The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Spring 2005

Self-directed Retirement Plans

Under §146.3(6) of the *Income Tax Act* an annuitant of a Registered Retirement Income Fund ("RRIF") is deemed to have received (as income), at the time of death, an amount equal to the fair market value of the property of the RRIF. More often than not this does not present any particular tax issue as there is a surviving spouse, common-law partner or perhaps a physically/mentally infirm dependent child or grandchild.

I've now run across two identical situations where there was no such beneficiary and where the RRIF had been invested in publicly-traded securities. By the time the RRIF proceeds were distributed to the estate there had been a downturn in the market and the proceeds received by the estate were less than the FMV of the RRIF at death (say $80,000 versus $100,000).

What is that $20,000 loss and how is it treated for income tax purposes? I'm not aware of anything in §146.3 that allows the $20,000 decline to be redirected to the deceased's terminal T1 and used to reduce the $100,000 originally included as income. Nor am I aware of anything that would allow the estate to claim this loss.

While §164(6) allows net capital losses incurred within the first taxation year of an estate to be redirected to a deceased taxpayer's terminal T1, there is a question as to whether the $20,000 is a capital loss. This would be the case only where the RRIF (which is a trust) collapses on the death of the annuitant[1], and the property held in the RRIF is distributed to the estate and so becomes capital property in the hands of the estate.

If the RRIF remains intact as a trust (which is what I suspect), the loss realized in the RRIF (from either a sale or a distribution of the securities) would then be, at best[2], a capital loss realized by the trust and capital losses of a trust can't be designated or allocated to a beneficiary (which is the estate). In this case the loss would be a "nothing" for income tax purposes.

Doesn't seem right does it? But whoever said taxes are fair?

Accounting Trivia

Why is the abbreviation for debit "Dr" when there's no "r" in debit? Debit comes from the Latin debere (which means "to owe").

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1. §146.3(3.1) appears to indicate that the underlying trust governing the RRIF ***does not*** collapse

2. If the ACB of the securities was $100,000; if not, then the loss is only an "opportunity loss"

Rule of Thumb Approach Loses (Yet Again!)

"There is absolutely no evidence before me to support such a 'rule of thumb' or industry practice applicable in the case before me", said Justice Henry Vogelsang in *Gwynneth Marlene McLean v. Paul Roderick McLean, 2004 ONSC 12377.* He rejected the proposition that a stock broker's 'book of business' has a value (for Family Law purposes) of 1% of the assets under management.

CRA Home Office Problems

I've recently heard that CRA is disallowing claims for office-in-the home against employment income on the basis that the work space isn't [as required by the Act] "the place where the individual principally performs the duties of the office or employment".

That's fair enough, but CRA is applying this requirement, via a *time spent* test, to situations where there is no employer-provided office and the employee, by necessity, works from home.

CRA is rationalizing this by assigning their usual interpretation of the word "principally" as meaning more than 50% and applying it rigidly to *time spent* in the office. For example, a salesperson is on the road meeting customers five or six hours of the day, leaving only three or four hours actually spent in their home office. CRA says this does not satisfy the "principally" requirement.

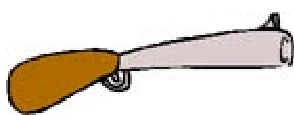
Absolute nonsense, I say! The rule that's under fire was added to the *Act* in 1994 (for 1991 onward) as an anti-avoidance rule to defeat claims for an office-in-the-home by employees who **already have an office provided for them, or available to them, at their employer's place of business**.

Prior to enactment of this provision, employees were successful in winning their cases, arguing that they had weekend and evening work, or 'sensitive' work, that couldn't be done at the employer's office. The enactment of §8(13) was designed specifically to put a stop to these part-time/occasional-use office claims by introducing the "principally" requirement. The clear intention was to legislate what was obvious — *the employee's principal place of employment was the employer's office*.

That history of the "principally" requirement seems to have now been forgotten by CRA. In my opinion, their current approach is outside the intended meaning of "principally" (as it applies to §8(13)) and accountants should be vigorous in disputing any disallowed work-space-in-the-home claims where the basis is *time spent*.

Faulty Shotguns

One of the purposes of a buy/sell provision in a shareholder agreement which is arranged as a 'shotgun' is to provide each shareholder with a level playing field. But, is it level if one shareholder has the financial means to exercise the option and the other does not? Doesn't the shareholder with the financial resources actually have the 'hammer'?



One of the ways around the problem is not to use 'boiler-plate' agreements, but rather to tailor the agreements to the client needs. In the case of unequal financial resources, the near-impecunious shareholder should be given time payment terms while his/her wealthier counterpart should be required to pay cash. At least that would somewhat even-up the playing field.

Capitalized Cash Flow Approach to Valuing A Business

Rather than valuing a business based on a capitalization of its maintainable earnings, it is oftentimes more appropriate to use a capitalization of cash flows.

The valuator's approach to cash flows differs from what accountants might consider cash flows in that repayment of debt is ignored. Why? In determining value, the valuator uses the 'model' of an optimally financed business, hence it would be inappropriate to consider debt repayment as part of cash flows.

Generally then, maintainable earnings ("M/E") are restated to sustainable cash flows by eliminating the capital asset amortization and substituting sustaining capital re-investment.

XYZ Limited - Valuation
(Cash Flow Approach)

	Low	**High**
Pre-tax M/E	$150,000	$200,000
Add amortization	50,000	50,000
	$200,000	$250,000

Income taxes are then provided for at the rates expected to prevail in the future. Many accountants find this step confusing (or at least the logic behind it), but it's logical in that — as you'll see — the valuator separately accounts for taxes relative to the capital assets.

Less income taxes	70,000	87,500
	$130,000	$162,500

Those preliminary cash flows are then reduced by the Sustaining Capital Re-investment ("SCR"), which is the estimated *after-tax* annual expenditure on capital assets required to maintain the operations of the business at its current level.

Less SCR	25,000	25,000
	$105,000	$137,500

The cash flows are then capitalized by the appropriate capitalization rate (stated as a multiplier). It may or may not be that the rate is the same as that which would be used in capitalizing maintainable earnings. A number of

factors would go into that decision.

Capitalized at	7×	6×
	$735,000	$825,000

The amount of tax shield available on the *existing* undepreciated capital cost ("UCC") of the company's depreciable assets is then added to the capitalized cash flows to determine the value of the business. 'Tax shield' refers to the net present value of the income taxes associated with claiming capital cost allowance.

Add Tax Shield	$ 75,000	$ 75,000
	$810,000	$900,000
FMV, Rounded	$800,000	$900,000

Little Known Regulation

What if your client was faced with the net CCA recapture result shown in Exhibit 1 below? It would be profitable to be aware of Regulation 1103(1) which is an election to include all the assets in Class 1 and thereby avoid the recapture (as shown at Exhibit 2) by deferring it. This election to move everything to Class 1 can be made only for Classes 2 through 10, 11 and 12. If there are assets in other Classes, they stay in those other Classes.

Exhibit 1							
Class	**UCC**	**Additions**	**Disposals**	**UCC**	**CCA Rate**	**CCA**	**UCC**
1	$100,000			$100,000	4%	$ 4,000	$96,000
3	$ 35,000		$ 75,000	($40,000)	5%	$ (40,000)	$ NIL
8	$ 12,000	$ 3,000		$15,000	20%	$ 2,700	$12,300
10	$ 30,000			$30,000	30%	$ 9,000	$21,000
					Recapture	$ (24,300)	

Exhibit 2							
CL 1	$177,000	$3,000	$75,000	$105,000	4%	$ 4,200	$100,800

An added beauty of this election is that it's not necessary to add any new future assets to the Class 1. All future additions are recorded in their usual Class. This election should be considered whenever a client is facing a material CCA recapture. The election is available to both individuals and corporations.

Tax Tips

A CGA recently told me that her medically infirm client's claim for the cost of the monitoring relating to a device he wore in case of medical emergency was disallowed as a medical expense.

There is nothing specific in either §118.2(2) or REG 5700 which allows this expense. Nonetheless, I advised her that the monitoring cost (up to $10,000) could likely be claimed as a medical expense as 'remuneration for attendant care'. I see no reason why not.

A client's husband recently moved to the United States and he continued to pay her child support pursuant to their 1994 separation agreement.

The good news for the client was that the child support was no longer taxable to her. Why not? Paragraph 6 of Article XVIII of the Canada-US Tax Convention (1980) specifies that the child support is exempt from taxation to the Canadian resident recipient.

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My Upcoming Presentations

Always Fun! Always Informative!

September 22	**Income Tax *Potpourri*** Income Tax Update Income Taxes at Death Section 85 Rollovers	Saint John, New Brunswick	Full Day
September 23	Business Valuation	Saint John, New Brunswick	Half Day
September 23	Business Succession Planning & Estate Freezes	Saint John, New Brunswick	Half Day