

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Autumn 2005

Income Trusts

As has been reported in the financial press, the growing popularity of Income



Trusts and Limited Partnerships (forms of flow-through entities) is giving the Department of Finance headaches.

Seems there was \$300 million in lost revenue to the treasury in 2004.

Finance reports that Australia, the UK, and the USA all tax these entities, either wholly or partially, as if they were corporations.

Given the lost revenue, Finance is looking at three alternatives to stem the tide

1. Limiting the deduction of interest expenses by operating entities;
2. Taxing flow-through entities as corporations; and
3. Improving the dividend tax credit.

Which of those three changes would you bet on them implementing?

Difficult Definitions

It's logical to think that when the *Income Tax Act* mentions 'cost amount' that it means 'cost', but as is frequently the case in tax law, the logical answer is the wrong answer.

Cost amount actually refers to what I call the 'tax value'. For example, the cost amount of a depreciable property is its undepreciated capital cost ("UCC"). As depreciable property is pooled into classes, the cost amount of

a particular property within a class of properties is determined by the formula:

$$\text{UCC} \times \frac{\text{capital cost of the particular property}}{\text{capital cost of all property in the class}}$$

All eligible capital property is also pooled, but it's only into one tax account called Cumulative Eligible Capital ("CEC"). To determine the cost amount of a particular property in that pool, the formula is:

$$\frac{4}{3} \text{CEC} \times \frac{\text{FMV of the particular property}}{\text{FMV of all property in the CEC}}$$

Fact!

The five most stolen items in a drugstore are batteries, cosmetics, film, sunglasses, and Preparation H.

Having to determine the fair market value of each property in the CEC pool in order to fix the *cost* amount of a particular property for tax purposes is an extraordinarily complex approach. Why can't the *Income Tax Act* allow it to be based on the cost of the properties in the pool like it does for depreciable property? Cost is much more readily determinable — it'd all be so much simpler. This would be a welcome amendment to the *Act*.

LSVCCs

Ontario has announced that it is ending its 15% tax credit for investments in Labour Sponsored Venture Capital Corporations. Rudy Luukko of Morningstar Canada reports that of the 18 funds his company tracks (each with more than five years of history), only three have “eked out positive returns since inception”, with the leading fund having an annualized return of 1.2 per cent.

Timing Is Everything

A capital gains reserve is not available to a non-resident person, nor to a person



who becomes a non-resident. The latter is interesting in that the taxpayer is disentitled from the reserve the year

before they become a non-resident.

This prevents an emigrant from minimizing their marginal tax rate on the otherwise deferred gain by leaving

Canada early in the new year.

Recently Read

The definition of a tax professional is someone who tells you about problems you didn't know you had, then fixes them in a way you don't understand.

Economic Value Added

Assume you are assisting a client in negotiating the sale of a business to a special-interest purchaser — say a competitor. You have identified and quantified a number of synergies that the prospective buyer will likely realize, and believe that you can assist the seller in negotiating the buyer into paying more for the business.

In advising the client as to what might be a reasonable price he or she can expect, should the expected synergies be valued using the same capitalization rate as is applied to the maintainable earnings (“M/E”)?

	<u>Low</u>	<u>High</u>
M/E	\$ 225	\$ 300
Synergies	<u>25</u>	<u>50</u>
	\$ 250	\$ 350
Capitalized at	<u>8</u> [×]	<u>7</u> [×]
Price	\$ <u><u>2,000</u></u>	\$ <u><u>2,450</u></u>

Clearly, this same rate approach will overstate the asking price and give the client a false expectation. The synergistic benefits are, at best, an estimate and so there's a greater

amount of risk that they won't be realized than the risk attached to realizing the maintainable earnings. A more likely price expectation is:—

	<u>Low</u>	<u>High</u>
M/E	\$ 225	\$ 300
Capitalized at	<u>8×</u>	<u>7×</u>
	\$ <u>1,800</u>	\$ <u>2,100</u>
Add:		
Synergies	\$ 25	\$ 50
Capitalized at	<u>5×</u>	<u>4×</u>
	\$ <u>125</u>	<u>200</u>
Price	\$ <u><u>1,925</u></u>	\$ <u><u>2,300</u></u>

Here the synergistic benefits estimated to be realized from combining the two businesses have been valued at a higher capitalization rate (lesser multiple) to reflect the higher risk attaching to them.

And the Oscar goes to

I see a lot of financial statements in my practice. While 99.9% are problem-free, every so often I see things that are wonders to behold.

The all-time award winner was where the corporation had without fail reported profits every year, *but the retained earnings never changed!*



No, the profits weren't being removed by dividends. The accountant was moving the profits to the shareholder loan account. And yes, the shareholder was drawing that out

tax-free! No one, including CRA, had ever noticed.

The runner-up award goes to the accountant who recorded the automobile standby charge taxable benefit as salary expenses and credited the shareholder loan account.

Honourable mention goes to the accountant who year after year had a line item in retained earnings labelled "Revenue Canada interest \$2".

You Can't Double Count

Your client has sold the shares she held in ABC Limited and realized a loss of \$50,000. ABC is a small business corporation, and so you advise her that the loss is eligible as a business investment loss and one-half of it can be claimed against any source of income (not just capital gains). Might you be wrong?

Let's assume that her adjusted cost base ("ACB") is based on the fair market value of the shares at V-Day. In this case, *and only in this case*, you must reduce her business investment loss by the amount of all **taxable dividends** she's received on the shares *after* 1971.

The reasoning is that the ACB of the shares is based, at least in part, on the retained earnings of the corporation at V-Day. Once those have been removed by the dividends, the ACB is gone.

The Bank of Vernal (in Utah) is the only bank in the world that was built from bricks sent through the mail. Back in 1919 the builders realized that it was cheaper to send the bricks through the United States Postal System (seven bricks to a package) than to have them shipped commercially from Salt Lake City.

What Earnings?

You've normalized¹ a complete business cycle of historical earnings for your client and you also have a management prepared forecast. Now you want to estimate the maintainable earnings — those earnings reasonably expected, year-in year-out (but not necessarily every year) in the foreseeable future.

Do you average those normalized earnings, do you use a weighted average, do you use the most recent year's earnings, do you use the forecast, or is it some combination of these approaches?

The estimate of maintainable earnings is an exercise in professional judgment, not a mechanical process. Here are some guidelines.

Straight Arithmetic Average: applies where earnings are stable and a change is unlikely.

Weighted Average: inconsistent

earnings but there is an overall up/downward trend.

Most Recent Year: there's been a drastic change; the business has matured; there's a continuous upward trend which is expected to continue; or there's been a recent change in product/service.

Forecast: a newer business; change in product/service.

Combination: where none of the other approaches in themselves result in a satisfactory measure on which you are prepared to "hang your hat".

¹ Normalized earnings are those reported in the financial statements which have been adjusted to remove non-recurring, unusual or discretionary items

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

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Comparison of 2005 Combined Federal and Provincial/Territorial Highest Marginal Tax Rates On Canadian-sourced Dividend Income and Capital Gains					
Jurisdiction	Dividends	Capital Gains	Jurisdiction	Dividends	Capital Gains
Alberta	24.08%	19.50%	Nunavut	28.96%	20.25%
BC	31.58%	21.85%	Ontario	31.34%	23.20%
Manitoba	35.08%	23.20%	PEI	31.96%	23.69%
NB	37.26%	23.42%	Quebec	32.81%	24.11%
Nfld	37.32%	24.32%	Sask	28.33%	22.00%
NWT	29.65%	21.53%	Yukon	28.63%	21.20%
NS	33.06%	24.13%			

The taxpayer resident in the highest combined rate province/territory pays **55% more tax on dividends and 25% more tax on capital gains** than the resident in the lowest combined rate province/territory



My Upcoming Presentations

Always Fun! Always Informative!

September 22	Income Tax <i>Potpourri</i>	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
September 30	Business Valuation	Saskatoon, Saskatchewan	Half Day
September 30	Estate Freezes	Saskatoon, Saskatchewan	Half Day
October 1	Income Tax Update & Refresher	Saskatoon, Saskatchewan	Half Day
October 22	Income Taxes At Death	Chatham, Ontario	Half Day
November 10	Section 85 Rollovers	Brampton, Ontario	Evening