

# THE Quarterly Dividend

Vol. 25 No. 4 Your guide to income tax & financial planning

## FAST TRACK



### Milestones

Every year we mark the anniversaries of major events that have happened in our lives on both the personal and familial level. We rejoice while thinking about milestone birthdays and wedding anniversaries and stop for a few minutes to commemorate sadder events that have touched our lives at this time of the year.

The small businessman is no different. In fact, he has additional opportunities to celebrate as he reaches

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## Two Legal Cases That Have Lingered A Long Time

Here are two longstanding legal cases that just do not want to be settled anytime soon. The Livent case dates back to the late 1990's and looks like it will finally be resolved when the Supreme Court rules on the matter, probably in 2017.

The Bronfman case shows no sign of being finalized as the Canada Revenue Agency appears to be in no hurry to outline, once and for all, its position on the deductibility of interest. Taxpayers will continue to have to "guess" whether their claims are "on side" or might be challenged when they do their income tax planning.

### LIVE ENTERTAINMENT CORPORATION OF CANADA (LIVENT)

Facts: (a) Garth Drabinsky and Myron Gottlieb owned 56% of the shares of a publicly traded corporation, Live Entertainment Corporation of Canada (Livent) in the 1990's;

(b) the company owned The Pantages Theatre in Toronto and produced such shows as "Phantom of the Opera", "Ragtime" and "Show Boat" for local audiences as well as touring productions throughout Canada and the United States;

(c) as a public company, Livent raised capital through initial public offerings on the Toronto Stock Exchange in 1993 and the NASDAQ Exchange in 1995. These raised more than \$360 million. To keep their listings on the Exchanges, the company was required to file quarterly and annual audited financial statements with both the Ontario Securities Commission in Canada and the Securities and Exchange Commission in the United States;

(d) the company, several high-ranking employees and its Directors (GD and MG) committed fraud when the company had "cash-flow"

problems that threatened to force it to close down;

(e) these frauds included (i) the improper recording of financial information in its books and records to overstate net income and retained earnings by shifting period expenses from an earlier period to a later one, capitalizing expense items and most damaging of all, by having the company's Information Technology department write customized software that allowed users to delete or modify entries directly in the accounting system without leaving an audit trail;

(f) GD and MG also breached fiduciary duties by entering into private "deals" with third parties that were not in the best interest of the company but enhanced their own personal well-being;

(g) the company also failed in its "corporate governance" requirements as mandated of public corporations;

(h) throughout this period, the auditing firm of Deloitte and Touche failed to detect the problems with the company's financial accounts and continued to issue "clean" audit opinions, particularly in 1997 when the fraud seems to have been at its height;

(i) by 1999 the full extent of the fraudulent activities of the company and its directors came to the attention of the regulators and criminal charges were laid by both the OSC and the SEC against the company, GD and MG, the auditing firm, and several high ranking employees;

(j) the company filed for bankruptcy. The judge ordered a trustee be appointed to work with investors and creditors to partially recoup some of their \$500 million in losses. The trustee sued the accounting firm claiming shareholders/investors/creditors had relied on financial

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personal and business milestones pertaining to the company he has been operating. This is because for him the business is more than simply a source of livelihood for himself and his family, it has been his focus of attention 24/7 each day from the time he gets up in the morning until he retires at night.

Those of us "lucky" to have been in business for ourselves understand this feeling in a way that is difficult to communicate to others who have not. There is no comparable feeling to the sense of satisfaction that wells up when a business or professional goal is attained.

That is why it is important for the entrepreneur to savour his accomplishments (and recognize his setbacks) at least once per year on these milestone occasions. He should stand back and consider the "big picture", what has propelled him to where he is now and what and where the future likely to take him.

But how can the owner/manager celebrate these occasions?

On the one hand, he would like to publicize these successes to business associates, customers, suppliers and others who have

statements that had not been properly audited;  
(k) convictions were obtained and jail time was ordered for GD and MG;  
(l) the auditing firm was found guilty and ordered to pay \$118 millions in fines. They have appealed these judgments to the Supreme Court of Canada who have agreed to hear the case, although no exact date has been set.

#### WHAT MAKES THIS CASE SO INTERESTING:

- (a) the case has become important in the legal community because it has historically been very difficult for investors to sue auditors when companies collapse amid allegations of accounting fraud. In fact, this case has opened the door for other groups to use as a precedent in their own lawsuits;
- (b) up until now, the Courts have ruled that auditors owe a "duty of care" to the corporation that hired them and not to individual shareholders or creditors directly. In fact, in order for the bankruptcy trustee to adhere to current legislation, he had to sue Deloitte and Touche directly even though the creditors and shareholders whom he represents are paying his legal costs and will reap the reward if he is successful.

#### BRONFMAN FAMILY TRUST FACTS:

- Facts: (a) the Bronfman family formed a trust consisting of a portfolio of investments;  
(b) in the mid 1980's the family wanted a cash distribution from the trust but was unwilling to sell its assets to raise the money, fearing an erosion of capital;  
(c) the family was also unwilling to delay the distribution it desired;  
(d) the family authorized the trustees to borrow

money to effect the distribution, thus keeping the "corpus" of the trust intact;

- (e) in the trust's annual return, it claimed the interest costs incurred on the borrowed money as an expense against the trust's earnings;
- (f) the Canada Revenue Agency disallowed the expense on the grounds that in order for interest to be deductible, there had to be a direct relationship between the borrowed money and the investments for which the borrowings had taken place;
- (g) the CRA argued that the money had been borrowed to effect a distribution, not to finance additional investments for the trust. It was certainly able to borrow money if it wished, it just could not deduct the interest costs incurred against income earned;
- (h) the trustees agreed that the money had been borrowed to finance cash distributions but that the trust was entitled to do so, and the interest deductible, if the funds were distributed to its beneficiaries;
- (i) the CRA and the trustees argued their positions in court, ultimately having the matter decided by the Supreme Court of Canada in 1987;
- (j) the Supreme Court sided with the CRA.

#### WHAT MAKES THIS CASE SO INTERESTING:

- (a) it was presumed that the CRA would use this "victory" to articulate once and for all their stand on the deductibility of interest. In fact, draft legislation was tabled in 2003 as a "trial balloon" to foster discussion within the investment community;
- (b) when it met with significant opposition, it was withdrawn and has not been revisited since;



## Turning 71

When a taxpayer who has been contributing to a RRSP turns 71, the funds that he has accumulated in the plan have to be converted to one or more of the following retirement income options by December 31 of that year. All funds have to be dispersed to the taxpayer by December 31 of the year he turns 95.

The major difference between the options lies in the amount of payout the taxpayer wishes to receive. And these will typically be determined by the taxpayer and his spouses age, health, lifestyle and amount accumulated in the RRSP

over the years. The full amount of the payout can be realized in (a) one withdrawal, (b) in a steady stream of payouts, (c) or a pre-determined schedule calling for lesser payments at the beginning, and larger payments as the years go by.

(a) a lump-sum cash withdrawal of all RRSP funds that have accumulated over the years.

This option gives the taxpayer 100% of the balance in his RRSP right away. The drawback is that he will be taxed on this amount for having received the money in one or perhaps two taxation years. This will often be at the highest



contributed to his success over the years and thank them for their contributions. But on the other hand it is not in his DNA to "pat himself on the back" and advertise his accomplishments to everyone with whom he comes into contact. In almost all cases, these successes are very personal in nature and cannot readily be explained to someone who will simply not understand all the efforts and sacrifices that he has made over the years.

One way to mark the milestone is simply to give yourself a day off from the busy routine that normally consumes your workday. Unfortunately, this is easier said than done.

How many times during the year do you plan to slip away from the office and have some "me time" only to have a customer show up at your door with a concern that only you can address? How many times have you wished you could emulate your employees and dash out the door at 5:00 pm sharp?

How many times have you told yourself that the business doesn't run itself and therefore necessitates your presence from morning to night?

How many times have you said to yourself that your

personal income tax rates applicable in those year(s).

(b) a Registered Retirement Income Fund (RRIF) functions like an extension of your previous RRSP. Your investments continue to grow tax-free but you must stop contributions and withdraw certain pre-determined amounts each year.

The taxpayer will be taxed on the full amount of the payout he receives each year, except for the \$2000 pension income non-refundable tax credit. This option provides for lower amounts of income to be withdrawn in early years and larger amounts as the years progress to age 95.

(c) an annuity provides for a guaranteed stream of payments for any number of years up to the age of 95.

Payments are considered to be partially a return of capital and partially investment income. The full amount of the annuity payout received will be taxable each year subject to the \$2000 pension income non-refundable tax credit.

Lucy turned 71 in October and has until December to decide how she should convert her \$250000 RRSP into retirement income. She has combined CPP and Old Age Security Pension benefits of

\$13600. Here is what she is considering at the moment as she contemplates her income until age 95:

(a) a \$250000 lump sum cash withdrawal will require her to pay \$107000 in income tax this year. She will retain \$143000 in capital and if she is lucky earn perhaps \$4300 annually in investment income. She will live on \$17900 before dipping into her capital;

(b) purchase a RRIF tailored to provide her sufficient income through age 95. The annual required withdrawal amounts will easily be met if she withdraws \$1333 monthly or \$16000 per year. Her income tax liability will be \$3300 and she will have \$26300 to live on.

(c) purchase a 20 year single premium guaranteed annuity for \$250000. This will provide her monthly income of \$1212 or \$14550 annually. Her income tax liability will be \$2100 per year and she will have \$26050 to live on.

The difference between (b) and (c) is not significant, only \$20 per month. However if that is the case, Lucy should go with the former and spend the extra amount on her grandchildren.



## New Rules, More Taxes

There is a common saying in the restaurant industry, "new menu, new prices!!". The same can be said about the Income Tax Act, "new rules and for sure, more taxes".

Commencing in 2017, the income tax treatment of such assets as goodwill, trademarks and patents will be significantly changed.

Up until now these expenditures were recognized for income tax purposes at three-quarters of their cost and amortized at a maximum of 7% per annum over their "lives".

Thus if Company A spent \$100000 on developing a patent in 2011, it would have assigned a tax value of \$75000 to this asset and "written it off" at 7% per year for the past five years. By now, its Eligible Capital Amount would be pegged at \$52178.

If the company sells the patent in 2016 for \$150000, three quarters of the proceeds or \$112500 are compared to the tax value of \$52178 and \$40215 is brought into income. This would have a tax cost of \$6135 for a Canadian

Controlled Private Corporation resident in Ontario.

Under the new regime and the same circumstances, but commencing in 2017, Company A would record the asset at its full \$100000 cost in a new Capital Cost Allowance class whose allowable rate is 5% per annum.

By 2022, five years after its development, the patent has a tax cost of \$79414 and when it is sold for \$150000 the amount brought into income is significantly different.

Company A must now recognize "recapture" of the value between the original cost of the asset and its current tax value. This is \$100000 minus \$79414 or \$20586.

It must also recognize a capital gain of \$25000 which is one-half of the difference between \$150000 and \$100000 for a total income for income tax purposes of \$45586.

The income tax liability would now increase to \$15180. Definitely a case of "new rules, more taxes!!"





employees do not work for you but in fact it is you who are working for them?

At least once per year, on your unique milestone day, put these thoughts aside and do something for yourself. Call it a "mental health" day or whatever, but as they say in the shoe business, "just do it!!" and see how invigorating it will make you feel.

This issue marks number 100 in the publication of the *The Quarterly Dividend*. It is a highlight of my professional career. I have learned more from its research and writing than I would have had I attended lectures on the various topics for as many hours as I have put into its creation. I thank everyone who has taken the time to read the articles. I hope they were informative and enjoyable. Now, if you will excuse me, I have some serious "me time" to attend to and I do not want any distractions!!

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## Corporate Minutes

One of the obligations assumed under Corporate statute is the requirement of a corporation to hold annual meetings of its Board of Directors and maintain accurate minutes of their proceedings. Documentation in the minutes serves as evidence that the Board has granted authority to the company's officers to carry out its directives while at the same time demonstrating their ability to having acted on an informed basis, in good faith and in the best interests of the company.

The minutes, themselves, should be (i) clear, accurate and objective; (ii) reflect the directors' thoughtful deliberation of the issues at hand; and (iii) demonstrate the extent to which issues were considered given their level of importance. Matters that come to a vote are recorded and individual directors who vote against an agreed upon course of action or choose to abstain from the vote authorizing that action will not be held responsible in the event that things do not work out as expected and the Board as a whole is called upon to defend its actions.

While the Statutes provide little guidance as to how minutes are to be kept, the courts have come

to expect the following minimal items to have been covered:

(a) kind of meeting: regular annual meeting or one called to address a "special" issue; (b) name of corporation; (c) date, time and place of meeting; (d) name of presiding officer and secretary; (e) names of those present and absent; (f) establishment of a quorum to make sure that decisions voted on can be enacted; (g) recording of actions undertaken under authority of previous Board meeting's directives; (h) motions presented and passed (note: those that were presented and defeated do not belong in the minutes); and (i) signature of presiding officer and secretary.

Finally, the level of detail to be outlined in the minutes can be either "bare bones" with very little narrative or one with a more informative style. Owner-managed corporations can prepare their minutes based on the former but as they grow in size directors should place on record the purpose and effect of their deliberations and conclusions so that they cannot reasonably complain that false inferences have been drawn from their report.

## When One Door Closes Another One Opens

One aspect of being in business for yourself is rarely addressed in the literature. And that is the situation of deep disappointment that comes over the entrepreneur when he loses a long-standing client for whatever reason. It may be easier to accept when the customer retires or sells his business and is therefore not leaving because of something you "did", but the void is still there as you remember the relationship you built with him over the years.

The range of emotions the entrepreneur feels includes sadness (of course), anger, fear and anxiety as he contemplates how to continue his business. How quickly can the lost client be replaced? Do I need so many employees if I no longer have this contract? Should any existing plans for expansion, renovation, etc be put "on hold" now this particular client will no longer be serviced?

All these and many other questions will have to be addressed. But here are a few coping mechanisms you might find helpful: (a) acceptance of the situation without over-estimating the problems that

will/may result from the loss of the client. As they say, the sun will still rise tomorrow morning and you will have to soldier on, so do not make things worse by over thinking about what has happened, just move on as there will be others to take his place; (b) talking it out with others is always a good idea. But not with just anyone. Choose someone you know who has gone through a similar experience and can relate to what you are feeling. Family members and employees, though well-meaning, may not have first-hand experience with what you are going through, so their input at this time is of limited value; and (c) stay busy with your existing customers and continue to work as hard going forward as you did in the past. Do not become discouraged and let one setback destroy your long held dreams and aspirations. Remember you are influenced by your actions. An owner-manager who constantly thinks about his business and is inspired to constantly improve it, faces a myriad of issues each day. And resolves them successfully. Think of this as just one more that will demand your attention.

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