

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Spring 2006

That Bites!

I recently was asked to comment on the reasonableness of the asking price for a small business. The price had been established by the vendor's accountant and I was provided with the schedules he'd compiled in support of the asking price (summarized below).



	<u>2005</u>	<u>2004</u>	<u>2003</u>
Reported pre-tax earnings	\$75,600	\$48,600	\$42,500
Adjust management salary	-	(4,000)	19,000
Other adjustments	12,900	7,900	12,700
(Gain)/loss on assets		(8,400)	600
	<u>\$88,500</u>	<u>\$44,100</u>	<u>\$74,800</u>
Income taxes	\$16,800	8,400	14,200
Adjusted income	<u>\$71,700</u>	<u>\$35,700</u>	<u>\$ 60,600</u>

Maintainable earnings (3-year average): \$56,000

Value (asking price): \$280,000 (5×)

That schedule appeared to be a reasonable presentation of maintainable earnings. However, reconciling it back to the financial statements revealed a serious error.

Actual management salaries were \$100,000 in 2005 (which was assumed to be the reasonable amount), \$104,000 in 2004 and \$81,000 in 2003. So, the normalization adjustments should have been *plus* \$4,000 in 2004 and *minus* \$19,000 in 2003. A totally different

picture then emerges because the adjusted 2003 income is really only \$29,800.

The correct maintainable earnings (based on a 3-year average) are \$48,000, not \$56,000, and the indicated "value" or "asking price" should be \$240,000. Which, if you're curious, is still far too high for this particular business. The somewhat embarrassed accountant is now re-positioning himself and presenting that the "value" is really supported by 4× the 2005 results.

What's the old saying? If the facts don't support the result - change the facts!

"bookkeeper" (including its cousin "bookkeeping") is the only word in the English language which has three double-letters in a row

Investing In Yourself

The shares of a small business corporation are qualified investments for an RRSP. So why don't business owners have their RRSP invested, at least partially, in shares of their own corporations? The answer is relatively simple.

Depending on the category within which the shares fall, the shares are qualified *only if* the RRSP annuitant is not a “connected” or a “designated” shareholder. Both of these terms mean someone who owns 10% or more of the shares of any class. Given that low threshold, it’s impossible for a small business corporation owner to qualify.

Interestingly, a person who is at arm’s length with the small business corporation can exceed the 10% threshold, but in that case the maximum investment which can be made is \$25,000. If the 10% threshold isn’t exceeded, then there is no dollar limit on the permitted investment.

Given the liberalization of RRSPs in the last few years — home buyer plans, life long learning plans and foreign property investments — maybe it’s time for the government to re-visit these small business corporation investment restrictions?

Personal Injury Damages/Awards

One of the principles enshrined in Canadian tax law is that personal injury



awards are not taxable, whether received as special damages or general damages. This tax exempt status applies to settlements as well as court awards, and it includes pre-judgement interest.

Where the taxpayer is a minor then the exemption goes beyond the award itself, and this is provided by statute rather than by “principles”.

Under §81(1)(g.1) of the *Income Tax Act* all income, including capital gains, earned from any property acquired with the award/settlement is tax exempt up to the end of the year in which the taxpayer turns 21 years of age. Under paragraph (g.2) this includes any income on re-invested income.

The tax exemption for capital gains is further enhanced by §81(5). It allows the taxpayer to elect to have disposed of any related capital property on the day before their 21st birthday at fair market value and to have re-acquired it at that value. This then ‘locks-in’ the tax exemption for the accrued capital gain.

While there is no word that is a true rhyme with “orange” (although “lozenge” is a half-rhyme) “silver” is also a word which doesn’t have a true rhyme

Change of Use

Where there is a change in use of a capital property, generally there is a deemed disposition of the property at its fair market value along with a deemed re-acquisition. Whether or not income taxes are exigible at that point on any accrued gains depends on if

there is a deferral provision available in the *Act*. Such a deferral is available, for example, at §45(3) where a rental property (on which no capital cost allowance has been taken) has been converted into a principal residence.

The §45 change of use provisions apply where a property has been acquired for income producing purposes and subsequently becomes used for some other purpose, and *vice versa*. A near-identical provision exists at §13(7) for depreciable property.

The Act only contemplates conversions from/to income-producing use. So what happens where there is a “change of use” of an income producing capital property, say a rental property, to an inventory? The Act is silent on this conversion, but we all recognize that something must be accounted for because capital gains are only half-taxable whereas inventory is fully taxable.

CRA’s view (IT-218R) is that there is a *notional* fair market value disposition and re-acquisition of the property at the time the property is changed to inventory. No income arises on this notional disposition. It is merely used as a “measuring or separation point” to establish the split of the future actual sale proceeds between capital gains and business income. For example:—

Proceeds	\$ 1,400,000
FMV at conversion	<u>900,000</u>
Business income	\$ <u>500,000</u>

FMV at conversion	\$ 900,000
ACB	<u>600,000</u>
Capital gain	\$ <u>300,000</u>

If capital cost allowance had been taken during the time this was a rental property, any recapture of that CCA is brought into income the year the property is actually sold and *not in the year of the notional disposition*. During the time the property is inventory, no CCA is allowed.

An American billion is 1,000,000,000, but this is really 1,000 million or a “milliard”. A true billion - at least by British or arithmetical standards - is a million million or 1,000,000,000,000.

Quality Counts

Selecting the capitalization rate to apply to earnings is arguably the most difficult step in the valuation of a business. One of the factors which go into the selection is the risk inherent in the business. This is why you cannot choose the capitalization rate in isolation from consideration of the tangible asset backing (“TAB”) of the business.

Tangible asset backing is defined as the aggregate fair market value, determined under a going concern assumption, of all tangible and identifiable intangible assets, where the latter have values that can be separately determined, less all liabilities. More simply, it is the current value of the shareholder equity (excluding

unidentifiable intangible assets and assets unrelated to operations).

In considering the TAB when choosing the capitalization rate you must look to both its quantity and its quality. If two business are identical (except for the composition of their TAB), does that mean they have the same value? Not necessarily.

Assume business A has the same \$700,000 TAB as business B, but that business A's TAB includes well situated real estate whereas business B is equivalently invested in rolling stock. Business A should have more value than Business B because of the quality of its TAB (less risk inherent in the business). So, A's \$200,000 earnings might be capitalized at 6.5× whereas B's \$200,000 earnings might be capitalized at 6×, which gives A an additional \$100,000 value.

Assessing the quality of TAB is done objectively by measuring the liquidation value of the business. Business A should have a higher liquidation value than B, and so there is less going-concern risk in A. Hence, the higher multiplier.

The only word in the English language that ends with "mt" is "dreamt"

The Association "Trap"

Associated corporations need to share their annual \$300,000 (federal amount) small business limit. There is a series of objectively determinable rules at §256(1) of the *Act* outlining when corporations are associated.

The association rules though go beyond what's found at §256(1) and include the following at subsection (1.4):—

"For the purpose of determining whether a corporation is associated with another corporation with which it is not otherwise associated, where a person ... has a right at any time under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, (a) ... to acquire shares of ... a corporation ... the person ... shall, except where the right is ... contingent on the death, bankruptcy or permanent disability of an individual, be deemed to own the shares at that time ..."

This provision is broad enough to cover most buy-sell (shotgun or put/call) arrangements commonly present in shareholder agreements. It is only through the good graces of CRA — see IT-64R4 — that it isn't usually applied.

Despite CRA's stated assurance this provision still represents, in the right circumstances, a dangerous trap for the unwary.

Federal Small Business Limit History		
Year	Limit	Comment
pre-1961	\$25,000	Applying CPI changes results in the 1961 limit being equivalent to \$241,000 today; but the 1976 limit is equivalent to \$535,000 today.
1961	\$35,000	
1972	\$50,000	
1974	\$100,000	
1976	\$150,000	
1980	\$200,000	
2003	\$225,000	
2004	\$250,000	
2005	\$300,000	

The limits shown for 1972 through 1980 were available only if accumulated small business earnings did not exceed, respectively by year, \$400,000, \$500,000, \$750,000 and \$1 million. This accumulation was called the Cumulative Deduction Account and it was repealed in 1984.

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



My Upcoming Presentations

Always Fun! Always Informative!

March 15	Income Tax Update	Mississauga	Evening
May 11	Federal Budget Review	Toronto	Evening
September 16	Corporate Re-organizations	Brampton	Full Day
	(Tentatively)		
September 23	Section 85 and Estate Freezes	Waterloo	Two Half Days