BUSINESS VALUATION REVIEW

CANADA-U.S. MOBILITY OF RESIDENCE AND IMMOBILITY OF FAIR MARKET VALUE

by

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FAIR MARKET VALUE AND SPECIAL PURCHASERS

When fair market value is determined absent arm's length, *open market* (real-world) negotiations, it is a *notional market* valuation.[1] The *notional market* is where hypothetical transactions occur, as opposed to the *open market* in which real-world transactions take place.

Fair market value determinations in Canada, as in the United States, are required in a notional market context in connection with:

- income tax and estate planning;
- matrimonial disputes;
- shareholders' agreements;
- employee stock option plans;
- financing negotiations,
- corporate reorganizations, etc.

"Fair market value" is generally defined in Canada as:

> "The highest price, in terms of money or money's worth, available in an open and unrestricted market between informed parties, acting at arm's length with neither party under any compulsion to transact."

In the U.S., "fair market value" is generally defined as:

> "The amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts".[2]

Unlike the Canadian definition, the U.S. definition refers neither to "the highest price", the "open and unrestricted market", nor "arm's length parties", although business valuators and the U.S. courts view the market and the parties in essentially the same way they are viewed in Canada. See, for example, the definition in the *International Glossary of Business Valuation Terms*, as adopted by the American Society of Appraisers, among others, which *does* include reference to an "open and unrestricted market" and "arm's length".

The interpretation of "fair market value" by the Canadian courts has its origin in the English case law. The courts in Canada assume that the notional market is open and unrestricted, from which no purchaser is to be excluded. For example, in *H.P. Connor* v. *The Queen*[3], the Federal Court of Canada stated:

> "When one comes to value the shares of a private company, the 'open and unrestricted market' must be assumed. That notional market ought not to be limited to the other shareholders; it should be assumed that strangers would be willing to take a position in the company at the right price and that the other shareholders would be willing to have him or meet his price. The applicable [Canadian income tax] legislation provides no alternative to the 'fair market value' approach where no 'open and unrestricted market', in fact, exists."

Therefore, in determining fair market value in a *notional* (as opposed to *open*) market context, all possible purchasers must be considered.

In Canada, if a willing and able "special purchaser", or strategic buyer, can be clearly identified[4], and the perceived net economic value-added — as a result of post-acquisition economies of scale, synergies and/or strategic advantages by combining the target's business with the purchaser's own business — can be reasonably quantified, fair market value in the notional market will reflect a premium ("special purchaser premium") over and above the stand-alone, intrinsic value of the acquiree. This latter value would generally be the price "ordinary" purchasers (financial buyers) would pay.

However, unless the market has been tested, or discussions or negotiations have actually been held with possible or potential purchasers, it is generally difficult, if not impossible, for the business valuator to know whether the "highest price" (the term employed in the Canadian definition) has been determined in a notional market valuation.

As the authors note in *Valuing a Business,* Fourth Edition:[5]

> "In most interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm's length, rather than any particular buyer or seller. In other words, a price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller."

In another Canadian decision, *Edmund Littler, Sr.* v. *Minister of National Revenue,*[6] the Federal Court commented as follows with respect to the acquisition of a Canadian publicly-traded company by a large U.S. purchaser, Standard Brands Limited:

> " … the shares of Lowney were worth far more to Standard [Brands] because Standard wished to acquire not only the voting control of Lowney, not only a passive holding, but a going concern to be integrated in their own business, as the business of Lowney, the making of candy, was akin to the one of Standard, the food business … Standard wanted a wholly-owned subsidiary. As to the value, in such an instance, the evidence of … [the] President of Kraft Foods (Canada) Ltd. is to the same effect."

If no purchaser can be clearly identified, it may be impossible to determine, or closely estimate, the actual price that the business would fetch if there would be an *open market* transaction. Therefore, Canadian business valuators will, like their American counterparts, calculate the fair market value of a business based (if appropriate) on its earnings and cash flows in relation to the going-concern value of the business' net tangible capital employed (referred to in Canada as "tangible asset backing") of the enterprise (including any identifiable intangibles), absent post-acquisition synergies, i.e., "intrinsic, stand-alone value", which equals fair market value.

In Canadian valuations, if one or more special purchasers can be specifically identified, fair market value in the *notional market* will consider an *open market* (real-world) price.

That is, the existence in the marketplace of a special purchaser may have the effect of increasing *fair market value* in the notional market to "*transaction value*" (or *price*) in the open market. It is in this context that "transaction value" for U.S. purposes might be equated with "fair market value" for Canadian purposes, in that the latter would include special-purchaser considerations.

However, simply because a special purchaser has been identified, it does not mean that the subject's notional stand-alone value will necessarily be increased by a special purchaser premium for Canadian fair market value purposes:

- If there is only one special purchaser for a business, the purchase price may be only slightly more ("one tick up", as the British say) than what ordinary purchasers would pay in order to ensure a successful bid.
- If there are two or more special purchasers, in which case the market would become a special-purchaser market (with possible competitive bidding), ordinary purchasers would then be excluded.

An example of the potential competitive bidding when there are two or more special purchasers is when two 49% shareholders each wishes to acquire the third shareholder's 2% interest; or where there are three 33-1/3% shareholders, one of whose shares are "up for grabs".

But even if there is only one special purchaser, the principle in the U.K. decision, *Glass* v. *IRC*[7], may apply. In that case, the Valuation Appeal Court held that where there was only one specific special purchaser for a parcel of land, speculators could bid up the price in anticipation of reselling it to the special purchaser. Thus, if there is a single special purchaser, and if it is general knowledge in the business community that the property has a special value to that purchaser, it is assumed that the market also includes speculators (in addition to ordinary purchasers) who would be prepared to pay more than ordinary purchasers, in anticipation of being able to then "flip" the property to the special purchaser at a profit. There may thus be a hypothetical "middle market" that comprises speculators.

On another note, a special purchaser is not an exceptional purchaser; rather, such purchaser is the more typical kind of buyer present in the open market. If all notional purchasers are willing to pay a "premium" over other purchasers, then it can hardly be considered a "premium", but simply the fair market value.

When a Canadian business valuator provides an opinion on fair market value for *notional market* purposes, the opinion will generally be accompanied by a caveat to the effect that, as the business had not actually been exposed for sale in the open market, it was not possible for the valuator to determine whether there were arm's length purchasers (including special purchasers/strategic buyers) who might have been prepared to pay a higher price for the business than the indicated value on which he or she opined.

As can be seen from the foregoing conceptual framework, Canadian business valuators must address the issue of special purchasers when determining fair market value.

For example, a valuation report of American Appraisal Canada, Inc., which was filed in a much-publicized Canadian case[8], included the following:

> "In order to conclude that fair market value is higher than the intrinsic value of an asset, one has to demonstrate that the following conditions are met:
>
> a. There is at least one purchaser in the market who can achieve synergy with the subject assets (i.e., a special purchaser). Synergy is defined as: ***The ability to obtain benefits over and above the cash flow expected to be obtained from the subject asset in its current use and under its current ownership.***
>
> b. That the special purchaser/s identified can be negotiated into a position to pay for such synergy."
>
> ….
>
> "It is widely accepted by valuation experts and courts in Canada that where there are two or more special purchasers for an asset, they create a market from which ordinary purchasers are excluded. Hence, in this situation fair market value will equal the intrinsic value plus the full synergy value.
>
> "However, there are two views on whether the fair market value of an asset is higher than its intrinsic value when only one special purchaser exists."

CANADIAN PRACTICE REQUIREMENTS

Standard 110 of The Canadian Institute of Chartered Business Valuators ("CICBV"), *Valuation Report Standards and Recommendations*, requires that:

> "5.e) The report must disclose **the extent, if any, to which special purchasers were considered and give reasons why.** *Recommendation:* Disclosure of the

> steps taken to investigate their existence, the problems of quantifying net economic value-added in open market price, and the degree to which they have influenced the conclusions."

Standard 110, which applies to all valuation reports that are not in draft form and are prepared by a valuator acting independently (as opposed to acting in an advisory capacity), states that such disclosure is mandatory.

Appendix A to the Standard relates specifically to Securities Regulations and Policies in the context of non-arm's length transactions. Ontario Securities Commission ("OSC") Companion Policy 61-501 CP to Rule 61-501, *Insider Bids, Issuer Bids, Going-Private Transactions and Related Party Transactions*, states that "the disclosure standards [of] Appendix A to Standard 110 of [the CICBV] ... generally represent a reasonable approach to meeting the applicable legal requirements ...".[9] The standard of value for purposes of OSC Rule 61-501 is "fair market value", defined as "the maximum monetary consideration that, in an open and unrestricted market, a prudent and informed buyer would pay to a prudent and informed seller, each acting at arm's length with the other and under no compulsion to transact".[10]

Also, CICBV Standard 120[11] requires the business valuator to consider "key valuation components and assumptions", including any "special purchasers".

Failure by an accredited member or a registered student to comply with the CICBV Practice Standards is a violation of the Code of Ethics.[12]

FAIR MARKET VALUE AND CROSS-BORDER TAXATION

Inclusion of a special-purchaser premium in determining fair market value can create potential income tax problems to Canadian individuals who leave Canada to reside in the U.S.

Canada taxes its residents on their world income (regardless of citizenship). The U.S. taxes its citizens regardless of their place of residence. (Therefore, American citizens who are resident in Canada — even though they may have been physically absent from the United States for many years — are nonetheless required to file a 1040 Return with the IRS.) Both countries allow the tax filers foreign tax credits and also have entered into a reciprocal income tax treaty.[13]

However, a serious problem can arise because of Canada's so-called "departure tax". When a Canadian taxpayer gives up his or her Canadian residence (and, say, becomes a U.S. resident), the taxpayer is deemed to dispose of all assets, including shares of closely-held corporations, at their fair market value at the time of departure.[14] Any capital gains accrued up to that time will be subject to Canadian tax (with a few possible elections to defer the immediate payment of the tax).

For purposes of measuring the gain for Canadian "departure tax" purposes, the fair market value of the émigré's shares would be determined in the notional market under Canadian valuation "rules". The Canadian émigré will therefore pay tax to Canada on a deemed gain (based on the fair market value in the notional market at the date of departure). However, upon entering the U.S., the cost basis of the Canadian expatriate's shares for U.S. tax purposes will be based on their *original cost* (not fair market value) of the shares. Subsequently, when there is an actual sale of the shares when the taxpayer is a U.S. resident, there would be double taxation, as outlined in the example below (ignoring foreign exchange considerations and growth in the value of the shares).

For an American moving from the U.S. to Canada, this would not occur. The individual could leave the U.S., take the shares to Canada and not incur any U.S. tax. When the assets are ultimately sold, the U.S. citizen/Canadian resident will file a 1040 Return in the U.S. and report the gain. On the taxpayer's Canadian tax return only the gain that accrued since becoming a resident of Canada will be included. The reason for this is that, under the Canadian tax rules, the immigrant is deemed to have disposed of the shares immediately before entering Canada for proceeds equal to fair market value (applying Canadian valuation principles) and to have reacquired the property at that same fair market value, thereby establishing a new cost basis for the shares upon entering the country. This avoids double taxation on the portion of the gain that accrued prior to becoming a Canadian resident.[15]

To help explain the double-taxation aspect outline earlier, assume:

(a) the original cost of the shares to the Canadian shareholder was $500,000;

(b) the intrinsic, stand-alone value (absent special-purchaser considerations) was $1,200,000 at the date of departure from Canada;

(c) the fair market value of the shares (considering identifiable special purchasers in the marketplace as of the departure date) was, at the time, $1,800,000; and

(d) the actual, arm's length selling price of the shares a year later, when the taxpayer is a resident of the U.S., was $1,200,000, as the special purchaser is no longer in the marketplace.

Upon departure there would have been deemed proceeds of $1,800,000 for Canadian tax purposes (subject to certain possible elections). Upon entering the U.S. the shares would have a cost basis of $500,000 for U.S. tax purposes. Say, however, that shortly thereafter the special purchaser exited the marketplace, so that the shares subsequently were sold for their intrinsic value of $1,200,000. Canada would tax a gain of $1,300,000 ($1,800,000 – $500,000) and the U.S. would tax $700,000 ($1,200,000 – $500,000) — so long as the present disconcordances remain in the respective tax laws, and the Canada-U.S. tax treaty continues to allow double taxation in such a situation. In other words, the “temporary” existence of a special purchaser causes the Canadian émigré to pay on a “phantom” gain of $600,000 ($1,800,000 – $1,200,000) merely because of the deemed disposition rule on departure. Even if there were no special-purchaser considerations, $700,000 would nonetheless be taxed twice.

As the treaty does not prevent double taxation of the pre-departure accrued gain (and it certainly does not address situations where there can be different fair market values applying Canadian and U.S. valuation principles), Canada is attempting to alleviate the double-taxation aspect. The Department of Finance has only recently enacted a new provision in the *Income Tax Act* that would grant the Canadian emigrant a limited foreign tax credit against the “departure tax”, in respect of U.S. taxes paid on the gain realized while resident in the United States. This is only an interim measure[16] in the course of treaty negotiations. The shares’ “fair market value” as of the date of immigration into the U.S., rather than original cost (as is the case at present), should be the immigrant’s cost basis for U.S. purposes under the treaty. But whose “fair market value”? In the foregoing example, would $1,800,000 or $1,200,000 be the deemed cost upon immigrating into the U.S.?

On another note, what about trapped-in capital gains taxes? Canadian tax laws — like those of the U.S. prior to 1987 when the *General Utilities*[17] doctrine was in effect — permit tax-free corporate reorganizations such that no tax is paid on accrued, and unrealized, capital gains. Similar to the pre-1987 rules under *General Utilities*, the cost basis of a Canadian holding company’s shares could be written up for tax purposes to fair market value, thereby avoiding recognition of the built-in gain on appreciated property, i.e., an acquiring corporation could re-value the target’s assets to current fair market values without paying a capital gains tax on the increase over the cost basis of the acquiree’s non-depreciable assets.[18] Will our two countries be able to deal with this difference under a new treaty, considering the current U.S. position of the IRS following *Eisenberg*[19] and recent similar cases.

One more unrelated example is that, in determining fair market value, the Canadian tax authorities generally do not permit a minority discount on shares held by family members in a family-controlled corporation (Canada's *Information Circular 89-3*); the IRS would generally not deny it (IRS *Revenue Ruling 93-12*). Therefore, if the Canadian emigrant held minority shares in a family-controlled company, and paid departure tax on a pro rata, non-minority-discounted value, how would the respective American and Canadian "competent authorities" deal with this issue for possible tax-treaty revision purposes?

Subsequent articles will identify other cross-border differences in business valuation principles and practices.

ENDNOTES

(1) See Z.C. Mercer and T. Brown, "Fair Market Value vs. The Real World", *Valuation Strategies*, March/April 1999, Vol. 2, No. 4, Warren, Gorham & Lamont, page 6, and J.E. Fishman and B. O'Rourke, "Whose Fair Market Value Is It Anyway?, 41 *Valuation* 92 (June 1997).

(2) American Society of Appraisers, Business Valuation Standards — Definitions.

(3) 78 DTC 6497; [1978] CTC 669 (FCTD); aff'd 79 DTC 5256; [1979] CTC 365 (FCA).

(4) In *Dominion Metal & Refining Works Ltd.* v. *The Queen*, 86 DTC 6311 (FCTD), the court held that "[t]he special purchaser theory … requires some evidentiary base before it may be applied" (at 6320).

(5) S.P. Pratt, R.F. Reilly and R.P. Schweihs, *Valuing a Business*, Fourth Edition, McGraw-Hill (New York: 2000), page 29.

(6) 76 DTC 6210 (FCTD); aff'd, 78 DTC 6179 (FCA).

(7) (1915), 52 Sc LR 414.

(8) *Pocklington Foods Inc.* v. *Alberta* (Provincial Treasurer), (1998), 159 DLR (4th) 81 (Alta. Q.B.), aff'd (2000) 184 DLR (4th) 152 (Alta CA).

(9) Subsection 5.1(2).

(10) Section 1.1.

(11) Section V.

(12) Code of Ethics, Section 201.1.

(13) *Canada-United States Treaty (1980).*

(14) Other than certain exempted property. As there is no actual sale at the time, the Canadian tax authorities may permit the taxpayer to provide security instead of having to pay the capital gains tax triggered by the deemed disposition.

(15) *Income Tax Act*, Section 128.1

(16) This new provision will apply to foreign taxes that are paid with respect to dispositions before the year 2007 provided that such taxes are paid to a treaty country, and the credits would be available only to the extent that such country is not required to give a foreign tax credit in respect of the Canadian taxes.

(17) *General Utilities and Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

(18) See *Estate of William T. Piper*, 72 TC 1062 (1979) at 1087.

(19) *Eisenberg* v. *Commissioner*, TC Memo 1997-483.