

The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Summer 2002

Exchange Rate Exemption

I recently read a review of a ruling from CCRA's Income Tax Rulings Directorate that left me scratching my head. The summary of the ruling indicated that their view is that the 'correct' computation of a capital gain considers the exchange rate at both the time of purchase and the time of sale (and I concur with that). The example used was:—

One hundred U.S. PubliCo shares acquired at \$10, when the exchange rate (for a Canadian dollar) was \$1.50, then sold at \$20, when the exchange rate was \$1.667. Apparently, CCRA ruled that the capital gain would be \$1,834, determined as:

$$\begin{aligned} 100 \times \$20 \times \$1.667 &= \$ 3,334 \\ 100 \times \$10 \times 1.50 &= \underline{1,500} \\ \text{Capital gain} &= \underline{\underline{\$1,834}} \end{aligned}$$

That is not correct! Subsection 39(2) provides individuals with an exemption of \$200 against exchange gains/losses, so the correct gain is \$1,634.

Technically, the taxpayer has a capital gain on the shares of \$1,500 and a separate \$334 exchange gain, of which \$200 is exempt, leaving a net exchange gain of \$134.

This exemption — albeit tiny — is frequently overlooked, and many taxpayers probably pay about \$45 too much tax every year. Hopefully neither you nor your clients are one of them.

Value by Rules-of-Thumb

For many kinds of business, certain industry rules-of-thumb exist as to the value of the business. These rules-of-thumb are really nothing more than rough approximations, but unfortunately many accountants and business owners use these to establish value.

Rules-of-thumb have many shortcomings and can be downright dangerous in the hands of the uninformed. Just consider the following questions about any particular rule-of-thumb:—

- is it applicable irrespective of whether we are in a low or a high interest rate environment?
- what if the economy (generally or locally) is in an up-turn or a down-turn?
- does it apply regardless of geographical differences (urban

centre versus small town, province 'A' or province 'B')?

- does it apply irrespective of whether the particular business is reasonably profitable, marginally profitable, breaking even or losing money?
- does it apply equally to a matured business and to one which is in a growth phase?
- does it measure net realizable value (liquidation value) or value-in-use (going concern value)?

Those are just some of the more obvious questions. There are two more key questions or issues about rules-of-thumb that are central to their legitimacy.

Does the 'value' supposedly measured by the rule-of-thumb include or exclude all, some or none of the tangible assets? This is almost never stated in the so-called 'rule'. And second, how does that 'business value' equate to share value (hint: it doesn't).

These questions about rules-of-thumb have lead to a valuator's rule-of-thumb — every business is an exception to the rule-of-thumb and valuations based on rules-of-thumb will rarely be correct and when they are it's only by co-incidence. Not something I'd want to "hang-my-hat" on.

Medical Credits — Clear as Mud

Just what is creditable as a medical expense? Most accountants thought they knew, but everyone is being challenged to have the faintest idea. To be sure, there is a list in subsection 118.2(2) of the Act and at Regulation 5700 to the Act. However, the interpretations being put on these items, and the word 'prescribed' in particular, is leaving many practitioners justifiably bewildered.

In *Gibson, 2002 DTC 6724* the taxpayer, who suffered from a severe and prolonged impairment, was allowed the \$8,761 cost of home renovations for the installation of a whirlpool spa. The renovations were considered eligible medical expenses as they enabled the taxpayer to be functional within her home.

Then in respect to the disability tax credit, consider *Hamilton, 2002 DTC 6836*. The taxpayer, who suffered from celiac disease and required a gluten-free diet, was allowed the disability tax credit because he was found to require an inordinate amount of time to find, procure and prepare foods that he could safely eat.

The court observed that persons *with that disease or other medical conditions that impose dietary restrictions are eligible for the disability tax credit* provided they can meet the above noted tests. Stay

tuned! This case may be very valuable to those of us (and your clients) with diabetes.

Accountants Beware!

In *Gagne, 2002 DTC 1378* the taxpayer disputed the validity of a waiver he had signed in the presence of his accountant and a CCRA auditor, and for which he was given a summary explanation by the auditor. [The court found that while the auditor could have been more explicit he was entitled to assume that the explanations relating to the waiver were the responsibility of the accountant.](#) Even if the accountant had breached his professional obligations, this was not a matter within the jurisdiction of the court, and could not be imputed to the Minister.

And this, brought to my attention by reader Michelle Causton, based on a recent experience:—

Under subsection 230(4.1) a *“person required to keep records who does so electronically shall retain them in an electronically readable format for the retention period ...”*. IC 78-10R3 goes further and requires that the electronic records be supported by *“a system capable of producing accessible and readable copy.”*

How many of you or your clients now have computers that can read 5¼” diskettes, where many of the old records may be stored? How many used DOS-based accounting programs

but still have a computer running DOS? Has the old program software been retained, especially when the newer versions can’t read the old files?

By sheer co-incidence I was recently engaged by a CGA firm to assist their client who had received a letter from CCRA noting *“we have had no success in our numerous attempts to obtain your original books”* and are proposing an arbitrary assessment including the application of gross negligence penalties under subsection 163(2).

The client had a diskette with all their accounting records for the particular year, but neither they nor CCRA had the software to run it! Oops!

Value versus Price

I’m always surprised when an accountant (who should know better) tells me that value is based on “what you can get”. **Not true!** A financial professional should realize that **‘value’ and ‘price’ are two different concepts**. While admittedly the definition of fair market value confuses that by referring to the “highest price”, it contains enough qualifiers that it ends up supporting the two concept reality.

In short, “value is what is received, whereas price is what is paid”. It becomes even clearer when you take time to ponder the consideration that

price “*is the benefit realized by the most successful negotiator*”.

Pay Equity

Last year I had a number of enquiries from my accounting firm clients, so maybe there are others out there who have mishandled federal civil service pay equity payments in filing deceased client or estate returns? These are mostly 2000 taxation year items, but those returns can still be amended.

- if the taxpayer died before November 16, 1999 the payment is not taxable, but any interest received with the payment is taxable to the deceased’s estate or beneficiaries; any CPP or EI withheld is 100% refundable;
- if the taxpayer died after November 16, 1999 but before the payment was received, the payment is taxable as a right or thing (eligible for separate tax return); any EI withheld is 100% refundable;
- any interest received with the payment is a right or thing for interest accrued to the date of death with the balance taxable to the deceased’s estate or beneficiaries.

Farm Property Capital Gains Deduction

There are two sets of requirements concerning what is qualified farm property and the cut-off point is property ‘last acquired’ after June 18,

1987. Property last acquired after that date is subject to far more stringent requirements than property last acquired before that date.

Where a taxpayer made the capital gains election in 1994 on their farm property, **they may now have to meet the more stringent requirements even where they have owned the property since before June 18, 1987.**

This is because that election deemed a disposition **and a re-acquisition** of the property. Hence, there is an issue as to when the property was ‘last acquired’.

Are You Ready?

For fiscal years beginning 1/1/03 privately-held businesses will no longer amortize goodwill (whether new or existing) in their financial statements. Instead they will be required to recognize (expense) any impairment in the carrying value of the goodwill by measuring its fair value.

Also at 1/1/03, identifiable intangible assets (whether new or existing) will only be amortized where they have a definite life. Where the fair value of an intangible asset, whether it’s being amortized or not, is impaired (less than its carrying value) the impairment must be recognized as an expense.

While the GAAP requirement is ‘fair value’ that really means (in most cases) fair *market* value. The use of the term fair value is interesting as there are many legal cases involving

valuation which found that fair value is something different than fair market value. Fair value is akin to “just and equitable value” and importantly it does not require that there actually be a “market” for the asset. Whether that is what is intended under GAAP remains to be seen.

The problem, as I see it, for most accountants, is that they are not familiar with the principles, approaches, techniques and methods of valuation and they are most certainly not business valuers or asset appraisers. Surely the GAAP-setters took this into account? Apparently not!

Are you or your firm prepared to take on this impairment measure and report on it in a financial statement? And don't believe for a minute that you can rely on management's [unsupported] representations (Gee Bob what do you think your fishing licence, dairy quota or business goodwill is worth?).

I've already heard from one respected American CPA that he expects most review engagement and audit reports issued by accountants on privately-held businesses will be **qualified**. That is, they will say “except for the determination of impairment, if any, in the carrying value of ...”.

Now I ask, “Is that good accounting or financial reporting?”. While within the rules of reporting standards, is it acceptable to clients and stakeholders?

Speaking of ...

If you look past all the chicanery, the root cause of the confidence crisis in accounting is the widely-held, yet erroneous belief, that accounting is an exact science. While labelled in the past as the ‘expectations gap’ I think it's even more basic than that and should be called the ‘understanding gap’.

There is a false belief that if two accountants use the same standards, whether that be Canadian, American or International accounting standards, they will both arrive at the same answer. Nothing could be further from the truth, and the profession has (obviously) done a terrible job in explaining that.

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