CANADA

NEWSLETTER

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VALUATION REQUIREMENTS IN CANADA

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Rajesh C Khairajani
Partner, Valuation

Kinjal Shah
Assistant Manager
Valuations

Valuation requirements in Canada are dictated by a variety of reporting standards and regulations. This article covers the valuation of businesses and intangible assets. Valuation requirements for tangible assets including real estate property is outside the scope of this article.

From a reporting standard/regulatory standards perspective, we briefly discuss the valuation requirements under the following:

- International Financial Reporting Standards (IFRS) and Accounting Standards for Private Enterprises (ASPE)
- Income Tax Act (ITA)
- Provincial family laws

FINANCIAL REPORTING STANDARDS

Canadian GAAP requires a publicly accountable enterprise[1] to use International Financial Reporting Standards (IFRS). A non-publicly accountable enterprise may either use IFRS or Accounting Standards for Private Enterprises (ASPE). Financial reporting in Canada, either under ***IFRS 3: Business combinations*** or ***ASPE Section 1582: Business combinations*** requires the determination of the fair value of assets acquired and liabilities assumed in a business combination at their acquisition-date. In addition, testing for impairment of identified intangible assets and goodwill is also periodically required under ***IAS 36: Impairment of assets* or *ASPE Section 3064: Goodwill and intangible assets***. Valuation specialists in Canada are frequently utilized to support financial statement issuers with the initial fair value estimates of acquired assets and assumed liabilities, as well as with subsequent impairment testing.

CANADIAN TAX LAWS

The Canadian Income Tax Act ("ITA" or the "Income Tax Act") references the term "fair market value" ("FMV") multiple times. While the term is not defined under ITA, it is generally defined by the courts as; *"The highest price available in an open and unrestricted market between informed, prudent parties acting at arm's length and under no compulsion to act, expressed in terms of money and money's worth."*

[1]A publicly accountable enterprises (PAE) is an entity that either:

- has issued, or is in a process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market (including a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)
- holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses

Banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks typically meet the second of these criteria.

Canada's ITA typically requires FMV information for:

ITA valuation requirements	
Purchase price allocations for tax purposes	Intangibles, including goodwill and patents
Non-arm's length transactions	Stock option compensation
Corporate re-organizations	Debt instruments and convertible securities
Royalty rates	Reasonable interest rates

CRA'S POSITION ON VALUATION

General valuation principles and policies adopted by CRA are outlined in Information Circular 89-C, Policy statement on business equity valuations. They are summarised as follows:

- The standard of value to be used is FMV.
- All relevant factors of the entity being valued must be considered.
- The approach to valuation must be justified.
- Factors used in determining the valuation multiple applied must be disclosed.
- Reasonable judgement and objectivity must be used.

While the CRA does not mandate that valuations be performed by a Chartered Valuator (CBV), it is preferable to have a CBV who would possess knowledge of such nuances to undertake a valuation to satisfy the CRA's requirements.

ESTATE PLANNING

Estate planning is essential to provide shelter from various unwanted taxability situations that may arise on the death of an estate owner. CRA imposes capital gains taxes upon death of estate owner via **section 70(5) of the Income Tax Act.**

One of the foremost of responsibilities of the estate representative on the death of the estate owner is getting an appraisal for the value of the estate in question.

An independent appraisal of an estate is useful for the following:

- Implementation of an estate freeze strategy under **Section 85/86 of the ITA**
- Preparation and filing of an estate tax return.
- Determination of estate and gift taxes likely to arise on transfer of estate.
- Last but not the least, an independent appraisal of an estate facilitates smooth and efficient transfer of assets in the estate.

EMPLOYEE SHARE OWNERSHIP PLANS ("ESOPS")

An ESOP issue in Canada generally entails four primary considerations,

Valuation requirements for an ESOP arise under the following:

- **Financial reporting standards:** Under ***IFRS 2: Share based payments,*** for the compensation cost analysis of equity settled transactions, the initial measurement is based on the grant date fair value of the equity instruments granted.

  In case of cash- settled transactions, an entity must recognise a cost and a corresponding liability based on the initial measurement. The recognized liability is remeasured every reporting date.

  Similar valuation requirements are noted under ***ASPE Section 3870: Stock based compensation and other stock-based payments.***

- **Income Tax Act:** Tax consequences for ESOPs in Canada arise **when the employee exercises the options.** The benefit accruing on exercise of the ESOP must be included in the income of the employee in the year in which he exercises the options. The benefit is quantified as the difference between fair market value of the shares and the exercise price of the option.

  Employees are entitled to deduct one half of the benefit while computing their taxable income under **section 110(1) of the Income Tax Act** subject to certain conditions. One of the conditions states that the option exercise price is at least equal to the fair market value of the underlying shares at the time of grant of the options.

  Thus, even though, a valuation at the time of grant of ESOPs is not explicitly required, it may be performed to ensure that the employee can avail the benefit of the deduction at the time of exercise.

FAMILY LAW

In Canada, property division during the dissolution of a marriage is regulated by family law provincially. For this article, reference has been made to the family law in Ontario ("the law"). According to the law, the value of any kind of property that was acquired by a spouse during a marriage and still exists at separation as well as increase in the value of any asset that was brought into the marriage must be divided equally between the spouses. The spouses or the Court may agree to a different proportion for the split.

The value of the aforementioned assets is determined by computing the **net family property** (NFP). NFP is computed as follows:

The value of assets on the date of separation
- Minus: The value of debts on the date of separation
- Minus: Value of (assets less debt) on the date of marriage
- Minus: Value of any inheritance, proceeds of a personal injury claim or gifts received during marriage and kept separate as at the date of separation

The spouse whose NFP is higher must pay 50% of the difference to the other spouse. This process is known as **equalization.** The equalization process can be complicated when the assets of any of the spouses include any direct or indirect interest in a company. In such cases, it is preferable to appoint a CBV to perform the valuation of the business for equalization.

This article briefly discusses the valuation requirements under various legislations in Canada. The next few articles of the series shall focus on each of the requirements in depth.

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For any queries, please contact markets@knavcpa.com or rajesh.khairajani@knavcpa.com

Visit us at: www.knavcpa.com

Canada office: 55 York Street, Suite 401, Toronto, ON M5J 1R7, Canada
Other offices: India | Netherlands | Singapore | UK | USA