

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Autumn 2006

Policy Changes at CRA



The following two policy changes were announced in Technical News #31R2.

Foreign tax credit

American social security taxes paid by an employee qualify for a foreign tax credit as a “non-business income tax” and CRA has previously confirmed that German and French social security contributions also qualify for a foreign tax credit.

From 2004 on only U.S. “FICA” taxes will be eligible as a foreign tax credit. Other contributions to a foreign social security by an employee resident in Canada will continue to be eligible for a foreign tax credit only if:

- The employee is compelled to make the contribution under legislation, and
- It’s reasonable to conclude that the employee will not be entitled to any financial benefit from his/her contribution because the foreign employment was temporary and for a short time.

Single-Purpose Corporations Holding U.S. Real Property

The policy has been *not* to assess a taxable benefit, but CRA now believes that amendments to the Canada-U.S. Tax Convention have resolved many of the U.S. estate tax issues which were [possibly] avoided by use of a single-purpose corporation, and so

From 2005 on the “no-benefit policy” will *not* apply to

- new property acquired by a single-purpose corporation, or
- a person who acquires shares of a single-purpose corporation (other than because of the death of a spouse/common-law partner), *but*
- the existing policy will continue to apply to renovations and additions to dwellings acquired before 1/1/05.

It’s interesting that the extended “no-benefit policy” does not recognize shares passed to a child on death.

Case Corner

In *Belkin, 2006 DTC 2016* the Tax Court of Canada found that a computer was a musical instrument.



In *Gilbert et al, 2005 DTC 1579* the Tax Court of Canada found that in

determining a shareholder's vicarious liability for a corporation's taxes, that the value of a dividend was to be reduced by the personal income taxes payable on the dividends.

In *Magnussen Furniture Inc v. Mylex Ltd*, 2006 CanLII 5309 the Superior Court of Ontario enumerated three considerations to be given to a claim for lost future profits:—

1. established with reasonable certainty and precision on a balance of probabilities, in which case damages are fully recoverable;
2. established only as a reasonable possibility which to some extent would have materialized, in which case a reduced or moderate sum may be awarded; and
3. so conjectural that it would be wrong to award any damages.

In *Ford Motor Company of Canada Ltd v. OMERS*, 2006 CanLII 7665, the Ontario Court of Appeal rejected a claim for inclusion of amounts in fair value to compensate for past oppression. The Court though did accept the Superior Court's inclusion of a \$52.36 per share "go forward" amount, reasoning that a potential purchaser of Ford Canada would have negotiated a "fair transfer pricing system" with Ford USA.

Sometimes Value is Clear

I recently came across a tax file where the accountant had valued (for the deemed disposition at death) the special shares of a private company as being equal to their redemption value.

The accountant did not perform a valuation, but rather merely calculated that the redemption amount of \$10,000 per share × the number of shares, equalled value.

A close look though at the financial position of the corporation clearly showed that the company did not have the net assets to cover the full redemption amount. Consequently, the shares should have been valued at something less than their redemption value. In this particular case it was something *substantially* less.



Questionable Freeze?

An estate freeze is oftentimes a very effective tax plan. Generally the approach to freezing is pretty much 'vanilla'. However, if the designer blindly follows the text book approach, she or he can find themselves unintentionally shortchanging the client. Take the case of Max.

Max owns OPCO, an active business corporation, which has been valued at \$400,000. Tax Adviser has frozen Max's common shares by swapping

them for preferred/special shares which are redeemable/retractable for \$400,000. Tax Adviser also had Max utilize the capital gains deduction on the freeze so the shares now have a 'locked-in' ACB of \$400,000.

Let's assume that Max's intention is to [eventually] retract the shares. His income tax position will be:—

Deemed dividend	\$ <u>399,900</u>
Capital loss	\$ <u>399,900</u>

The deemed dividend will attract income taxes of about \$125,000.

What seems to have gone wrong is that proceeds of disposition, which could have been received tax-free because of the capital gains deduction, have been converted into a taxable dividend.

It's also *possible* that in this particular case Max should not have used up his capital gains deduction on the freeze, but that's another story, for another day.

If instead of freezing his common shares, Max had instead sold them to his children, he'd realize the \$400,000 in his pocket. But, that's not the whole story is it?

To have \$400,000, the children have two possibilities:—

1. they've already earned the money and paid tax on it, leaving the \$400,000 as after-tax dollars sitting in a bank, *or*

2. they have to withdraw it from the company and pay tax on the withdrawal.

There is really no difference between the children's two situations (#1 only feels different because the taxes were long ago). Actually, come to look at it, it's all really only a question of "who" should pay the tax — Max or the children.

Let's make A Deal!

Subsection 4(2) of the Barbados Income Tax Act says "*notwithstanding* [the section charging that a corporate tax is payable] *no tax is payable by a company operating in Barbados where an agreement is entered into between that company and the Government of Barbados for non-payment of such tax.*"

Now, where else in the world can you get a deal like that?

Capitalization vs. Discounting

Are capitalization rates and discount rates the same thing? The answer can be confused by the fact that a capitalization rate is really a discount in perpetuity. The real answer though is that they are similar, but different. Here's an illustration.

Assume a business is valued at \$2.4 million based on a capitalization rate of 12.5% ($8 \times$ \$300,000 of cash flows).

Selecting an appropriate capitalization rate is never an easy exercise and it's

compounded by the fact that, where appropriate, it includes a growth factor. That is, any anticipated growth in annual earnings is a consideration (one of a great many) in choosing a capitalization rate. Let's assume in this case that annual growth was assumed to be 4%.

If instead of valuing this business based on capitalized cash flows we instead

used a discounted cash flow ("DCF") approach, would we use a discount rate of 12.5%?

The answer is no. In the DCF approach, earnings growth is included in the projected cash flows to be discounted. Applying the same rate to those cash flows as was used in capitalizing cash flows **would amount to double counting.**

**Sample Co Ltd
Statement of Cash Flows**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4 on</u>
Cash flow (4% annual growth) Capitalized at 12.5%	\$300,000	\$312,000	\$324,000	\$ 337,000 <u>8×</u> \$2,696,000
Present value factor (16.5%)	<u>0.86×</u>	<u>0.74×</u>	<u>0.63×</u>	<u>0.63×</u>
Present value	\$258,000	\$231,000	\$204,000	\$1,698,000

Net present value (rounded) \$2,400,000 [same as value per capitalized cash flows]

When using the discounted cash flow approach, to arrive at the same result as the capitalized cash flow approach, we had to use a discount rate of 16.5% to adjust for the 4% earnings growth assumption.

In summary then. A capitalization rate is used to convert a *single* number into a value, whereas a discount rate is used to convert a *series* of numbers into a value.

Carry Forwards

The 2006 Federal Budget extended the non-capital loss and investment tax credit carryforward period to 20 years

from 10 years. This new period applies to losses and ITCs incurred/earned in taxation years ending after 2005.

There are now three pools of non-capital losses:—

- seven year carry forward for those prior to 23/3/04;
- 10-year carry forward for those after 22/3/04; and
- 20-year carry forward for those after 31/12/05.

All part of the program to simplify taxes!

Where The Action Is

2005 GDP Increase ¹		New House Price Increase ²	
Alberta	5.2%	Calgary	56.0%
NFLD/LAB	5.0%	Edmonton	29.7%
B.C.	4.0%	Winnipeg	9.7%
Manitoba	3.5%	Regina	9.3%
SASK	3.2%	Halifax	6.7%
Ontario	2.7%	Hamilton	6.0%
Quebec	2.2%	Vancouver	5.4%
N.B.	2.5%	St. John's	5.2%
N.S.	2.0%	Montreal	4.5%
PEI	2.0%	Kitchener	4.3%

1 Bank of Montreal (BMO)
2 July over July, Statistics Canada

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My Upcoming Presentations
Always Fun! Always Informative!

September 16	Corporate Re-organizations	Mississauga	Full Day
September 22	Income Tax Update	Toronto	Morning
September 23	Section 85 and Estate Freezes	Waterloo	Two Half Days
October 20	Income Tax Update	Sarnia	Morning
October 27	Essentials of Corporate Tax	Oakville	Full Day
November 17	Income Tax Update & Refresher	Thunder Bay	Full Day
December 14	Business Valuation	Oshawa	Evening

Also expecting to have a presentation in the Burlington/Hamilton area but the date/topic is not set yet. A Tax Update is also scheduled for Oshawa the evening of January 23, 2007. Other presentations have been booked for January to May 2007 in Toronto, Oshawa, Mississauga and these will be detailed in the December 2006 newsletter.