The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Spring 2007

Replacement Property

Where a capital property, other than a share in a corporation, is disposed of involuntarily, the *Income Tax Act* provides an opportunity to defer the taxes arising on any resulting capital gain and/or depreciation recapture. The only requirement is that the disposition proceeds are received as compensation for (1) property unlawfully taken, (2) property destroyed, or amounts received under an insurance policy for loss or destruction, or (3) property taken under statutory authority, and that a replacement property is acquired within a specified time. That time is the later of the end of the second taxation year following the year the amount becomes receivable and 24-months after that year.

There is a similar replacement property rule for voluntary dispositions, but this is restricted to former business property ("FBP"). FBP is any capital property which is real property used by the taxpayer or by a related person, primarily to gain or produce business income. The time period to acquire a replacement property is also different. Here it is the later of the end of the first taxation year following the year any proceeds become receivable and 12-months after that year.

What's interesting is how these rules work where the subject is depreciable property and the replacement property is acquired after the year of disposition.

You do ***not*** move the cost of the replacement property into the CCA schedule of the disposition year. You merely reduce the old property's proceeds of disposition by the amount which would have been the CCA recapture. The addition to the CCA schedule for the cost of the replacement property isn't made until the acquisition year. While this eliminates the CCA recapture, this also eliminates any opportunity for CCA on the new asset until the actual acquisition year.

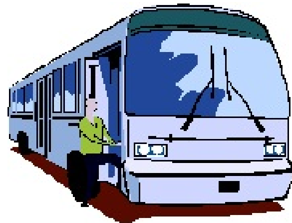
The cost of the replacement asset which is added in that future year to the CCA schedule is the actual cost *minus* the amount used in the prior year to defer the recapture.

The election to defer recapture by

using the replacement property provisions can't be made until the year the replacement property is acquired. In the meantime the tax on the recapture is due, although it will be refunded on making the election. Where payment presents a hardship to the taxpayer, CRA is willing to accept security for the taxes due.

Take The Bus?

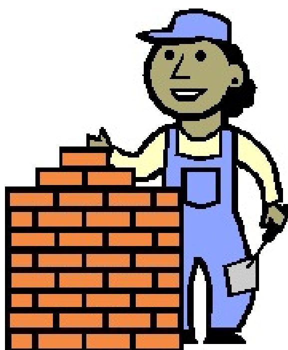
If a taxpayer needs to travel to receive medical services because those services aren't available where they live, they can deduct the cost of using a transportation service as long as the medical services are at least 40km away.



However, where the patient drives themselves or has a friend, family member or neighbour drive, the medical service must be at least 80km away. Strange!

Knowledge Is Always Under Construction

At a seminar I recently presented, several people didn't seem to be aware of two things and so I thought they were worthwhile to repeat here.



Item 1: While an individual's provincial income taxes are payable to the province where the taxpayer resides, this is not true of provincial taxes on an individual's business income. Those are paid to the province where the business is located.

Item 2: While rent received from an associated corporation which runs an active business is considered active business income to the receiving corporation, this is not true where the corporations are related rather than associated.

Professional Service Opportunity

Many accountants proclaim that they'd like to expand their professional services beyond what they see as the mundane world of debits and credits and basic tax services. One of the opportunities out there, perfectly suited for accountants, is becoming competent in the measurement of income under the federal[1] child support guidelines and providing that service to family law lawyers and their clients.

The starting point for measuring income under those guidelines is the T1 return; but then Schedule III to those guidelines presents a set of adjustments. Almost all accountants in 'public practice' will be intimately familiar with the required concepts.

But your skills as an accountant can really be used in a more exciting way

because the guidelines allow income to be imputed in a number of circumstances, and corporate income to be attributed to someone who is a shareholder, officer, or director. This all requires the application of sound business and tax analysis, and effective report writing. Family law lawyers would — in my opinion — embrace the opportunity to have you 'on board' as part of a team.

You can learn about the guidelines at www.canada.justice.gc.ca/en/ps/sup/ and to get a taste for how interesting the work can be check out the case of *Ewing v. Ewing, 2007 ABCA 72* <www.albertacourts.ab.ca/go.aspx?tabid=13> where the court found — based on an accountant's analysis — the husband had $1.1 million in 'available' income and awarded $365,000 in child support arrears.

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[1]Manitoba, New Brunswick and Quebec have provincial guidelines

Arm's Length

The *Income Tax Act* deems that it's a 'question of fact' as to whether unrelated parties are indeed arm's length. This charge presents tax advisers with grave difficulty, not to mention uncertainty, when advising a client who shares a business relationship with another. For example, is a 40% shareholder at arm's length with the corporation where the 60% controlling-shareholder is otherwise unrelated? Are the two shareholders themselves at arm's length?

The courts have developed three questions which provide a framework for analysis:—

1. is there a common mind directing the bargaining for both parties to the transaction?
2. did the parties to the transaction act in concert without separate interests?
3. did one party to the transaction exercise *de facto* control over the other?

A tax commentator recently offered that "CRA continues to claim that unrelated persons are not at arm's length when they complete a transaction that is beneficial to both."

If that's so (and under that test wouldn't almost everyone be non-arm's length?) then it's to your benefit to be aware of the court's tests in case you need to pull them from your back pocket one day.

Confused Principles

Yet another accountant prepared valuation has landed on my desk with what seems to be a fairly common error in the approach to measuring maintainable earnings, or maybe it's cash flows; I really can't tell.

It is not correct to add back depreciation when estimating maintainable earning or sustainable

cash flows, without making an allowance for the replacement of those capital assets. What business can sustain its operations without replacing its capital assets from time to time?

Depreciation is a proxy for the annual re-investment in capital assets required to sustain operations. Where the accounting purpose depreciation is an over/understatement of that, then by all means adjust it, but don't eliminate it.

Federal Budget

I'll be back in your e-mail in-box this Monday night with a report on the federal budget.

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Comparison of Provincial/Territorial Tax Rates on Small Business For 2006			
Province/Territory	Tax Rate	Province/Territory	Tax Rate
British Columbia	4.5%	New Brunswick[3]	1.75%
Alberta	3.0%	Nova Scotia	5.0%
Saskatchewan[1]	5.0%	Newfoundland/Labrador	5.0%
Manitoba[2]	4.5%	Northwest Territories	4.0%
Ontario	5.5%	Nunavut	4.0%
Quebec	8.0%	Prince Edward Island[4]	5.67%
		Yukon[5]	2.5%/4.0%

[1] annual business limit increases to $500,000 on July 1, 2008
[2] 3% as at January 1, 2007
[3] 1% as at July 1, 2007; and the annual business limit increases to $500,000 at same time
[4] phased-in annual reductions will bring the rate to 1% on April 1, 2010
[5] lower rate applies to manufacturers only

My Upcoming Presentations

Always Fun! Always Informative!

May (date not set yet)	Federal Budget Review	Toronto	Evening
June 22	Corporate Re-organizations	Red Deer, Alberta	Full Day

A number of other presentations are tentatively booked, but not yet finalized.
For more information see this space in the June issue.