

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Summer 2005

Tax Shield

Tax shield is the description given to the net present value of the tax savings resulting from claiming capital cost allowance ("CCA") under the *Income Tax Act*. While used mainly by business valuers in estimating the cash flows of a business, accountants can find many other uses for this determination, including assisting their clients in deciding on capital asset purchases.

The formula, which accounts for CCA determined on a declining balance basis (an infinite series), is

$$\frac{\text{cost} \times \text{tax rate} \times \text{CCA rate}}{\text{rate of return} + \text{CCA rate}}$$

but because of the half-year rule, the result needs to be adjusted (reduced) by multiplying it by a second formula

$$\left(1 - \frac{\text{rate of return}}{2 (1 + \text{rate of return})} \right)$$

On a proposed \$30,000 Class 10 (30% rate) asset acquisition, assuming a tax

rate of 40% and a 10% rate of return, the tax shield (adjusted for the half-year rule) is \$8,591. The net cost of the asset then is \$21,409.

If the half-year rule didn't apply or if you were calculating the tax shield on an existing undepreciated capital cost ("UCC"), you would only apply the first part of the formula (substituting UCC for cost) and the result is \$9,000.

The same formula can be applied to determine the tax shield from amortizing

eligible capital property or any other declining balance amortization.

The only complicating issue is that you need to estimate the rate of return realizable on assets employed in the business. In estimating this always bear in mind that the rate of return on capital assets is usually less than the overall composite rate of return on all assets employed in the business.

Knowing how to estimate the tax shield is also useful in resolving differences between buyers who want

Accounting Trivia

Last issue we answered why the abbreviation for debit is "Dr" even though there's no "r" in debit. An alternative answer is that "DR" stands for Debit Register and "CR" stands for Credit Register.

to purchase assets and sellers who want a share transaction. All in all, a useful addition to your toolbox.

Going Too Far

Over the years I've seen a countless number of T1 returns where CCA has been used to drive income below the basic personal tax credit threshold. Unless that taxpayer is a dependant on someone else's tax return, that's just a waste of CCA (assuming you're not picking up something, like the OAS supplement, somewhere else).

Ripple In The Pool

One of the more interesting fairly recent (February 27, 2000) changes to the *Income Tax Act* is the option to account for the disposal of an eligible capital property (other than goodwill) *outside* the Cumulative Eligible Capital ("CEC") pool.



Assume an eligible capital property, originally acquired for \$100,000 is sold for \$150,000. If you account for this through the CEC pool, the following results where the pool balance was \$87,500 (there are also other assets in the pool).

CEC	\$ 87,500
\$150,000 × 75%	<u>112,500</u>
Negative balance	\$ <u>25,000</u>

This negative balance is recaptured amortization and it's all taxed as business income.

The optional alternative is to account for the sale of the property outside the CEC pool. In order to do this the property must first be removed from the pool, and this occurs at cost.

CEC balance	\$ 87,500
Remove asset at cost	
\$100,000 × 75%	<u>75,000</u>
Revised CEC balance	\$ <u>12,500</u>

You then account for the sale of the property in the same manner as you would for any other *capital* property.

Proceeds	\$ 150,000
Adjusted cost base	<u>100,000</u>
Capital gain	\$ <u>50,000</u>
Taxable capital gain	\$ <u>25,000</u>

There are several advantages to electing this alternative. Among them is that the gain is now taxable as a capital gain rather than as business income and so the taxpayer can offset this with capital losses which might have otherwise gone unused. If the property is qualified farm property, such as a quota, the income is now eligible for the capital gains deduction.

Also, you'll note with the optional alternative there is still a balance remaining in the CEC pool, so the

taxpayer's income can be reduced by the available 7% amortization (\$875) whereas with the accounting through the CEC pool there is no balance left to amortize.

Averting The Deadly Mix

I was recently engaged by a client who was looking to acquire a business. This client was a reasonably astute business person — although he'd been an employee all his life — and he'd already done a significant amount of due diligence on a potential acquisition.



When he came to me he was already pretty much sold on the opportunity. His bank had helped this along by telling him “it looks pretty good” and informally indicating they would help finance the acquisition. Good thing he sought out help!

When all was said and done, the business would have provided a 7% return on his investment with limited upside potential. My client was shocked when I told him the most he could offer was 25% of the asking price. He protested, but in the end took my advice to “keep looking”.

We averted the deadly cocktail — unrealistic and unfounded beliefs by vendors as to the value of their business

and enthusiastic buyers looking to become self-employed at almost any price.

Deemed Dividend Exception

When a company redeems, acquires or cancels its own shares, the amount received by the shareholder in excess of the paid-up capital of the shares is deemed to be a dividend. Most accountants know that. But like all rules, there is an exception — and many accountants aren't aware of the exception.

Where a subsidiary is wound-up into its parent company and section 88 of the *Income Tax Act* applies, amounts received by **minority** shareholders are considered proceeds of disposition. This results in capital gains/losses and possibly business investment losses, rather than deemed dividends.

Did you know that cost accountants are mentioned in the Bible? Luke 14:28 says “*For which one of you, when he wants to build a tower, does not first sit down and calculate the cost, to see if he has enough to complete it?*”

Choices, Choices, Choices

It's an understatement to say that the *Income Tax Act* is growing in complexity each year. Clients seem to know that but have a misplaced

expectation that their accountant should have everything at their fingertips. And accountants, for some inexplicable reason, also believe that to be true. Well it just ain't so, and the sooner you come to grips with that reality, the more profitable your practice will be.

Take the case of a simple business transaction where your client acquires a licence for a process to be used in their manufacturing business. What is the tax accounting for that licence?

The answer isn't simple and it takes a fair bit of research time to find because it isn't dealt with in one place in the *Act*.

Whether the licence is for a limited time or an unlimited time matters not, the asset is a Class 44 (25%) depreciable property. However, an election can be filed pursuant to Regulation 1103(2h) *not* to include the asset in Class 44. Where then does it go?

If a limited life licence it goes into Class 14 and the CCA is calculated on a straight line basis over the life of the licence. If the licence has an unlimited life then it is an eligible capital expenditure and 75% of its cost goes to the CEC-pool where it's amortized at 7% on a declining balance basis.

Why Qualify Fair Market Value

It's common practice to qualify the fair market value expressed in valuation

reports as excluding consideration of "special purchasers". Those are prospective purchasers who may be willing to pay higher prices because of reduced or eliminated competition, ensured sources of supply or sales, cost savings resulting from business combinations following acquisition, or other synergies.

The qualification recognizes, among other things, that unless a business is exposed for sale in the open market it's speculation as to whether a special purchaser exists and even if they do exist, whether they can be negotiated into paying, and how much they would pay, for the advantages they would realize.

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Comparison of 2004 Combined Federal and Provincial/Territorial Tax Rates							
Jurisdiction	Personal	Small Business	Other Business	Jurisdiction	Personal	Small Business	Other Business
Alberta	39.00%	16.37%	33.87%	Nunavut	40.50%	17.12%	34.12%
BC	43.70%	17.62%	35.62%	Ontario	46.41%	18.62%	36.12%
Manitoba	46.40%	18.12%	37.62%	PEI	47.37%	20.62%	38.12%
NB	46.84%	15.87%	35.12%	Quebec	48.22%	22.02%	31.02%
Nfld	48.64%	18.12%	36.12%	Sask	44.00%	18.62%	39.12%
NWT	42.55%	17.12%	36.12%	Yukon	42.40%	19.12%	37.12%
NS	48.25%	18.12%	38.12%				
Highest personal marginal tax rates and those on small business non-manufacturing income up to \$250,000							



My Upcoming Presentations

Always Fun! Always Informative!

September 22	Income Tax <i>Potpourri</i> 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
October 22	Income Taxes At Death	Chatham, Ontario	Half Day