

The J Thomas McCallum Letter

Advancing the understanding of income tax and valuation matters

Summer 2004

Buyer Beware!

As consumers we are all charged with the responsibility of *caveat emptor* but it is equally applicable to business acquisitions and investments.

For the second time in the last few years I've been witness to a minority share investor getting skewered by a majority shareholder who also held a second operating company.

Guess what happened when it came time to allocate the annual business limit (the base for the small business deduction)

Change of Control

Almost every accountant I know speaks of a year-end occurring immediately when there is a change in control of a corporation. That's wholly understandable because "change of control" is not only the 'street language' it's also the heading at §249(4) of the *Income Tax Act*.

Yet, a closer examination of §249(4) reveals that it isn't a "change of control" which triggers a year-end, but rather it's an "*acquisition of control*".

Excuse me ... what time is it?

Well, according to Income Tax Act §13(21.2)(e)(iii) it's ...

.... the transferor is deemed to own a property that was acquired before the beginning of the taxation year that includes the particular time and ... until the time that is immediately before the first time, after the particular time

between the two associated corporations? You're right — it was taken totally by the second corporation, leaving the first corporation (the one with the minority investor) stuck with the higher tax rate.

This could have been avoided by a shareholder agreement provision that "locked-up" the annual business limit.

Control means ownership of a majority of the voting shares, unless the Act indicates otherwise by using the words "*directly or indirectly in any matter whatever*".

Assume taxpayer 'A' held 100% of the issued shares of Xcorp. She sells 50% of those shares to taxpayer 'B' and Xcorp is now held 50/50 by A and B.

There is no doubt there has been a change of control, but has there been an “*acquisition of control*”? I think not.

Estate Freeze Preferred Shares

When a person performs an estate freeze of their OPCO common shares they usually swap those shares for ‘freeze preferreds’. These freeze shares are usually, among other characteristics, redeemable/retractable for the fair market value (“FMV”) of the exchanged common shares.

Where that share exchange is governed by a §85 election (or similar ITA provision) there is an inherent *assumption* that the freeze shares have a FMV equal to that of the predecessor common shares. In actual fact it is highly unlikely that the FMV of the freeze shares is their retraction/redemption price. The assumption of equal value is a practical solution by CRA to an otherwise insurmountable §85 dilemma.

To explore this, let’s look beyond the initial freeze transaction and consider the situation where the freezor dies holding the freeze shares. What is the FMV of the shares for the deemed disposition at death? Assume nothing has changed operationally or asset-wise in the corporation since the freeze, that the company has no borrowing capacity, and that a large part of the original common share value was attributable to goodwill.

If you said that the redemption/retraction price of the shares is their FMV, then you are likely wrong. There are at least

four possibilities that need to first be weighed and considered:—

1. The full value (the r&r price) of the shares *might* be realized *if* there was a sale of *all* the outstanding shares in the company to a third-party purchaser;
2. The company could sell its assets/operations to a third-party on a going-concern basis and then redeem the shares, but the full r&r price wouldn’t be realized due to the incidence of corporate taxes on the asset/operations sale;
3. The company could liquidate its assets and redeem the shares, but again that couldn’t possibly be for the full r&r price due to the less than going-concern values realized for the assets, income taxes and other asset realization costs; or
4. A purchaser could possibly be found for the shares, but there’d be a **super-sized** discount in the realizable price.

All in all then, there’s no way that the fair market value of the shares is equal to their redemption/retraction price.

Be sure and read my next Tax Strategy article in CGA Magazine where I show that the term “*new work location*” as used for moving expenses probably doesn’t mean what you think it does!

Related Persons

Recently I was designing a corporate re-organization for a client where I nearly fell into a sizeable trap. It was avoided

only at the very last second when something in the back of my mind went ‘click’ during my quality control review.

OPCO was held equally by two brothers and they also equally held REALCO which rented its property to OPCO. As the two corporations are associated the rental income is active business income to REALCO — see §129(6) of the Act.

At the end of the re-organization OPCO was held equally by Brother/Nephew and REALCO continued to be held by the two brothers.

Oops! Uncles and nephews aren’t related persons and so OPCO and REALCO were no longer associated and the rental income would now be subject to the higher tax rates associated with income from property.

We solved the problem fairly easily by having Brother own 50.1% of the voting shares of OPCO, but had the shortcoming not been caught it would have been disastrous.

A Secondary Lesson — What was also an interesting exercise was to note that while the two corporations would not have been associated with the proposed 50/50 Brother/Nephew ownership, they would have continued to be related corporations pursuant to §251(2)(c)(v). A good reminder of the “rule” I learned long ago by the acronym AR — all associated corporations *are* related, but not all related corporations are associated.

Critical Observations

I probably see more than my fair share of shareholder agreements, and I must say that some (too many?) are curious oddities in the buy/sell provisions area.

The latest one to cross my desk provided that **“Goodwill shall be valued in accordance with the balance sheet of the company as prepared by the accountants”**. **Pray tell, what does that mean?**

Accountants can’t be held faultless either. I can’t recall how often I’ve seen refundable taxes reported in the financial statements as part of the income statement’s income tax expense. Sorry folks, refundable taxes are supposed to be charged directly to retained earnings.

And lastly, what I believe is a fair comment on Notice To Reader (“we have not audited, reviewed or otherwise attempted to verify accuracy or completeness”) financial statements and the ever increasing use of those by accountants in serving clients.

I recently saw a case where a prospective buyer for a business (\$2.6 million) wanted a warranty from the seller that the financial statements “presented fairly, *etc*”. The seller didn’t understand what that meant and looked to his accountant to provide him with assurance that he could sign that warranty. The accountant couldn’t provide any such assurance as the financials had been prepared under a Notice to Reader.

The point here is that Notice to Reader financial statements may very well be of little value, due to the lack of reliance that can be placed on them, when it comes time to sell the business. Once the client made the accountant aware he'd be putting the business for sale, I think the accountant should have upgraded the engagement to at least a review.

The most recent survey of the Canadian Institute of Chartered Business Valuators revealed that almost 50% of CEOs, CFOs and business owners were not aware of the term business valuation.

Dispositions of ECP from CEC

There seems to be a lot of confusion surrounding the [tax] accounting for a disposal of eligible capital property. Of course if you've taken a peek recently at the §14(5) definition of cumulative eligible capital you'll know why. What a nightmarish recital!

Here's a complete example that should help.

Assume that Mary acquired an eligible capital property (goodwill) in the early-1980s for \$50,000. At her 1988 "adjustment time" (when the amortization rate changed to 7% of 75% from 10% of 50%) her CEC balance was \$16,500. She also elected \$100,000 under the last-chance capital gains deduction election in 1994, and she's now sold the goodwill for \$250,000.

Mary's Historical CEC

Starts at 1/2 \$50,000	\$ 25,000
Amortization to 1988	<u>8,500</u>
pre-adjustment time CEC	\$ 16,500
Add 1/2 at adjustment-time	<u>8,250</u>
Adjusted CEC	\$ 24,750
Amortization up to sale	<u>17,000</u>
CEC prior to sale	\$ 7,750

Mary's CEC accounting in Year of Sale

Add 1/2 pre-adjustment time amortization	4,250
Add 75% of 1994 election	<u>75,000</u>
Adjusted CEC	\$ 87,000
Proceeds @ 75%	<u>187,500</u>
Negative CEC pool	\$100,500
Attribute to recapture ((\$8,500 + \$17,000))	<u>25,500*</u>
Remaining negative pool	\$ 75,000
1/3 non-taxable	<u>25,000</u>
2/3 taxable amount	<u>\$ 50,000*</u>

* \$75,500 income, taxed as ordinary business income; if this was a corporation, \$50,000 would also be added to the Capital Dividend Account and be eligible for distribution as a capital dividend

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J Thomas McCallum, FCGA, CBV

www.jthomasmccallum.com

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Corporate Tax Rates for 2000 to 2006

Year	Federal Tax Rate ¹	Federal Surtax ²	Maximum Federal Small Business Tax Rate Income ³	Federal Tax Rate on Small Business Income exceeding Small Business Tax Rate Income but less than \$300,000	Ontario General Tax Rate	Maximum Ontario Small Business Tax Rate Income ⁵	Ontario Small Business Tax rate ⁵
2000	28%	1.12%	\$200,000	28%	14.83%	\$240,000	7.33%
2001	27%	1.12%	\$200,000	21%	13.62%	\$280,000	6.37%
2002	25%	1.12%	\$200,000	21%	12.5%	\$320,000	6.0%
2003	23%	1.12%	\$225,000	21%	12.5%	\$360,000	5.5%
2004	21%	1.12%	\$250,000	N/A ⁴	14.0%	\$400,000	5.5%
2005	21%	1.12%	\$300,000	N/A	14.0%	\$400,000	5.5%
2006	21%	1.12%	\$300,000	N/A	14.0%	\$400,000	5.5%

1 the indicated rate reductions from 28% do not apply to income eligible for the SBD, M&P credit or refundable taxes

2 4% of 28% = 1.12% of taxable income

3 taxed at a federal rate of 13.12%

4 not applicable as the general federal tax rate is now the same as this (previously special) 21% rate

5 clawed-back where Ontario income exceeds the base amount

Current as of the publication date, and all amounts/rates indicated are based on a calendar year



My Upcoming Presentations

Always Fun! Always Informative!

September 25 th	Succession Planning	Parry Sound, Ontario	Half-Day
October 2 nd	Business Valuation	Toronto, Ontario	Half-Day
October 23 rd	Section 85	London, Ontario	Half-Day
January 19, 2005	Income Tax Update	St. Louis, Missouri, USA	By Satellite
February 1-2, 2005	Personal Tax Fundamentals	Toronto, Ontario	Two Full Days
February 24, 2005	Income Tax Beyond the Basics	Toronto, Ontario	Full Day