BUSINESS VALUATIONS: PART 1

Hendry Warren Chronicle - Tax and Accounting Simplified **May 2017**

Where two parties to a transaction are not related, determination of fair market value is simple. The vendor and purchaser establish value through their negotiations and ultimately a final price is established. In cases where the parties are related or "not dealing at arm's length", determining the fair market value is more difficult as parties may be biased by various factors including the income tax implications. For example, where a parent wishes to transfer ownership of a corporation to their child for succession reasons, the sale price will determine the capital gain realized by the parent and the cost of the shares for the child on a go forward basis. The Income Tax Act ("ITA") contains several provisions to help ensure such transactions occur at fair market value.

The remainder of this newsletter will outline why business valuations are important from an income tax perspective. Part 2 of this newsletter will focus on the types of valuation reports that are available and the methods available to help determine the fair market value of a business.

Income Tax Considerations

To the extent that a non-arm's length transaction takes place at other than fair market value, the transaction may be subject to the provisions of section 69 of the ITA. Section 69 can result double-taxation, in that one side of the transaction will be adjusted without a corresponding adjustment to the other side. For example, assume a parent sells their shares of their corporation to their child for $1,000,000 but the actual fair market value is $2,000,000. Section 69 would result in the parent being deemed to have disposed of their shares for $2,000,000 (the actual fair market value). However, the cost of the shares for the child would be limited to $1,000,000 (the price used for the transaction). Double tax would result in the future when the child sells the shares as they cannot access the full $2,000,000 cost on which the parent paid tax on.

Rather than selling shares of a corporation in this manner, the parent could undertake a tax planning technique commonly referred to as an estate freeze. Estate freeze is a term used to describe reorganization in which the value of an company is "frozen" in fixed-value preferred shares equal to the fair market value of the business or assets of the corporation at the date of the freeze. This permits future growth in value of a corporate entity to be attributed to common shares held by others, such as children or a family trust. The child can subscribe for shares for a nominal price as all of the value of the company is frozen in the hands of the parent. In our example, the parents would receive $2,000,000 worth of fixed value preferred shares and the child would

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

subscribe for new shares. Such a reorganization could occur on a tax deferred basis, usually pursuant to either section 86(1) or 51(1) of the ITA, with no immediate income tax implications to the parent or the child.

Much like a sale of shares, the value of the preferred shares issued to the parent is important. Where the value of the freeze shares received by the parent is less than the value of their old shares, and it is reasonable to consider the difference as being a gift to the child, subsection 86(2) or 51(2) of the ITA will apply. Subsection 86(2) and 51(2) provide formulas which determine the amount of the proceeds of disposition of the old shares and the adjusted cost base of the new shares received on the reorganization. The automatic application of these formulas in the aforementioned circumstances may result in the triggering of a capital gain on the disposition of the old shares, such that the estate freeze would no longer occur on a tax deferred basis.

Value is also important for a number of other provisions of the ITA which are beyond the scope of this newsletter. Some of these other key provisions include: 15(1) (shareholder appropriations), 85(1) (tax-deferred transfers to a taxable Canadian corporation), and 74 (attribution rules).

Price Adjustment Clauses

A price-adjustment clause is generally incorporated into a purchase and sale agreement in non-arm's length transactions to provide for an adjustment to the transaction price in the event that a third party, such as the Canada Revenue Agency ("CRA") or a court, determines that the fair market value of the shares or property is other than that agreed to by the parties. The price-adjustment clause is generally used in order to avoid adverse tax consequences such as the examples described above.

The CRA states in Income Tax Folio S4-F3-C1 - Price Adjustment Clauses that they will accept a price adjustment clause where the agreement reflects a bona fide intention of the parties to transact at fair market value. When the difference between the fair market value determined by the taxpayers and the real fair market value is significant, it may indicate that the taxpayers did not make a real effort to determine the fair market value of the property. What constitutes a significant difference must be determined on a case–by–case basis

Income Tax Folio S4-F3-C1 - Price Adjustment Clauses goes on to state that the fair market value for the purposes of the price adjustment clause must be determined by a fair and reasonable method. The taxpayer's reliance on a different valuation method than the one chosen by the CRA and the relative inaccuracy of a fair market value determination performed in good faith will not, in and of itself, compromise the effectiveness of the price adjustment clause. However, it is necessary that the valuation method be properly applied having regard to all the circumstances.

The CRA does not require that a valuation report be prepared, nor do they require the input of a certified business valuator. However, in order to support the value used for the purpose of a transaction, the taxpayers must be able to provide documentation to support the value used and the methodology used to determine the value.

Conclusion

Where related parties are carrying out transactions and the value used is subjective, there are a number of provisions which could apply if the value used is not appropriate. Price adjustment clauses can help provide some protection to the taxpayers where they made reasonable efforts to transact at fair market value. However, what constitutes a reasonable effort will be reviewed by CRA on a case by case basis. We strongly recommend engaging a certified business valuator where shares of a company operating an active business are being exchanged or sold between non-arm's length parties. Please keep an eye out for our June newsletter which will provide more information about business valuations.

HENDRY WARREN LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

Jacob Milosek , CPA, CA
Partner

Contact Us

Give us a call for more information about this article.

Hendry Warren LLP
881 Lady Ellen Place, Suite 200
Ottawa, ON K1Z 5L3

(613) 235-2000

Visit us on the web at
www.hwllp.ca