

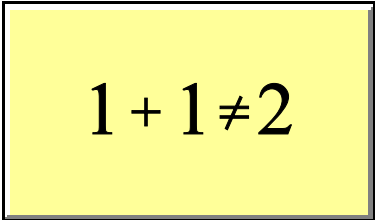
The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Winter 2004

When Capital Cost May Not Be

When a depreciable property is acquired from a non-arm's length taxpayer it is possible that the acquiring taxpayer's capital cost for income tax purposes is less than their actual cost.


$$1 + 1 \neq 2$$

Assume Dad sold a depreciable property to Son for \$300,000 and that Dad's capital cost (and ACB) was \$175,000. Dad has a capital gain of \$125,000. Son's capital cost will be \$237,500, not \$300,000!

Quite simply, Son's \$300,000 capital cost is reduced by one-half of Dad's capital gain (\$300,000 - .5(\$125,000)). This adjustment is logical as it prevents Son from claiming capital cost allowance on an amount Dad never paid income taxes on.

This adjustment — which is found at §13(7)(e) of the *Income Tax Act* — only affects Son's capital cost, his adjusted cost base on the property remains \$300,000. **This adjustment does not apply where the depreciable property is acquired because of the death of the transferor.**

Life Insurance Securing Debt

Bank indebtedness, such as lines of credit, is quite often secured by life insurance held by the bank on the debtor's life. Where the debtor is a private corporation that insurance will usually be on the life of one or more of the principals of the corporation. On the death of the insured the life insurance proceeds will be applied to the bank debt.

Surprisingly (at least it was to me), those life insurance proceeds are **not** added to the debtor corporation's Capital Dividend Account and consequently are ineligible for payout to the corporation's shareholder(s) as a tax-free Capital Dividend.

Deceiving Appearances

Assume you are valuing a business that owns the real property from which the business operates. Also assume that the property is debt free and the only occupancy expenses are property taxes and incidental repairs/maintenance.



The real property has appreciated substantially in value and so the tangible

asset backing (“TAB”) of the business is:—

Shareholder equity	\$ 300,000
Add market value of real estate	800,000
Less net book value of real estate (<u>100,000</u>)	
Tangible Asset Backing	<u>\$1,000,000</u>

The maintainable earnings of the business are \$80,000, which is an 8% return on TAB. By all measures this is less than what is required given the risk in the business.

From that you conclude that the business is either correctly valued at its net asset value of \$1,000,000 or alternatively that the liquidation value method is appropriate and so value is something less. Are you correct?

Pretend for a moment that the business is a tenant, not the building owner, and that the fair rent for the property is \$30,000 annually (taxes are additional). With that assumption the maintainable earnings are redetermined as:—

M/E as before	\$ 80,000
Less rent	<u>30,000</u>
	\$ 50,000
Add tax recovery on rent	<u>6,000</u>
Maintainable earnings	<u>\$ 56,000</u>

Without the real estate the TAB is now \$200,000 (\$300,000 shareholder equity less the \$100,000 net book value of the real property). The return on TAB ($\frac{\$56,000}{\$200,000}$) is now 28%.

Assuming a reasonable return on TAB is 16 $\frac{2}{3}$ %, the value of the business (*sans* land and building) is now determined as $6 \times \$56,000 = \underline{\$336,000}$. Rounding that off to say \$325,000, the goodwill value is \$125,000 (\$325,000 - \$200,000).

The \$800,000 real property value is additional to that \$325,000.

Failing to recognize the building as a hidden redundancy would have caused you to understate the overall value of this company.

Yet Another!

I got to read yet another interesting shareholder agreement last month. This one had the surviving shareholder acquiring the deceased shareholder’s shares from the deceased’s estate. Excellent so far! But then, “ ... *if the price paid for the shares is taxable in the hands of the estate, then the tax payable by the estate shall be paid by the surviving shareholder ...*”.



price paid for the shares is taxable in the hands of the estate, then the tax payable by the estate shall be paid by the surviving shareholder ...”.

Yikes!

Reserve [mis]Calculations

You’ll frequently hear (where there are deferred proceeds) that a capital gain must be brought into income over a five year period at a minimum of 20% of the gain each year. **This isn’t true.**

The reserve mechanism at §40(1)(a) of the *Act* is actually the *lesser of*

- (i) a reasonable reserve, and
- (ii) the 80%, 60%, 40%, 20%, or 0% amount (depending on which year of the five you're in).

There is more than one way to measure a "reasonable reserve" but the generally accepted way is:—

$$\frac{\text{Gain}}{\text{Sale Price}} \times \text{Amount Not Due}$$

Assume that Nguyen sold his property for \$100,000, received \$75,000 down, with a 10-year interest only vendor-take-back mortgage, and his capital gain was \$40,000. His minimum annual capital gains for the current and future four years then are:

- Year 1 - \$30,000
- Year 2 - zero
- Year 3 - zero
- Year 4 - \$2,000, and
- Year 5 - \$8,000.

He could of course choose at any time to recognize a greater amount because the reserve system is an optional mechanism.

And remember, the five-year maximum reserve period becomes 10-years when the property is sold to a child and is land or depreciable property used in a farming business, a share in a family farm corporation or an interest in a family farm

partnership, or a share in a small business corporation.

A Picture's Worth a 1,000 Words

When a taxpayer dies they are deemed to have disposed of all their capital properties at fair market value (ignore the available rollover to a surviving spouse). Capital property includes listed personal property and that includes "prints, etchings, drawings, paintings, sculptures, or other similar works of art".

Now I ask you honestly, when was the last time you (as the preparer of the deceased's tax return) asked the executor whether the deceased owned any of these? When was the last time you saw a tax return reporting capital gains on these? Just something to think about.

Don't Forget!

Transportation employees are allowed a deduction for meal expenses of \$15 per meal, \$45 per day. If the claims are in connection with travel in the United States, those amounts are in American dollars.

The "Bump"

Accountants often advise their clients not to purchase shares because they'll be inheriting the latent income taxes associated with the corporation's existing appreciated capital assets. My view is that advice is often misplaced, most notably because there is usually no planned disposition of those assets in the foreseeable future. You are after all, (I

assume) buying a going-concern and those taxes are so far in the distant future that they aren't material today.

Nonetheless, here is a case where the advice may be relevant.

We'll say that Beatrice owns FARMCO and the principal asset is the farm land which is worth \$1 million. The land has a \$200,000 ACB to FARMCO. If Buyer pays \$900,000 for the shares of FARMCO, they will (indirectly) inherit that \$200,000 ACB. Because of the farm property capital gains deduction Beatrice wants to sell her shares, but Buyer's accountant is saying "don't buy shares". Is there a solution?

Well, there is the obvious one of discounting the share price for the [eventual] taxes on the accrued capital gain. Then there's §88(1)(d) in the *Act*.

Instead of buying the shares directly, Mr. or Mrs. Buyer incorporates Acquisitions Limited and it acquires the FARMCO shares from Beatrice. Acquisitions Limited then amalgamates with FARMCO or FARMCO is wound-up into Acquisitions Limited. The survivor corporation is then entitled (subject to two things which don't apply in this example) to add the \$700,000 difference between the \$900,000 ACB of the FARMCO shares and the \$200,000



cost base of the land to its ACB. So survivor corporation's new ACB on the land is \$900,000. **Caution: If Beatrice and Buyer were related, this approach would not apply.**

Tax Tip

Retiring allowances can be rolled into an RRSP on the basis of \$2,000 for each year of employment before 1996 plus another \$1,500 for each year before 1989 where the employer contributions to a pension or deferred profit sharing plan did not vest in the employee.

A "year" is defined as a stated or named calendar year of employment. So employment from December 1981 to December 1995, is 15 years and not 14 years.

The J Thomas McCallum Letter

Published periodically as information for the accounting, legal and other professional firms who are clients of or referral sources for the tax and valuation practice of

J Thomas McCallum, FCGA, CBV
Whitby, Ontario
1-800-265-2686 or 905-579-0022
www.jthomasmccallum.com

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

© J Thomas McCallum

History of the Capital Gains Deduction (In Case You Forgot or Never Knew)	
1985	\$500,000 capital gains deduction for all capital property introduced but is phased-in for capital property <i>other than farm property</i> at \$20,000 in 1985, \$50,000 in 1986, \$100,000 in 1987, \$200,000 in 1988, \$300,000 in 1989 and \$500,000 in 1990
1988	\$500,000 capital gains deduction for small business corporation shares introduced but capital gains deduction on all other capital property (<i>except farm property</i>) capped at \$100,000
1988	individuals with negative amounts in their eligible capital property pool (“CEC”) can now allocate that income as first being recapture of previous amortization and elect the excess to be capital gains which are eligible for the capital gains deduction
1988	cumulative net investment loss (“CNIL”) introduced which limits access to the capital gains deduction to capital gains in excess of investment income losses since 1987
1992	capital gains deduction eliminated for capital gains on real property (<i>other than farm property</i>) but existing properties continue to be eligible for a pro rata qualification based on period of ownership before March 1992 to date of sale
1994	the \$100,000 capital gains deduction was eliminated entirely but all taxpayers given a ‘last chance’ election to report capital gains accrued to February 22, 1994 and claim any capital gains deduction they had available against those accrued gains



My Upcoming Presentations

Always Fun! Always Informative!

January 12 th	Income Tax Update/Refresher	Oshawa, Ontario	Evening
January 19, 2005	Income Tax Update	St. Louis, Missouri, USA	By Satellite To Edward Jones offices in Canada
February 1-2, 2005	Personal Tax Fundamentals	Toronto, Ontario	Two Full Days
February 8 th	Income Tax Update/Refresher	North Bay, Ontario	Evening
February 9 th	Income Tax Update/Refresher	Sudbury, Ontario	Evening
February 24, 2005	Income Tax Beyond The Basics	Toronto, Ontario	Full Day
March 5, 2005	Income Tax Update/Refresher	Barrie, Ontario	Half-Day
March 16, 2005	Income Tax Update/Refresher	Mississauga, Ontario	Evening