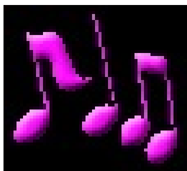
The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Summer 2008

Sound Advice



About 20-years ago, Art Guthrie, Ph.D, FCGA, CBV gave me one of the best pieces of advice I ever received. That advice was [paraphrasing] "no matter the restricted purpose you indicate in your valuation report and no matter the limits/qualifications you provide, once it has been issued there's no telling where it will end up and who will misuse it, so always write your reports and work to standards with that in mind." That advice transcends seamlessly to all professional work.

After years of resistance I recently incorporated the following caution into my "standard" report:—

The analysis and conclusion herein must be considered as a whole. Selecting portions of the analysis without considering the impact on the overall valuation could result in an erroneous or misleading view of not only the methods used and the underlying assumptions, but also of the value conclusion.

> One professional accounting body says "We've got to increase student enrolment" and the other one says "We've got to attract more people to the profession". Both bodies have an education 'arm', but which of the two sees itself beyond that?

One of my valuations recently came 'under fire' where it was asserted my multiplier (applied to earnings) was too high. It's true, the multiplier was higher than what would appear to be justifiable by the income stream; but it was high for a reason and that reason was explained in the report.

Had the critic really read the entire report he'd of had his explanation, and the criticism shouldn't have arisen.

In short, the explanation is that I was compensating for a redundant asset which I hadn't accounted for separately. This is an acceptable practice, albeit definitely not a preferred one.

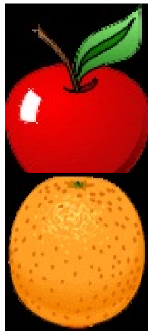
By honing in on one aspect — the multiplier — that went into the valuation conclusion, the critic missed the "whole".

One of the practical lessons here is for those who want to know "what's the multiple or cap rate for 'x' industry" or

"business 'A' has earnings of $x, what's a reasonable multiple"?

Earnings/industry are only a factor that goes into selecting the appropriate earnings multiple and it cannot be determined in isolation from the other factors. **There is no "magic bullet or wand" — so quit looking for one.**

Apples/Oranges Conversion



Taxpayers who hold American securities will usually be provided with statements from their broker/dealer denominated in U.S. dollars. The statement will show something like this:

Book value	$ 75,000
Market Value	$100,000
Gain	$ 25,000

A mistake made all too often in preparing personal income tax returns is to pick up the $25,000 gain and convert it to Canadian dollars at the exchange rate of the day. Say that's 0.98, so the reported gain is $24,500.

What though if the securities were acquired in November 2004 when the exchange rate was 1.1930?

The correct way to calculate the gain is to convert both the cost and the selling price by the exchange rate prevailing at the time of each event. Correctly determined, the above gain is really:

ACB	$ 89,475
Price	$ 98,000
Gain	$ 8,525

When did a hockey sweater become a "jersey"? [Answer: maybe when the NHL offices moved to New York from Montreal]

Be Careful Out There!

Accountants frequently talk about a "change in control" and the income tax consequences thereof — such as a deemed year end or realisation of "pregnant losses". First and foremost, it's not a "change in control" that is the test, but rather an "*acquisition* of control". While 99% of the time a "change" results in an "acquisition" that isn't necessarily so, and you'd do well to use the correct terminology to eliminate the prospect of wrongly applying the tax consequences to the event.

Also you need to be aware that in some circumstances there is deemed to be no acquisition of control, even though there has been a "change" in control. These include

- where the new controller acquired the shares from a related person,

- where the new controller was, *prior to acquiring the shares*, related to the corporation,

- where an estate acquires shares on the death of the shareholder, and

- where a person acquires the shares from the estate of person with whom they were related.

The most obvious example is there is no acquisition of control, and so no deemed year end etc, where daughter/son acquires shares from Mom/Dad.

"The Tie That Binds"

About two weeks or so ago, I ran across a file where the accountant confused "related" and "associated". This isn't surprising considering all the similarities of the pieces which go into solving the puzzle.

Under the *Income Tax Act* there are several possibilities which might tie two or more persons (including corporations) together, including: "related" "associated" "affiliated" and "connected". All sound the same, but are actually quite different, and apply in different circumstances with different results. In my experience the key things to remember are that corporations can be "related" but not "associated", and parents and children are "related" but not "affiliated".

Most times "connected" is generally believed to require that Corp X either controls Corp Y or owns more than 10% of the voting shares and shares which have a value of more than 10% of the value of all Corp Y's issued shares. Sounds straight forward doesn't it? And we believe we know what "control" means.

But there's a tiny little provision in Part IV of the *Act* which precedes the above, and it says (among other things) that Corp X controls Corp Y if more than 50% of Corp Y's voting shares are held by a person(s) who isn't at arm's length with Corp X.

That certainly changes what we might normally think of as "control".

Things I Wish I'd Said

"Lipstick on a pig", because it so aptly describes the spin being put on changes to Ontario's public accounting laws.

"Nothing runs like a Deere", which is a perfect description of John Deere's decision to move manufacturing out of Canada and down to Wisconsin and Mexico.

"If life was fair, Elvis would be alive and all the Elvis imitators would be dead".

Beneficial Ownership

In an effort to avoid probate fees, all too frequently the extent of the planning is that Mom adds daughter Sally as a joint owner of (for example) her securities. To the surprise of many, for income tax purposes that's a disposition of half the securities.

Now you can try to argue that it's not a disposition because the *Income Tax Act* excludes dispositions where there's no change in the beneficial ownership of property. Barring written evidence (legal agreements: a statutory declaration or declaration of trust) I wish you luck with that argument.

However, consider that even if you are successful in your argument (no transfer of beneficial ownership), you'll likely go 'full circle' because Mom's interest in the securities is then probably subject to probate.

This [joint-names] over-simplification of planning is best avoided, and certainly shouldn't be practised by accountants; always refer your client to their lawyer.

As an accountant you *will* though want to be familiar with and advise on alter-ego trusts and/or joint spousal trusts as a planning tool. These will accomplish the probate avoidance objective and solve the deemed disposition problem.

However, these trusts aren't a panacea and can create other problems, so again, always refer your client to their lawyer.

Caveat: the accountant and the lawyer should not work independently in serving the needs of the client, but rather as a team.

Great Quote!

"You get bigger by being better, you don't get better by being bigger." John Stumpf, CEO, Wells Fargo.

Another Great Quote!

"If you think professionals are expensive, you should see what amateurs cost."

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Federal Corporate Income Tax Rates						
Year	2007	2008	2009	2010	2011	2012
General rate	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%
Reduction*	7.0%	8.5%	9.0%	10.0%	11.5%	13.0%
Surtax	1.12%	-	-	-	-	-
Net tax rate	22.12%	19.5%	19.0%	18.0%	16.5%	15.0%
Small business limit	$400,000	$400,000	$400,000	$400,000	$400,000	$400,000
Small business rate	13.12%	11.0%	11.0%	11.0%	11.0%	11.0%
* doesn't apply to investment income eligible for refundable taxes						

Make A Note to Attend

My Upcoming Presentations

Always Fun! Always Informative!

October 18	Income Tax Update	Chatham	Half-day
October 18	Income Tax *Pot Pourri*	Chatham	Half-day
October 23	Income Tax Update (at Controllers Congress)	Ottawa	Half-day
January 14	Income Tax Update	Peterborough	Evening
January 21	Income Tax Update	Oshawa	Evening
January 30	Income Tax Update (at Controllers Congress)	Toronto	Half-day
February 4 & 5	Personal Income Tax Fundamentals	Toronto	Full-day
February 17	Income Tax Update & Refresher	Kingston	Full-day
February 23	Income Tax Beyond The Basics	Toronto	Full-day
February 25	Income Tax Update	Mississauga	Evening
June 3	Corporate Re-organizations *Plus*	Toronto	Full-day