The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Winter 2003

Now this is interesting!

Despite 36 years of income tax practice experience here's something I never realized could be done (you never stop learning, do you?).

When someone passes away owning a principal residence, the subsequent disposition of that property by their estate *can result in a deductible capital loss*.

Gains made on a principal residence are generally non-taxable due to the principal residence exemption. As a principal residence is a personal-use property no capital losses are allowed. Consequently there is a common tendency among accountants to more or less ignore that property at a client's death.

While gains aren't taxable and losses aren't deductible to the deceased, there is nonetheless, at death, a deemed disposition of this capital property at fair market value. Those deemed proceeds become the adjusted cost base of the property to the deceased's estate.

Once in the estate, *provided that no beneficiary or related person uses the property for personal use or enjoyment*, the property loses its personal-use property character. Any loss realized on selling the property can then be used against capital gains made by the estate or alternatively, where there is a net capital loss within the first taxation year of the estate, that capital loss can be carried back to the deceased's terminal T1 under subsection 164(6).

It wouldn't be unusual for an estate to realize a loss on the actual disposition of the deceased's residence because of realtor and legal fees. On an average home of say $200,000, with typical realtor and legal fees the loss might be $12,000 to $14,000. Claiming half of that as a capital loss could result in a tax recovery of about $3,000. No small potatoes!

Valuation Methodology

Awhile ago I got into an interesting discussion with a professional accountant who claimed that the capitalization of EBITDA (earnings before interest, taxes, depreciation and amortization) was a superior valuation method than capitalization of maintainable earnings.

He was quite right that the EBITDA method eliminates subjectivity regarding the valuation entity's financing structure and depreciation

(amortization) being a proxy for sustaining capital re-investment.

Assume a business is correctly valued at 8× its $50,000 maintainable earnings. Assume its EBITDA is $100,000. To arrive at the same value you'd have to capitalize EDITDA at 25% — 4× $100,000. That was easy, but it's not really that easy.

Consider two companies, each is identical except that one is optimally financed and the other is not. Both have EBITDA of $200,000. If we capitalize EBITDA at 4× are we left to assume that each company has the same value? That can't be correct as the sub-optimally financed one should have less value. There's either higher investment risk or it requires a capital infusion.

The value of the sub-optimally financed business determined under the EBITDA method has to be adjusted to allow for the *actual* sub-optimal financing as the capitalization of EBITDA *assumes* optimal financing.

	A	**B**
EBITDA capitalized value	$ 800	$ 800
Capital infusion required	NIL	200
Value	$ 800	$ 600

The capitalization of EBITDA is fraught with not only the same difficulties as capitalization of earnings (which by the way, also assumes optimal financing), but also introduces other elements of uncertainty.

The capitalization of EBITDA is a useful measure to compare companies in the same industry and to isolate and explain why Company X has more or less value than Company Y. As a stand-alone method of determining value, it is a less than ideal method as it fails to account for the 'specifics' of the company being valued.

Following Up

In the last edition I noted that there *may* be an issue as to which test a qualified farm property had to meet where the 1994 capital gains deduction election had been made.

CCRA has confirmed that where that election was filed, it considers the farm to have been 'last acquired' *after* June 18, 1987. Even if the farm property was owned before then, it must now meet the more stringent tests of post-June 18, 1987 property. Those include the two-year gross farm revenue test (being more than 50% of a taxpayer's net income).

Still following-up ...

The last edition mentioned the *Hamilton* case (celiac sufferer allowed disability tax credit). The February federal budget amends the disability tax credit by defining "feeding onself" as excluding "any of the activities of identifying, finding, shopping for or otherwise procuring food, and the activity of preparing food, to the extent that the time associated with the activity would not have been necessary in the absence of a dietary restriction

or regime”. *Whew, that’s a mouthful!*

That pretty well ends any thought of access to the disability tax credit by those who suffer from a dietary restriction, *except that* “the incremental cost, to an individual who suffers from celiac disease, of acquiring gluten-free food products as compared to the cost of comparable non gluten-free food products” has been added to the list of eligible medical expenses.

Looks like you’ll have to not only keep your grocery bills or cash register tapes, but a comparable ‘cost’ list. *Sorry, but isn’t this getting silly [no pun intended]?*

Speaking of ...

There’s an annual debate on the CGA Association of Ontario’s discussion list concerning the appropriateness of deducting medications, supplements and similar items as medical expenses. Perhaps *Dunn 2003 DTC 5029* will pre-empt this year’s discussion.

The taxpayer had been *prescribed* and provided with medications by her physician, dentist and naturopath. Paragraph 118.2(2)(n) of the Income Tax Act requires not only that the medication (and similar) be prescribed by a medical practitioner or dentist *but also that it be recorded by a pharmacist*. The taxpayer’s claim was disallowed as it didn’t meet that requirement.

Beware! The Importance of Adjectives

Everyone knows that a capital gain is only partly taxed. A *taxable* capital gain is currently 50% of the capital gain.

Article VI of the Canada-Ireland Tax Agreement imposes a 15% tax on *income* derived in Canada by an Irish resident. This treaty was ratified in 1962, long before Canada imposed a tax on capital gains.

In a very recent tax case — *Beame 2003 DTC 73* — the taxpayer was found liable for the 15% tax on his *gross* capital gain, not his taxable capital gain, as that was considered to be his income pursuant to the treaty.

The Ireland treaty is not the only one which pre-dates certain realities of current Canadian taxation, so beware!

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