

The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Spring 2002

Non-competition Payments

Based on the successful appeal of the 1997 Tax Court of Canada decision in the *Fortino* case (*The Queen v. Fortino et al*, 2000 DTC 6060), many accountants have been advising their clients that amounts received pursuant to the non-competition provisions of a sale agreement are not income. Unfortunately for these accountants, the *Fortino* victory was in part based on – dare I say – faulty pleadings by the Crown.

For some inexplicable reason, sections 38 and 39 were not raised in the Crown’s pleadings. A last minute attempt to include them failed and the case proceeded based solely on the assertion that the amounts were income under either section 3 or alternatively, under section 14 of the *Income Tax Act*.

The technical deficiency in *Fortino* was overcome in *Manrell*, 2002 DTC 1222.

In what I believe is the correct decision, the Tax Court of Canada ruled that the non-competition arrangement was a “property” within the meaning of the Act, and was capable of being disposed of. The disposition was one of a “right to

compete”. Hence, the amounts received were capital, and the proceeds formed part of the taxable capital gain on the shares.

Related Family Law Matter

In a kind of *Fortino* “copy-cat” case – *Clegg v. Clegg* [2001] 202 D.L.R. (4th) 300 (Ont. C.A.) – a husband appealed a trial judge’s finding that his interest in a non-competition agreement constituted property for purposes of equalization under the *Family Law Act*. His appeal was dismissed with brief reasons.

Shareholder Agreements

Many shareholder agreements, particularly older ones, have a less than desirable “right of first refusal” (ROFR) provision.

A ROFR that gives the party enjoying the ROFR a right to match the price, terms and conditions of a *bona fide* arm’s length market offer is a less than preferable approach.

The reasons are simple. Any prudent prospective purchaser will be less than willing to devote the required resources (time and money) to adequately investigate the acquisition opportunity where they know that

there's another player who can simply match the offer (without investing very many resources) and win the day.

It is unreasonable to download those costs and in all probability, even if an acquiror willing to incur those costs can be found, it is unlikely any offer arising will have been adequately investigated. Where the due diligence process has suffered, the selling shareholder may not realize his or her "true value".

A far superior approach is to require that the shareholder who wishes to sell establish a price and terms, and then propose this to the shareholder holding the ROFR. Usually that shareholder will be given a term of 30 - 60 days for acceptance. If they do not exercise the ROFR, the seller is then free to sell in the open market at a price equal to (or higher) and on terms no less favourable than what was in the ROFR offer.

This forces the selling shareholder to consider his or her price/terms very carefully. It maximizes the value realizable/acceptable, and lays the costs where they belong.

Most certainly this is not a perfect approach, and it too has flaws, but it's definitely better than the "matching" ROFR.

Putting Your Faith in Interpretation Bulletins

Tax practitioners tend to admonish their non-tax practitioner colleagues for relying on Bulletins, Circulars and publications other than the Income Tax Act in researching a tax issue. Given the complexity of the Act, this is often too harsh and unfair.

However, every once in awhile along comes a tax case that reinforces the underlying reasons for this seemingly "high road" approach.

With some exceptions, a corporation whose principal business is to derive income from property will be classed as a "specified investment business" unless it employs more than five full-time employees. If this test is not met, the small business deduction is not allowed and the higher corporate tax rates apply.

Where a corporation was a member of a joint venture or other form of co-ownership, IT-73R5 indicated that the total number of full-time employees who worked jointly for all the co-owners could be allocated to each co-owner in accordance with the co-owner's percentage interest in the property.

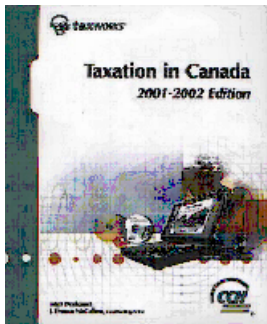
For example, if there were 18 full-time employees and Corporation X held a 30% interest in the joint venture, that corporation would be considered to have 5.4 full-time employees. This

would allow Corporation X access to the small business deduction (“SBD”).

Lerric Investments Corp relied on that IT and claimed the SBD. CCRA however, turned on its own IT and disallowed Lerric’s claim for the SBD.

Lerric lost at the Tax Court of Canada and again at the Federal Court of Appeal (2001 DTC 5169). IT-73R5 has been withdrawn and replaced by (draft) IT-73R6. The new IT expressly denies the fractional full-time employee allocation.

Latest Book



My latest tax book is now available from CCH Canadian.

“Taxation in Canada” is the text of choice in the CGA Program of Professional Studies TX-1 tax course and will make a great addition to your tax library.

Shelf Corporations

There has always been a concern that the shares of “shelf” corporations may not be considered newly-issued treasury shares for the purpose of (among other things) access to the capital gains deduction without meeting the 24-month holding period test. In a technical interpretation

issued December 13, 2001, CCRA indicated that such shares will be considered newly-issued “provided that the shares and assets of the corporation have always been nominal in value (not more than three shares and not more than \$1 per share)”.

Watch Those Multiples!

Where an earnings or cash flow approach is appropriate in valuing the shares of a corporation, an accepted methodology is to multiply those earnings/cash-flows by the inverse of the capitalization rate. For example, if the expected rate of return, given the risk inherent in the business, is 20%, then the multiple is 5 \times . The capitalization of earnings/cash-flows is the same as a discounted cash flow approach taken to infinity.

Deciding on the appropriate capitalization rate (or multiple, if you prefer) is a key decision in valuation. Too often I see accountants, as well as business people and other professionals, applying an inappropriate rate. Most often they’ve read an article, seen a valuation report, heard from a “source”, or otherwise determined in some non-objective manner that a multiple of ‘x’ is generally used.

A business valuation report once crossed my desk that declared “in Canada the appropriate capitalization rate applied to a small business is prime + 5”. Sheer and utter nonsense!

The capitalization rate depends on a host of factors, not the least of which is the existing equity in the business (at fair market value). Saying that earnings are worth 'x' times, without regard to existing equity fails in that it does not consider one of the measures of the risk attached to the business. The existing equity needs to be assessed in both qualitative and quantitative terms.

Consider two businesses, identical in all respects but one. Corp X has existing equity of \$300,000 and Corp Y has existing equity of \$100,000. Using an earnings basis approach, which business has more value?

Indiscriminately applying the earnings capitalization approach will lead you to conclude that each is worth the same:

$$\text{Earnings} \times (\text{say}) 5 = \$ \underline{\text{Value}}$$

It should be obvious that Corp X has more value than Corp Y. You need to delve much deeper and consider, among other things, whether:—

- X should have a higher multiple
- Y should have a lesser multiple
- X might have redundant assets
- Y might need an equity infusion.

Selecting a multiple in isolation leads to an accurate valuation only by accident.

Chartered Business Valuator designation

There are approximately 900 CBVs in Canada and a few others in foreign countries. The CBV designation is bestowed by the Canadian Institute of Chartered Business Valuators to those who have completed the CBV program of studies (six specialized courses), passed the membership entrance examination, and have a minimum of two years full-time valuation experience.

More information on the CBV designation, services and publications provided by the Institute, and its education program can be found at the CICBV web site www.cicbv.ca.

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Readers should not rely on the information provided as a basis for a course of action without first obtaining professional advice.

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