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FAMILY LAW: ADVANCED FINANCIAL ISSUES

Distributive Taxes in the Valuation and Division of Capital Property

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DISTRIBUTIVE TAXES IN THE VALUATION AND DIVISION OF CAPITAL PROPERTY

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I. What is Distributive Tax and when Does it Arise?

In a property division case involving a corporation, typically one spouse retains the shares in the corporation (the owning spouse) and makes a compensation payment to the other (the non-owning spouse) for his or her interest in the shares. In these cases, the court must often decide whether or not there should be a deduction from the value of the business to take into account possible distributive taxes which may arise if the owning spouse realizes, in the future, for his or her personal use, the equity in the corporation. The owning spouse may realize the equity in the corporation by either selling the corporation, or more likely by taking out the equity by way of dividends: *Hartshorne v. Hartshorne,* [2001] B.C.J. No. 409 (S.C.).

Either method of realization, by sale or corporate distribution, will result in a liability to the owning spouse for personal income taxes: *Plester v. Plester*, [1998] B.C.J. No. 2438 (S.C.).

Simply stated, distributive tax is the personal income tax payable by a shareholder when removing corporate surplus or equity from a company. The 2005 maximum rate for distributive taxes in B.C. was 31.58%.

II. Common Misconceptions about Distributive Tax

Distributive tax is often confused with capital gains tax. For example, if the shareholder owns a company that owns real property, and the company sells a piece of property that has gone up in value, then the company is subject to a capital gains tax. As another example, the tax on the disposition or sale of shares is not a distributive tax—it is a capital gains tax.

Distributive taxes do not necessarily arise on the sale of the business. If a company sells its assets and does not remove the retained earnings from the company, there are no distributive taxes paid until the shareholder starts to take out cash.

Distributive taxes are not a component of fair market value, *per se*. However, it may be a consequence at some point in time, and therefore the court may take this consequence into account when valuing and dividing corporate property.

III. What is the Law?

It is well settled in B.C. that there is no absolute rule as to whether tax consequences should be taken into account in the valuation of assets or in the determination of the amount of the compensation order: *Halpin v. Halpin*, [1996] B.C.J. No. 2178 (C.A.). It depends on the circumstances of each case and the evidence available at trial. Huddart J.A. said the appropriate rule was clarified by McKinlay J.A. in *Sengmueller v. Sengmueller* (1994), 17 O.R. (3d) 208 (C.A.) at 215:

> If the evidence satisfies the trial judge, on a balance of probabilities, that the disposition of any item of family property will take place at a particular time in the future, then the tax consequences (and other properly proven costs of disposition) are not speculative, and should be allowed either as a reduction in value or as a deductible liability.

Following *Halpin v. Halpin*, *supra*, the consistent thread throughout the cases is that in the absence of evidence of a need or clear intention to sell an asset in the near future, the calculation of tax liability is too speculative to require a judge to deduct it: *H. v. H.*, [1998] B.C.J. No. 2 (S.C.). However, there are a line of cases, such as *Hartshorne v. Hartshorne*, *supra*, where the court does take into account distributive tax (albeit at a discounted rate) where there is evidence that taxes will be incurred at some definite future date.

There are also cases where the court has refused to apply a deduction for distributive taxes but perhaps has recognized the future tax issue in another way. For example, in *Redpath v. Redpath*, [2005] BCJ No. 909,[1] the trial judge declined to recognize distributive taxes, yet went on to deduct $75,000 from the wife's interest in the husband's business because she was to receive cash rather than a share of a business, the value of which was subject to some debate and the vicissitudes of the future market. A discount for cash, maybe, or otherwise a recognition of distributive taxes, or both. It is a matter for argument.

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1 *Redpath v. Redpath* was affirmed, in part, on appeal at [2006] B.C.J. No. 1550 (C.A.).

IV. Building Your Case

A. Evidence Required at Trial

1. Expert Evidence

If you represent the non-owning spouse who will be receiving his or her share of the business through a compensation order or by retaining other assets, you will require an expert report of the fair market value of all the issued shares of the company without any deduction for distributive taxes.

If it is anticipated that the owning spouse will give evidence that he or she will retire within a definitive period of time (for example, in five or ten years), your expert should provide you with discounted figures.

Example (taken from W.A. McMann's expert report in the case *Anderson v. Anderson*, [2004] B.C.J. No. 2293 (S.C.)):

> Distributive Taxes:
>
> No deduction has been made in the calculation of fair market value for any distributive taxes which may arise when value is withdrawn from the corporation. The timing of such withdrawals and the amount of the tax then payable is both speculative and indeterminate.
>
> Assuming a withdrawal by way of dividend at the maximum rate of tax on dividends at 31.58% the tax is as follows:
>
> $149,281 at 31.58%

Current	5 years	10 Years
	Discounted at 10%[2]	
$47,142	$29,271	$18,175"

If you represent the spouse retaining the shares in the business, you should instruct your expert to include as a section in his or her report, as Mr. McMann did above, a range of calculations on distributive taxes. The courts repeatedly say that a distributive tax is an area for argument between counsel, the outcome of which depends on the circumstances of each case. Accordingly, unless your client must immediately remove corporate surplus or equity from the company (in which case you would argue for a 100% deduction of distributive tax), it is inappropriate for counsel to turn the expert into an advocate for a deduction of distributive taxes.

2. Evidence from the Owner of the Shares/Spouse Making the Compensation Payment

As noted above, your client should provide evidence as to the probable time of disposition.

Sample questions include:

> When do you intend to retire and/or sell your shares?
>
> Will you be required to sell shares or withdraw money from the company to make a compensation payment to your spouse?

---

2 The discount rate choice is subjective in nature. It is intended to reflect risk and the time value of money. The higher the discount rate, the smaller the present value will be.

Will the business be sold or merged?

If the business is going to be sold, when is the sale likely to take place?

Other considerations include:

What tax planning might take place?

What is the present value of a dollar paid when the sale takes place?

Is one spouse likely to retain a tax-free asset, such as the matrimonial home?

V. Arguments to be Made at Trial

A. If You Represent the Owner of the Business

The court should take into account distributive taxes because there will undoubtedly be tax to pay at some point in the future. While they can be deferred, they cannot be avoided. Nothing is as certain as death and taxes. If a business owner sells his shares, he or she will pay capital gains taxes if there is a gain. Moreover, if the company sells assets then there will inevitably be cash in the company, which cannot be taken out without the owner paying taxes.

In order to take into account the principle of fairness, the cost of disposition as well as benefits should be shared equally between the spouses. Otherwise, it is not fair for one party to retain an asset, such as the former matrimonial home, which is an entirely tax free asset, compared to the spouse who retains the business asset which has a tax attached to it at some point in the future. Fairness dictates that the future taxes be taken into account, now.

B. If You Represent the Non-Owning Spouse

Any future obligation to pay taxes is speculative, and the amount indeterminate.

If shares are sold and there is a capital gain then there may be a $500,000 capital gains exemption available to the non-owning spouse. This exemption may increase, as governments consistently talk about doing away with capital gains tax. Currently, only 50% of a capital gain is taxed. At prior times it was 75% and 66%.

If assets are sold the tax payable depends on the structure of the sale. Timing of a withdrawal of funds is then speculative and indeterminate. When do the withdrawals start? How much each time? What is the tax rate at the time?

The greatest misconception is that the owner will have to incur distributive taxes.[3]

- As an example, if the company is worth $5 million, why is there an assumption that at retirement, the owner will sell and incur distributive taxes to withdraw the surplus? The non-owning spouse should argue that if there were such a sale of assets, instead of an ongoing business, there would then be a holding company with $5 million cash in it and that cash would continue to be invested by the company to earn a return.
- At a modest 6% return the annual corporate income is $300,000 before taxes. The owner can withdraw all or some of that to live upon and there is no need to encroach on the $5 million corporate value and incur distributive taxes. No tax advisor would advise his or her client in

3 This is essentially the argument made in *Plester v. Plester*, [1998] B.C.J. No. 2438 (S.C.).

such circumstances to withdraw the whole $5 million and pay $1.5 million in taxes to Ottawa simply to put $3.5 million in the individual's pocket.

- The owner will of course pay taxes on the income that he or she does withdraw to live on, but that is a far cry from giving credit in the distribution of assets for $1.5 million in taxes or a discount on that.

When faced with these scenarios, the speculative and indeterminate nature of the problem then surfaces and one can understand why the courts are reluctant to readily recognize distributive taxes.

Courts do not like to entertain speculation without precise evidence. How can one be precise about an unknown future contingency?[4]

C. Examples from the Caselaw

1. Plester v. Plester, [1998] B.C.J. No. 2438 (S.C.)

Mr. Plester was 54 years old and owned a number of corporate shareholdings. The parties disagreed about whether the fair market value of the shareholdings should be adjusted to recognize potential personal distributive income taxes arising at an unknown future date.

Position of the Parties at Trial

Mr. Plester's position was summarized by the trial judge as follows:

> [74] The respondent argues I ought to deduct distributive income taxes of $374,000 from the agreed value of his corporate shares of $2,194,224 and $33,000 from the agreed value of the petitioner's Lookout shares of $181,400. The respondent argues his corporate valuator, Mr. Crosson, discounted by 50% his distributive taxes to arrive at $374,000. He submits that the petitioner's valuator, Mr. McMann took a strictly theoretical approach by opining that the strict accounting definition of 'fair market value' does not contemplate an estimate of personal distributive taxes.
>
> [75] The respondent also argues the petitioner will likely retain use of the net proceeds of the former matrimonial home now in the form of her Marguerite home and the Nesbitt Burns Trust Fund. These are tax free, except for the tax on the income earned by the trust fund. On the other hand, the respondent says he will retain the corporate assets with a substantial tax liability.

In making those submissions, Mr. Plester relied on the evidence of Mr. Richard Crosson, who made the following statement on the issue of distributive taxes in his expert report:

> [78] The value of Mr. Plester's shares reflects the Companies' undistributed fair market value equity. To realize or have personal use of the value residing in the shares will require either their sale, or the distribution of their corporate surpluses by way of dividends. Either method of realization, by sale or by corporate distribution, will result in a liability for personal income taxes.
>
> ...
>
> It should be understood that while latent personal income taxes are not an element of the value of the subject shares, in a matrimonial situation the future obligation to pay latent income taxes attaches to and is conveyed with the transfer of share ownership. The party awarded ownership of the shares, whether Mr. or Mrs. Plester, will obtain

4 See *Stein v. Stein*, [2006] B.C.J. No. 2020 (C.A.) for a recent discussion of a future contingent tax debt on tax shelters.

> them with their existing income tax cost base and income tax characteristics. The net benefit which will result from ownership of the shares will not be the shares' fair market value; the benefit will be the fair market value of the shares, net of the present value of the future income tax obligation which is assumed along with their ownership.
>
> ...
>
> While latent personal income taxes relating to the subject shares can be deferred, they cannot be avoided. Latent taxes will eventually be realized by the party to whom the court awards ownership, whether Mr. or Mrs. Plester—either on the sale of the shares or on the distribution of the value residing in the shares.

Mrs. Plester's position at trial was that possible latent distributive taxes should not be taken into account in valuing the business assets. She relied on the expert report of W.A. McMann. In contrast to Mr. Crosson, Mr. McMann said in his expert report as follows:

> [79] ... Fair market value is a defined term and we agree on the definition. Implicit in the definition is an assumed or notional sale of their shares by the Plesters at the valuation date.
>
> Mr. Crosson in the instruction from Mr. Rose is calculating a deduction beyond the definition of fair market value. He states:
>
> > In my view it is more likely that the value residing in these investments will be realized over time by way of dividend distributions.
> >
> > As distributive income taxes will not be payable until funds are distributed to Mr. and Mrs. Plester, it is appropriate to only recognize the net present value of the latent distributive tax: the extent to which taxes are recognized depends primarily upon the timing of withdrawals.
>
> I believe the above statements cannot apply to an opinion of fair market value which implies a sale by the parties at the valuation date. Fair market value, in my opinion, does not contemplate an estimate of future taxes on withdrawals of funds from a corporation. Even if that were to be the case, I would suggest that if cash value of some $3,812,000 ($1,906,000 for 50%) was available in 257855 B.C. Ltd., the shareholders would not prudently withdraw the sum personally and incur income taxes but would continue to invest same by way of personally owned holding companies.

Result

MacKenzie J. found Mr. McMann's opinion persuasive because it was consistent with both the evidence before the court and the principles in *Halpin v. Halpin*. Mr. Plester did not testify that he would be required to sell any of his shares. He said it was dependent on the outcome of the case. There was no evidence of a clear intention to sell the shares in the near future. In the result, the trial judge did not make any deduction for distributive taxes on the basis they were speculative.

2. Russell v. Russell, [2002] B.C.J. No. 1983 (S.C.)

Mr. Russell was 43 years old and owned a dental laboratory business. At trial, the parties agreed the pre-tax value of Mr. Russell's corporate assets was $3,095,000. The value, net of personal taxes at 100% would be $2,419,000. The value of the shares, net of personal taxes recognized at 50% would be $2,757,000. Mr. Russell argued that the value of the corporate shares should be valued net of personal tax recognized at 100%, or alternatively, at 50%. Mrs. Russell argued that possible latent or notional distributive taxes should not be taken into account in valuing the business.

Position of the Parties at Trial

Mrs. Russell's position is summarized in the reported decision as follows:

> [101] Mrs. Russell submits that possible latent or notional taxes should not be taken into account in valuing the business assets. She says that while Mr. Russell may pay tax on corporate assets at some date, there has been no evidence led to establish the basis upon which that tax will be incurred nor the amount of that tax. She also submits that Mr. Blair's estimates of tax are based on assumptions under which the tax burden would be the most severe, that there is no evidence that the assumed events are likely to take place. Finally, Mrs. Russell submits that various arrangements for satisfying Mrs. Russell's share of family assets will become available whereby the tax burden may be minimized or eliminated.
>
> [102] In short, counsel for Mrs. Russell submits that cost implications (including tax and any other financial factors) based on assets being sold where that event is speculative should not be taken into account when valuing the assets. She submits that such factors are only relevant where there is sufficient evidence to establish the probability of such a sale, and when there is reliable evidence establishing what the cost implications of a sale would be in the circumstances.

Mr. Russell's position is summarized as follows:

> [98] Mr. Russell submits that the value of the corporate shares subject to division should be valued net of personal tax recognized at 100% or, alternatively, at 50%. He submits that it is appropriate to take into account the tax consequences that he says will, inevitably, be visited upon him since he will either sell the shares and incur taxes on the distribution of the assets, or die and taxes will be incurred.

In making those submissions, Mr. Russell relied upon the evidence of Mr. Vern Blair whose valuation of Mr. Russell's corporate holdings became the basis of the value agreed upon by the parties. In his valuation report Mr. Blair stated:

> [99] ... While latent personal income taxes are not an element of the fair market value of the subject shares, in a matrimonial situation, the future obligation to pay latent income taxes attaches to and is conveyed with the transfer of share ownership. The party awarded ownership of the shares will obtain them with their existing income tax cost base and income tax characteristics. The net benefit, which will result from ownership of the shares, will not be the shares' fair market value; the benefit will be the fair market value of the shares, net of the present value of the future income tax obligation associated with their ownership.

Result

While Mr. Justice Davies recognized the common sense proposition that at some distant point in time Mr. Russell might incur some tax liability upon disposition of the corporate assets, His Lordship was of the view that to attempt to value such an event and its prospects as to amount and of timing would be to engage in speculation and analysis contrary to the Court of Appeal's ruling in *Dowling v. Dowling* (1997), 43 B.C.L.R. (3d) 59. In Mr. Justice Davies' view, Mrs. Russell should not suffer a present diminution of her asset base in circumstances where Mr. Russell may never suffer a corresponding and quantifiable loss.

3. Hartshorne v. Hartshorne, [2001] B.C.J. No. 409 (S.C.)

Mr. Hartshorne was 54 years old and owned a law corporation. Taking into account the entire net value of the corporation, the expert retained by Mr. Hartshorne, Mr. Vern Blair, provided three scenarios for the calculation of distributive taxes. One scenario assumed the taxes would have to be paid immediately. A second and third scenario used a present valuation to recognize the taxes would not have to be paid until some time in the future and 10 year and 16 year deferrals, respectively, were

employed. Under the first scenario, if the entire net equity of the corporation was dividended out immediately, taxes payable on the dividends would amount to $124,549. Under the second scenario, if the equity was taken out of the company by way of dividends 10 years hence, the present value of the future tax liability was calculated by Mr. Blair to be $62,275. Under the third scenario, if the deferral was for a period of 16 years, at which time the plaintiff would have been 70 years old, the present value of the taxes payable would be $41,475.

Position of the Parties at Trial

Counsel for Mr. Hartshorne urged the court to use the 10 year deferral calculation, on the basis that the plaintiff was likely to slow down, and then retire, starting in the relatively near future. It was submitted that 10 years represented a reasonable period within which the plaintiff would have ceased to have a law practice, or a significant law practice, given that he was 54 years old at the time of trial.

Counsel for Mrs. Hartshorne argued there was no evidence of an immediate plan to sell or liquidate and therefore calculated distributive taxes should not be used to reduce the net equity available for distribution between the parties. Any future obligation to pay taxes was speculative, and the amount indeterminable.

Result

In the result, Beames J. was satisfied that distributive taxes should be taken into account in this case. At paras. 44 and 45 Her Ladyship states:

> [44] In many instances, using notional distributive taxes to reduce fair market value of an asset, where no sale or liquidation of the asset is contemplated, is inappropriate. However, the asset being valued here is the plaintiff's law corporation. Its existence is tied to the plaintiff's practice of law and his partnership interest. The plaintiff will obviously not practice law forever. I am satisfied that this is an appropriate case for the taking into account of distributive taxes.
>
> [45] In determining the appropriate discount for distributive taxes, a significant factor is the length of the deferral of sale or liquidation of the asset. In this regard, I am mindful that the plaintiff need not incur tax immediately upon ceasing the active, or full time, practice of law. Further, he can reasonably expect to have responsibilities to his youngest children for maintenance, or assistance with post-secondary education, for at least 10 years, and quite possibly longer. He has shown, in the past, an interest in deferring taxes, to the extent that is possible. Taking into account all of the evidence, I am of the view that the approximate deferral period is 16 years.

VI. Possible Solution to the Distributive Taxes Argument

A. Section 85 Corporate Butterfly

Section 85 of the *Income Tax Act*, R.S.C. 1985 (5th Supp.), c.1, may provide a solution to the distributive taxes argument in that it results in a sharing of the burden of distributive taxes by the parties via the ownership of their own corporations. When they take the surplus out of their respective corporations, the taxes are payable by each of them.

The corporate butterfly is complex and should only be effected with care and good advice from a tax professional. Courts will not impose the corporate butterfly as a solution. Not only are judges not tax planners, the corporate butterfly requires the co-operation of a company which you may not have named as a party to the action.

The corporate butterfly is used as a solution in the settlement process, outside of court.

B. How the Corporate Butterfly Works—Example

The husband in a matrimonial proceeding runs a business worth $1 million. At trial, the court orders an equal division of the business wherein each party is to receive $500,000. The owning spouse of the business argues that he should only be required to pay the wife $350,000 in cash, because to raise $500,000 cash he is required to pay $150,000 in personal distributive taxes. The wife argues that she should receive $500,000 in full because the calculation of the tax liability is too speculative.

To bring some certainly to this situation, the parties could simply agree to implement the corporate butterfly pursuant to s. 85 of the *Income Tax Act*. This section allows the parties to take the money out of the company without paying the tax immediately (i.e., the wife's $500,000 is taken out of the original business and deposited in a separate company set up for her and owned solely by her). The wife would only pay distributive taxes as and when she removes cash from her company. Accordingly, the tax associated with the transaction is in her hands, and the same applies to the husband.

VII. Appendix "A"—Trial Argument Extract

Anderson v. Anderson [2004] B.C.J. No. 2293 (S.C.)

Distributive taxes should not be deducted from the share value

Background:

1. In *Anderson v. Anderson* [2004] B.C.J. No. 2293 (S.C.), Mr. Anderson, 50 years of age, was a chartered accountant, with an interest in a company called B.J.A. Ltd. He held 100 Class A voting common shares in the company as well as 1000 Class B preferred redeemable shares at $100,000. Mr. Anderson was employed by B.J.A. Ltd. to work in the chartered accountancy firm, Nemeth Thody Anderson.

2. Mr. McMann of PriceWaterhouseCoopers LLP had valued the total interest in B.J.A. Ltd. as at December 31, 2003, on the basis of its 2003 financial statements, at $215,189. This consisted of a shareholder interest of $202,550 and a shareholder's loan of $12,632. The $202,557 of shareholder equity was made up of $173,701 as the fair market value of the goodwill in the chartered accountancy practice of Nemeth Thody Anderson owned by B.J.A. Ltd. as a partner and the balance as its equity in partnership capital.

3. There was no dispute between the parties that the starting point for valuing the interest in B.J.A. Ltd. as of December 31, 2003, was the $215,189 value placed upon it by Mr. McMann. However, their agreement stopped there, because Mr. Anderson stated the goodwill component of the shareholder interest would not be realized by him until he retired at the age 65, which was 15 years from the date of trial, and only after distributive taxes were paid on the withdrawal of the goodwill component of B.J.A. Ltd.

4. Mrs. Anderson sought an order whereby Mr. Anderson would compensate her for her interest in B.J.A. Ltd. In doing so, she sought to offset Mr. Anderson's interest in the family home (which she wished to retain) against her interest in B.J.A. Ltd. In respect to the calculation of the value of B.J.A. Ltd., the most Mrs. Anderson was prepared to concede, should the court find a deduction for taxes to be appropriate, was the present value of distributive taxes that would be paid upon Mr. Anderson's retirement at age 65.

5. An excerpt from the written argument prepared by counsel for Mrs. Anderson on the issue of distributive taxes is reproduced below.

Excerpt of Argument:

"Value of B.J.A. Ltd: Distributive Tax Issue

6. In providing his opinion on the value of the shares in Bruce J. Anderson Ltd., the business evaluator, Mr. McMann, does not deduct from that figure, any notional distributive taxes.

7. Mr. Anderson argues that taxes will be payable, and ought to be deducted. He relies on the decision of this Court in *Anderson* v. *Anderson* [1996] B.C.J. No. 2103 (S.C.).

8. Mrs. Anderson submits that, having never been followed or considered in subsequent cases, that decision stands alone. There is a long line of authority, which provides otherwise, and the reason Mr. McMann has not deducted distributive taxes from his opinion figure. These cases are as follows:

    (a) *Danish v. Danish* [1981] B.C.J. No. 1396 (C.A.) (commercial real estate)

    (b) *Murchie v. Murchie* [1984] B.C.J. No. 1582 (C.A.) (scrap gold)

    (c) *Jeffery v. Jeffery* [1984] Unreported B.C.S.C. decision of Rowles J. (as she then was) (accounting partnership)

    (d) *Tearle v. Tearle* [1985] B.C.J. No. 1241 (S.C.) (company shares)

(e) *Dibbley v. Dibbley* [1986] O.J. No. 1233 (Ont S.C.) (accounting partnership)

(f) *Halpin v. Halpin* [1996] B.C.J. No. 2178 (C.A.) (company shares)

(g) *H. v. H.* [1998] B.C.J. No. 2 (S.C.) (company shares)

(h) *Plester v. Plester* [1998] B.C.J. No. 2438 (S.C.) (company shares)

(i) *Lonergan v. Lonergan* [1998] B.C.J. No. 150 (S.C.) (taxi and license)

(j) *Russell v. Russell* [2002] B.C.J. No. 1983 (S.C.) (corporate assets)

(k) *S.K.C. v. G.Y.F.* [2003] B.C.J. No. 1320 (C.A.) (R.R.S.P.)

9. Commencing with the Court of Appeal decisions of *Danish v. Danish, supra* and *Murchie v. Murchie, supra*, and more recently, the case of *S.K.C. v. G.Y.F., supra*, the question of the tax impact on the realization of an asset has been an ongoing subject before the court. The consistent thread of these decisions is that in the absence of evidence of a need or clear intention to sell an asset in the near future, that the calculation of tax liability is too speculative to require a judge to deduct it (*H. v. H., supra*, at paragraph 25).

10. In *Murchie v. Murchie, supra*, the husband, who confined his professional practice to restorative dentistry, had a quantity of scrap gold to which the trial judge had attributed a value of $50,000. On appeal, Lambert J.A., at paragraph 23, said in relation to the value placed on the gold:

> The submission on behalf of the husband was that if the asset was realized all in one year it would bear tax at the husband's marginal tax rate, which might be high, depending on the tax shelter, so the value to the husband of the scrap gold might be reduced by one-half. All that may be so, though, as was said in *Danish v. Danish*, *these matters of the tax impact of the realization of assets and the effect on their valuation are sometimes very speculative and depend upon hypotheses as to the future course of events and indeed as to whether there is going to be any realization, which may not in fact occur. There is, therefore, no absolute rule as to whether tax consequences should or should not be taken into account. The circumstances of each case will dictate what seems to be the best course in valuation*. [emphasis added]

11. Following *Danish v. Danish, supra* and *Murchie v. Murchie, supra*, the reasons for judgment of Rowles J. (as she then was), in *Jeffery v. Jeffery, supra*, as well as the reasons for judgment of Rosenberg J. in *Dibbley v. Dibbley, supra*, are particularly apt in the case at bar.

12. In the *Jeffery* case, the court was valuing an accountant's interest in a professional partnership. The defendant was 38 years old and had been in partnership with three other chartered accountants for the previous 11 years. Rowles J. attributed a value of $65,000 to the defendant's partnership interest and considered whether there should be a reduction made to the value of Mrs. Anderson's interest in the partnership by reason of his having to pay tax at some future date when he disposed of his partnership interest.

At pages 14 through 17:

> In his evidence, Mr. Blair acknowledges that the amount of tax which Mr. Jeffery will pay when he disposes of his practice is speculative, depending as it does, on a number of factors, such as the method of sale, his other income, if any, at the time, and what tax sheltering devices, if any, are used. Mr. Blair also stated that if a sale did not occur for 12 years, the amount of tax which would be paid, discounted to a present value, would be negligible.
>
> It is true that in a numbers of cases, valuators have given evidence which has been accepted, of some reduction in the value of an asset based on an assumed disposition of that asset at a future date. Whether such a reduction for future tax liability is justified has been the subject of comment in two British Columbia Court of Appeal cases *Danish v. Danish* and *Murchie v. Murchie*.

...

In this case there was no convincing evidence that Mr. Jeffery intends to or would be forced to dispose of his accounting practice in the foreseeable future. He is now 38 years of age and retirement seems unlikely to be imminent.

It was not suggested by Mr. Blair that any future tax liability Mr. Jeffery might incur on the sale or disposition of his practice affected the present fair market value of the husband's interest in the goodwill of the partnership. *In my view, any future tax which Mr. Jeffery may have to pay is far too speculative to be taken into account in ascribing a value to this asset, and I decline to do so.* [emphasis added]

13. Similarly, in the *Dibbley* case, the court was valuing an accountant's interest in an accounting partnership. At 45 years of age, the accountant was still comparatively young at the time and would have to withdraw from the partnership in order to trigger any tax consequences. After quoting the aforementioned statement made by Lambert J.A. in *Danish v. Danish, supra*, Rosenberg J. made the following comments at page 5:

There was evidence at the trial that a practice the size of Cox, Hyatt is usually not purchased but is usually merged with a larger firm. Mr. Dibbley is comparatively young and it is unlikely that he will sell and retire in the near future.

If the court were to determine that tax should be deducted from the market value, then the same asset would have different values in different people's hands depending on their tax rate, the amount of capital losses or other losses they may have, etc. The court would have to determine:

(1) When is the sale likely to take place?

(2) What is the present value of a dollar paid when the sale takes place?

(3) What is the tax rate likely to be in the future?

(4) What tax planning might take place...?

(5) Will the practice be sold or merged?

(6) Will the selling partner, if he sells, retire or take with him the goodwill and many of the accounts and accounts receivable?

These and many other considerations that would go into a determination of such a tax deduction, in my view, make it impossible to make any reasonable allowance for the payment of such taxes. [emphasis added]

14. Here, Mr. McMann testified that the amount of tax which Mr. Anderson will pay when he disposes of his practice is speculative, and the amount, indeterminable, depending as it does, on a number of factors, including those espoused by Rosenberg J. in *Dibbley v. Dibbley*. He also stated that distributive taxes are not a component of determining fair market value, an opinion which has been adopted by this Court in decisions such as *Plester v. Plester, supra*.

15. At paragraphs 80 through 81 of *Plester, supra*, MacKenzie J. states:

I find Mr. McMann's opinion persuasive because it is consistent with both the evidence before me and the principles in *Halpin*. The respondent did not testify that he would be required to sell any of his shares. He said it depended on the outcome of this case...

There is no evidence of a need or clear intention to sell these shares in the near future: *Hu v. Hu*, [1998] B.C.J. No. 2 (S.C.). There will be no deduction for distributive tax because they are speculative. This case will not involve an *in specie* division of the corporate shares owned by the respondent. Rather, he will retain

> them. For the same reasons, such taxes will not be deducted from the value of the petitioner's interest in Lookout.

16. In the more recent decision of Davies J. in *Russell v. Russell, supra*, the parties had agreed that the pre-tax value of Mr. Anderson's corporate assets was $3,095,000. The husband, who was 43 years old at the time of trial, argued that the value of the corporate shares subject to division should be valued net of personal taxes at 100% or, alternatively, at 50%. He submitted that it was appropriate to take into account the tax consequences that he said would, inevitably, be visited upon him since he would either sell the shares and incur taxes on the distribution of the assets, or die and taxes would be incurred. After reviewing the authorities, Davies J. states at paragraphs 105 through 107:

> While I have some evidence of the potential tax liability that Mr. Russell could at some point in time face if he disposes of some of the family corporate assets, I have no evidence that any sale in the immediate future is likely or even in contemplation...
>
> *Mr. Russell is a relatively young man engaged in a still flourishing business with continued good prospects. He will be in a position to engage in tax planning for many years to minimize or eliminate any present latent tax consequences that could arise from disposition of his business interests.*
>
> While I recognize the common sense proposition that at some distant point in time Mr. Russell may incur some tax liability upon disposition of corporate assets, *I am of the view that to attempt to value such an event and its prospects as to amount or timing would be to engage in speculation and analysis of hypothetical facts contrary to the Court of Appeal's ruling in Dowling. In my view, Mrs. Russell should not suffer a present diminution of her asset base in circumstances where Mr. Russell may never suffer a corresponding and quantifiable loss.* [emphasis added]

17. In the case at bar, similarly, this Court has heard some evidence of the potential tax liability that Mr. Anderson could at some point in time face if Mr. Anderson disposes of his interest in the accounting partnership. However, this Court has heard no evidence that any sale in the immediate or even the near future is likely or even in contemplation.

18. The evidence is that Mr. Anderson is 50 years of age, is engaged in a successful accounting business, which potentially could merge with another firm one day, or which could carry on by the replacement of an exiting partner with a new partner, etc. Mrs. Anderson submits that any future tax liability Mr. Anderson might have to pay is far too speculative to be taken into account in ascribing a value to the accounting practice.

19. Mr. Anderson has not called rebuttal evidence in respect of Mr. McMann's opinion value of $215,186. Therefore, in our submission, Mr. McMann's opinion value without reduction ought to be accepted by the Court.

20. However, in the event the Court determines that distributive taxes ought to be deducted, then Mrs. Anderson submits that the appropriate deferral period for distributive taxes is 15 years, which Mr. McMann calculated at trial as being $15,313 (namely, the present value of $63,967 in taxes in 15 years, which is when Mr. Anderson would be 65 years old). This result would be consistent with the view of the Court in *Hartshorne v. Hartshorne* [2001] B.C.J. No. 409 (S.C.), affirmed by [2002] B.C.J. No. 2416 (C.A.), reversed in [2004] 1 S.C.R. 550 (neither the Court of Appeal nor the Supreme Court of Canada dealt with the point for which the Supreme Court decision is cited).

21. In *Hartshorne, supra*, the asset in question was the husband's law corporation. Counsel for the plaintiff urged the court to use a 10 year deferral calculation, on the basis that the plaintiff was likely to want to slow down, and then retire, starting in the relatively near future. It was submitted that 10 years represented a reasonable period within which the plaintiff would have ceased to have a law practice, or a significant law practice, given that he was 54 years of age.

22. In the result, taking into account all of the evidence, Beames J. was of the view that the appropriate deferral period was 16 years. In coming to this conclusion, the court was mindful that Mr. Anderson need not incur tax immediately upon ceasing the active, or full time, practice of law.

23. In the case at bar, Mr. Anderson testified that he does not foresee himself retiring prior to reaching the age of 65. He also gave evidence that he would likely stay with his current partnership until then. Mrs. Anderson submits that it is too speculative to discount this asset by future tax, but if the Court determines there is sufficient evidence to warrant a tax discount, it is respectfully submitted that the discount share be no greater than $15,313."

Result at Trial:

24. In the result, Mr. Justice Truscott declined to take into account distributive taxes that might be payable on the sale of Mr. Anderson's interest in 15 years time because it was unknown if that interest would still exist in 15 years time, nor how it would be taxed. His Lordship also expressed that it was inappropriate to discount the present value of the goodwill on the basis that it would not be sold for another 15 years.

25. Mrs. Anderson should be entitled to a compensation order from Mr. Anderson out of Mr. Anderson's interest in the family home, to compensate her for her interest in B.J.A. Ltd. However, because of the circumstances related to the interest in B.J.A. Ltd outlined above, His Lordship took into account some of the factors outlined in *Blackett v. Blackett* (1989), 40 B.C.L.R. (2d) 99 (C.A.), including that tax considerations may be appropriate, a compensation is not a mere calculation, and expert values are mere opinions. Alternatively, His Lordship stated, a reapportioning of the interest in B.J.A. Ltd. in favour of Mr. Anderson was supportable under s. 65(1)(f) of the *Family Relations Act* as being related to the preservation of the asset by Mr. Anderson.

VIII. Appendix "B"—Trial Argument Extract

Redpath v. Redpath [2005] B.C.J. No. 909 (S.C.)

Distributive taxes should be deducted from the share value

Background:

1. In *Redpath v. Redpath* [2005] B.C.J. No. 909 (S.C.), Mr. Redpath was the operator of a number of businesses which were owned corporately. The first business was Stuart's Bakery on Granville Island, which was owned by Granville Island Bakery Ltd. He also ran two Max's delis - one on Oak Street and one on West 8th. Also, on West 8th he operated a bakery plant. Both Max's Delis and the bakery plant were owned by Redpath Foods Inc. Redpath Foods Inc. was in turn owned by Granville Island Bakery Ltd.
2. Granville Island Bakery Ltd. also owned real property at 525-527 West 8th. This was next door to a property at 521-524 West 8th owned by Mr. Redpath personally. The two properties were assessed together by Grover, Elliott & Co. Ltd, real estate appraisers, for the purposes of trial. They concluded the combined fair market value of the properties to be $2,080,000. This value was found on the basis of the highest and best use of the two contiguous lots being sold as one parcel and redeveloped.
3. At trial, Mr. Redpath testified that he did not intend to sell the real property for at least the next 10 years, when he would be 65 years of age. Rather, he intended to keep the businesses, which had provided well for the family, operating until then. In the meantime, he required a substantial amount of money for seismic upgrading, for bringing the West 8th property into conformity with the city by-laws, and for renovations.
4. Mr. McMann, of PriceWaterhouseCoopers, provided an opinion that the fair market value of the parties' interest in Granville Island Bakery Ltd, and its subsidiary companies, was $686,700. He noted there was an outstanding shareholders loan to Mr. Redpath in the amount of $57,431. He also said the figure of $686,700 did not include the appraised value of $924,000 for the portion of the West 8th property owned personally by Mr. Redpath.
5. Mr. Vern Blair, an expert business valuator who testified on behalf of Mr. Redpath, agreed with the value of $686,700, which Mr. McMann had assigned to Granville Island Bakery Ltd. However, because Mr. Blair valued the two contiguous real estate holdings as one block, he assessed the total value of the business assets at $1,161,335. As noted, Mr. McMann had not included Mr. Redpath's personally owned property on West 8th.
6. While both experts agreed on the share value of Granville Island Bakery Ltd. at $686,700, Mr. Blair reduced that value by the sum of $57,431 for the shareholder's loan account which the father owed the company. Mr. McMann ignored that deduction. Further, he assumed a sale of the real estate on West 8th, allowing for tax and selling costs of $130,000. On learning of the testimony at trial that the business and properties would not be sold for 10 years, Mr. McMann reduced the latter allowance by approximately one-half.
7. The parties agreed that Mrs. Redpath should receive a cash payment as compensation for her share of the business.
8. There were five disagreements between the parties regarding the corporate valuation. These were whether the shareholder loan of $57,431 should be considered an asset of Granville Island Bakery Ltd, how future capital gains should be taken into account with respect to the real property, whether future distributive taxes should be deducted from the current value of the company, what mortgage value should be deducted from the personally owned property, and whether the expected costs of upgrades, seismic improvements, and renovations should be taken into account. Another issue was whether Mr. Redpath ever took advantage of the one time $500,000 capital gains allowance.

9. An excerpt from the written argument prepared by counsel for Mr. Redpath on the issue of distributive taxes is reproduced below.

Excerpt of Argument:

Value of Shares in Granville Island Bakery Ltd: Distributive Tax Issue

10. In Mr. McMann's report, no distributive taxes have been deducted from the share values. In Mr. Blair's report, he deducts distributive taxes from the share values.

11. In direct testimony, Mr. Blair gave the following evidence:

- According to the chartered accountant, the $500,000 once-in-a-lifetime tax-free gain, if even available to Mr. Redpath, may not qualify for two reasons. First, some of the corporate-owned real estate is rented to non-business third parties and does not qualify. For the real estate to qualify, it must be used for the deli business.
- Second, 90% of the assets have to be used for the business. You would have to move the building that the business is located in, or remove the other businesses in the building, in order to qualify.
- Eventually, a sale or a death will occur and then the taxes will have to be paid. The taxes are a certainty - only the timing is uncertain. Mr. Blair noted that Mr. Redpath is 55 years old. Mr. Blair assumed the sale of the shares, which is the cheapest form of sale.
- Mr. Blair took away the tax-free part of the gain ($192,000). He recognized 50% of the capital gains with the idea that they are not payable today as Mr. Redpath has no intent to liquidate at this time. He testified that he calculated a 7% discount rate over 10 years and reduces the value by 50%, which is a number often used as a proxy when amounts are not known in the future. At that point, Mr. Redpath will be 65 years old.
- Mr. Blair took the net amount, and reduced it by the present value of the distributive tax to arrive at the value of $581,269 ($629,269 - $48,000).

12. It is well settled in this province that there is no absolute rule as to whether tax consequences should or should not be taken into account in the valuation of assets or in the determination of the amount of the compensation order. The circumstances of each case will dictate what seems to be the best course in valuation. The same can be said as to the amount of compensation (*Halpin v. Halpin* [1996] B.C.J. No. 2178 (C.A.), at paragraph 63).

13. In the case at bar, Mr. Redpath's position is that it is appropriate to take tax consequences, including latent personal distributive taxes, into account when considering the division of assets and the value of Mr. Redpath's business.

14. Mr. Redpath is 55 years old. He testified that he plans to retire from his business in 10 years time. Accordingly, Mr. Redpath concedes that the appropriate deferral period for distributive taxes is 10 years, when Mr. Redpath plans to sell the business. This approach is consistent with the view of the court in *Hartshorne v. Hartshorne* [2001] B.C.J. No. 409 (S.C.), affirmed by [2002] B.C.J. No. 2416 (C.A.), reversed in [2004] 1 S.C.R. 550 (neither the Court of Appeal nor the Supreme Court of Canada dealt with the point for which the Supreme Court decision is cited).

15. In *Hartshorne, supra* the asset in question was the husband's law corporation. At issue was whether there should be a deduction from the value of the law corporation to take into account possible distributive taxes which may arise if Mr. Redpath realized, in the future, for his personal use, equity in the corporation. He could do so by either selling the corporation, or more likely, by taking out the equity by way of dividends.

16. Taking into account the entire net value of the corporation in the *Hartshorne* case, Mr. Blair provided three scenarios for the calculation of distributive tax, one assuming the taxes would have to be paid immediately, and two using a present valuation to recognize that the taxes would

not have to be paid until some time in the future. If the net equity of the corporation were dividended out immediately, taxes payable on the dividends would amount to $124,549.00. If the equity was taken out of the company by way of dividends in 10 years, the present day value of the future tax liability was calculated by Mr. Blair to be $62,275.00. If the deferral were for a period of 16 years, at which time Mr. Redpath would be 70 years old, the present value of the taxes payable would be $41,475.

17. Counsel for Mr. Hartshorne urged the court to use a 10 year deferral calculation, on the basis that 10 years represented a reasonable period within which the plaintiff would have ceased to have a law practice, or a significant law practice, given that he was 54 years old.

18. Counsel for Mrs. Hartshorne submitted that distributive taxes were speculative, and given that there was no evidence of an immediate plan to sell or liquidate, should not be used to reduce the net equity available for distribution between the parties. As in the case at bar, in the *Hartshorne* case, Mr. McMann, on behalf of Mrs. Redpath said that he does not believe that distributive taxes are a component of determining fair market value. He said that any future obligation to pay taxes was speculative, and the amount indeterminable.

19. Beames J. made the following conclusions, at para. 45:

> In determining the appropriate discount for distributive taxes, a significant factor is the length of the deferral of sale or liquidation of the asset. In this regard, I am mindful that the plaintiff need not incur tax immediately upon ceasing the active, or full time, practice of law. Further, he can reasonably expect to have responsibilities to his youngest children for maintenance, or assistance with post-secondary education, for at least 10 years, and quite possibly longer. He has shown, in the past, an interest in deferring taxes, to the extent that is possible. Taking into account all of the evidence, I am of the view that the appropriate deferral period is 16 years.

20. In the case at bar, Mr. Redpath testified that he plans to retire at age 65. Mr. Redpath is currently 55 years of age. Following *Hartshorne,* supra, in the event the Court determines that distributive taxes ought to be deducted, the appropriate deferral period for distributive taxes would be 10 years. Mr. Blair's calculation is that a 10-year deferral results in the present value of the taxes payable being $48,000."

Result at Trial:

Distributive Tax Issue

21. In the result, Mr. Justice Williamson accepted Mr. McMann's concession at trial that given the father's evidence he intended to operate the businesses for another 10 years, 50% of the future capital gains tax and selling costs on the real property owned by the business ought to be taken into account. The same applied to the future tax and selling costs on the property owned personally by Mr. Redpath. In the circumstances of this case, having taken into account future capital gains and selling costs, Williamson J. did not think it necessary to take into account distributive taxes. Citing the Court of Appeal decision in *Halpin v. Halpin, supra*, His Lordship reiterated there is no absolute rule concerning distributive taxes. Each case is to be decided on its own circumstances.

22. Notwithstanding the foregoing, Mr. Justice Williamson went on to recognize that Mrs. Redpath's interest in the business was not a readily marketable asset. His Lordship took into account that she would be receiving cash rather than a share of the business, the value of which is subject to some debate and vicissitudes of the future market. In doing so, he relied on the principles enunciated in *Blackett v. Blackett* (1989), 40 B.C.L.R. (2d) 99 (C.A.).

23. In the *Blackett* case, Southin J.A. said that in deciding the amount of compensation, a number of factors should be taken into account. Among the factors she referred to were the tax consequences of the sale, including capital gains and other taxes payable in the future, the difference in the value of cash in hand and someone's valuation of the company, and the

marketability of the asset in question. Southin J.A. also stated that a compensation order ought not to cripple the paying spouse financially. She added that "there may be other considerations which will come to the minds of the learned judge and counsel".

24. In *Redpath*, the evidence was that Mr. Redpath did not intend to sell his interest in the business for approximately 10 years. He needed the business to continue to generate income to support the family. Williamson J. agreed it would be counter-productive to cripple those enterprises. His Lordship also took into account that Mr. Redpath would likely have to borrow and thus pay interest on funds in order to meet the compensation order and to do the various seismic and other upgrades, which were found to be appropriate expenditures.

25. Keeping in mind the approach in *Blackett* and the various factors set out there which His Lordship found were applicable to the case at bar, Williamson J. reduced Mrs. Redpath's compensation order by $75,000.