

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Summer 2007

The 'Key' To Business Expenses

There is a widely-held misconception by accountants (and others) that the *Income Tax Act* contains specific provisions denoting each and every item which is a deductible business expense.



The truth though is that if you look, you'll see that the *Act* is actually silent on several specific items; that is, no where will you find a direct provision specifying 'x' is deductible. For example, nowhere in the *Act* is there specific provisions for the deduction of common business expenses like salaries and wages, rent, advertising and promotion, and automotive expenses. The authority for the deduction of these is found rather obliquely in paragraph 12(1)(a), read in combination with paragraph 18(1)(a).

12(1)(a) — *Subject to this Part, a taxpayer's income for a taxation year from a business ...is the taxpayer's profit from that business ... for the year.*

18(1)(a) — *In computing the income of a taxpayer from a business ... no deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or*

producing income from the business ...”.

The latter paragraph is interesting because it can be (and is) read that *if* an outlay or expense was incurred for producing business income, then that outlay or expense is deductible.

While accountants like to think that profit for tax purposes is measured by GAAP (generally accepted accounting principles), that's not true. The courts use what they've labelled *ordinary commercial principles*.

While OCPs are similar to GAAP, they do differ; sometimes remarkably so. An item capitalized for accounting purposes pursuant to GAAP, might actually be deductible as a current expense under OCPs. One of the more recent and definitive cases to highlight OCPs versus GAAP is *Canderel Limited v. The Queen*, 98 DTC 6100.

Self-employed = A Business?

From my perspective as a business valuator there is a more than a subtle difference between being self-employed and having a business.

For example, Joe is a carpenter and works as a subcontract trade to home builders. He has a few hand tools and a truck/van. His gross revenues are

\$60,000 and he reports a net income for tax purposes of \$45,000.

While there's no question Joe is self-employed, personally I'd be very hesitant to call this a *business*. Yet, I receive a dozen calls a year asking me to value this 'business' for matrimonial purposes.

Leaves You Confident Eh?

Finance Minister Flaherty recently backed down on his budget proposal to prevent Canadian corporations from deducting interest on debt used to acquire foreign affiliates. The proposal met with a lot of opposition and has been revised and re-directed to target "towering" and "double dipping".

The financial press reported that in interviews following the announcement the Minister indicated that he and his department **did not know** how prevalent double-dipping and towering are, nor did they have any kind of calculation about how much government revenue would be gained by clamping down on interest deductibility. *Amazing, simply amazing!*

Only In America (we hope)

As of March 2007, 52 patents have been issued in the United States for tax strategies, and an additional 84 are pending. To be granted a patent, tax strategies have to be considered novel, non-obvious, and useful.

In April, Stanley Blend, the incoming

president of the American Bar Association Tax Section, called the idea of patenting tax strategies "*a threat to the American tax system*", and he vowed to work to undo this new idea that tax strategies can be patented.

The May 2007 *Journal of Accountancy* reports that the American Institute of Certified Public Accountants has indicated "*Congress should restrict patents on tax strategies or protect taxpayers and preparers from infringement actions arising from them*".

I think it's safe to say that laying claim to technology patents has become somewhat of a cottage industry, but tax strategy patents? Boggles the mind!

EV "Enterprise Value"

Although not applicable to valuing a private corporation, EV is a growing approach in the valuation of public companies. EV is calculated as:—

market cap, plus debt, minority interest and preferred shares, minus total cash and cash equivalents

The enterprise multiple is then calculated by dividing EV by EBIDTA (earnings before interest, depreciation, taxes and amortization).

A low enterprise multiple is an indicator that a company might be undervalued. Bear in mind that a 'low' multiple means when compared to the

industry or other companies in the industry.

X Co has a share price of \$45, a price/earnings ratio of 10×, and a market cap of \$13.5 billion. With \$30 billion in debt, the EV is \$43.5 billion, and with EBIDTA of \$3.4 billion, the EV multiple is 13×.

Compare Co Ltd has a share price of \$23, a price/earnings ratio of 20×, and a market cap of \$6.1 billion. With net debt of \$3.5 billion, the EV is \$9.6 billion, and say the EV multiple is 10×.

While X Co appears to be priced at half of Compare Co Ltd, the latter is actually priced at much less per share and offers more ‘value’ for its price.

German Social Security

The percentage of German social security taxable in Canada depends on the year the pension commences. It started at 50% in 2005 and grows by two percentage points a year until 2021 when it becomes one percent per year. Starting in 2040 100% of the pension is taxable.

At first glance then you might assume that 50% of the pension is [forever] taxable if it began in 2005, 54% if it began in 2007, and so on. Alas, things aren’t necessarily that simple.

The non-taxable portion of the pension is actually ‘fixed’ in the year following the year the pension began. This is best explained by the example at the Canada Revenue Agency website.

- 2005 pension was \$12,000, so 50% taxable;
- 2006 pension was \$12,600 (Germany increased the pension half-way through 2006), so 50% or \$6,300 taxable;
- the other \$6,300 now becomes the fixed-for-life non-taxable amount; and
- 2007 pension was \$13,800 (again Germany increased the pension half-way through 2007), and \$6,300 is non-taxable, so \$7,500 is taxable.

While this CRA example is relatively easy to follow, I think it can be misleading because it assumes a constant exchange rate between the Euro and the Canadian dollar. I suggest that the fixed-for-life non-taxable portion should be stated in Euros. For example:—

- 2005 pension was \$12,000 (8,000€ at 1.5 Canadian dollars), so 50% taxable;
- 2006 pension was \$11,928 (8,400€ at 1.42 Canadian dollars); so 50% or \$5,964 taxable;
- the other 4,200€ (and not \$5,964) now becomes the fixed-for-life non-taxable amount, and
- 2007 pension income was \$12,360 (9,156€ at 1.35 Canadian dollars), and \$5,670 (4,200€ at 1.35×) is non-taxable, so \$6,690 is taxable.

Where Do You Stand?

Michelle Causton sent this along from “*Troublesome Words*” by Bill Bryson.

A **lectern** is the stand on which the speaker places his/her notes.

A **podium** is the raised platform on which he/she and the lectern stand. A podium can hold only *one* person. A platform for several people is a **dais**.

A **rostrum** is any platform; it may be for one speaker or many.

And while we're here ... you'll often hear it said that "we need to find **alternate** sources of energy", but that really should be **alternative** sources.

The former is "(of two things) each following and succeeded by the other in a regular pattern", whereas it's the latter which is "(of one or more things) available as another possibility".

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My Upcoming Presentations

Always Fun! Always Informative!

June 22	Corporate Re-organizations	Red Deer, Alberta	Full Day
October 20	Income Tax Update and Refresher	Windsor, Ontario	Half-day
October 20	Corporate Re-organizations	Windsor, Ontario	Half-day
January 23	Income Tax <i>Pot Pourri</i>	Niagara On The Lake	Evening
February 4 and 5	Essentials of Income Tax	Toronto	Two Full Days
February 22	Income Tax: Beyond The Basics	Toronto	Full Day

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