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THE PLAYBOOK

HOW TO REMAIN PROFITABLE IN DIFFICULT TIMES

BY DAVID SHUBS

The Canadian economy looks to be stabilizing, with Canadian businesses communicating a generally positive yet cautious outlook. Since July 2009 more than 400,000 jobs have been created and the unemployment rate has dropped to under 8 percent. Firms are currently reporting sales growth and expect this trend to continue over the next 12 months. Businesses report that they are reaching capacity points and therefore anticipate hiring new employees.

Based on this growth and the future outlook for the Canadian economy, the Bank of Canada has raised interest rates 0.75 percent since the summer. However, the Bank understands the delicate nature of this recovery and has accordingly reduced its outlook for future growth.

The lessons of the consumer and the government should not be lost on businesses. For the building industry, the Ontario housing market has been trending upward, yet growth remains uncertain. Current issues facing the Ontario housing market are:

- The effect the HST will have on new home sales.
- How interest rate increases will reduce the mortgage value that households can carry.
- The financial discipline that individuals are displaying. They are not creating the bidding wars that were seen 24 months, or even 10 months ago.

THE CHALLENGE

In the long run, the financial discipline displayed, by both consumer and government, should lead to a more stable economy. However, the short term will likely be defined by volatile markets and shaky consumer confidence. Skittishness and uncertainty within the industry is likely to prevail.

THRIVING IN A DIFFICULT ENVIRONMENT

In these circumstances, it is even more important to make every dollar stretch a little further. *Ontario Home Builder* asked several industry experts to provide general business information for home builders and service providers to the industry. Our participants include lawyers at two different firms, a business specialist, a tax accountant as well as successful industry insiders, who would rather share their insights anonymously. Specifically, we asked all of them how to make a company more efficient.

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FINANCIAL INSIGHTS FROM INDUSTRY INSIDERS

The easiest way to put your company at an immediate disadvantage is to overpay for a property. It is in this early phase that companies can shoot themselves in the foot before they even start. Investing in anything is about a risk/reward tradeoff. Higher returns necessarily require higher risk.

The use of leverage (using borrowed money) increases an investor's potential return on capital. By using other people's money, generally at a lower rate than equity dollars invested, large returns can be made on small initial capital outlays. While the upside is large, the downside is too. Debt payments have the power to cripple the ability of a business to finance ongoing operations. Inability to pay debt can lead to negotiating from a position of need versus a position of power. This can potentially dilute the value of the original equity dollars invested and, in the most extreme cases, even force bankruptcy.

Using options to buy land is another tool used to make investment dollars go further. With options, a small premium is paid for the right to purchase the land within some defined time frame. While this does require a smaller sum to tie up the land, there is no guarantee that the land will appreciate in value during the period that the options are owned. If the land does not appreciate, the options can expire worthless and the payments made to secure the land are lost forever.

In times like this, protecting your downside is of paramount importance. Cash flow is king, so maintaining a strict adherence to budgets is important. Ensuring that any debt that is taken is easily within the budget is crucial to long-term survival.

THE POWER OF EMPLOYEES

MATTHEW WISE, A PARTNER WITH MACDONALD SAGER MANIS LLP

Labour is a critical part of both corporate operations and expenditures. Understanding a corporation's obligation to its employees is important.

When an employee is terminated without cause in Ontario, employment law is generally more favourable to the employee. When the decision to terminate an employee is made, the employer is obligated to provide the terminated employee with reasonable notice or payment in lieu of notice. The Employment Standards Act, 2000, enumerates the number of weeks of notice, or pay in lieu of notice, that a terminated employee is entitled to.

However, employers must be mindful that the notice required by the Act is only a minimum and terminated employees will in most instances be entitled to far more termination pay than what is listed in the Act. The common law contemplates several factors in determining the appropriate amount of notice required. These factors include the age of the employee, the status of the employee and the duration of employment, among others.

One way to minimize an employer's obligations is to include a clause in the employment contract that limits an employer's liability upon termination. While putting a cap

"DON'T LOOK TO JUMP OVER SEVEN-FOOT BARS. . .LOOK FOR ONE-FOOT BARS THAT YOU CAN STEP OVER" WARREN BUFFET

on a terminated employee's entitlements is not always possible, having a well-worded contract can go a long way towards tilting the balance back in favour of the employer.

When termination is not appropriate in the circumstances, another option is to place the employee on a temporary layoff. A temporary layoff can typically last for up to 13 weeks in any 20-week period. However, it is important to note that if a definitive call-back date is not provided to the employee prior to the conclusion of the 13-week period, the employee can treat the temporary layoff as a termination.

While there are no hard and fast rules for an employer to rely upon, with proper planning and advice, employers can minimize their exposure when the realities of the economy make terminations necessary.

HOW DOES CORPORATE STRUCTURE HELP?

DAVID HANICK, A PARTNER WITH OSLER, HOSKIN & HARCOURT LLP

Choosing the most appropriate legal structure for your business can provide significant benefits if structured properly, as well as significant liabilities if constructed improperly. There are three basic business structures in Canada: sole proprietorship, partnership and corporation.

The simplest form of a business is a sole proprietorship in which an individual is the sole owner and is personally liable for its debts and obligations. Since a sole proprietorship is not a separate legal entity, all income and losses accrue to the individual and are taxed as personal income. Given that the continuity of the business is tied to the sole proprietor, its ownership cannot be transferred or inherited.

A partnership exists where two or more individuals undertake a common venture with a view to profit. A partnership is not a separate legal entity and each partner shares in the profits and losses which are taxed as personal income. The extent of liability depends on the type of partnership and whether the individual is a general partner or a limited partner.

The most common business structure in Canada is the corporation, which can be created under either provincial law or federal law. Unlike a partnership and sole proprietorship, a corporation is a separate legal entity which exists separate and apart from its shareholders. A corporation is also considered a separate entity for tax purposes and, consequently, its income is taxed separately from that of its shareholders. Double taxation is created when a corporation's after-tax income is distributed to its shareholders because the distribution is again taxed at the personal level; in certain circumstances tax credits are available to alleviate this burden.

"ONLY WHEN THE TIDE GOES OUT DO YOU DISCOVER WHO'S BEEN SWIMMING NAKED." WARREN BUFFET

A corporation's existence is dependent on satisfying statutory requirements rather than continued involvement of the original owners. Directors, who are elected by the shareholders, have the responsibility and obligation to act in the best interests of the corporation. Generally, a shareholder is not personally liable for the debts and obligations of the corporation. Reasons for the proper corporate structure go beyond liability and transferability.

KEEPING THE GOVERNMENT AT BAY

PETER WEISSMAN, TAX PARTNER AT CADESKY PARTNERS

Structuring your business in a tax-efficient manner can help free up working capital and reduce the need for external financing. With thoughtful structuring you can realize absolute tax savings and obtain tax deferrals (essentially, interest-free loans from the government).

The common practice of running separate real estate projects through separate corporations may not always be optimal. Admittedly, balancing the business and tax benefits of separate ownership is always difficult. In Canada, we do not have the notion of consolidated income tax filings so, where separate corporations are used, losses from one corporation cannot be offset against profits earned in another.

Corporate ownership also requires that each shareholder be bound by remuneration and tax decisions made at the corporate level. For example, if a corporation earns income and the decision is made to bonus the income out to reduce corporate income tax, each shareholder will receive bonus payments, which are treated as salary, and pay the ensuing tax bill. If one shareholder did not require the bonus, they end up paying tax early, and at a higher rate than if the funds were taxed inside the corporation. Where business reality permits, a partnership can allow:

Losses to be offset against profits (absolute tax savings).

For a deferral of income tax (interest-free government loan).

Each partner more flexibility over their own tax planning decisions (absolute savings and deferral opportunities).

Assume that John and Susan have decided to build two condominium complexes. A common structure would be for each project to be developed in a separate corporation. This structure provides creditor protection since creditors of Project No. 1 could not generally access the assets of Project No. 2 (since it would be carried on in a separate corporation). However, any losses that might be incurred, say, on Project No. 1, cannot be used against profits realized on Project No. 2.

If John and Susan are in different personal tax and financial positions they will lose tax savings, flexibility and deferral. For example, if John would prefer to receive salary and Susan would prefer to receive dividends, they will not have the flexibility to accommodate both needs. Finally, corporate tax on the profits will be due two or three months after the company's year-end, depending on certain circumstances.

If John and Susan each created a partnership to develop both projects, the loss from Project No. 1 could be used to reduce the profit from Project No. 2. The partnership does not pay tax. The partnership's taxable income would be allocated to each partner, being John and Susan, or preferably, their personal partner companies.

In the situation described, the allocation of income to John and Susan's partner companies would allow them to make their own tax planning decisions at their corporate level without impacting each other. John's company could declare a salary or bonus to him while Susan's company could choose to pay corporate tax and reinvest the after-tax funds. By 2014, this strategy will defer 21% tax, in Ontario. That's a lot of extra capital to invest.

The use of separate partner companies would allow John and Susan to determine their own income splitting and estate planning structures without involving the other.

Finally, because the partners, not the partnership, pay tax, the use of corporate partners can result in a tax deferral of up to 11 months. If the partnership has a Dec. 31, 2010 year-end and the partner companies have Nov. 30th year-ends, the partner companies will not include the Dec. 31, 2010 partnership income in their income until their Nov. 30, 2011 tax year. This makes tax payable in January 2011 or February 2012 rather than February or March 2010. This partnership structure is one example where advance tax planning can help you save tax and access working capital without even having to go to the bank.

TIMING OF TECHNOLOGY UPGRADES

BOB RIDLEY, A PARTNER WITH BUILDING BETTER HOME BUILDERS

There are at least two schools of thought about the timing of technology upgrades. Some would say that the question is not whether this is the right time to upgrade, but rather what requires upgrading. Others would say that the question is simply one of cost benefit and specifically whether it will cost more not to upgrade than to upgrade. It's a decision between "tried and true" or "latest and greatest."

In general, there really is no time like the present: demand is not so high that there is not some additional capacity for change; business performance is more critical (especially maintaining margins) and improvements now can lead to more efficiencies and a more competitive position in the future. This is tempered by the capacity available for technology change. This is often thought of as the financial capacity (affordability), but it can also be the organizational capacity (human resources), e.g. the availability of properly skilled staff, suitable business processes and/or competing demands.

Technology change should always be guided by a broad strategic plan and it should form part of a business plan. Based upon our experience, the usual objectives of technology change are to address current business issues, support the provision of new services and/or achieve improved operating performance (usually productivity or return).

The key to technology change is to ensure that there is a balance of people, processes and technology. The need for the upgrade, and hence its priority/timing, depends on current performance and the nature of the upgrade. Cost benefit can provide an important indicator of the timing, but don't forget to consider life cycle costs and other longer-term organizational implications, such as (hardware, people, business process improvement etc.). Cost benefit can be affected dramatically by some simpler approaches to meeting technology needs; for example, open source software.

The right time to upgrade your technology is whenever your technology is not supporting your business needs, or is not keeping pace with changes in your business or when you are introducing new products or services that new technology can better support. **OHB**

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