The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Autumn 2008

English Required

This could be re-labelled *"My Favourite Tax Case Of All Time"*.

In 1974 Joseph Corbet claimed his daughter for [what was then] the equivalent married exemption. As Mr. Corbet was married, the DNR [as CRA was then] disallowed the claim.

At the Tax Review Board (the predecessor of the Tax Court of Canada), Mr. Corbet was successful in demonstrating that the *Act* actually allowed him to claim the exemption because of the wording of subparagraph 109(1)(b)(i) ... *"was an unmarried person or a married person who did not support or live with his spouse and was not supported by his spouse"*.

The key to Mr. Corbet's success was the word *"or"*. While Mr. Corbet lived with his wife, she had her own income, and so he did not support her. The Board found that the word "or" was disjunctive, not conjunctive, and so Mr. Corbet only had to satisfy either of the tests specified before/after the *"or"* of *"did not support **or** live with his spouse"*.

As he didn't support his spouse, he was allowed the exemption, notwithstanding that he lived with her.

> A man goes into a book store and asks the clerk where the self-help section is. The clerk responds "If I told you, it would defeat the purpose".

The *Act* was subsequently amended (retroactively) to read:— *"was an unmarried person or a married person who **neither** supported **nor** lived with his spouse and was not supported by his spouse"*

There's Always An Exception

As accountants progress in their careers they begin to develop a set of recallable rules. This allows them to do the 'ordinary' without having to look up the formal rules or law each and every time they're faced with "situation x".

However, one 'rule' they frequently tend not to file away in their mind is that there is an exception to every rule.

An example is that the cost of an asset which is inherited, whether by a beneficiary or the estate itself, is equal to the proceeds that the deceased was deemed to receive. Depreciable property can be an exception to that rule. I say "can be" because this exception only applies in non-arm's length cases. Consider though that not too many people leave something to an arm's length person.

Say that Sarosh has passed away and left a rental property asset to his sister. The fair market value of the property at the time of Sarosh's death was $90,000, but Sarosh's cost was $120,000.

Here, the sister's ACB (adjusted cost base) will be $120,000, *not* $90,000; **but** her capital cost (a different concept than ACB) will be $90,000.

Let's assume the sister sells the property a few years later for $140,000 (without ever having taken capital cost allowance). She will realise the following income:—

	CCA Recapture	**Capital Gain**
Proceeds	$120,000	$140,000
UCC	90,000	N/A
ACB	N/A	120,000
	$ 30,000	$ 20,000

Accountants who aren't aware of the exception would erroneously report a capital gain of $50,000 on the sister's tax return ($140,000 - $90,000). The tax liability is then understated by around $6,000.

Would CRA likely ever catch the error? Probably not. Such (to some) is the joy of tax practice .... no one will ever know you made a mistake. Then again, that's why professional liability insurance is mandatory.

Why does "route" (correctly pronounced "root" as it's from the French "rute" for road) suddenly become "rout" when a football receiver runs a pass pattern?

Lost Over Time

As a new generation of accountants and lawyers take over from us 'oldies' things sometimes get lost, leaving the 'newbie' wondering "what is that?" or worse, mis-interpreting it.

A case in point is the line "contributed surplus" in a corporate balance sheet.

Today, that often represents the income/gain deferred in a section 85 rollover, and so it's a visible signal to someone reading the financial statements that there was a tax-deferred rollover at some earlier time. But that's not always the case because in the 'old' days of par value shares,

contributed surplus represented the excess of the amount paid-in for the shares over that par value. The latter is part of the paid-up capital (PUC) for tax purposes, but the former is not — an extremely important difference.

Another example is shares existing at April 26, 1995 which have been 'grandfathered' from the "stop loss" provisions of the *Income Tax Act*. Being aware of the grandfathering is critical to the accurate determination of losses where there has been a capital dividend on those shares.

Yet, a 'newbie' consulting his/her *Income Tax Act* will have an extremely difficult time finding this grandfathering as it's buried deep in the "history" of the *Act* provisions. Quite simply, few people (myself included) actually look in the "history" part; so unless the April 26, 1995 change was part of your professional education/training, it's easily missed.

Are they or aren't they? *They are!*

Am I the only one who finds it more than a little strange that under Ontario's Public Accounting Act CGAs are considered qualified to perform audits as long as there is no fee, yet they are viewed as not qualified if they charge a fee? Seems to me the Ontario government is saying they *are* qualified to do audits [period!] as the existence of fees isn't a measure of competency (by anyone's standard).

Liquidation Value

The "classical" determination of liquidation value, which you'll find in virtually every business valuation text allows that it is a net, net determination:

Realizable value of assets[1]	$ 300,000
Less all realization costs, including income taxes	100,000
Distributable cash[2]	$ 200,000
Less personal taxes	35,000
Liquidation Value	$ 165,000

[1] net of liabilities

[2] composed of return of paid-up capital, capital dividends and taxable dividends

I have seen several instances where accountants, who are not trained as business valuators or who do not hold a CBV designation, use this value in advising clients in the sale of shares in intra-family transactions or in deemed disposition at death for income tax purposes.

While the "classical" determination is appropriate, under assumed circumstances, for a company under distress, it is not appropriate, for example, in valuing a real estate holding company.

The reason is simple — a shareholder who sold their shares for this price (liquidation value) will incur income tax on his/her capital gain. Assuming a nominal ACB, the income taxes here

might be around $35,000 and so the shareholder's net cash in hand would only be $130,000; obviously they wouldn't sell the shares for that liquidation value.

The price actually required for the shareholder to net the same $165,000 would be $209,390 (which is 'close' to the $200,000 in distributable cash). But would they even sell for that?

To answer that let's dig deeper. A sale at $200,000 to $210,000 would give the purchaser full credit for the taxes/costs they will incur on a disposal of the assets. But that event might be years away, and so this is likely too generous on the seller's part. Yet, a prospective purchaser can't ignore those eventual costs.

In truth, the fair market value of the shares lays somewhere between the liquidation value and the going-concern value (realizable value of the assets) — what we can term "modified liquidation value". Just exactly where will depend on the circumstances surrounding the purpose of the valuation.

Terms I Wish I'd Invented

"Condoronto" (new descriptive name for the city of Toronto)

"Halfrican American" (as in Barack Obama)

"Yanksgiving" (distinguishes the American Thanksgiving from the Canadian one)

Proposed RRIF Changes

Given the situation in Ottawa, will the proposals regarding 2008 RRIF withdrawals ever see the light of day?

Regardless of that question, CRA has announced that it will follow tradition and permit (as proposed) a 25 per cent reduction in the minimum amount that a senior must withdraw from his or her RRIF in 2008. If more than the new reduced minimum amount has already been withdrawn, the excess can be re-contributed to the RRIF and a deduction may be claimed for this amount for 2008.

Happy Chanukah!
Merry Christmas!
And a very Happy New Year!

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Provincial Small Business Income Corporate Income Tax Rates (Excluding the Territories) - As At 31/12/08										
	Alta	BC	Man	NB	Nfld	NS	Ont	PEI	Que	Sask
Rate	3%	3.5%	2%	1.5%	5%	5%	5.5%	3.2%	8%	4.5%
BC goes to 2.5% by 2011 Manitoba goes to 1% on 1/1/09 PEI goes to 2.1% on 1/4/09 and to 1% on 1/4/10										
Annual Limit ($,000's)	$460	$400	$400	$475	$400	$400	$500	$400	$400	$500
Alberta goes to $500,000 on 1/4/09										

Make A Note to Attend

My Upcoming Presentations

Always Fun! Always Informative!

December 16	Income Tax *Pot Pourri*	Toronto	Evening
January 14	Income Tax Update	Peterborough	Evening
January 21	Income Tax Update	Oshawa	Evening
January 30	Income Tax Update (Controllers' Congress)	Toronto	Afternoon
February 4 & 5	Personal Income Tax Fundamentals	Toronto	Full-day(s)
February 12	Section 85 Rollovers	Toronto	Evening
February 14	Income Tax Update	Scarborough	Morning
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