CANADA

NEWSLETTER

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MARITAL DISSOLUTION IN CANADA

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Marital property division is a complex process in a marriage given the high emotional stakes involved.

Every asset acquired and value of which increased during the marriage is subject to division. When such assets include shares in a company, stock options or one or both the spouses' businesses, valuation becomes a tricky business necessitating the appointment of a professional valuer such as a Chartered Business Valuer ("CBV").

The Ontario Family Law Act ("the Act") governs the property division in a marital dissolution in Ontario.

The regulations

Per the Act, value of any kind of property that was acquired by a spouse during marriage and exists at separation must be divided equally between the spouses. The division captures any change in value of the assets that existed at the time of marriage and continued to exist at the time of separation.

The spouses or the Court may agree to a different proportion for the split.

Net family property

The value of the assets is determined by computing the **net family property** ("NFP"). Per the Act, "net family property" means the value of all property that a spouse owns after adjusting for:

- The spouse's debts and liabilities
- Value of property owned by spouse (net of debt and liabilities) **as of the date of marriage.**

Property does not include:

- Property acquired by gift or inheritance and any income therefrom. (Except matrimonial home. See *"Specific considerations"* below);
- Damages for personal injuries, nervous shock, mental distress or loss of guidance, care and companionship;
- Proceeds from a life insurance policy;
- Property expressly agreed between spouses not to be included in the calculation of net family property.

From the above definition, we understand that net family property represents the value of the property that has been acquired during the marriage. If a property existed as of the date of marriage, NFP captures the increase in the value of the property.

Equalization

According to Section 5(1) of the Act, when a divorce is granted or a marriage is declared a nullity, or when the spouses are separated and there is no reasonable prospect that they will resume cohabitation, the spouse whose net family property is the lesser of the two net family properties is entitled to one-half the difference between them.

This process is known as **equalization.** For example, if NFP of Spouse A is $ 1,000,000 and that of Spouse B is $ 1,500,000, Spouse A is entitled to (1,500,000 – 1,000,000)* 50% = $ 250,000

It is pertinent to note that the Court may award an amount to a spouse which is more or less than half the difference between the net family properties. This decision may be taken by the court if it believes that equalizing the net family properties is unfair on account of various reasons mentioned in the Act.

Specific considerations

- **Matrimonial home:** Matrimonial home is defined in the act as, *"every property in which a person has an interest and that is or, if the spouses have separated, was at the time of separation ordinarily occupied by the person and his or her spouse as their family residence is their matrimonial home".* Thus, any property that is/was ordinarily occupied by the spouses as the family residence would be considered a matrimonial home.

  Per the Act, matrimonial home is excluded from the definition of net family property. This is because unlike for net family property, where the spouse with the lower net family property has rights to 50% of the difference between the net family properties, each spouse has an **equal share** in the **total value** of the matrimonial home.

  For example, if one of the spouses owned a matrimonial home worth $ 400,000 at the time of marriage and it was worth $ 500,000 at the time of separation, the other spouse is entitled to $ 250,000 i.e., half of $ 500,000. This division is in contrast to the general equalization rule. Let's say, if instead of a matrimonial home, the property subject to division was a business. In that case, the other spouse would be entitled to just one half of the increase in the value of the business. The entitlement would be calculated as (500,000 – 400,000)*50% equal to $ 50,000.

  Another striking issue w.r.t the matrimonial home is that if assets that are usually excluded from the net family property have been used to purchase/converted into a matrimonial home, the exemption is withdrawn. For example, a house received by either of the spouses as inheritance would not be included in the calculation of net family property. However, if the house is then converted into a matrimonial home, it shall be included in the derivation of NFP.

- **Negative net family property:** According to the Act, if the net family property of either of the spouses is calculated as having a negative value, it shall be assumed to be equal to zero.

Valuation

When assets subject to division include shares in a company or a business, a professional valuation is warranted. The starting point for any valuation exercise is determination of valuation date.

Per the Act, valuation date means the earliest of the following dates:

a) The date the spouses separate and there is no reasonable prospect that they will resume cohabitation.

b) date a divorce is granted.

c) The date the marriage is declared a nullity.

d) The date one of the spouses commences an application based on subsection 5 (3) of the Act (improvident depletion) that is subsequently granted.

e) The date before the date on which one of the spouses dies leaving the other spouse surviving.

Thus primarily, the valuation date would typically be the separation date for a couple. Determination of a separation date is not as straightforward as it appears because more often than not it is a subjective call. In some cases, the separation date is the date when a couple announces their separation to the family. In the event when no such announcement is made, the court considers various factors.

Once the valuation discusses is determined, the next step would be the valuation of the subject property. This newsletter discusses business/equity valuation and does not consider tangible property valuation. The process of valuation for marital dissolution purposes is in principle similar to valuation for any other purposes. Following are the commonly used approaches to business valuation:

Income approach

The income approach focusses on the income-producing capability of the business, business ownership interest, security or asset being valued. The income approach requires estimation of revenues, expenses and cash flows.

Valuation techniques under the income approach include the following:

Capitalized cash flow method

- This method involves dividing or multiplying a representative cash flow level by an appropriate capitalization factor to convert the cash flows to value.

Discounted cash flow method

- This method involves estimating cash flows for each of several future periods. These cash flows are converted to value by applying an appropriate discount rate and using present value procedures.

Market approach

The market approach is based on the principle of substitution, which reflects the premise that an informed investor would pay no more for a security or asset than he/she could pay for another security or asset of equal utility.

Two types of methods are generally encountered under the market approach:

Guideline public company method

- This method values a business based on trading multiples derived from publicly traded companies that are similar to the subject company. The steps taken in applying the guideline public company method include identifying comparable public companies, adjusting the guideline public company multiples for differences in the size and risk of these companies compared to the subject company, and then applying the adjusted pricing multiples from the representative companies.

Guideline transaction method

- This method values a business based on pricing multiples derived from the sale of companies that are similar to the subject company. The steps taken in using the guideline transaction method include finding transactions involving the purchase of comparable companies, selecting the transactions that closely mirror the company's operations and which occurred in similar industry and economic conditions, and finally, applying the indicated pricing multiples from the representative transactions.

- **Cost approach**

The cost approach assumes that a prudent investor would pay no more for a security or asset than the amount at which it could be replaced or reproduced.

Under the cost approach, the aggregate value of the underlying assets owned by the subject is to be considered net of its liabilities. This value can be presented in terms of either the proceeds from liquidation or the cost of replacing the assets.

Selection of methods

Unlike valuation for financial reporting purposes, where the valuation is based on hypothetical market participant assumption, courts prefer valuation undertaken for marital dissolution purpose to reflect the economic realities at the time of separation. That is to say, the approach selected must be aligned with the intended use of the asset by the owner at the time of separation.

For example, if one of the spouses intends to liquidate the business post separation, a cost approach of valuation may be appropriate vis-à-vis an income approach which assumes that the business would continue in perpetuity.

Dissolution of a marriage is an emotionally taxing process. The legalities associated with it should not become an additional point of concern for the couple. While your lawyer will assist you in navigating the process, having an independent valuer by your side to derive a fair and independent valuation for the equalization process ensures that you have a seamless experience of the process.

KNAV possess rich experience in valuation of businesses, equity shares, ESOPs, intangibles etc. If you would like to discuss how we can help you with your valuation needs, contact us at **rajesh.khairajani@knavcpa.com** or **markets@knavcpa.com**

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