



Mertens Valuation Review

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The *Mertens Valuation Review* is a bi-monthly publication providing our clients and other interested readers with topical information on business valuation and financial litigation support.

Value Attributable to Owners and Key Employees

In business valuation it is fundamental to consider the contributions of owners and key employees (hereinafter referred to as “key individuals”) of the business being valued. Likewise when assessing a business as an acquisition candidate, it is critical to assess the impact key individuals have on the earning capacity of the business.

Earnings directly attributable to key individuals’ business skill, technical expertise, reputation, personal contacts, etc, is often referred to as “individual goodwill”. At issue is how much of the individual goodwill is transferable (or retainable) on sale of the business. Conceptually, to have commercial value, goodwill must be transferable. Goodwill that accrues to an individual, but is not transferable, is referred to as personal goodwill and generally has no commercial value.

The question is to what extent earnings would diminish upon the withdrawal of certain key individuals from the business and how best to mitigate this potential erosion to earnings. Where it may be practical to expect (or desire) key individuals to remain with the business subsequent to a purchase, then the following elements should generally form part of the deal as a means to secure individual goodwill value:

- Post acquisition management contracts;
- Non-competition agreements; and
- Non-compliance risk assessment.

When individual goodwill is in effect crystallized (or secured) by executing post-acquisition agreements, it is important to recognize that the associated value resides in the agreements themselves and not in the fair market value of the related business.

Even when the above-noted agreements will form part of the deal, it is prudent to consider the risks of non-compliance and the potential impact thereof on prospective

earnings. If post acquisition agreements will not be executed, the additional risks and costs associated with the withdrawal of key individuals should be factored into the pricing strategy. Items to consider include:

- Estimate of immediate and future loss of earnings from withdrawal of key individual(s);
- Estimated time required to recover lost earnings (or a portion thereof);
- Ability of key individual to compete (i.e. ability to retain / attract existing customers, time required to re-enter the market);
- Likelihood of key individual to compete (i.e. intentions, age, health, financial status);
- Strength of the existing competition and nature of the market in which the business operates;
- Incremental costs to mitigate negative effects of competition from key individual (i.e. costs of increased marketing efforts, discounting of goods or services); and
- In the case of a key individual with technical expertise, the costs associated with finding and training a suitable replacement.

Non-competition Agreements - Tax & Valuation Considerations

A detailed discussion of the income tax implications to the purchaser and vendor in respect of “non-competition agreements” in the context of the purchase and sale of a business is beyond the scope of this article. The following comments provide only a very general overview sufficient to introduce an interesting matter of business valuation.

On October 7, 2003, the Department of Finance proposed new rules to the *Income Tax Act* (Canada) (the “Act”) to legislate the tax treatment of restrictive covenants (including “non-competition agreements”). Most of the proposed new rules are contained in draft section 56.4 of the Act and were released as part of the February 27, 2004 draft technical amendments. Generally, the new rules in draft section 56.4 of the Act apply to amounts received or receivable after October 7, 2003.

As background, the new rules were introduced in response to the Federal Court of Appeal’s decision in the *Manrell* case (2003 DTC 5225), where the Court found that a payment received by the taxpayer for entering into a non-competition agreement (in the context of the sale of his shares in a corporation) was a non-taxable receipt. Also, in response to the earlier *Fortino* case (1997 DTC 55, and affirmed 2000 DTC 6060), where the Court found that a similar payment received in the context of a share sale was not taxable under the eligible capital amount rules or as income from a source under section 3 of the Act.

The new rules require that amounts received or receivable by a taxpayer in respect of a non-competition agreement be included as regular income for the year, unless one of the exceptions to the new rules applies. Generally, one of the exceptions (draft paragraph 56.4(3) of the Act) allows a vendor of shares (or partnership interest)¹ to treat

¹ A similar election is available in respect of an eligible capital amount in the context of an asset sale.

an amount received (or receivable) in respect of a non-competition agreement as proceeds of disposition of the vendor's shares (or partnership interest), thereby affording capital gains treatment, if the following criteria are met:

- The amount must be consideration for the vendor not to provide property or services in competition with an arm's length purchaser;
- The vendor and purchaser must jointly elect in prescribed form and file the elections with their tax returns for the year; and
- The amount received for the non-competition agreement does not exceed the value thereof which is inherent in the value the shares (or partnership interest).

The above-noted value criteria is provided by way of formula in draft subparagraph 56.4(3)(c)(iii) of the Act. The amount derived by the formula is basically the fair market value of the shares assuming that all reasonable non-competition agreements are executed (and no consideration has been paid for such agreements) less the fair market value of the shares assuming that the particular non-competition agreement has not been executed.

Therefore, to support treating the non-competition receipt as proceeds of disposition for income tax purposes, the valuator will need to determine the fair market value of the shares both with and without the non-competition agreement taking into consideration the various factors noted in the opening section of this article.

Draft subsection 56.4(4) of the Act contains the rules governing the tax treatment to the purchaser for an amount paid (or payable) for a non-competition agreement. Providing the purchaser and vendor have made the requisite joint election discussed above, the amount allocated to the non-competition agreement will form part of the purchaser's cost of shares (if a similar election is made in the context of an asset sale, the amount will be an eligible capital expenditure)².

However, all other things being equal, a purchaser will generally prefer to treat the payment for a non-competition agreement as a current expense. If the amount paid (or payable) for a non-competition agreement is considered employment income of an employee of the purchaser, the amount will be considered wages paid by the purchaser and therefore a current expense³. This may be tenable for agreements with key employees, but a vendor / employee will generally want to ensure capital gains treatment to minimize his or her tax liability.

Draft section 56.4 of the Act appears to have introduced some uncertainty for both the purchaser and vendor of shares (or assets) in situations where a non-competition agreement has been executed, but no joint election has been made. For the vendor, if they report the full selling price as proceeds of disposition of their shares to get capital gains treatment, there may be a risk of the Canada Revenue Agency ("CRA") assessing on the basis that some portion of the proceeds should properly have been allocated to the non-competition agreement. Absent the joint election, the amount assessed in this fashion would be regular income to the vendor. For the purchaser, it is not apparent

² Draft paragraph 56.4(4)(c)

³ Draft paragraph 56.4 (4)(a)

from the new rules how they should report an amount paid for a non-competition agreement in the absence of a joint election (although based on past CRA administrative practice we would expect them to accept adding the amount to the cost of the shares).

Simplified Valuation Example – with and without non-competition agreement

Assume the following facts:

- The shares of Company A can be appropriately valued using a multiplier of 4 times maintainable earnings.
- Company A has maintainable earnings of \$250,000 assuming that a non-competition agreement is executed.
- Estimated that maintainable earnings will decrease by approximately 20% without a non-competition agreement and no mitigating steps.
- With increased marketing efforts at an annual cost of \$15,000, earnings will only decrease by 10%.
- Non-recurring recruiting and training costs are estimated at \$25,000.

Company A – with non-competition agreement:

Maintainable earnings	\$250,000
Earnings multiple	<u>4.0</u>
Fair market value of shares	<u>\$1,000,000</u>

Company A – without non-competition agreement:

Maintainable earnings (with non-comp)	\$250,000
Less 10% decrease	(25,000)
Less increased annual marketing costs	<u>(15,000)</u>
Maintainable earnings (without non-comp)	210,000
Earnings multiple	<u>4.0</u>
Capitalized earnings	840,000
Non-recurring recruiting / training costs	<u>(25,000)</u>
Fair market value of shares	<u>\$815,000</u>
Maximum amount – 56.4(3)(c)(iii)	<u>\$185,000</u>

Summary

When assessing a target business for acquisition it is critical to assess the impact key individuals have on the earning capacity of the business. An assessment should be done to distinguish between personal goodwill and individual goodwill that may be transferable. To the extent individual goodwill may accrue to the target business, consideration should be given to executing post-acquisition agreements to crystallize as much of that individual goodwill as practical.

The income tax implications to both the purchaser and vendor in respect of post-acquisition agreements should be carefully reviewed to ensure no undue results. As always, it is prudent to have well documented valuation support for both pricing and reporting the transaction.

Economic Watch

Next Bank of Canada interest rate announcement - May 25, 2005 (current rate 2.50%)

Next U.S. Federal Reserve interest rate announcement – June 29, 2005 (current rate 3.00%)

Statistics Canada will release the April 2005 CPI figures on May 20, 2005 (Core CPI for March 2005 was 1.9% year-over-year)

Statistics Canada will release the April 2005 Leading Indicators data on May 24, 2005 (the Composite Index grew by 0.2% in March 2005)

In its April 2005 Monetary Policy Report the Bank of Canada projects annual economic growth at 3.00% for the second half of 2005 and 3.25% in 2006

As at May 3, 2005 the Chartered Banks' prime lending rate remained unchanged at 4.25%

As at May 3, 2005 the Government of Canada Benchmark Bond Yields were 3.28%, 3.53% and 4.12% for 3-year, 5-year and 10-year respectively

The *Mertens Valuation Review* provides topical information on business valuation and financial litigation support and is not intended to render any form of professional advice. The reader should consult with a professional advisor to determine the relevance of any comments contained herein to a particular circumstance.

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