

The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Summer 2003

On, Off, On Again!

As noted in the Spring 2002 issue of this letter the Tax Court of Canada held (*Manrell, 2002 DTC 1222*) that non-competition arrangements were property and payments received thereon were capital gains. This contradicted the notable *Fortino* case (*2000 DTC 6060*) which had held that payments received from such arrangements were not taxable.

On appeal (*Manrell, 2003 DTC 5225*) the Federal Court of Appeal, in a surprise decision (at least it was a surprise to me), held that there is nothing in the statutory context to support the proposition that the phrase “a right of any kind whatever” as used in subsection 248(1) is intended to require a non-exclusive, commonly held right to carry on a business to be treated as a “property” for income tax purposes.

In a nutshell, the “right to compete” surrendered by *Manrell* was not a “property”. No property — nothing to dispose of — no income — no tax — it’s just that simple.

Where’s this leave us? Probably waiting for Finance to amend the Act to provide specifically for the taxation

of non-competition agreements. ‘Til then it’s open season.

Family Law Sidebar

I wonder how this might impact the Ontario Court of Appeal ruling in the family law matter of *Clegg v. Clegg*. There the court held that a husband’s interest in a non-competition agreement was “property”.

Oops!

I’ve had two cases in the last six months where shares of a private corporation were acquired in arm’s length transactions. Nothing unusual about that, but they both had the same potentially disastrous oversight — there was a (credit) balance in the shareholder loan account which went unaddressed in the purchase and sale agreement.

In the worst of the two cases, the buyer paid \$100,000 and this was all attributed to the shares. Meanwhile there was \$72,000 in the shareholder loan account. Strictly speaking then the selling shareholder could still claim the \$72,000 due him from the corporation. What a surprise that was

to the buyer who thought she was getting everything “lock, stock and barrel”.

As equally unpleasant would be where the acquiring shareholder draws the \$72,000 (thinking it’s now hers — the account, after all, is labelled “due shareholder”). That \$72,000 would be income!

Simple solution. The purchase and sale agreement must always attribute the price *first* to any balance in the shareholder loan account and the rest to the shares.

Know what you’re doing

One of the first rules of professional practice is not to do work in which you are not competent. Seems sometimes that’s forgotten.

I recently valued a small trades person business under a matrimonial dispute. Half of my battle (actually it was fun) was spent (easily) discrediting the valuation that had been done by a professional accountant.

This professional was the accountant for the corporation (held by the husband) but accepted an engagement to prepare a valuation report for the wife’s side. That in itself is a story, but for another day.

This accountant issued a page and a half valuation report, with none of the required reporting standards, offering that they were “not a business evaluator” [incorrect terminology], “this is not a business valuation”, but

“it is my opinion as to the value of the business”, and that it has been prepared “solely for use by management” (despite the fact they hadn’t been hired by management). It then opined that the value of the business (share value) was \$587,168. *Pretty exact eh?*

Incredibly, this amount was arrived at by averaging:—

(a) average *revenue* for the last three years, plus net book value, and

(b) the total of the last four years *management salaries*, plus net book value.

As the net book value of the assets was \$84,000, the implied goodwill is just over \$500,000. An astounding 17.85× average annual earnings! *Pretty good for an electrician with two vans, one employee and some small tools.*

My valuation came in at \$65,000 to \$85,000 based on the adjusted net assets approach (*there is no goodwill in this business*).

A poor business valuation report is one thing, but one that demonstrates a complete lack of any basic business acumen is quite another. That this report was issued by a designated professional, supposedly trained and experienced, is beyond belief.

Life Insurance

Bob and Harpal’s shareholder agreement provides that the proceeds of the corporately-held life insurance

will be used to redeem the deceased's shares from his estate.

The share redemption is deemed to be a dividend (amounts in excess of paid-up capital, which we can assume is nominal) by subsection 84(3) of the Income Tax Act. However, an election is filed to make that deemed dividend a tax-free capital dividend under subsection 83(2). As a result, there's no income tax to the estate.

Now contrast that with Betty and Fatima's shareholder agreement. It specifies that the surviving shareholder is to buy the deceased's shares from her estate.

The corporately-held life insurance proceeds flow out to the surviving shareholder tax free as a capital dividend. She uses the money to pay for her acquisition of the shares from the deceased's estate. No income tax arises in the estate as proceeds equal adjusted cost base (ACB is the fair market value of the shares at the time of the shareholder's death).

Assume that in both cases there was no tax on the deemed disposition at death because of the capital gains deduction for small business corporation shares.

Are these situations equal, as they appear to be? In both cases there is no tax to the estate and no tax at death. In both cases the surviving shareholder now owns 100% of a corporation with a value of \$x.

Focus on the survivor, not the deceased. In Bob and Harpal's case, the surviving shareholder has the same ACB on his shares as he did before the death. In Betty and Fatima's case, the surviving shareholder's ACB has increased.

My experience is that the lion's share of shareholder agreements call for redemption. Re-visiting these presents a golden opportunity for client service.

Business Valuation Ranges

Almost every business valuation estimate/opinion of fair market value expresses the value as a range, say — \$300,000 to \$400,000. Why is that and how do you interpret it?

“Why” is because valuation is more art than science, and definitely not an exact science.

While the range appears to be a straight line, it's really curved (like a bell). That means that the value actually being either the low or the high is an equal possibility, but the likelihood of value being either of those is small. Likelihood increases as you move to the centre of the range. Consequently, the mid-point of the range is generally used where a specific number is required.

Tax Quickies

Finance has announced that they will *not* be granting any tax relief to taxpayers who were taxed on stock option benefits but where the value of the acquired shares subsequently

evaporated, leaving them with a (probably near-useless) capital loss.

To get around the §85(1) denial of land inventory rollover to a corporation, land inventory is first rolled into a partnership via §97(2) and then the partnership interest is rolled into a corporation via §85(1). CCRA's policy has always been to deny this approach. In *Loyens, 2003 DTC 355*, the Tax Court of Canada held that this was an acceptable strategy and it did not offend GAAR (general anti-avoidance rule).

In *S. C. Ross Enterprises Ltd, 2002 DTC 2078*, the taxpayer was a director and executive vice-president of a company, but also provided services to that company via a corporation. Those services were not part of his exec-VP's duties. The Tax Court of Canada ruled that the corporate income was *not* that of a personal services business.

Beware! In a startling case that upsets conventional thinking (*Crawford, 2002 DTC 1883*), the Tax Court of Canada held that an employee could **not** deduct their meals (a typical transportation employee claim on a TL2 form) because §8(1)(g) requires "meals *and* lodging", and the taxpayer had no lodging expense.

In *Isaac, 2003 DTC 485*, the taxpayers had mortgaged their home to make a business investment and so the interest was tax deductible. The mortgage was discharged when they sold that home, but it was paid out from the mortgage arranged on their new home. It was

held that the interest was no longer tax deductible.

Lastly, consider *Johnston, 2003 DTC 5295*. The taxpayer had a mortgage-free home in Toronto. On moving to Winnipeg he had to arrange temporary financing on his new home while he waited for his Toronto home to sell. Once it did he paid off the temporary financing on the Winnipeg home. His moving expense claim for the interest incurred in the temporary financing (3-months duration) was denied.

Travels

Had a great time last month in Red Deer presenting my seminar on corporate re-organizations. Very much looking forward to Saskatoon on September 27th (tax seminar) and St. Andrews, New Brunswick on October 16th and 17th (income tax update and corporate re-organizations seminars).

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Published periodically as
information for clients of
J Thomas McCallum

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