

One Business Valuator's **OPINION**

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Business Valuers often are asked "Just what, exactly, is a business valuation?" With the recent global financial meltdown, the concept of fair market value, and in particular the methodologies of determining fair market value, have come into question.

It is important to note that the valuation of any entity, whether public or private, is determined at a point in time. Thus, it is the factors that exist at the valuation date and the market's future expectations *at that point in time* that affect the value of a business.

The values of publicly held companies are primarily determined by market forces, as publicly held shares transact on the open market.

The economic laws of supply and demand come into play in the pricing of publicly traded shares. When there is speculation that a company will exceed its financial forecast, the market responds by raising the stock price due to increased demand. Conversely, if the company is expected to miss its forecasted results, the market will adjust and reduce the stock price as demand falls.

The stock price of a publicly traded share is impacted by many issues. The issues tend to be forward looking. With the recent credit crisis and the increase in global risks, the future earnings of public companies come into question. As negative economic signs become more prevalent, the market adjusts economic forecasts downward, devaluing the stock.

Unlike publicly held shares, private companies are valued in a notional setting without the direct impact of market influences. However, market and general economic conditions are considered by Business Valuers in assessing the risks and the ability of the entity to achieve expected results. A business valuation in a notional setting is conducted by an experienced Business Valuator with the insight and experience of an organization's senior management team.

Valuations of privately held businesses typically are performed for purposes of strategic planning, divesting of business interests, acquisitions, corporate restructuring, succession planning, and resolving matters between shareholders and spouses.

Business valuations play a significant role in any estate planning exercise with respect to transferring wealth and the growth of a business. It is the Canada Revenue Agency's intention that appropriate business valuations be completed in this area and significant penalties can apply where it deems a valuation to be inadequate. Having a Chartered Business Valuator prepare the valuation will help to avoid such sanctions.

"A trained and experienced Business Valuator is critical to the process."

The Valuator either will have the necessary industry background or will gain the industry knowledge

through research. The Valuator's understanding of the business is necessary for the purpose of understanding key value drivers and risks, as well as the expected future operating results of the entity. Appropriate research will uncover variables that might impact value and affect the Valuator's conclusions. At this stage, the Valuator often will assess the need for additional specialists to assist with various aspects of the valuation.

The Valuator will assess and select from a number of different valuation approaches. The selection of the appropriate approach is based on the nature of the business, its asset base, historical performance, future expected operating performance, and other factors.

Under the liquidation approach, the Valuator will select between an orderly or a forced liquidation framework. The conclusions derived from each approach can vary significantly.

With the going concern approach, sustainable earnings (or cash flow) is a key variable. The Valuator will assess the future sustainable earnings of the business, often

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requiring some level of judgment on the part of the Valuator. The Valuator often will turn to the business's historical performance and financial forecasts, adjusting for cost structures and revenue streams that are not normal to the operations.

The appropriate determination of a capitalization rate depends on the approach used and whether the valuation is performed at the enterprise level or the equity level. The cost of equity forms one component of the weighted average cost of capital. Typical methods for determining the cost of equity include the capital asset pricing model and the buildup method, among others. Assessing appropriate capitalization rates requires significant judgment and experience.

Redundancies must be considered in any valuation. Fair market value and normalized earnings/cash flow are adjusted for these redundancies, which may be apparent or hidden. Assessing the value of redundancies requires experience and significant judgment.

Inherent in the value of a going concern entity is commercial goodwill, which is attributable to the product or service, the location of the operations, the systems and processes of the operations, the customer base, and other key value attributes. The difference between the

going concern value of an entity and its tangible asset base is considered goodwill. In order for goodwill to retain any value, it must be transferable with commercial value. Personal goodwill typically rests with the individual and is not transferable, and therefore has no value. The Valuator uses his/her judgment along with management's insight to assess the transferability of goodwill.

Valuators typically consider the *en bloc* value (the entire value) of the business. If a particular shareholder's interest in the corporation is being valued, the size and level of control of the interest are relevant factors. A shareholder's control is measured by the ability to elect key Directors, control dividend flow, and make key strategic decisions. Minority and marketability discounts must be assessed with respect to partial interests. Control premiums must also be assessed in situations of controlling interests. Again, assessing discounts and premiums involves significant judgment and experience.

A business valuation is a complex process for uncovering the true value of an enterprise through a series of questions, research and techniques. A trained and experienced Business Valuator is critical to the process.

Contact your valuation professional at Collins Barrow for further information or assistance. §

NEW RRSP AND RRIF PENALTIES

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It is an unfortunate fact of life that the transgressions of a few individuals often lead to onerous penalties or compliance costs for the innocent majority.

The 2011 Federal Budget presented certain measures that would appear to relate to such situations. In particular, the Budget will extend certain anti-avoidance rules — that currently apply only to Tax Free Savings Accounts (TFSA) — to Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs), with potentially costly results to many owners of private businesses, and to investors in publicly traded companies and funds.

Currently, there are rules governing which types of investments can be purchased through RRSPs and

RRIFs. Publicly traded investments are generally acceptable. However, RRSP/RRIF funds may also be invested in shares of a private qualifying small business corporation, provided the RRSP/RRIF annuitant (i.e. the person to whom the funds in the plan will be paid) owns less than 10% of the shares of any class of the corporation or of a corporation related thereto. In making this determination, shares owned by related persons and by the annuitant's RRSP/RRIF are included.

Alternatively, even if an arm's length annuitant owns 10% or more of a company's shares, the shares can still be considered a qualified investment if the cost of the shares is less than \$25,000.

All of these tests are one-time tests that must be met at the time the shares are acquired. Thus, any subsequent changes to the key factors (i.e. percentage shareholdings, arm's length relationships, etc.) do not affect the shares' status as a qualified investment.

However, the proposed Budget measures extend the "prohibited investment" rules (that formerly applied only to TFSAs) to RRSPs and RRIFs. A prohibited investment includes:

- debt of the RRSP/RRIF annuitant;
- an investment in shares or debt of entities in which the RRSP/RRIF annuitant, plus his/her RRSP/RRIF and non-arm's length parties, own at least 10% of the outstanding shares of any class of the company or a related company; and
- a corporation that does not deal at arm's length with the annuitant or with a corporation, partnership or trust in which the annuitant has an interest of 10% or more.

As a result of the extension of these prohibited investment rules to RRSPs and RRIFs, investments that previously were qualified investments may now be prohibited where they exceed the 10% threshold. The previous \$25,000 *de minimus* exemption will no longer apply. Consequently, the only acceptable holding of small business corporation shares is where the RRSP/RRIF and related parties own less than 10% of the shares of any class of the company, and the annuitant always deals at arm's length with it. In addition, in the public market context, an investor could be caught by these prohibited investment rules if he/she and any related parties own 10% or more of any company, fund or partnership.

The penalty for holding a prohibited investment is equal to 50% of the value of the investment for the calendar year in which the RRSP/RRIF acquires the prohibited investment, or in which property held by the RRSP/RRIF becomes a prohibited investment. The tax is refundable if the RRSP/RRIF disposes of the investment by the end of the year following the year in which the tax arose. However, no refund is available if the annuitant knew, or ought to have known, that the property was or would become a prohibited investment. As originally

announced in June, the new rules would have applied to prohibited investments in an RRSP or RRIF at March 22, 2011, with potentially tremendous costs to annuitants where the value of their initial investment had increased significantly. Fortunately, the draft legislation released on August 16, 2011 changed the application of the prohibited investment penalty to investments acquired *after* March 22, 2011.

In addition to the 50% penalty, the TFSA rules that tax any advantages (at a rate of 100%) are also being extended to RRSPs and RRIFs. An "advantage" is any transaction that is designed to exploit the advantages of the RRSP/RRIF, and will include income and capital gains from prohibited investments. In particular, capital gains arising from a "swap" transaction (i.e. where the RRSP/RRIF annuitant pays cash to acquire investments owned by the RRSP/RRIF) will be considered an advantage, except where the swap is undertaken in order to remove a prohibited investment from the plan after 2012.

As a transitional measure, the August 16, 2011 draft legislation reduced the 100% tax on income and capital gains realized on prohibited investments owned at March 22, 2011, to 42.9% if:

- the annuitant of the plan files an election by June 30, 2012; and
- the income is earned or capital gains are realized before 2017, and are paid out of the plan within 90 days after the end of the particular year.

This provision will require trustees of registered plans to assume the administrative burdens of tracking this information, following up with the annuitant to determine whether an election has been filed, and ensuring that the income is paid out annually. It will be interesting to see if the provision survives.

Finally, the Canada Revenue Agency can waive or cancel any of these penalties at its discretion.

Contact your Collins Barrow advisor for more information on these new penalties, or to help determine how they may impact your RRSP/RRIF strategies. §

Input Tax Credits and **DOCUMENTATION**

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There are a few basic requirements to permit a GST/HST registrant to claim an input tax credit (ITC). As a general rule, an ITC can be claimed when taxable property or services have been acquired by a registrant for consumption or use in the course of commercial activity. Subject to some restrictions, registrants can claim 100% of the GST/HST they have paid or that is payable on property or services used exclusively in commercial activities. However, the requirements to make the claim do not end there.

Subsection 169(4) of the *Excise Tax Act* (the Act) imposes some requirements on documentation and information when a registrant claims an ITC. The subsection requires every ITC claimed by a registrant to be supported by sufficient information. The supporting documentation required for ITCs is the same as that required to support expenses deducted under the *Income Tax Act (Canada)*. CRA auditors often focus on this particular requirement when reviewing ITC claims.

Supporting documentation can take many forms: it can be in paper form, but can also be in electronic form as long as the required information is present. Some examples of supporting documentation include:

- invoices
- receipts
- credit card receipts (it is important to note that statements are not sufficient)
- debit notes
- books or ledgers of account
- written contracts

The details required to be disclosed in the supporting documentation vary based on the level of consideration paid or payable for the supply. If the supporting documentation shows an amount under \$30, the required information includes:

- the supplier's name or trading name;
- the date on which the GST/HST relating to the supply was paid or became payable; and
- the total amount that was paid or is payable for the supply.

If the amount is \$30 or more but less than \$150, the supporting documentation must provide:

- the information required for amounts under \$30, as noted above;

- the registration number of the supplier; and
- either the GST/HST charged on non-tax-included purchases, or the rate of GST/HST charged on tax-included purchases.

If the supplies are exempt, a statement to that effect is required. If there is a combination of taxable and exempt supplies, the tax rate for each item must be identified.

For supplies of \$150 or more, the supporting documentation must provide:

- the information in the two categories above;
- the recipient's name, trading name or name of the agent or representative; and
- a description sufficient to identify the supply

The registrant must obtain all of the information noted above prior to filing a return in which the ITC is claimed.

Note that, when the name on an invoice is not the name of the registrant claiming the ITC, CRA auditors tend to have an easy time making an adjustment against the recipient. This result occurs commonly with related companies, when one company pays invoices for another. In such cases, the transactions should be accompanied by an agreement setting out which party is authorized to claim the ITC.

Subsection 169(5) of the Act gives the Minister discretion in certain circumstances to exempt specific registrants, classes of registrants, or registrants in general, from having to comply with these information requirements. At this time, the Minister has allowed a few exemptions for registrants in general. These include:

- unvouchered cash payments made to coin and/or bill-operated machines;
- computerized records;
- contracts;
- meal and entertainment expenses and reimbursements (as long as the prescribed factor calculation for eligible ITC is applied); and
- allowances.

The best way to avoid unnecessary denial of ITCs is to ensure that all of the supporting documentation for your ITC claims is in order.

Contact your Collins Barrow advisor for more information or for help in claiming your ITCs. §

Optimizing Tax Instalments to **MANAGE CASH FLOW**

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During down periods in the economy, cash management can become a critical issue for many small businesses. Highly leveraged yet profitable businesses may have difficulty obtaining additional financing on short notice. In these situations, one strategy for short-term internal financing that is often overlooked is the opportunity to reduce tax instalments.

Tax instalments for a particular year typically are based on the prior year's taxes payable. If the net income after the previous year end, and presumably the expected taxes payable for the current year, have fallen, it can be crippling from a cash flow perspective to pay higher instalment amounts. The solution to this problem is to understand and apply the relevant rules in order to optimize the instalments paid to the Receiver General.

Below are several ways of achieving an optimal tax instalment regime to maximize cash flow without incurring interest charges (or penalties) on late instalments.

Deferring tax instalments

Not surprisingly, it is advantageous to defer tax instalments for as long as possible. The general rule for corporate instalments is that they must be paid on a monthly basis. However, Canadian Controlled Private Corporations (CCPCs) may qualify for quarterly instalments if they satisfy three requirements:

1. a perfect compliance history;
2. have claimed a small business deduction for the current or previous tax year; and
3. have less than \$500,000 in taxable income and \$10 million or less in taxable capital employed in Canada for the tax year (together with all associated corporations for the current or previous year).

Achieving a "perfect compliance history" requires that all GST/HST filings and remittances, source deduction withholdings, and corporate tax filings and remittances were made on time in the twelve months prior to the most recent instalment due date. Switching from monthly to quarterly remittances will result in a deferral of two months every quarter. Consult your Collins Barrow advisor for assistance in making this change.

Reducing tax instalments

Instalment payment requirements may also be reduced to align with the expected tax payable for the current year. Generally speaking, the default calculation for tax instalments takes one-twelfth (for monthly filers) or one-quarter (for quarterly filers) of the previous year's tax payable. This method is used commonly because, regardless of the income levels in the current year, no interest will be charged on any instalment shortfalls that result in tax payable.

There is, however, another option. A taxpayer may pay one-twelfth (for monthly filers) or one-quarter (for quarterly filers) of the *estimated current year's* tax payable. The risk with this option is that the CRA will charge interest (and possible penalties) where the actual tax due for the year exceeds the estimated amount. It is thus imperative that the estimate be accurate. A Collins Barrow advisor can help in this regard.

The CRA will assess a return using the option that results in the least amount payable by instalments. If income has fallen off in the current period and a budgeted estimate of the tax payable can be computed, significant savings may be realized.

Filing on time

It is important for eligible small CCPCs to ensure the correct instalments are filed on time to avoid unnecessary interest and penalties, and to maintain the quarterly filer status. Instalment payments are due on the last day of every complete month of the tax year, or the last day of every complete quarter for eligible small CCPCs. Interest accrues on unpaid balances at the CRA's prescribed rate (currently 5%) compounded daily from the balance due date to the date of payment. Penalties may also apply when instalment interest exceeds \$1,000.

Contact your Collins Barrow advisor for more information. §

Update: **EMPLOYEE PROFIT SHARING PLANS**

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In the Fall 2010 issue of *Tax Alert*, we provided an overview of employee profit sharing plans (EPSPs), including several primary advantages typically associated with these plans. These benefits included the possible reduction or elimination of Canada Pension Plan (CPP) and Employment Insurance (EI) premiums, and significant tax deferral opportunities.

In Budget 2011, the Federal Government announced its intention to review the existing rules to determine if technical amendments were required, and also noted that it would consult with stakeholders prior to proceeding with any proposals. In this regard, on August 30, 2011 the Department of Finance issued a press release inviting comments on the various tax rules for EPSPs.

Within the release, the Department of Finance reiterated concerns noted in Budget 2011, stating:

In recent years, these plans have increasingly been used as a means for some business owners to direct profit participation to members of their families with the intent of reducing or deferring taxes on these profits. Some employers are also using EPSPs to avoid making Canada Pension Plan contributions and to avoid paying Employment Insurance premiums on employee compensation...

Several questions were also put forward to relevant stakeholders, some of which included:

- Is there specific rationale for allowing non-arm's length employees to participate in an EPSP?
- Is there specific rationale for excluding EPSP allocations from the tax on split income provisions?
- Is there specific rationale for allowing unlimited EPSP employer contributions?
- What would be the impact to a business or its clients if EPSPs became subject to income tax withholding requirements similar to those applying to salary or wages paid directly by the employer for the year?
- What would be the effect of this change if EPSP allocations were also considered employment income paid by the employer for EI and CPP purposes (and, therefore, subject to EI and CPP withholdings)?

It is difficult to forecast what specific proposals and implementation dates, if any, will result from these consultations. It is clear, however, that the Department of Finance is concerned with the advantages presently associated with the typical EPSP strategy.

Stay tuned for additional Tax Alerts as more news becomes available, or contact your Collins Barrow advisor for more information. §

Collins Barrow publishes a quarterly *Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While *Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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