported by professional advice, but the decision itself cannot be delegated to these same professionals.

## Supervisory Role

The directors' role is one of overall supervision ensuring that the executives perform their duties in the best interest of the company.

All companies have officers, presidents, vice presidents, treasurers and secretaries hired by the board of directors. That being said, the directors cannot shirk their overall responsibilities to manage a company by irresponsibly delegating management to the officers. Ultimately, the directors are responsible for the actions of the appointed officers.

## Directors' Liability

When directors act in good faith and within the boundaries of their authority it is difficult to be held liable for decisions or actions that may have precipitated from those decisions.

If however, it is established that the directors' decisions were designed to intentionally harm a third party, the directors could be held liable by the plaintiff for tortious acts. Similarly directors could find themselves in trouble if they are negligent in performing their duties and cause harm to a third party.

If, for example, directors have complied with prevailing safety legislation by reviewing all health and safety requirements of their business, it is unlikely they would be held liable if a worker were injured on the job. On the other hand if a worker was injured on the job and it was established that the directors had ignored legislation, failed to consider available accident reports or advice from officers or employees, there is a high probability the directors could be held personally and jointly liable.

### Avoiding Liability

There are three ways directors can reduce the risk of liability—due diligence, disclosure of personal interests and self defense.

### Due Diligence

Directors could ward off negligence lawsuits by keeping records that show they obtained the required information, examined and understood it (and/or sought professional expertise), and made an informed decision. Cautious directors may wish to maintain personal records of all decisions in which they participated as well as copies of all minutes.

### Disclosure of Personal Interests

Failure to disclose conflict of interest can result in voided contracts if the conflicted director is present during the vote or if it was determined that the director was part of the quorum that authorized the agreement. Further, the director may be required to make restitution for any profits made from the non-arms length project.

### Self Defense

By mere attendance at the directors' meeting a director may be deemed to have consented to the resolutions passed even without actually voting. This could be disastrous to a conflicted director long after the directors' meeting if legal action is taken against the company and its directors.

To ensure the conflicted director is exonerated from any participation the director should exercise these self-defence strategies:

- If present at the meeting, request that an abstention or dissent be entered in the minutes.
- Send written dissent to the secretary of the meeting before the meeting adjourns.
- Send a registered letter to the corporate registered office immediately after the meeting indicating dissent.
- Be able to prove there was no consent on her/his behalf regarding the resolution.

Directors who vote for or consent to a resolution are not entitled to dissent. Thus, if a director disagrees with the other Board members, abstention does not clear potential responsibility. If you disagree, vote "no" and make sure the vote is recorded.

### Insure Your Directors

Because directors can be sued, companies should ensure indemnification of all legal expenses, including amounts paid to settle actions or satisfy judgements. The company should purchase and maintain liability insurance for the directors.

Obviously, the coverage would hold only if the director acted honestly and in good faith in the best interests of the company. If the case against the director is criminal or administrative the coverage would only hold if the director(s) had reasonable grounds for believing that conduct was not unlawful.

### Review Your Position

Owner/managers should review corporate documents with their company lawyer to determine who are the directors of record, and with their lawyers and accountants, those areas where they may be held personally liable if they fail in their compliance with legal and regulatory requirements. If the potential risk to personal assets is greater than the owner/manager wishes to assume, it may be possible to restructure the organization to lessen or eliminate the personal impact. It may also be possible to shelter personal assets from future contingent liability by reviewing ownership of personal holdings.

If restructuring is not possible then a full understanding of corporate areas that may transfer personal risk will permit the owner/manager the ability to institute appropriate protocols and procedures to limit personal exposure. ■





# Memories Are Made of This

**C**arelessly managed data storage can cause some very big headaches.

Regardless of the size and type of your business, chances are you are constantly gathering and storing data. Whether it is simply names and addresses or more detailed personal information such as social insurance numbers, drivers' licence numbers, medical history or family names and birthdates, such information must be protected in accordance with the provisions of the *Privacy Act*.

Unfortunately, news headlines about lost customer data can generate negative publicity for your company, which could potentially cost you business. To avoid such problems, ensure your company has policies governing data use, storage and disposal. Data that may no longer be needed may still be quite useful to criminals.

### In the Old Days...

When hardcopy was king, and files had been in storage long enough to meet statutory retention requirements, businesses simply called up the shredding company and watched as documents were safely destroyed. Digital data has not only different disposal problems, but also can be transmitted almost anywhere.

### Storage Today

Today a wide variety of digital devices can become storage media for confidential data. For instance, PDAs or smartphones of staff and management may easily contain contact names, addresses, birthdates and photographs. USB flash drives and hard drives can store significant amounts of information, and could potentially contain data about your company, clients, engineering plans, budgets, passwords, addresses, or payroll, just to use a few examples.

Whether it's Mini SD, micro SD, or Compact Flash, they all store data. These memory cards increase a device's basic storage capacity to the extent they can store sufficient personal and business data to create serious breach-of-confidence issues if used by unauthorized individuals. Many of these cards are interchangeable between devices; for example, the card on the corporate camera may contain data that was on a laptop or PDA.



Digital cameras used to create visual records of client assets (trailers, trucks, backhoes, etc.), office and plant layouts are harmless when used for insurance purposes, for example. Such data in the wrong hands, however, could provide details on assets location, alarm systems, and floor or yard plans that could be used to commit a crime.

Many newer photocopiers have hard drives that support copy, print, scan and fax functions. Some copiers can also support user-based access to thousands of stored documents.

Old laptops and desktops rendered obsolete by changes in operating programs often remain loaded with information transferred to newer technology. This data is easily accessible and could be a goldmine of information for the unscrupulous if thrown away.

Let us not forget the storage devices that existed before flash memory such as tapes backups, ZIP drives and floppy diskettes. Much of their information has been transferred to new technologies but kept on the old computers. CD+/-R or DVD+/-R discs can store roughly 700MB or up to 8.5GB of data, respectively. There are probably hundreds of discs in your office containing backup data that is accessible to anyone with an optical drive on their computer.

## Ensure Proper Disposal of Data

Protecting and properly destroying old but still accessible information requires management to re-establish control.

### *Take Inventory*

1. Inventory all old floppies, ZIPs, tape drives, computers, removed hard drives as well as equipment currently in operation.
2. Document the type, location and users of all media.
3. Determine whether the data and/or equipment need to be retained.
4. Determine whether the data was simply archival.
5. Find out whether the data has been migrated to newer equipment.
6. Establish the age of the data.
7. Is older equipment required to read the data?

Once all this has been determined you can decide whether the older data and equipment can safely be destroyed.

### *Understand the Flow of Information*

- What information is being collected?
- What information should be considered confidential?
- Where and on what media is the information stored?
- Is the information on paper?
- Is the information on a centralized server?
- Is the information on individual standalones, laptops, or a combination of all of the above?

This knowledge will tell you where critical information is located and will assist in determining what needs to be destroyed.

### *Manage Data and Its Carrier*

Once all the information has been located, you need to determine the possibility of limiting the media using and storing the data. For example, if data is stored on a main server, how frequently is it backed up, what medium is used and where is it stored?

Laptops, flash drives and other data storage media supplied to staff should be accounted for at all times. Any missing backup disks should be investigated immediately, especially if they contain sensitive information. All changes to equipment such as hard drive upgrades must be accounted for. Retired equipment should be inventoried and stored in a secure location until a decision is made to purge the data and destroy the medium.

Defining the medium recording the original data source and limiting the number of backups to a predetermined protocol will also make it easier to determine where the data resides when the time comes to destroy it. For example, if the original data is on a server and operational procedures require daily saving onto a hard drive and weekly saving onto a DVD or CD securely stored to record disc number, date deposited, date removed and by whom, there should be little need for additional backup. Should it become necessary to retrieve older data the records will be available.

## Disposal

### *Hard Drives*

Hard drives store information magnetically; deletion does not actually remove the data, it simply marks it as "deleted" to be overwritten later. A determined individual could recover the deleted data. Prior to disposing of hard drives, consider wiping the drive with a utility that will overwrite each bit with null data, thus making data recovery that much more difficult.

### *CDs and DVDs*

Rewritable and reusable CDs or DVDs should be reformatted before being reused. Discs that cannot be reused should be shredded.

### *Memory Cards*

If memory cards can be removed from PDAs, cell phones, cameras, etc., remove and reformat them for future use. Resident memory in portable devices should be reformatted and, as a final security, crushed to ensure that the memory cards are no longer useable.

### *Establish and Police Policies*

Staff policies should ensure that all equipment and memory devices are accounted for. Downloading sensitive data to home-office computers or personal laptops should be prohibited without management's permission.

Follow-up procedures should ensure data is erased from personal laptops once the job is completed and the office files are updated. Sensitive data files should be encrypted and password-protected to make unauthorized access more difficult. This will help prevent unauthorized distribution of company data and ensure all data can be destroyed in an appropriate manner.

The proliferation of electronic devices allowing storage of confidential data within an organization is overwhelming. Implementing and adhering to controls on how data is accessed, stored and ultimately destroyed can reduce the risk of unauthorized access to and distribution of sensitive information. ■

# The Stock Market

**D**on't underestimate the dangers or the benefits.

## Investment Criteria

Saving for retirement or for your children's education can often involve some investing in the stock market, a notoriously treacherous place for the experienced and inexperienced alike. Since the autumn of 2008 we have seen a dramatic decline and recovery of world markets that has left many portfolios in tatters. Nevertheless, historical experience has shown that, despite such reversals, the long-run market trend is upward to reflect the growing wealth of the global economy.

Successful investing requires self-discipline and criteria for buying or selling. Software that takes the emotion out of buy/sell decisions is now available to screen stocks to meet the investor's own risk profile. These criteria will determine tolerable risk given your age, net worth, rate of return required to meet your objectives and the time frame for achieving them.

Some of the fundamentals can be summarized as follows:

### *Understand the Various Market Sectors*

The stock market and the indices that measure its performance are broken into sectors such as energy, real estate or technology. Sectoral indexing describes the relative trends in the values investors are prepared to pay for various industries as measured by their willingness to own stock in the major companies that make up the industry.

### *Fundamental Analysis*

Understanding the sector in which you wish to place your future is of paramount significance. Study of the companies in any sector is, of course, fundamental to any investment decision and can even be a lot of fun. Reading annual reports available for free at the companies' web sites enables you to understand a company's financial strengths, weaknesses, and performance. Reading analysts' reports (often available for nominal cost from the online brokers) is also important because the analysts follow events in the sector closely and their opinions reflect what the market is currently expecting from the companies by way of earnings projections.



### *The Price/Earnings Ratio*

The price earnings ratio (or simply P/E) is calculated by dividing a company's projected annual earnings per share by its current price per share. If, for example, the market price of the stock is \$50 per share and earnings for the next year are projected to be \$2.00 per share, the P/E ratio for the stock would be 25 (\$50/\$2.00).

A high P/E implies that investors are looking towards high percentage gain in earnings while a lower P/E says investors are expecting slower growth. The question always is whether the earnings projection on which the current P/E is based is itself justified. That is determined by the earning power of the company in the current economic environment. Any company's P/E should be compared with those of other companies in the same industry and even with those in other industries to see what investors are prepared to pay for different values.

Investments should never be made based upon one financial result, however. Balance sheets, cash-flow positions and income statements are essential components of measuring a company for stability, liquidity and future promise.

Using historical records to evaluate a company for investment potential is just a starting point. A balance sheet with strong assets and low liabilities implies good prospects for the future. On the other hand, losses on the income statement must be judged as a one-time event or the beginning of longer-term problems. The balance sheet must be taken together with the cash-flow statement for the past year to determine whether the company is generating the cash to meet current and future payments. Even if revenue and profits are good, a deteriorating cash position could mean the company's inability to pay bills in the future.



### *Dividend Income*

Earnings growth means not just capital gains from an increasing stock price, but it can also mean a rising stream of dividends. A company's dividend policy can be very important to anyone needing dividend income for living. As part of the investment criteria investors may wish to review the number of times dividends are paid throughout the year and the amount of the dividends paid. This will provide an idea of the return on investment. If the current stock price is \$25 and the company pays out \$0.35 per share per quarter in dividends, the yield is 5.6%. A review of other companies may indicate that they never pay dividends and thus as an investor you would be relying on share value increase to build your portfolio. This may not be acceptable if income is a stated criterion for investment.



### *Use the Tools Available*

Whether you handle your own investments or use a broker you must monitor the results on a regular basis to ensure that your financial goals are being met and that your investment criteria continue to provide the required results. There are powerful online tools available to assist. In addition to the company financial statements and analysts' reports mentioned above, screened results by P/E ratio, dividend yield, and numerous other criteria from reputable sources such as Standard & Poor are also available online for a fee.

Charts are another important way to see the history of a stock's performance. The Toronto Stock Exchange (<http://www.tmx.com/>) provides free charts of the market as a whole and for individual listed stocks for frequencies of one day, one month or one year. Online brokers sometimes provide charting for longer periods. Overlay charting can show trading volumes, dividend payments, stock splits, company comparisons and the relationship of individual stock performances to the overall market indices. Other charts can show changes in balance sheet and income statement ratios as well as cash flow.

### **Risks and Rewards**

The stock market is a difficult place and not for the squeamish. No doubt about that. Nevertheless, the need for asset growth to offset inflation and the need for dividend income to supplement pensions should not be minimized. Knowledge, discipline and the use of the new online tools, however, are the foundation of portfolio management. ■

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*BUSINESS MATTERS* is prepared bimonthly by The Canadian Institute of Chartered Accountants for the clients of its members.

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