The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Autumn 2007

Measuring Up

To be a small business corporation, and thus have the shares thereof potentially eligible for the capital gains deduction, the corporation must, among other things, meet certain asset "use" tests including an *"all or substantially all"* test.

Let's say that a corporation's assets, as shown in its balance sheet, are $300,000[1] and that all, except one, are used in an active business. The inactive use asset is the $100,000 cash surrender value of a life insurance policy which, in accordance with generally accepted accounting principles, is presented as an asset in the balance sheet at $15,000, that being net of a related $85,000 policy loan.

While the corporation appears to satisfy the *all or substantially all* asset use test as only five per cent of its assets are 'offside', **it actually fails the test**.

Why? Because the Income Tax Act provides that the cash surrender value of the life insurance policy is *"computed without regard to any policy loans made under the policy"*. And so, of its now [restated] $385,000 in assets (as valued for income tax purposes), $100,000, or 26 per cent, is 'offside'.

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[1] assume this also represents fair market value

What "Market"?

A business valuator offers opinions on *fair market value*. The adjective "fair" qualifies the word "market", and so we search for the value in a "fair market". A fair market is defined as one which is consistent and unaffected by a transient boom or panic.

Some American valuators having been having some 'fun' in recent editions of the U.S. newsletter *"BVWire"* by 'poking' at the accepted definition of fair market value. I thought these worth passing on.

One wrote of *flair* market value, another of *fools* market value. Both mean much the same thing — the price paid by irrational buyers.

Here, irrational buyers are those who pay more than intrinsic value by getting caught up in the hype or glamour of a particular asset class or market segment. These irrational buyers create a *speculative* market and more often than not, once the bubble bursts, are left 'holding the bag (of losses)'.

Words, Words, Words

The words "principally" and "primarily" are used in several places in the Income Tax Act, usually as part of some "use" test. CRA's view is that these words mean "more than 50 per cent". Is that view correct?

It's well established that the words used in the Act are to be given their ordinary, everyday meaning where they are not otherwise defined in the Act.

Oxford defines both principally and primarily as "for the most part; chiefly". It defines chiefly as "mainly" and mainly as "more than anything else; for the most part".

Consequently it's easy to see that these words ***don't*** — in my opinion — mean "more than 50 per cent", but rather they mean "plurality". So as long as a particular use is the *greatest* use, then it should be considered "used primarily or principally".

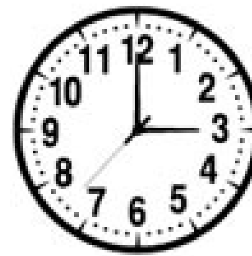
For example, if a building is used 45 per cent for manufacturing, 20 per cent for rental income, 20 per cent for retail space, and 15 per cent for personal use, then the building (viewed as a whole) should be considered used principally or primarily for manufacturing.

If the words used in the Act were intended to mean "more than 50 per cent", then surely, to provide clarity, the Act would say "majority".

> **A Valuable Caution Regarding Use Of Generally Accepted Accounting Principles**
> Don't count your chickens until they're hatched; but then again, don't count it as a chicken if it's an omelette

Timing (again) Is Everything

Under the Income Tax Act the time of an event can be crucial. Take the case of a tax-free capital dividend. It can, assuming there are no prior capital losses which are greater, be paid near-immediately after realising a capital gain because the Capital Dividend Account is calculated at a *"particular time"*. If you wait to pay the capital dividend, a capital loss experienced before paying out the capital dividend will reduce the available tax-free dividend.



One time though that you **must wait** to pay the capital dividend, and that time is until *after* the corporation's year end, is where the gain is from eligible capital property.

This is because here the addition to the Capital Dividend Account is based on the income flowing from the corporation's Cumulative Eligible

Capital account and the balance in that account isn't determined until the end of the year.

The penalty for incorrect capital dividend elections is 75 per cent (it's proposed to be revised to 60 per cent) of the excess amount; so you don't want to be wrong! And a premature election would be wrong.

You Can't Always Bury The Past

I was recently engaged to value a business for a matrimonial dispute. My client was the non-share owning spouse.

In my opinion the business was a going-concern. Its maintainable earnings exceeded $200,000 and it had a tangible asset backing north of three-quarters of a million dollars. Given the nature of the business my opinion was that the value of the goodwill wasn't much more than one year's income.

The business was also valued for the husband (the sole shareholder) by the company's external accountant, who was not a CBV. While he used an asset basis in opining on the value, and I admit it was definitely contentious as to whether there was goodwill, what was surprising were the adjustments he made in valuing the assets.

In addition to a fairly large write down of the accounts receivable, he wrote down the value of the inventory from $650,000 to $75,000. In anyone's eyes that is quite a material change. His final opinion on share value was $25,000.

This same accountant had issued a Review Engagement Report on the company's financial statements, wherein he'd given the assurance that *"nothing has come to my attention that causes me to believe that these financial statements are not, in all material respects, in accordance with generally accepted accounting principles"*. Importantly, those principles include the plausibility of the value of the accounts receivable and inventory.

This contradiction stretched the credibility of the accountant's valuation report so far that it was impossible for him to recover. He was caught between a rock and a hard place. Either his valuation was wrong or his financial statements were wrong.

Also, to add salt to an already open wound, this same accountant had 'crystallized' his client's capital gains deduction only a year earlier. In that tax election, the indicated fair market value of the company's shares was $1.5 million. ***Oops* again!**

More May Only Be *Some* Of More

As announced in the 2007 federal budget, the base amount for the spouse or equivalent tax credit is being increased for 2007 so that it's the same as the basic personal amount. For 2007 that's $8,929.

What will come as a surprise to many is that the base amount is now reduced by the dependent's income on a $1 for $1 basis. There is no longer an income threshold that first needs to be surpassed.

Here's a comparison of 2006 and 2007:—

	2006	2007
Base amount	$7,505	$8,929
Spouse's income	751	751
Amount for spouse	$7,505	$8,178

Don't Miss Out

The increase in the 2007 employment tax credit base amount to $1,000, from $250 in 2006, means that incorporated small business owners should draw at least that amount as salary rather than wholly remunerating themselves through dividends.

As the following illustration shows, there's an outright tax savings of around $130:—

Corporate income	$1,000	$1,000
Salary	1,000	-
Corporate income	$ NIL	$1,000
Corporate tax		$ 186
Dividend		$ 814
Personal tax (highest rate)	$ 464	$ 255
Federal tax credit	155	N/A
Total tax	$ 309	$ 441

Pension Income Splitting

2007 will be the first tax year that spouses and common-law partners can split eligible pension income (up to 50 per cent) as long as they are not separated at the year end because of a breakdown in their marriage or common-law partnership.

Where the marriage or common-law partnership begins in the taxation year, or where the transferee spouse dies, the split is prorated based on the appropriate number of months in the year.

For example, if the pensioner marries in July, only half of his/her year's pension income can be split.

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Published periodically as information for the accounting, legal and other professional firms who are clients of or referral sources for the tax and valuation practice of

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Make A Note to Attend

My Upcoming Presentations

Always Fun! Always Informative!

October 20	Income Tax Update and Refresher	Windsor	Half-day
October 20	Corporate Re-organizations	Windsor	Half-day
January 23	Income Tax *Pot Pourri*	Niagara On The Lake	Evening
January 25	Topics not yet finalized	Winnipeg	Two Half-days
February 4 and 5	Essentials of Income Tax	Toronto	Two Full Days
February 22	Income Tax: Beyond The Basics	Toronto	Full Day

Federal Corporate Income Tax Rates - 2007 through 2011

	2007	2008	2009	2010	2011
General rate	28.0%	28.0%	28.0%	28.0%	28.0%
Rate reduction	7.0%	7.5%	8.0%	9.0%	9.5%
4% surtax	1.12%	-	-	-	-
Net rate	22.12%	20.5%	20.0%	19.0%	18.5%
Small business limit	$400,000	$400,000	$400,000	$400,000	$400,000
Small business deduction	16.0%	16.5%	17.0%	17.0%	17.0%
Net rate	13.12%	11.5%	11.0%	11.0%	11.0%
CCPC investment income	35.79%	34.67%	34.67%	34.67%	34.67%

The three Canadian accounting bodies have never been closer than they are right now in being virtually identical on not only the three main qualification fronts — education, examination and experience, but also as to public accounting practice rights. Isn't it time someone moved this — [which is] in the public interest — along to its natural and eventual conclusion of one accounting body?