

THE RELEVANCE OF A PROPER BUSINESS VALUATION IN ESTATE PLANNING

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discounted or considered not to be relevant or worth the fee to have it professionally completed. The reason often given was that we will offset this risk with a price adjustment clause.

I am writing this article in order to assist you in understanding why a proper business valuation is relevant in any estate plan and why you as the client should be concerned when your advisor discounts this aspect of the plan when in fact it is probably the most important aspect of any effective estate plan. I am basing this comment from experience as both a tax and business valuation advisor.

LET'S START OFF BY DEFINING A FEW KEY AND RELEVANT TERMS: Business Valuation

The act of determining the value of or the estimated value of a business enterprise or an interest therein.

Chartered Business Valuator

An individual meeting the professional standards and experience requirements of the Canadian Institute of Chartered Business Valuators and is typically engaged in determining the estimated value of a business enterprise or an economic loss. This individual is recognized by the Canada Revenue Agency and the Courts for their expertise in the field of business valuations and economic losses.

Tax Specialist/Advisor

An individual who has gained the in-depth technical requirements and tax knowledge to effectively advise on both personal and corporate tax matters while remaining compliant within the income tax act ("ITA"). A tax advisor/specialist can also provide efficient and effective tax planning opportunities.

Accountant

An individual engaged in providing compliance services in the preparation of personal and corporate tax returns and financial statements and other matters pertaining to financial statements.

Investment Advisor

An individual engaged in providing advice pertaining to your investment portfolio. Your investment advisor will typically be able to assist you in ensuring your investment mix is in line with your risk tolerance. The investments typically include public company stocks, mutual funds, bonds, guaranteed investments and typically exclude private company investments.

Estate planning whether it is for the realization of tax efficiencies, assisting with succession issues and creditor proofing often requires an understanding of business value. I have been practicing for over 24 years, a Chartered Accountant for approximately 21 years and a Chartered Business Valuator for approximately 16 of those years. Over the course of my career I have seen many tax and estate plans where I participated as both a tax advisor and a business valuator. I have also worked with many accountants and tax advisors. The estate, succession and creditor proofing plans developed were well planned and considered to be effective tools in accomplishing the client's objectives. However too often in the planning process the business valuation aspect of the exercise was

Tax Re-organization Plan

A reorganization of the corporate share structure through various provisions of the Income Tax Act ("ITA") for the purposes of succession planning, realizing tax efficiencies and creditor proofing.

Price Adjustment Clause

A price adjustment clause is generally incorporated into a purchase and sale agreement in non-arm's length transactions or in the preference share provisions. This clause typically provides for a retroactive adjustment to the transaction price or the redemption price in the event that the Canada Revenue Agency ("CRA"), with the concurrence of the transferor or a court, finally determines that the transaction price of the property is an amount other than that agreed to by the transacting parties. A price adjustment clause is only effective where a bona fide intention of the parties to transfer the property at fair market value and arrives at that value for the purposes of the agreement by a fair and reasonable method.

Capital Gains Exemption

Dispositions of qualified property which consists of shares of a Canadian-controlled small business corporation or of qualified farm property or qualified fishing property are eligible for an exemption of up to \$800,000 of capital gains (Budget 2014).

CRA Penalties

Penalties invoked by CRA where the taxpayer or preparer have violated or been abusive to certain provisions of the Income Tax Act.

As indicated above a tax reorganization plan is often completed in order to transfer the business and growth in value to the next generation and as a creditor proofing exercise. So what is the relevance of a fair and accurate business valuation? Well the following points are relevant:

The shareholder is transferring ownership to another party albeit a related party. It is similar to selling your business; the shareholder wants to ensure his/her estate is made whole. A poorly executed valuation could leave the transferor with a short fall if the value is too low. Therefore those siblings who do not participate in the transfer of the business will be unfairly treated with respect to any equalization payments made to them by the transferring shareholder. If the value is too high the objective of transferring future growth of the business to the next generation has not been accomplished as any subsequent sale of the business by the next generation may not be able to utilize the life time capital gains exemption. Further as with any sale or transfer, the transferee sibling may have over paid for the business.

Where improper business valuations have been prepared (subjectively determined by CRA), CRA has the right under various sections of the income tax act to impose strict penalties against the taxpayer and advisor. These penalties often result in double taxation and out of pocket costs. The effectiveness of a price adjustment clause is subjective and based on the position that CRA decides to take. An effective price adjustment clause is one where the transfer agreement reflects a bona fide intention of the parties to transfer the property at fair market value and arrive at that value for the purposes of the agreement by a fair and reasonable method. Again whether the method used by the parties to determine fair market value is fair and reasonable is based on CRA's view and will depend on the circumstances in each case. It is not necessarily fair and reasonable solely because the method was applied correctly. Further in a technical interpretation CRA cautioned that the existence of a price adjustment clause is not enough to negate

the conclusion that a benefit was desired to be conferred. If the CRA deems that the transferor benefited from a higher value, the transferor may be deemed to have received from the corporation a shareholder benefit under subsection 15 of the income tax act which leads to an income inclusion, additional taxes owing and other penalty provisions for late payment of taxes. If the transferor conferred a benefit to a related party as a result of a lower value, provisions such as section 85(1) (e.2) provides that the transferor must include the excess benefit in the proceeds of disposition therefore a capital gain is triggered without any corresponding increase of the cost base of the shares taken back or an increase in the cost base of the shares held by the shareholders who benefited. As can be seen the various penalty provisions can be costly.

The above points can be mitigated by having a business valuation prepared by an independent valuation firm. It will be easier to prove to CRA that the valuation provided by an independent and qualified valuation firm is fair and reasonable and therefore support any price adjustment clause if necessary. The cost of a valuation report is nominal against the legal costs and other professional fees of defending your position with CRA in tax court. Further if you're unsuccessful the costs of the various penalty provisions will dwarf the cost of any formal valuation report.

In an information circular issued by CRA outlines that the professional standards and ethics of the Canadian Institute of Chartered Business Valuators should be used in preparing Business Valuations. A Chartered Business Valuator has to meet rigorous professional testing standards and experience requirements in order to obtain his or her designation.

An experienced valuator brings to bear a number of skills, which are of value to any business. Professional training, the ability to assess risks, the ability to uncover hidden value and losses, determining a suitable valuation approach and reconciling alternative approaches, coupled with a strong in-depth financial background are some of the ingredients required in a seasoned business valuator.

If your advisors still don't believe an independent valuation is required, I would be careful because an element of their fee whether it's described as tax planning or other includes a fee for the valuation. So in the end you will most likely be paying relatively the same for the tax plan and the valuation, however lack the credentials and support of an independent and qualified valuation firm, thereby weakening your position. Further I would remind your advisors of the preparer penalties which can be onerous.

This article has been written to give you the client a better understanding of the risks and the standards that you should accept when preparing your succession/reorganization plan. After all anything worth doing is worth doing right. So make sure you have the right professionals on your team.

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