# The J Thomas McCallum Letter

*advancing the understanding of income tax and valuation matters*

Spring 2009

## Tax Free Savings Accounts

There is nothing inherently 'wrong' with TFSAs, but what's all the fuss and excitement about? Or put another way "how soon we forget".

Until taken away by the so-called tax reform of 1987, Canadians were allowed the first $1,000 of their Canadian-sourced interest and dividends as well as capital gains on Canadian-securities **tax free**.

That was all made possible by a simple deduction in the personal income tax return. Unlike TFSAs, no special account was required, and so administrative costs (from all perspectives) were virtually zero.

Why TFSAs, and what's in it for the government? Simple — unlike RRSPs (and RPPs) where the capital contribution is tax deductible, the capital contributed to a TFSA is in after-tax dollars. So the government gets its tax up front rather than having to wait 'til the taxpayer's retirement.

In my opinion what you are witnessing is the beginning of the end for RRSPs and RPPs[1]. I'm predicting that within a decade (or sooner) these will be phased-out, thus providing the federal and provincial governments with the billions of dollars they presently forego in current annual revenues.

[1] pension plans will continue to exist, with employer contributions still deductible to the employer but taxable to the employee

> Congratulations are due to the CICA for their wonderful advertising campaign which in 10-second and 30-second slots manages to actually describe not only what [chartered] accountants do but what they bring to the table!

## Lent-Back Dividends

Cash dividends from OPCO to HOLDCO are oftentimes returned to OPCO in the form of a loan.

Whenever possible, these shareholder loans should be secured by a general security agreement and registered under the Personal Property Security Act. That way, in the event of insolvency, shareholders *may* be secured creditors and enjoy priority over unsecured creditors. The general security agreement need not specify the amount of the loan.

There are numerous legal requirements and issues involved, which vary from province to province, and so it goes without saying that a lawyer with expertise in commercial law should be consulted each and every time.

## Three Questions

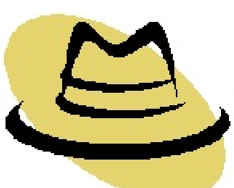
1. Why not have a "do call" list instead of a "do *not* call" list?

2. Why are the words manhunt, taxman, and manslaughter still used? All are negative images and aren't they every bit as 'sexist' as chairman, mailman, and fireman?

3. Shouldn't politicians (and others) be talking about *creating* jobs rather than "protecting" jobs?

## FASB adds the Fair to Market Value

Hats off to the Financial Accounting Standards Board in the United States which recently released American banks from the compulsory mark-to-market accounting for certain assets.



This is a welcome change as it epitomizes the true definition of a fair market — one which is consistent and unaffected by a transient boom or panic.

Further, current market prices can easily represent the price achievable by a distressed seller — another concept foreign to the definition of fair market value.

## 'Pregnant' Losses

About two months ago another accountant and I were discussing a situation where his corporate client was being purchased by an arm's length acquirer. I raised the issue of 'pregnant' losses and he surprised me by saying he didn't know what those were.

Section 111 of the *Income Tax Act* requires the recognition (in the year ending on the acquisition of control) of terminal losses accrued on depreciable property, capital losses accrued on capital property, and losses accrued on eligible capital property. Hence the term 'pregnant' losses.

Section 111 also contains a partial relief offset to this requirement as it allows the corporation to designate any capital properties (of its choosing) to be deemed disposed of at (up to) fair market value. Capital gains triggered in this manner will absorb the aforementioned losses. Perhaps more, or at least as importantly, this designation 'bumps-up' the ACB (adjusted cost base) of the designated property.

## T1135 Penalties

If a client owns foreign-property with a **cost** exceeding $100,000 they need to file form T1135 not later than the due date of their personal income tax return. As one of my accountant clients recently discovered, the penalty for late-filing is $25 per day, with a $100 minimum, to a maximum of $2,500.

However, the accountant's story ends well. He wasn't aware that personal-use property — in his client case it was a winter home in Florida — is ***not*** reportable in the T1135. Once that error was explained, CRA removed the penalty, and in fact, the entire T1135 was scrapped. All's well that ends well!

Perhaps it's worth re-iterating: reportable property is that with a ***cost*** (not a value!) exceeding $100,000. This is the aggregate cost of all foreign-property, not each individual property. It should also be noted that where property is received as an inheritance or gift, the cost of the property is its fair market value at the time of the gift/inheritance.

## Ontario: The Good and The Bad

Ontario deserves full marks for the corporate tax reductions announced in its latest provincial budget. The general rate goes to 12 per cent (from 14%) on July 1, 2010, with further reductions in each of the next three years, bringing it to 10 per cent at July 1, 2013. The small business rate goes to 4.5 per cent (from 5.5%) on July 1, 2010 (no further reductions are scheduled). The growth-killer small business rate claw-back (introduced many years ago by Premier Rae) is finally also gone as of July 1, 2010.

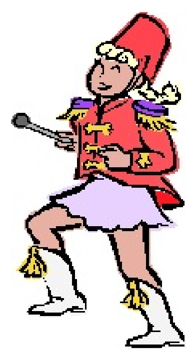
On the personal tax front, the lowest tax bracket is reduced to 5.05 per cent (from 6.05%) effective January 1, 2010.

These are all great things, but if they are recession fighter moves, I'm left to wonder why not start July 1, 2009?

Hidden in all the tax-cut gems is the tax *increase* on dividend income. The increase begins in 2010 and grows in each of 2011 and 2012.

## Ontario: The Ugly

Don't be planning that AIT (Agreement on Internal Trade) victory parade route just yet. While apparently willing to spend billions of dollars to keep its south-direction highways open, Ontario wants to shut down its east/west highways.



Seems its relations with the USA are simply more important than its relations with the rest of Canada.

Then again, in a view from the other side, there's an accounting body that supports a national securities regulator over the passport system alternative. However, that body also supports the

AIT, which is a passport system. The two items are not mutually exclusive; they are inextricably linked, so I'm confused by the policy contradiction.

## Valuing Preferred/Special Shares

Assuming the issuer is a going-concern, the value of publicly-traded preferred shares is principally driven by the dividend rate. The same though is not generally true of the preferred or special shares of a closely-held private corporation. There, the value is principally driven by the attributes of the shares and the facts surrounding ownership. The considerations to be taken into account include:

- are there dividends?
- if there are dividends, what rate and are they fixed or discretionary?
- are the shares redeemable? retractable?
- are the shares voting or non-voting?
- relationship to other (controlling common) shareholders?
- what are the participation/rights on winding-up?
- what is the company's ability to pay dividends and/or to redeem/retract the shares?
- and so on, almost *ad infinitum*.

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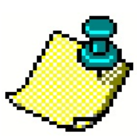

Make A Note to Attend

## My Upcoming Presentations

**Always Fun! Always Informative!**

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|---|---|---|---|
| June 3 | Corporate Reorganizations *Plus* | Toronto | Full-day |
| October 21 | Section 85 Rollovers (and Related Areas) | Toronto | Full-day |
| October 28 | Essentials of Private Corporation Income Tax | Ottawa | Full-day |
| November 19 | Essentials of Private Corporation Income Tax | Toronto | Full-day |
| December 9 | Income Taxes At Death | Toronto | Full-day |