

The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Autumn/Winter 2003

Busy Times

It's been a very busy last two or so months at Finance. In early-October there were changes to the tax treatment of non-competition payments (see October's special issue). At the end of October changes were proposed to the deduction of business and property losses, and in early-December changes to donations were announced.

Business or Property Losses

It's proposed that beginning in the year 2005, losses from business or property will only be available if *in that year* it is *reasonable to assume* there will be a *cumulative profit* from the business during the time it has been carried on or can reasonably be expected to be carried on, or during the time the property was held or reasonably expected to be held. And "profit" excludes capital gains.

This is really just legislating the old "reasonable expectation of profit" test and as Everybody Loves Raymond's father would say — "Holy Crap!".

The proposal, as constructed, is a well-meaning but poorly-conceived approach, impractical and devoid of any

redeeming qualities. Finance is attempting to legislate a solution to what it views as a deep, dark hole that needs filling-in. If enacted, there will be all kinds of horrendous application and administration problems, including expensive compliance costs.

One of the principles of taxation is certainty. By legislating the reasonableness of expectations as a basis for taxation, this proposal violates that principle, and consequently it is unacceptable. How can second-guessing by Monday morning quarterbacks be an acceptable basis of taxation?

Projections are only as good as the underlying assumptions and these are often subjective (educated guesses) rather than objective. While it might be thought that the future 'actual' validates or invalidates the assumptions, this is not necessarily true as a host of internal and external factors can cause anyone to exceed, meet or fall short of their projections.

On the face of it, it is improper, although CCRA will have it available (taxpayers won't), to use hindsight



(comparing actual future outcomes) in assessing projections previously made. It is the validity of the underlying assumptions that needs to be attacked for an assessment of non-loss (for tax purposes) to hold up. As long as the assumptions underlying the expectation of future profits were valid *at the time of the projection*, the loss is allowable.

I also find myself wondering about the accountant's possible liability under the preparer penalties and/or under claims for negligence, where the accountant makes (due to real or perceived client constraints) no attempt or only a feeble attempt to perform the required diligence.

Might it not have been simpler and have satisfied the certainty test, if Finance instead proposed that capital gains be 100% taxable to the extent that non-capital losses have been used to reduce other income. Only capital gains beyond the non-capital loss threshold would be eligible for the 50% income inclusion.

That's a simple, objective, workable, albeit not necessarily fair, solution.

Of course this all assumes you can buy-into a 'problem' existing in the first place. Maybe Finance should just accept the current situation as a cost of doing business — people investing to make the country grow.

Tax Shelter Donations

Far less controversial, due to being perceived as action against abuse of the tax system, are Finance's proposals

(effective as at December 5, 2003)



regarding charitable gifting buy-low/donate-high 'schemes'.

With certain exceptions (publicly traded securities, certified cultural property, ecological gifts, or real property situated in Canada), the value of a gift of property is now limited to the donor's cost where the property is donated within three years of acquisition or where it was acquired under a gifting arrangement or in contemplation of a donation.

There are some other rules connected with this proposal, such as an 'other than at-death' rule, but I'll not go into these here. I only wonder now if Canadian-produced comic books, or more relevant to me — records, can be certified as 'cultural property' under the Cultural Property Export and Import Act <smile>.

Minority Discounts/Premiums For Control

In valuing a minority shareholding it may be appropriate to apply a discount from rateable value. The discount represents the disadvantages stemming from owning a non-controlling interest. These disadvantages include the inability to:—

- dictate future direction/operations of the company;

- elect, or be elected to the board; and
- set dividends.

The discount also recognizes any inherent lack of liquidity and/or marketability.

To understand the rationale of the discount you need only look at the stock market. Daily trading activities are trades of minority interests, and there is an inherent discount. So when, for example, a takeover is proposed, there is almost always a premium — usually labelled *a premium for control*. This so-called premium is really lack of a minority discount, i.e. the absence of the discount from rateable value inherent in daily trading.

In valuing a privately-held corporation, it is generally inappropriate to add a “premium for control”. Control blocks are valued at rateable value, and minority holdings are valued at a discount from that.

There are exceptions though. Consider for example, where there are three equal shareholders. Each of the three shareholdings, **viewed independently**, might be valued at say \$25,000 whereas the value of the company *as a whole* is \$100,000. In the right circumstances, the value of any one of the three shareholdings might actually be \$41,666. Why?

If one shareholder sells to another, the acquiring shareholder will own two-thirds of the company. The value of his/her 2/3 holding would be \$66,666,

and so $\$25,000 + (\$66,666 - \$50,000) = \$41,666$ is the price she/he might be willing to pay for another 1/3. That \$16,666 is a *true* premium-for-control.

In my experience the shareholders of most privately-held businesses do not want a minority discount applied in valuing any one particular shareholder’s interest. **This should be specified in the shareholder agreement, otherwise generally accepted valuation principles dictate the application of a discount.**

Home in a Work-Space

About five years ago I was asked to offer advice on a situation that a CGA’s client was facing. CCRA was proposing to disallow the portion of losses on their bed-and-breakfast operation that were attributable to expenses on the home. CCRA’s position was that §18(12) of the *Act* prevents losses due to a home work space.

I argued — quite novel too I thought — that §18(12) didn’t apply as the taxpayer had a home-in-the-work-space, not a work-space-in-the-home. This argument fell on deaf ears and the client was not willing to pursue the issue.

Well the Tax Court of Canada must have been eavesdropping, because that was exactly its finding in *Klaus Sudbrack v. The Queen, 2000 DTC 2521*.

And speaking of English

Some of you know that I get annoyed when Canadians use foreign spellings — license, installment, color, analyze, jewelry and traveling just aren't right.

However, I found some common [otherwise] “-ed” ones that few of us, including me, actually use (although many of us pronounce some of them in this ‘correctly’ spelled way): burnt - dreamt - leant - learnt - smelt - spelt - spilt - spoilt.

Does this look like it's spelt right? “I dreamt I was sent to gaol after I leant over and smelt her hair, which was burnt and spoilt after I spilt peroxide on it. I learnt a lot that day.”

Partners' Salaries

Salaries to partners have long been used as an approach to allocating partnership income based on the ‘inputs’ of the partner to the business.

For example, assume F and B are 50-50 partners in XYZ. F contributes 100% of her time to the partnership whereas B is employed full-time elsewhere and only works weekends and the occasional evening at the partnership business. The partnership agreement specifies that F is to receive a salary of \$24,000 and only the remaining profits are divided 50-50.

If the pre-partner's salary income of the partnership is \$40,000, F's income is \$32,000 and B's is \$8,000. This is what each will report for tax purposes.

Despite the supporting decision in *Archbold*, CCRA has announced that it will deny a deduction for partner salary in computing the net income of a partnership. Apparently the rationale is that a partner cannot be an employee of him/herself. This approach by CCRA is inconsistent with the Ontario Partnership Act, and defies economic reality. Hopefully they'll change.

Contest!

Link to or paste these three addresses into your web browser (one at a time). First one to e-mail me correctly naming the three singers gets a prize. All are country songs but none of the singers are famous for country music.

<http://66.175.36.231/dad/surpriseartist1.mp3>

<http://66.175.36.231/dad/surpriseartist2.mp3>

<http://66.175.36.231/dad/surpriseartist3.mp3>

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