

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Summer 2006

Uh Oh!

The Finance department continues to slug away at drafting the legislation regarding the enhancement to the dividend tax credit. What's taking time is the difficulty surrounding its application to Canadian-controlled private corporations. There are several complexities, including that eligible dividends (those grossed-up 1.45×) only flow out of active business income in excess of the \$300,000 annual business limit.

The new tax credit is apparently more likely to be 18.97 per cent rather than the 19 per cent that's been commonly mentioned by Finance. That revised number is determined as $\frac{11}{18}$ of the new 45 per cent gross-up, which works out to \$27.50 per \$100 of actual dividends.

Manitoba and Quebec are the only provinces which have announced their new dividend tax credit rate on eligible dividends. Manitoba's new tax credit is 11 per cent (up from 5 per cent) and Quebec's is 11.9 per cent (up from 10.83 per cent).

What I don't think anyone expected is that both of those provinces have

decreased their dividend tax credit on ineligible dividends (those still subject to a 25 per cent gross-up and a 13 $\frac{1}{3}$ per cent tax credit). Ineligible dividends include those coming out of small business tax rate earnings.

Manitoba's new tax credit on ineligible dividends is phased in over two years and will be 4.87 per cent in 2006 and 3.67 per cent in 2007 (*down* from 5 per cent), while Quebec's is 8 per cent (*down* from 10.83 per cent).

Given that two provinces have decreased their tax credit on ineligible dividends can we assume the others will be following suit? This also leaves me wondering if the federal government is contemplating doing the same. **These decreases are really back-door tax increases on small business, and I don't recall that ever being mentioned as part of the new dividend tax deal.**

Answer ≠ Question

There is a tendency in the business press when reporting on corporate acquisitions to indicate that the acquisition cost was \$500 million "and



included the assumption of \$500 million in debt, bringing the total price of the deal to \$1 billion". The selling shareholders of course only get the \$500 million and that's really their "price".

Maybe there's a lesson here for accountants and business valuers?

We report on share value, not asset value, and small business owners often get confused by that. Their question is usually "what's my *business* worth?" and so the answer that their *shares* are worth \$300,000 can frustrate them because they had a much larger amount in mind. It's all in the question versus the answer presented isn't it?

If we reported something along the lines of "... the value of your shares in XYZ Limited is \$300,000, and we expect that the price realizable for your business as a whole would be \$500,000 given that the purchaser would be assuming the existing \$200,000 in liabilities/debt ..." would this improve the business owner's understanding?

Family Business Scholarships

If a son or daughter doesn't work in the family business because they're attending university full-time, there isn't an opportunity to split income by paying them a reasonable salary. *But*, what if the business gave



them a bursary or scholarship?

I'm not aware of any prohibition against this approach, including the deductibility to the business of the scholarship or bursary, other than the "reasonableness" test found at section 67 of the *Income Tax Act* and satisfying the "outlay or expense to earn an income" test at paragraph 18(1)(a) of the *Act*.

Given that it's now proposed that scholarships and bursaries are totally tax-free (requires full-time enrolment) it seems that this may be something not to be overlooked in tax planning.

Post-emigration Loss

With a handful of exceptions, taxpayers have a fair market value deemed disposition of their capital property on emigration. Is there a Canadian tax consequence if that taxpayer ultimately realizes a loss (post-emigration) on an actual disposition of that property?

The answer depends on whether the particular capital property is a *taxable Canadian property* as defined at subsection §248(1) in the *Act*. I'll use the shares of a private Canadian corporation as an example (shares of a public corporation generally aren't taxable Canadian property).

Assume the following was the case at the point of emigration:—

FMV at emigration	\$ 150,000
ACB	<u>40,000</u>
Gain	<u>\$ 110,000</u>

That gain is taxable on emigration, but let's say our client only realizes \$60,000 for her shares sometime after she's left the country.

As the shares are taxable Canadian property she has a loss for Canadian tax purposes of \$90,000 (\$60,000 minus their \$150,000 adjusted cost base). Not



having any other gains in the year, the first reaction is that this capital loss is essentially useless.

Fortunately the *Act* allows her to **amend her year of departure tax return**, revising the reported proceeds to \$60,000, leaving her with a \$20,000 capital gain in that emigration year. Her proceeds for the shares are then also adjusted in the year of actual sale to \$150,000, which with an ACB of the same amount, leaves her with a capital gain of \$zero.

While this is 'in effect' a carry back of the \$90,000 capital loss it's important to realize that it's not actually that.

The carry back of a capital loss to a previous year is limited to three years, but there is *no limitation* — except that it only applies to deemed dispositions on emigration occurring after October 1, 1996 — on the number of years which

have passed to which you can apply this 'revised proceeds' approach.

Note also that while I've used the entire \$90,000 loss in adjusting the previously reported proceeds in the example, a lesser amount can be selected. A lesser amount might be appropriate in several circumstances.

Debt or Equity?

In valuing the shares of a business you can treat shareholder loans as either debt or equity. The choice of which approach is appropriate depends on a number of factors, but those are outside what I want to examine here.

If the loans are treated as debt then it's most likely that (assuming they are interest free advances) you should impute an interest expense when estimating the maintainable earnings of the business. This will affect the determined value of the shares, but not the presentation of your valuation conclusion:

Estimated FMV of shares \$200,000 to \$250,000

Where the loans are treated as equity (now you don't impute interest) then you should present your valuation conclusion differently:

Capitalized earnings	\$300,000 to \$350,000
Less shareholder loans	<u>100,000 to 100,000</u>
Estimated FMV of shares	<u>\$200,000 to \$250,000</u>

If the answers (share value) should come out approximately the same, then it's fair to ask "what's the big deal

about choosing one approach (debt or equity) over the other?”.

Well, consider that under the debt option both maintainable earnings and tangible asset backing (adjusted shareholder equity) will both be less than each is with the equity option. So, what changes is the capitalization rate.

Consequently, the approaches are really a complement to each other and test whether or not the capitalization rate you've chosen is appropriate given the financing method used in the business. In short, it's a tool. Another way of 'validating' the accuracy of your valuation conclusion.

Snooze You Lose

One of the major conditions for recognizing an allowable business investment loss (“ABIL”) is that the uncollectible debt must be due from a small business corporation (“SBC”).

A SBC is defined as a Canadian-controlled private corporation with all or substantially all (CRA says that means 90% or more) of its assets used in an active business. [note the present tense of the definition]

For the purposes of recognizing a debt as an ABIL, the subject corporation needs to have been an SBC not later than 12-months earlier. This allows a 'window' (during which the corporation wouldn't meet the SBC definition) in which to establish the non-collectibility of the debt. If the time when the debt is established to be a bad debt falls outside

this time window, then it's too late for the bad debt to be an ABIL.

Another example of this 12-month window is where the uncollectible debt arises from the shareholder's guarantee of the corporation's debt. CRA's view (Interpretation Bulletin 484R2) is that



a debt **does not arise** between the corporation and the taxpayer *until a payment is made*. That is, the guarantee alone does not

create a debt. So again, if the taxpayer doesn't act within the 12-month window, they will be out of luck as far as claiming an ABIL.

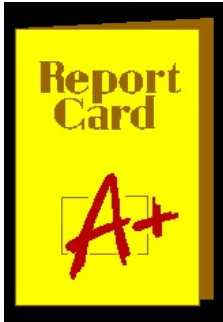
Pursuant to subsection 39(12) of the *Act*, a payment made (even those made after the 12-month window has expired) under a guarantee is deemed to be a debt due from an SBC *if* (a) the payment is to an arm's length person, **and** (b) the corporation was a SBC *both at the time* the corporation incurred the debt *and* at any time in the 12-months preceding the time the *first* payment is made under the guarantee.

More Right?

I recently reviewed a valuation prepared by an accountant. Notwithstanding that he'd made near-countless errors, he actually had arrived at a reasonably accurate conclusion, although it was nothing

more than a fortunate (for him) coincidence.

He took great pleasure at pointing out the 'accuracy' of his valuation answer, and I of course took great exception to his pleasure. Only when I put it in the following terms did he see my point.



A client brings you a set of books which shows his or her profit as \$68,000, but the

books are really a mess. It takes you, as an accountant, and bringing all your skills to the task, 15 hours and 32 adjusting entries to correct all the errors and get the books 'right'. **But, lo and behold**, the final 'right' profit as determined by you is the same \$68,000.

So while the client, like my valuation accountant, got the right answer, they didn't get there correctly. Their 'right' answer was really wrong. It isn't the accuracy of the answer which makes you a professional, it's knowing how to get the right answer.

Old Is New

The 2006 federal budget introduced a new employment tax credit, which begins on July 1st. The base amount for the credit is \$250 in 2006 and \$1,000 in 2007. Think this is really something new? Think again! It's just an old idea re-cycled.

Employment Tax Deduction or Credit		
Year	Limit	Comment
2007	\$ 1,000	The deduction was first allowed in 1972 and repealed in 1988; in 2006 it's back as a tax credit
2006	\$ 250	
1988 - 2005	\$ N/A	
1979 - 1987	\$ 500	
1977 - 1978	\$ 250	
1972 - 1976	\$ 150	

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My Upcoming Presentations

Always Fun! Always Informative!

June 24	Federal Budget 2006	St. Jacobs, Ontario	Morning
September 16	Corporate Re-organizations	Brampton	Full Day
September 23	Section 85 and Estate Freezes	Waterloo	Two Half Days
Either October 27 or 28	Essentials of Corporate Tax	Oakville	Full Day

Also tentatively scheduled to present a Tax Update at the CGAO Public Practice Convention on September 22, 2006