Crowe Soberman LLP
Member Crowe Horwath International

2 St. Clair Avenue East, Suite 1100
Toronto, ON M4T 2T5
416.964.7633
416.964.6454 Fax
www.crowesoberman.com

The Value in a Valuation

By Neil Maisel, BComm, CA•CBV, CFE, *Valuations | Forensics | Litigation and Family Business Services*

Stan and Gloria arrived for their yearly meeting with Jennifer, their accountant, to review their business interests and other financial matters. This meeting, though, had a different focus than usual.

“Jennifer,” began Stan, “Gloria and I have realized that we’re at an age when we should probably think about estate planning around our business. We want to treat our children, Rachel and Mark, equally in our estate, and we’d like your professional advice on how best to do that.”

“That makes sense to me,” Stan,” replied Jennifer. “I suggest you consider what’s known as an estate freeze. This would fix the value of your business interests at their present level, and you could then determine how you want to allocate the future growth of the business.”

Stan and Gloria agreed to the estate freeze, but had difficulty understanding how it would work. As they explained to Jennifer, Rachel is an integral part of the business, but Mark is successful in his own right and has never worked in the business at all. Their intention is to have Rachel ultimately own the business.

Jennifer explained that accomplishing the freeze would require some tax work and that the value of the business would have to be determined. Like many business owners, Stan and Gloria thought they had a handle on the value of their pet supply store, and they suggested it should be $1,000,000.

As a professional who had worked with many clients in similar circumstances, Jennifer knew that Stan and Gloria would be well advised to have their business interests valued by a Chartered Business Valuator, or CBV, as their own estimate of $1,000,000 might not be accurate. Stan and Gloria, however, had other ideas. They were reluctant to spend the CBV’s fee to value their company when they felt they had already done so themselves.

"I realize you believe your valuation of your business is accurate," said Jennifer, "but I urge you to consider retaining a CBV nonetheless. The valuation affects not only your estate plan, but also income tax and other considerations." What did Jennifer mean by this?

Estate planning

In their estate planning, Stan and Gloria should properly value all of their assets, including the significant component represented by their business interests. We already know they want their estate to be split equally between their children, Mark and Rachel, on their deaths. The valuation of their business materially affects this plan.

Let's first assume their own valuation is correct, and that they have a combined net worth of $2,000,000 including their business valued at $1,000,000. Wanting to achieve a 50/50 split of their assets, they leave their shares in the business to Rachel and all other assets to Mark.

However, what if it turns out that Stan and Gloria are wrong, and their business is worth $500,000 instead of $1,000,000? This makes the value of the estate just $1,500,000. Using the previous scenario of leaving the business to Rachel and everything else to Mark, Rachel would receive only one-third of the estate and Mark the other two-thirds.

Clearly, an accurate valuation of their business is essential for the equal treatment of their children, and the best way to achieve this is through a professional valuation by a CBV.

Income tax

The Canada Revenue Agency (or CRA) understands that valuation is an art, not a science. When they disagree with a valuation, therefore, they will allow for retroactive changes — provided that there is a price adjustment clause in the agreement and they believe that the taxpayer has made a reasonable attempt to determine the value of the business.

While the CRA does not define what constitutes a reasonable attempt to determine value, it is likely that the "back of the napkin" type of valuation prepared by Stan and Gloria will not qualify! On the other hand, a valuation done by a CBV is more likely to meet the CRA's criteria.

What if Stan and Gloria had undervalued their business, and the CRA determined it was actually worth $2,000,000 instead of $1,000,000? The CRA could take the position that Stan and Gloria conferred a benefit of $1,000,000 on Rachel. In these circumstances, Stan and Gloria would be subject to immediate income tax as well as interest and possible penalties. Rachel could also be subject to tax on this $1,000,000 value in the future when she disposes of her shares.

If, however, the CRA agreed that a reasonable attempt at determining the fair market value of the shares had been made with a formal valuation, they would allow for the value at the time of the freeze to be seen as $2,000,000. This is, effectively, a retroactive adjustment, and no taxes or penalties would be incurred.

Other questions

On the personal side...

Let's consider what would happen if Stan and Gloria decided to separate a year after the freeze.

They own their shares equally, and Gloria wants to buy out Stan's share interest. In these emotionally charged circumstances, Stan claims that, notwithstanding their valuation of a year earlier at $1,000,000,

he and Gloria both knew the shares were probably worth $1,500,000. He says they “low balled” the value to try to defer more income tax on death.

Would Stan now be allowed to state that the previous valuation was flawed? What would this do to both Stan and Gloria’s credibility? What if Stan was right and the shares really were worth $1,500,000 at the time of the freeze?

On the business side...

Let’s say the main supplier of pet food to Stan and Gloria’s store unilaterally cancelled its contract with the store. Stan and Gloria couldn’t find a suitable replacement product, with the result that they had to close the business. They might suggest that the value of the “lost” business was more than their $1,000,000 back of the napkin business value for purposes of a damages claim for breach of contract.

But might that supplier not claim that when Stan and Gloria filed their valuation for income tax purposes they suggested that the company was worth $1,000,000? Now that they are seeking damages, how can they now claim a higher value? What would that do to Stan and Gloria’s credibility and their claim against the supplier?

These are interesting questions that Stan and Gloria might not have considered without expert advice.

While most clients understand that a successful estate/succession plan involves careful income tax planning, many do not recognize the value of engaging a CBV to prepare the valuation.

Like Stan and Gloria, any business owner should understand the value a CBV can add to the business and estate planning process.

November 2012

Neil Maisel *is a Partner with the Valuations | Forensics | Litigation and Family Business Services Group, also known as the SuRE Group, at Crowe Soberman LLP. The firm is one of the top public accounting firms. Neil specializes in family law and matrimonial matters, shareholder disputes, corporate and commercial damage claims, business valuations and litigation support. Contact Neil at neil.maisel@crowesoberman.com.*