The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Winter 2004

"All or substantially all"

Several Interpretation Bulletins indicate that CRA's interpretation of the *Income Tax Act* phrase "all or substantially all" is that it means "90% or more". This interpretation is so ingrained that many accountants often mistakenly repeat it as if it were a 'rule'.

In *Keefe, 2003 DTC 1526*, the Tax Court of Canada found that 81% was sufficient to be "all or substantially all". Other cases have also found that something less than 90% was sufficient to meet the "all or substantially all" test.

Does this mean 81% is the new threshold? Of course not. Every taxpayer is different, every situation unique. And that's the way it should be.

What's funny to me is that most accountants will tell you that when it comes to income tax they prefer hard rules to abstract concepts, so these kind of cases present a problem for them. Yet, is there anything more abstract than generally-accepted accounting principles? Somehow these same accountants don't seem to have a problem with those. Amazing, isn't it?

Freeze Preferred Shares

All too often family businesses do not succeed past an inter-generational transfer. Several studies have indicated various reasons for this, but I believe that in a great many cases it's because the first generation won't let go.

Nowhere is this more evident to me than in the style of estate freeze shares. Very often these are voting shares so that Mom and/or Dad can continue to exercise control.

In my view the psychology of this is detrimental to the child's chances of success. It's saying up front "I don't trust you" or "I don't really have confidence in you". In short, voting shares are too 'in-your-face'.

Rather than voting shares I much prefer the use of retractable shares. These are effectively a 'silent' hammer of control and provide better 'optics'.

In some cases you might want to add a shareholder agreement that gives Mom and/or Dad a director's position. I've found that the second generation is readily willing to accept the parent in what's then seen as an advisor's role.

The retractable shares and the board position is really the same as the voting shares, but leaves the second generation feeling more like it's their business now. That's my experience anyway.

Do Income Taxes Count?

I was just talking to a CGA about this topic yesterday, so here it is for everyone to see.

In a family law case — *Russell v. Russell, [2002] B.C.J. No. 1983 (S.C.)* — the husband sought to have the potential tax liability he faced on selling the shares in his wholly-owned corporation considered in the determination of his family property. The agreed fair market value of the shares was $3,095,000, so the income taxes arising on a sale would be fairly substantial.

Although the trial judge recognized that at some distant point in time the husband might incur a tax liability, it was concluded that to value this event as to amount or timing would be to engage in speculation and analysis of hypothetical facts.

And that fairly well summarizes the current thinking of the family law courts. Unless there is evidence the sale is imminent or contemplated in the near future, the future tax liability will be ignored.

The 'Smell' Test

When all is said and done in a valuation assignment and all the approaches have been weighed and considered and after all the valuation principles applied, the final test of the valuation conclusion is the 'smell' test.

Although you'll see this test mentioned in the valuation literature there's no guidance on how to perform it. The question is simply "Does this smell right?" This is really a logic test based on experience — and most accountants have that experience.

I ran across a valuation report (done by a [self-described] accountant) last week on a corporation that owned one apartment building. It failed the test. Here's how he laid out his valuation.

Shareholder equity per financial statement	$ 18,000
Add market value (as appraised) of real property in excess of book value	$ 1,500,000
Fair market value of shares	$ 1,518,000

Now ask yourself — who would pay that price? The answer is likely no one, at least not a prudent person. Obviously then it's not fair market value.

The 'true' fair market value lays somewhere between the absolute liquidation value of the shares (factor in taxes on the capital gain inherent in the current value of the property, taxes on any depreciation recapture, disposal costs, refundable taxes, and personal taxes on a liquidation dividend) and the foregoing value. Where between? Well that can't be said with any certainty (there's no general rule I can share with you) and would depend on the facts of the case.

Untimely Deaths

In my seminars I'm fond of jokingly saying "clients have a bad habit of dying at inopportune times". As an example I give the situation of a shareholder who dies at a time the corporation's shares aren't eligible for the capital gains deduction because the corporation fails the 'assets used' in an active business test (see ITA 248(1) definition of a small business corporation).

Based on that unscientific survey, it appears that many accountants aren't aware that ITA paragraph 110.6(14)(g) deems the shares to be those of a small business corporation (at the time of death) if they were such at anytime in the 12-months preceding the shareholder's death.

The same is true of the Business Investment Loss provision — ITA paragraph 39(1)(c). For that purpose, a small business corporation includes one that met the 'assets used' test at anytime in the preceding 12-months.

RDTOH

Corporation X is winding-down. Its only asset is $10,000 in cash and it has no liabilities, but it does have $6,000 in RDTOH. Refundable Dividend Tax On Hand is really a contingent asset, in that the government will refund it on the basis of $1 for every $3 paid in taxable dividends.

So, if Corporation X pays a $10,000 dividend it will receive $3,333 from CRA as a dividend refund. If it pays out the $3,333 as a taxable dividend, it will receive a further $1,111 dividend refund, and so on. That's not very convenient though is it? It would be far easier to pay one dividend, but how much?

It's actually very simple. The one-time dividend required to exhaust the maximum accessible RDTOH is $15,000, and it's determined as the *lesser* of:—

- cash + RDTOH, and
- cash × 3/2.

A $16,000 dividend can't be declared because $10,000 + 1/3 of $16,000 is only $15,333, so where would the additional $667 come from?

Double Dipping

Car sales folks love to deduct everything under the sun as an expense. Often that includes the couple of hundred bucks a month they pay their employer for use of a demo.

More often than not though the employer has already used that $2,400 to reduce the stand-by charge that's included in the sales person's T4 as a taxable benefit. So claiming it as an expense is really a 'double-dip'.

Shareholder Agreements and 'Value"

Assume the shareholder agreement says that on death the surviving shareholder shall purchase the shares of the deceased shareholder at book value, *i.e.*

ignore the value of any goodwill the business might possess.

Is that book value then the fair market value that should be used in the deceased's terminal return when accounting for the deemed disposition at death? Many readers will be surprised to learn that the answer is no.

While the provisions of a shareholder agreement will generally *influence* the determination of value, they are not determinative of value, irrespective of the fact that they spell out a valuation mechanism. Generally, provisions such as the one laid out here, will have a depreciatory effect on value, but again, not a determining effect. Why is that?

Ignore the fact of the death. Whichever of the two shareholders who survive the other will reap a 'windfall' if the business actually has value in excess of book value. Consequently, a prospective buyer of the shares would be willing to gamble that she'll be the survivor. So fair market value then is that as otherwise determined (ignoring the shareholder agreement provision) less a risk factor presented as a discount from that value.

That of course assumes that the shareholder agreement says that any prospective purchaser needs to become a party to the agreement. If it doesn't, the discount would disappear.

Yes, that could leave the estate in the unenviable position of paying tax on proceeds of disposition that it will never actually receive.

Epidemic!

Forty-seven year old Jimmy Streater, who started in 11 games as quarterback for the Toronto Argonauts back in the late-70's, died recently in a Tennessee nursing home. Cause of death was a heart attack brought on by complications from diabetes. Jimmy had already had an arm and a leg amputated because of his diabetes and was near-totally disabled by a previous stroke linked to his diabetes. What a tragic death, not only for an athlete, but for anyone.

I was also saddened to learn that Ray Turner, my best friend back in grade five also recently passed away in a Kenora nursing home at age 57 from complications caused by his diabetes.

It's estimated that some two million Canadians have diabetes but aren't aware of it. **It's a silent disease, and a killer! *Please* have yourself checked!**

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