

The J Thomas McCallum Letter

advancing the understanding of income tax and valuation matters

Summer 2010

Shareholder Loans

Here's a common situation. Opco Ltd is held 100% by Bob, and there's a "due shareholder" on the balance sheet. Bob organizes a holding company and transfers his Opco shares to Holdco. The "due shareholder" on Opco's balance sheet now becomes (re-label) "due Bob". Failure to do this could have catastrophic results.

The other alternative, although I can't think of a reason to do this, is for Bob to transfer his receivable to Holdco. Almost without exception that would be for a note back as consideration.

Holdco would then have a "due from subsidiary" and a "due shareholder" on its balance sheet, and the "due shareholder" remains (as it was) on Opco's balance sheet.

Eligible Capital Property

Goodwill and other so-called 'nothings' are examples of eligible capital property as are government licences. The cost of these assets are housed in a tax account

called Cumulative Eligible Capital and amortized to income on a declining balance basis.

The *Income Tax Act* is quite clear — this process only applies to a **business**. A business is defined in the *Act* as including "a profession, calling, trade, manufacture or undertaking of any kind whatever".

Now assume a non-corporate client has purchased a taxi licence for \$200,000, and is common in the industry, the licence will be rented out month-by-month.

The rental income is income from property, not business income.

How Come?

On my summer holiday trip home I was amazed that virtually every Mom & Pop motel along the highway offered free high-speed internet access. Yet when I stay at almost any one of the major hotels in downtown Toronto there's a charge of around \$15 per day.

The question then arises: can that client include the licence as eligible capital property and amortise it to income? Put another way, is this a business notwithstanding that the income isn't business income?

The answer is yes. Albeit perhaps somewhat of a 'strange' concept, a taxpayer can be in the business of earning income from property.

Section 85 Rollovers

The mere mention of Section 85 strikes fear into the hearts of most accountants. Perhaps that's rightfully so as there are a host of places where you can go wrong in the election. However, Section 85 is also one of the most misunderstood provisions in the entire *Act*.

The purpose of the provision is to allow a taxpayer the opportunity to transfer assets to a corporation, in exchange for shares and debt, on a tax-deferred basis. It is *not* — as per the popular misconception — used for the tax recording of all such asset transfers.

If there is no income or capital gains triggered by the transfer of the assets, or there is but it's not to be deferred, then you don't use Section 85. It's just that simple.

My Section 85 professional development course has just been updated and is available from CGA-Canada.

One area of confusion is when not all the property in a depreciable Class is being transferred.

The minimum that can be elected as the agreed amount is the *least* of (1) UCC of the Class, (2) cost of the property, and (3) fair market value of the property. Notice that two of the reference points are in respect of the

particular transferred property but the first is to *all* the property in the Class.

Assume the transferred property had a cost of \$100,000 and a fair market value of \$150,000, whereas the UCC of the Class to which the property belongs is \$350,000.

The minimum agreed amount (recognized as proceeds of disposition by the transferor and acquisition cost by the corporation) is \$100,000.

Some practitioners see this as illogical because they know that the particular property has been depreciated by the transferor. So they ignore what the *Act* allows and instead utilise an allocation of UCC. This gets rationalized as being “correct” — but it isn't — because it has the effect of ‘moving’ the accrued depreciation recapture on the transferred property to the corporation.

However, there is one time (strictly by CRA policy, not law) when the UCC *can* be allocated to a transferred property or properties. When there's a divisive re-organization, AKA a “butterfly”, the parties can allocate UCC to their particular property by the formula:

$$\frac{\text{cost of particular asset}}{\text{cost of all assets in the Class}} \times \text{UCC}$$

Assume Betty and John own BJ Ltd 60/40, and are dividing into two

separate corporations they will each solely own.

There are two properties in Class 3: one cost \$6,000, the other \$4,000, the UCC of the Class is \$5,000, and Betty will receive the \$6,000 property.

On the section 85 rollover connected with the “Betty” butterfly, the election can be made at \$3,000. Were it not for this ‘friendly’ CRA allowance the butterfly couldn’t be achieved on an equitable basis from a tax position perspective.

Keeping It Straight

It’s always interesting that some people spell the noun “licence” in its verb form (with an “s” rather than a “c”). It’s really as simple as “An organization can license its members and that’s evidenced by the member having a licence”. Practice and practise are the same: “The members will practise their profession through their professional practice”.

A Professional’s “Hidden Asset”

Section 34 of the *Income Tax Act* allows professionals (accountants, dentists, lawyers, medical doctors, veterinarians, and chiropractors) to elect to exclude their work-in-progress (WIP) from income. If the practice is carried on by a professional corporation, that corporation is also allowed the election.

The resulting accounting method then is a modified accrual basis. In my experience, almost all those

professionals use this method.

The WIP asset then is a ‘hidden’ asset (exists, but not recorded). What makes this fascinating is its correct treatment on terminating the practice (including transferring it to a corporation) or death.

Under section 10 of the *Act* WIP is valued at “the amount that can reasonably be expected to become receivable in respect thereof after the end of the year”.

When the professional terminates his/her practice, the WIP is realised as income immediately following the termination.

WIP is inventory, notwithstanding that it’s not recorded, and so in order to avoid its immediate realisation as income at anything other than \$1 on its transfer to a professional corporation, it must be elected on under Section 85.

On death, WIP is considered a “right or thing”. Consequently, it’s eligible to be included in a *separate* T1 for the deceased practitioner. This could save thousands of dollars in tax.

The Risk Premium

When estimating the value of a private business the income or cash flow multiple is a critical determination.

	High/Low Range	
risk free rate, say	4%	4%
risk premium	x%	x+%

illiquidity premium	$\frac{y\%}{\text{sum}}$	$\frac{y+\%}{\text{sum}}$
capitalization rate		

The multiple is the inverse of the capitalization rate; for example a 20% rate is 5x.

Of the three elements, the most difficult is the risk premium. Its quantification should be supported by a qualitative evaluation of the risks inherent in the business. Those risks can be broadly categorized as internal and external.

This evaluation won't give you the actual premium, but rather it's a guide to assist in its quantification.

Of the external risk considerations, there are three that likely, depending on the business/industry, have more emphasis today than in the past. These are (1) product life cycles, (2) political environment, and (3) social environment. This observation is supportable if you reflect on rapidly changing technology, turmoil and uncertainty in the capital markets, and "going green".

Free Software

While many of us have discovered and use the AVG anti-virus software, here are some useful **free** maintenance utilities:—

- Glary Utilities from GlarySoft (has a number of processes and modules)
- Disk Defrag from Auslogics
- Registry Cleaner from Auslogics
- Revo Uninstaller from VS Revo Group.

Disclaimer: If you download and try any of these you're doing so at your own risk. They've worked for me, but that's no assurance you won't run into problems on your computer.

A group of chess enthusiasts checked into a hotel, and were standing in the lobby discussing their recent tournament victories. After about an hour, the manager came out of the office, and asked them to disperse.

"But why," they asked, as they moved off. "Because," he said. "I can't stand chess nuts boasting in an open foyer".

The J Thomas McCallum Letter

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

J Thomas McCallum, FCGA, CBV
Whitby, Ontario
1-800-265-2686 or 905-579-0022
www.jthomasmccallum.com

Readers should not rely on or use the information provided as a basis for a course of action without first obtaining the appropriate professional advice.

© J Thomas McCallum



Make A Note to
Attend

My Upcoming Presentations

Always Fun! Always Informative!

October 7	Business Valuation	Toronto	Full-day
October 23	Income Tax Update + Tax Bits & Bites	Sarnia	Full-day
October 26	Section 85	Toronto	Full-day
October 29	Section 85 (private group function)	Niagara Falls	Half-day
November 23	Estate Freezes	Toronto	Full-day
November 25	Section 85	Ottawa	Full-day
November 26	Estate Freezes	Ottawa	Full-day
November 30	Section 85	Oshawa	Full-day
December 3	Corporate Reorganizations <i>Plus</i>	Toronto	Full-day
December 8	Essentials of Private Corporation Tax	Oshawa	Full-day
December 14	Income Tax Bits & Bites	Toronto	Full-day
December 16	Essentials of Private Corporation Tax	London	Full-day
December 20	Ontario Business Corporations Act for Accountants	Toronto	Full-day