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Marmer Penner Inc. Newsletter

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What's in that Thick Corporate Document?

When asked to determine the value of a party's corporate interest and/or determine that party's income pursuant to the *Federal Child Support Guidelines* ("*Guidelines*"), the financial documents commonly reviewed include corporate financial statements, corporate income tax returns and personal income tax returns. While the financial statements are often referred to for a preliminary assessment of a company's financial health and while personal income tax returns are the starting point of any *Guidelines* income determination, corporate tax returns also provide valuable information for these purposes.

Here is our top five (or six) list of the more salient schedules in a corporate tax return which provide valuable information in a valuation and/or income determination analysis:

1) Schedule 1 – Net income/(loss) for income tax purposes – the numbers presented on a company's financial statements are in accordance with accounting standards such as the often encountered accounting standards for private enterprises ("ASPE") which are adopted by small enterprises. As accounting policies often differ from the rules of the income tax act ("ITA"), Schedule 1 of the corporate tax return converts the income reported for accounting purposes to income in accordance with the ITA. This schedule may assist a business valuator in identifying amounts recorded in the books of the corporation that may require further analysis in determining their validity as business expenses. For example, club dues and fees are not deductible in accordance with the provision of the ITA. Meals and entertainment amounts are only 50% deductible. Life insurance premiums are not deductible. When these amounts are added back as income on Schedule 1 of the corporate tax return, we know that they have been deducted as business expenses for accounting purposes. Though the mere inclusion of these amounts on Schedule 1 does not automatically translate into inappropriate amounts being deducted as business expenses, this will

provide a business valuator with a focused area of analysis in order to arrive at their own assessment.

There are other items that may be included on Schedule 1 such as a deduction for income arising from holdbacks in, for example, a construction company. When a construction company bills out its work, it records the full amount for accounting purposes as revenue, even though it will not receive a certain percentage of its invoiced amount, the holdback, for a number of months. Under the ITA, the amount for the holdback can be deducted for tax purposes and included in income only when received. This alerts the valuator of future tax liabilities which should be considered as part of the company's tangible asset backing (see separate newsletter in January 2016 which focused specifically on this topic);

2) Schedule 3 – Dividends received/paid – this schedule provides details of the dividends received and paid by the corporation during the year. When a corporation receives dividends, it must pay tax on those dividends. The amount of tax paid is added to a notional tax account known as the Refundable Dividend Tax on Hand ("RDTOH"). The balance in the RDTOH account can be partially distributed when the company eventually pays out dividends of its own, resulting in a refund of the tax paid on the previously received dividend. A business valuator will recognize that an RDTOH account exists and although the balance of such account is not indicated on this schedule, it is disclosed elsewhere in the tax return. For valuation purposes, a company with an RDTOH account is more valuable than one without it, all things being equal. Additionally, this schedule also details the dividends paid by the company, be it capital or taxable. The payment of capital dividends may highlight the possibility that a capital dividend account exists which affects the calculation of contingent disposition costs on the sale of the business, as a portion of proceeds can be received on a tax-free basis. Furthermore, when calculating *Guidelines* income, the receipt of capital dividends by a taxpayer is not included on a personal tax return given that they are received on a tax-free basis. This schedule may point to amounts received by the spouse which we would not know about;

3) Schedule 4 – Schedule of losses – this schedule provides balances of various accumulated losses that are available to be applied to future income including capital, non-capital, and farm losses, among others. When a corporation generates losses in a particular year, it is permitted to apply those losses to future or past income. A corporation with an accumulation of prior year losses may have be worth more than one that does not have any losses, all things being equal, assuming the corporation has changed its course and has turned into a profitable entity. The tax savings arising from

the application of losses need to be considered in the valuation exercise which impact overall value;

4) Schedule 9 – Related and Associated Corporations and Schedule 50 – Shareholder Information – quite often we are provided organization charts as a starting point which illustrates the entities requiring a valuation and the entities to be considered in a *Guidelines* income determination. Schedule 9 of the corporate tax return requires disclosure of the names of all associated and related corporations to the subject corporation. This schedule can be used as a cross-check against the organization chart provided to ensure we are aware of all business interests that need to be considered. Additionally, a business valuator may give some thought to transactions between related/associated entities and assess whether they are effected at market rates which can influence the conclusion of the valuation. Schedule 50 discloses the shareholders of the corporation which can also be used as a cross-check against the organization chart provided; and

5) Schedule 53 – General Rate Income Pool (GRIP) Calculation – though the information on this schedule does not affect the valuation of the corporation, it does impact the calculation of the contingent disposition costs upon the sale of the entity. A company with a GRIP balance can distribute dividends known as eligible, which are taxed at more favourable rates than other-than-eligible dividends which are distributed by a company without GRIP.

As shown above, the corporate tax return provides much more in-depth analysis of the various assets or liabilities that may have to be factored into a determination of value and can also provide details pertaining to the determination of *Guidelines* income. The usefulness of a corporate tax return should not be discounted, as it can provide valuable information that cannot be necessarily found on any other financial documents.

This newsletter is not intended to substitute for proper professional planning. It is intended to highlight areas where professional assistance may be required or enough to discuss at the next hoedown. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at ***www.marmerpenner.com***.