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# Understanding Net Family Property and the Valuation of Your PREC in Separation Situations

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# Before incorporating your Ontario real estate business through a PREC, have you considered the implications if you were to subsequently get separated?

For married couples, one of the crucial financial issues that arises during a separation/divorce is the equalization of net family property ("NFP").

Simply put, NFP is the change in a spouse's net worth (from a family law perspective) between the date of marriage and the date of separation. In terms of an equalization payment, the spouse with the higher NFP pays half of the difference to the other spouse, so that both of their NFPs are equal after separation.

The value of a spouse's business interests is part of NFP as an asset as at the applicable date, and this ultimately forms part of the amounts that must be equalized.

Similar to income for support, this process raises concerns over the financial ramifications when a married real estate agent who owns a PREC finds themselves in the process of a separation.

## **What does this mean for real estate agents in Ontario who are not incorporated?**

Up until the October 2020 PREC announcement, the process was simple: Every real estate agent in Ontario would earn commissions through their self-employed business and report the entirety of the commissions earned in each tax year in their personal tax return.

In other words, the self-employed business was not a separate legal entity.

In this case the need for a valuation and any financial impact on the NFP was limited, usually arising only in one specific circumstance. If the real estate agent had any commissions owing to themselves at the marriage or separation date, this unpaid commission net of taxes would form part of the spouse's assets in the NFP and be subject to equalization.

Consider the following example: Jane is an unincorporated real estate agent who is going through a separation with her husband, John. Jane and John separated on September 29, 2020 (the "date of separation"). Jane sold a property on July 31, 2020 with a closing date of September 30, 2020, shortly after which she expects to receive \$35,000 in gross commissions. As the sale had not yet been closed as at the date of separation, the commissions are considered to be a receivable owing to Jane. Therefore the \$35,000 of commissions would appear (less deductions and applicable taxes) in Jane's NFP under the list of her assets. These commissions, along with other net assets accumulated during the marriage, would form part of Jane's NFP and would factor into any equalization payment.

Ordinarily, this is the only significant item that impacts unincorporated self-employed real estate agents from a business perspective in the property portion of a family law matter.

## **What does this mean for married real estate agents in Ontario that operate their business through a PREC and who are going through a separation?**

With the introduction of PRECs (which are distinct legal entities, separate from the individual real estate agents), the issues surrounding property and valuation become much more complex and may require analysis, review, and examination by a Chartered Business Valuator ("CBV").

Similar to income for support, the valuation of a spouse's business interests has the potential to be another contentious family law issue. Typically, this requires the spouse to hire a CBV to independently and objectively prepare a formal valuation conclusion, which will then be used in the calculation of assets that form part of the spouse's NFP.

As a real estate agent's business is based on their ability to personally generate leads and leverage their contacts, these types of businesses would likely not have much, if any, transferrable commercial goodwill. Put plainly, a third party

is unlikely to want to purchase a PREC from a real estate agent to benefit from its future income/cash flows.

Therefore, a CBV would use an asset-based approach in valuing the PREC as the value is based on the underlying assets of the corporation as opposed to any future income/cash flows.

A CBV would commonly use an adjusted book value approach, which starts with the shareholder's equity balance from the financial statements and adjusts certain assets and liabilities up or down to their fair market value, arriving at an 'en bloc' fair market value of the PREC.

## **What happens if a real estate agent does not withdraw the entirety of the income generated in a PREC during a given year to minimize taxes?**

One of the advantages of a PREC is being able to retain income in the corporation and only take income as required, thus reducing overall taxes payable. However, as the PREC accumulates income over time and does not pay it all out, it becomes part of the retained earnings of the company, and therefore shareholder's

equity. As discussed above, the shareholder's equity balance forms part of the value of the PREC.

## **What about other investments held in the business?**

Another noteworthy feature of a PREC is that although an agent can't use it to trade in real estate, they can use it to hold other passive investments and/or business ventures.

If it were to be used to hold a portfolio of marketable securities, these too would need to be adjusted to their fair market value (i.e. less a provision for some or all of the taxes on any unrealized capital gains and hypothetical selling costs) as at the applicable date.

Similarly, if the real estate agent were to hold another business entity or joint venture through the PREC, that would also need to be valued at the applicable date.

The more complex the PREC becomes, the more adjustments and considerations need to be made to arrive at a valuation conclusion for family law purposes.

## Are there any tax implications?

When a CBV performs a valuation on a business for family law purposes, in addition to the potential corporate taxes to consider, it is also necessary to consider the personal taxes on the eventual disposition/wind-up of the business. Essentially, based on the information provided, the CBV would make an estimate as to when and how the spouse would exit his or her business (i.e. a sale or wind-up) in the future and calculate the hypothetical taxes as at the applicable date.

The net of the value of the business and the hypothetical future taxes is the amount that ultimately goes in the NFP as an asset.

Depending on the calculated equalization payment and the assets available to pay same, an adjustment to the calculation of personal disposition costs may be required.

## What if the real estate agent takes draws as shareholder loans?

Any loans made to the business or from the business from/to the shareholder also impact the NFP. Shareholder loans owing to the business would appear as a liability on spouse's NFP, thereby reducing it. Whereas shareholder loans owing from the business would appear as an asset on the spouse's NFP. Essentially, in either case the personal loan offsets the shareholder advance on the financial statement of the PREC. For example, if the real estate agent owed the PREC \$50,000, there would be a liability

of \$50,000 in the NFP, and the PREC's shareholder's equity (i.e. asset) would also be higher by \$50,000. The net effect of this is \$nil before tax implications.

If you are a real estate agent in Ontario and are concerned about how your real estate business may impact your Net Family Property in a separation situation, reach out to [Crowe Soberman's Valuations, Forensics, and Litigation Group](#) to discuss the various family law concepts, issues, and parameters.

*This article has been prepared for the general information of our clients. Please note that this publication should not be considered a substitute for personalized advice related to your particular situation.*

## Connect with the Author

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