

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Winter 2005

Dividend Confusion

In what was seen in most circles as a somewhat surprising move, the Minister of Finance announced that the federal dividend tax credit would be enhanced starting in 2006.

Ostensibly, this change is being introduced to discourage public companies from morphing into income trusts, thus preserving federal (and provincial) tax revenues.

Individual investors (outside of tax-sheltered or tax-deferred vehicles) who invest in dividend paying shares of public companies are the immediate beneficiaries of this manoeuvre.

The federal dividend tax credit is being increased to 19 per cent from 13 $\frac{1}{3}$ per cent of the 'taxable amount' of a dividend, but that amount is, in turn, also being increased to 1.45 \times the actual dividend from the current 1.25 \times . For someone in the highest tax bracket, the net result of this change is a *reduction* of \$5.03 in federal tax on every \$100 of Canadian-source dividends.

Several public companies have already deferred payment of their December 2005 dividend to January 2006 to allow shareholders the improved after-tax result.

The reality though is that Finance's objective will not be totally successful unless the provinces/territories cooperate by also enhancing their dividend tax credit. Finance is suggesting that the provinces/territories increase their dividend tax credit (on average) to 13% from the existing levels which, excluding Quebec, are (on average) 5.8%. It remains to be seen whether the provinces/territories will be that generous.

Eligible Dividends

Only dividends from public companies and resident corporations which are *not* Canadian-controlled private corporations ("CCPC's") are eligible for this new enhanced approach. However, there is an exception.

Dividends from a CCPC which flow from income (other than investment



income) which was subject to the general corporate tax rate *are* eligible for the new approach. This would be active business income in excess of the annual limit, which is currently \$300,000 federally.

While that — a dual gross-up/dividend tax credit system for CCPC dividends — seems simple enough, practically-speaking it really is going to be difficult, especially from a compliance cost perspective. Here are three of the more difficult questions:

1. Will dividends be deemed to flow from higher tax rate earnings before lower tax rate earnings, or vice-versa? From investment income before active income, or vice-versa?
2. Will some taxpayers be faced with a ‘triple’ dividend tax credit calculation because their province/territory has an annual business limit greater than \$300,000?
3. What about pre-2006 retained earnings that were taxed at the higher rates?

Stay tuned to see if this revised dividend tax credit ever gets enacted and/or what the ‘details’ will be, especially where the provinces/territories are going to land.

There are two words in the English language that have all five vowels in order: "abstemious" and "facetious."

Redundant Assets

It’s fair to say that a common error made when valuing a business is failing to recognize and account for redundant assets. This failure can result in a material misstatement of value.

Assume you valued a business with a tangible asset backing (current value of shareholder equity) of \$400,000 at multiples of 6× and 7× its \$100,000 maintainable earnings. The estimated value of the business then is \$600,000 to \$700,000, which also implies that the goodwill is \$200,000 to \$300,000.

A closer examination of the assets of the business reveals that there is a redundant asset valued at \$35,000 which has been included in the tangible asset backing. Should this have impacted on your business value determination?

A redundant asset is defined as one which does not contribute to the earnings of the business. Obvious examples include idled or surplus capital assets. By definition, the value of any redundant assets should be excess to the going-concern value of the business determined on a capitalization of earnings or cash flows

approach.

The correctly determined value of the subject business then is:—

	Low	High
\$100,000 × 6, × 7	\$600,000	\$700,000
Add redundant asset	<u>35,000</u>	<u>35,000</u>
Fair market value	<u>\$635,000</u>	<u>\$735,000</u>

This also changes the amount attributable to goodwill. The goodwill now implied is \$235,000 to \$335,000.

Earnings value	\$600,000	\$700,000
Tangible asset backing	<u>365,000</u>	<u>365,000</u>
Goodwill	<u>\$235,000</u>	<u>\$335,000</u>

While the foregoing adds the full value of the redundant asset to the earnings value, it should really be reduced for any income tax, selling and other costs associated with its disposal.

More is Less?

The amount on which the federal basic personal tax credit is based was retroactively increased for 2005 by \$500. But, the lowest marginal tax rate has also been decreased to 15% from 16%, and so personal tax credits are now based on that lower percentage. Consequently, as quirky as it might seem, the personal tax credit has actually decreased!

The new personal tax credit is \$8,648 × 15%, which is \$1,297, whereas the old personal tax credit was \$8,148 × 16%,

which was \$1,304.

Yes Virginia There Really Is A ...

CRA's policy (Technical News #22) in respect to gifts changed after 2001.



Employees can receive, as a non-taxable benefit, two non-cash gifts per year for special occasions such as Christmas,

Hanukkah, birthdays, marriages and similar.

These gifts, notwithstanding that they are non-taxable (up to \$500 in total) are still deductible to the employer. There is no arm's length requirement, and so this policy is very handy at this time of the year!

Come to think of it, there's another non-taxable gift available. Up to \$500 can be received by employees in a non-cash gift/award for years of service, for meeting or exceeding safety standards, and similar milestones. Again, there's no requirement that the employee be at arm's length.

“stewardesses” is the longest word you type using only your left hand, “lollipop” is the longest word typed using only your right hand, and “typewriter” is the longest word that is typed using only one row of the keyboard.

“Gomer” Goodale?

The Finance Minister did his best imitation of Gomer Pyle (surprise! surprise! surprise!) — sorry if you’re not old enough to remember— in November and caught the Canada Revenue Agency off guard.

CRA had already printed the 2005 T1 income tax returns by the time Mr. Goodale announced the retroactive 2005 tax changes (increase in the personal tax amounts and reduction in the lower rate). I’m told that CRA will not be re-printing the T1 returns, but that they’ll be including an ‘information card’ with the returns telling taxpayers of the changes.

Amounts Due to Related Persons

Near all practitioners are aware that in order to be deductible in the year, most forms of remuneration recognized as a liability must actually be paid within 180-days after the taxation year end.

Less familiar is the three successive balance sheet rule regarding non-arm’s length deductible outlays and expenses. The most common example of this is rent owed by a business to a related person.

Where the amount owing is unpaid at the end of the *second* taxation year following the year the expense was recognized as a liability, the amount becomes income **to the payer** in the *third* taxation year. While those of you

who are accountants might think of this as the *Income Tax Act* version of a ‘reversing entry’ it is not. This is because when the amount is actually subsequently paid it is ***not deductible*** *although it would still be taxable income to the recipient*. Yes, that’s double taxation!

The purpose of this rule is to prevent the possibility of a near-permanent deferral of income where the payer is on the accrual basis of accounting but the payee is on the cash basis.

Fortunately there is an alternative to the payer income inclusion. The payer and payee can file a joint election (T2047) to include the amount owing in the payee’s income in that third taxation year. If this election is filed late then it will still be accepted but 25% of the amount owing will **also** be included in the *payer’s* income. That’s the penalty for filing the election late.

An American Death

Where a deceased person’s capital property passes to their spouse there is a deferral of any associated capital gain as the property is deemed to be disposed of its adjusted cost base.

For this rollover to apply, both the deceased and the surviving spouse need to have been resident in Canada. However, there is at least one exception to that rule.

Under Article XXIX B of the Canada-United States Income Tax Convention (1980) an American resident is deemed, *for the purposes of this rollover*, to be a Canadian resident. To my knowledge, this is the only tax treaty which has such a provision.

Thus an American resident who owns taxable Canadian property, such as a cottage, which is otherwise deemed disposed of at fair market value on death, can take advantage of the permitted rollover.

Comparison of 2005 Provincial/Territorial Dividend Tax Credit					
Jurisdiction	Tax Credit	Jurisdiction	Tax Credit	Jurisdiction	Tax Credit
Alberta	6.4%	Nfld	5.0%	Ont*	5.13%
BC	5.1%	NWT	6.0%	PEI	7.7%
Manitoba	5.0%	NS	7.7%	Sask	8.0%
NB	3.7%	Nunavut	4.0%	Yukon	5.87%

* The effective rate is 8% for someone in the highest tax bracket as the Ontario surtax is calculated after the dividend tax credit

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My Upcoming Presentations

Always Fun! Always Informative!

January 19	Income Tax Update	Oshawa	Evening
February 8 and 9	Personal Income Tax Fundamentals	Toronto	Two Full Days
February 13	Income Taxes At Death	Burlington	Evening
February 18	Business Valuation	Toronto	Afternoon
February 22	Income Tax Beyond The Basics	Toronto	Full Day
March 4	Income Tax Update	Barrie	Half Day
March 15	Income Tax Update	Mississauga	Evening