THE VALUATION LAW REVIEW

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Taxation Decisions and Legislative and Administrative Developments

The Valuation Law Review is a publication of the Canadian Institute of Chartered Business Valuators, edited by Dennis Turnbull, Canada Revenue Agency, and Ed Kroft of McCarthy Tétrault LLP. This issue summarizes taxation law decisions of interest to business valuators. The Valuation Law Review is not intended to provide legal advice and readers should not act on information in the publication without seeking particular advice on matters that are of concern to the reader.. Readers are cautioned against relying upon the decision abstracts contained herein, which are edited and in outline form only, and are directed to the full report of the reasons of the Court.

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These were joint appeals of a reassessment from a "buy-low, donate-high" limited edition print case similar to *Klotz*. The Court was very impressed by the qualifications and testimony of the taxpayer's two witnesses. In their opinion the correct reference market for value was the retail market. This argument had been rejected in Klotz. However, given the quality of the expert evidence presented in these three cases, the Court agreed with the taxpayer's appraisers that the retail market should be used as the reference market for determining value and that a discount for blockage was not appropriate. Given the Court's acceptance of the appellant's expert evidence the burden of proof passed to the Minster. As the Minister had not entered any expert evidence, the appeal was allowed.

PROPOSED AMENDMENTS TO THE INCOME TAX ACT ARE INTENDED TO ELIMINATE "BUY-LOW, DONATE-HIGH" CHARITABLE DONATION ARRANGEMENTS.

Three cases in this issue of the Valuation Law Review (*Malette, Klotz,* and *Nash*) involved so-called "buy-low, donate-high" charitable donation arrangements. In these cases taxpayers purchased property as part of a pre-planned series of transactions and donated it to a charity. They claimed fair market values much higher than their purchase prices. The Crown has had mixed success in contesting these issues in court. Although the subject of the arrangements in these cases involved artwork any property could be used as long as the fair market value could be supported by an appraisal or valuation. Typically the spread between cost and fair market value has been defended on the basis that the properties were acquired at wholesale prices but the fair market value should be determined on a retail basis. Properties donated in these arrangements have included artwork, foodstuffs, comic books, collectable trading cards, pharmaceuticals and medical supplies.

On December 5, 2003 the Department of Finance ("Finance") proposed legislation intended to end these arrangements. Finance proposed a new Paragraph 248(35)(a) to the Income Tax Act which stipulates that if a donor has acquired a property under a "gifting arrangement" the fair market value of that property is the lesser of either the fair market value otherwise determined or the donor's cost (or ACB for donations of capital property). This is effective for transactions occurring after 6 PM EST on December 5, 2003. Since this proposed legislation does not allow a donation amount in excess of the gift's cost the fair market value of the gift cannot be used to inflate the tax credit amount. "Gifting arrangements" are defined in subsection 237.1(1) and include tax shelter donation transactions such as the "buy-low, donate-high" arrangements.

Additionally, where a gift is not made through a "gifting arrangement", proposed paragraph 248(35)(b) deems fair market value to be the donor's cost unless the donor acquired the property more than three years prior to making the gift or where the gift is made as a consequence of the taxpayer's death. If it can be reasonable to conclude that the donor purchased the property in anticipation of gifting it, the three year test does <u>not</u> apply and the fair market value is deemed to be cost regardless of the time interval between the acquisition and donation of the property. It should be noted that all of this proposed legislation, which was again released in February 2004, is still in the draft stage and may be subject to further change. It is expected that this legislation will be introduced in bill form in 2005.

It appears from some of the exemptions to these fair market value "grind" provisions that Finance is not overly concerned about properties with relatively easily determined values. Real property situated in Canada, publicly traded shares, and inventory are exempt. These properties have generally accepted reference markets and do not lend themselves to easy manipulation of value. Donations of certified cultural property and ecological gifts are also not subject to the new legislation, presumably not to discourage these types of donation.

McClintock v. Canada
2003 D.T.C. 576 (Tax Court of Canada)
May 2, 2003

Mr. McClintock was a senior officer of Alias Research Inc. ("Alias"). Alias was a Canadian controlled private corporation based in Toronto engaged in the business of creating and marketing advanced computer aided industrial design software products. On April 25, 1990 and July 5, 1990 Mr. McClintock exercised stock options for a total of 24,338 Alias shares and sold all of these option shares on May 31, 1991. Mr. McClintock claimed a deduction under paragraph 110(1)(d) of the Income Tax Act in computing taxable income. He was denied the deduction on the basis that the option exercise price of $6.00 per share was less than the fair market of the shares on the two acquisition dates.

In both *McClintock* and *Noble* the Courts relied on hindsight in coming to their decisions. In *McClintock* the Court based its conclusion on the price realized in a public offering made shortly after the valuation dates. In *Noble* the Court used the arm's length price realized on the subject shares thirteen months after the valuation date.

At the times that Mr. McClintock exercised his options Alias was not listed on any public stock exchange. Alias made an initial public offering of its shares on the NASDAQ exchange on July 17, 1990 and the offering successfully sold out at US$13.00 per share. The Court considered the basis on which the $6.00 per share option value was determined and the process which led to the public offering shortly after the valuation dates. Mr. McClintock testified that every year the directors of Alias determined a fair market value amount for the common shares of Alias for purpose of employee stock options. At a meeting on April 25, 1990 the board of directors determined the amount of $6.00 per share as the fair market value of Alias common shares as of that date. Mr. McClintock testified that, at the time of the April 1990 director's meeting, Alias was considering the possibility of offering its shares to the public. According to the minutes of the directors' meeting management was to continue expeditious preparations for an initial public offering of shares of Alias. Mr. McClintock insisted, however, that no decision to go public had yet been made and, in retrospect, he had no idea the IPO would proceed as quickly as it did. A meeting with the underwriters did not take place until May 1990. The underwriters estimated a value range of between US$9.00 and US$11.00 per share in a draft prospectus filed with the SEC on May 24, 1990. On July 15, 1990 the Board met with the underwriters and agreed to a US$13.00 per share offering price. The underwriting agreement was signed July 16, 1990 and trading commenced on NASDAQ on July 17, 1990.

Mr. McClintock did not produce an acceptable valuation report supporting the $6.00 per share value. He entered in evidence a draft valuation report which, while accepted by the Court because it had been cited by both parties, was not given any evidentiary weight because the author of the report was not called as a

witness. Mr. McClintock retained a professional valuator to comment on, and rebut, the findings of a critique report of the Alias shares prepared by the Minister's valuator.

The Minister's expert concluded that the amount of Cdn$11.55 was a reasonable indication of the fair market value of the shares of Alias on July 5, 1990. This was based on the Cdn$15.00 IPO price discounted by 25% for the lack of marketability of the subject shares. The valuator stated that the market had made a valuation determination on the day the shares of Alias were first exposed to the open market through the IPO. He accepted this as indicative of the fair market value of Alias' shares at the subject dates. The value, as determined through the IPO, could be assumed to have existed at the valuation dates unless there were intervening events which might have impacted on value. An analysis indicated no such events occurred. The valuator therefore concluded that a discount for lack of marketability would be the only factor affecting the value of Mr. McClintock's shares compared to the IPO price.

The taxpayer's expert argued in rebuttal that the Minister's valuation was flawed due to a lack of any fundamental earnings or asset based analyses or discussions with key directors, officers and employees of either Alias or its underwriter. He also criticized the valuation for failing to consider post-IPO trading restrictions because they would impact the risk and liquidity of the shares.

The most significant issue was the purported use of hindsight. The taxpayer's valuator argued that a valuation of the Alias shares based on the IPO price was inappropriate because it was dependent on hindsight and the use of hindsight had been expressly rejected by the courts. *National System of Baking, 78 DTC 6018 (F.C.T.D.)* was cited as support for this position. The realization, success, and price of the IPO would have been unknown at the valuation dates and thus irrelevant. The taxpayer's valuator also suggested that any reference to the meeting of the board of directors on April 25, 1990, regarding expeditious preparations for an IPO was irrelevant because contemplation and preparation are not synonymous with a realized or successful IPO at $15.00 per share.

The Court rejected these criticisms of the Minister's report and concluded that hindsight was appropriate given the particular facts of the appeal. In the opinion of the Court the trial judge must exercise discretion whether or not to use hindsight to assist in deciding fair market value. This was particularly relevant when there

were no sales of any comparable properties immediately prior to the valuation date. While Mr. McClintock had relied on the $6.00 per share value determined by the company's board of directors it was apparent that Alias shares were definitely worth more than $6.00 each on the relevant dates. The Court was influenced by the fact that there were no fundamental or significant changes in the operations of Alias between April 25, 1990 and July 17, 1990. Given the lack of any apparent value change between the dates it was the opinion of the Court that Mr. McClintock had not adequately explained the reason for the increase in value of the shares during the period from $6.00 to the IPO price of $15.00.

Estate of Helen M. Noble v. Tax. Commissioner of Internal Revenue
T.C. Memo 2005-2 (United States Tax Court)
January 6, 2005

The use of hindsight appears to be gaining some judicial acceptance in American tax cases. Hindsight was the deciding factor in a January 6, 2005 United States Tax Court decision, the *Estate of Helen M. Noble v. Tax. Commissioner of Internal Revenue, T.C. Memo 2005-2*. At issue was the fair market value of a minority block of shares in the Glenwood State Bank at the taxpayer's date of death. The shares constituted 11.6% of the total outstanding stock and were the only shares not held by the controlling shareholder. The taxpayer died on September 2, 1996 and the Estate sold the block of shares to the controlling shareholder on October 24, 1997. In the 15 months prior to the taxpayer's death the controlling shareholder had made two other arm's length purchases of minority blocks of Glenwood shares. Both blocks were about 1% of the total issued stock.

Before arriving at its decision the Tax Court did an extensive review of American jurisprudence related to the acceptability of hindsight. The Court relied on a judgment by the Court of Appeals for the Eighth Circuit which held that, in determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length in the normal course of business within a reasonable time before or after the valuation date were the best criteria of market value. The Tax Court stated that, generally speaking, a valuation of property for federal tax purposes is made as of the valuation date without regard to any event happening after that date. However the Court concluded that "*An event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical buyer would have paid a hypothetical willing seller for the subject property as of the valuation date.*"

The Tax Court did not consider the two sales made prior to the valuation date to be the best available comparable transactions because they were for much smaller blocks than the subject shares. The Court concluded that the sale of the subject shares subsequent to the valuation date was the most relevant comparable transaction since it was for the exact shares under consideration. As the Court could not see any material changes in the circumstances of Glenwood between the valuation date and the subsequent sale it determined a fair market value equal to the actual sales price less a minor adjustment for inflation.

Brown v. Canada
[2004] S.C.C.A. No. 298 (Supreme Court of Canada)
January 23, 2004 – Leave to appeal refused
2003 D.T.C. 5298 (Federal Court of Appeal)
April 24, 2003
2001 D.T.C 1094 (Tax Court of Canada)
November 15, 2001

Housen v. Nikolaisen
[2002] 2 S.C.R. 235 (Supreme Court of Canada)
October 2, 2002

The trial judge's valuation conclusion was sustained on appeal because there was no palpable or overriding error in his decision.

Brown was initially heard by the Tax Court of Canada and decided in November 2001. That decision was reviewed in the June 2002 edition of the Valuation Law Review – Taxation Decisions. Briefly, *Brown* involved the fair market value of eleven computer game engines purchased by the CEG partnership for a total price of US$8,170,000. At trial the Minister's expert supported a valuation range of US$1,255,000 to US$2,135,000. The taxpayer's expert valued the software at a range of US$9,250,000 to US$10,200,000. The Court determined a value of Cdn$4,146,000.

The taxpayer appealed this decision to the Federal Court of Appeal claiming that the Tax Court of Canada had erred in its valuation conclusion. The taxpayer claimed that the determination of fair market value was highly complex and virtually impossible and advanced a number of reasons why the Tax Court of Canada should have rejected certain evidence. He argued that, had the Court rejected this evidence, it would have concluded that the fair market value approximated the partnership's purchase price. The appellant argued that, while a trial court's conclusion on valuation issues is a finding of fact, a lower standard of deference was applicable to the assessment of expert evidence by a trial judge.

The Federal Court of Appeal did not accept this position. The court stated that the Supreme Court of Canada decision in *Housen v. Nikolaisen, 2002 SCC 33* established that this was no longer the case. Findings of fact and factual inferences

drawn by a trial judge, whether from expert or other evidence, were to be reviewed on a palpable and overriding error standard. The Tax Court Justice had conducted a thorough analysis of the valuation of the software programs. It was apparent that he tackled the difficult task of estimating fair market value in a diligent and thorough manner and it was not suggested he had not understood the evidence. Barring palpable and overriding error the Court's decision was not to be interfered with. The Federal Court of Appeal stated that the appellant had failed to show palpable and overriding error on the part of the Tax Court of Canada with respect to the valuation issue. The taxpayer appealed this decision to the Supreme Court of Canada. The Supreme Court failed to grant leave to appeal to the taxpayer in January 2004.

In *Housen v. Nikolaisen* the trial judge was faced with conflicting expert evidence on the issue of the correct speed at which an ordinary motorist would approach a curve in a road. The Court of Appeal overturned the trial judge's decision on the basis that she had not correctly understood or applied some of the expert evidence. The Supreme Court of Canada confirmed the original trial court decision. The role of the appellate court is to uphold decisions unless a palpable error leading to a wrong result has been made by the trial judge. The Supreme Court referred to standard dictionary definitions of "palpable error" and concluded that a common element of all the definitions was that palpable is plainly seen. Based on this definition the Supreme Court concluded that the appellate court was in error in deciding that the trial court judge had made any palpable error.

The Supreme Court commented that the trier of fact has the advantage of having extensive exposure to the evidence, the advantage of hearing viva voce testimony, and familiarity with the case as a whole. Because the primary role of the trial judge is to weigh and assess voluminous quantities of evidence, the expertise and insight of the trial judge in this area should be respected. The Supreme Court concluded that the appellate court was not free to interfere with a factual conclusion that it disagreed with where such disagreement resulted from a difference of opinion over the weight to be assigned to the underlying facts. The finding of facts and the drawing of evidentiary conclusions from facts is the province of the trial court judge.

McCoy v. Canada

2003 D.T.C. 660 (Tax Court of Canada)

additional reasons at 2003 D.T.C. 1559 (Tax Court of Canada)

May 15, 2003

A software valuation case in which the judge rejected all of the expert evidence submitted to the Court and determined fair market value based on the consideration paid for the software. One taxpayer's witness was rejected because of his lack of qualifications. Another taxpayer witness was rejected because he had only reviewed the first witness's report for reasonableness. The Court did not accept that this gave the first report any credibility. The Crown's witness was apparently rejected because of the Court's concern that hindsight may have played a part in his valuation conclusion.

The taxpayer was a member of the Trafalgar II Limited Partnership which, in February 1995, purchased a 22.07% interest in a software program called MarketVision for $12,140,000. MarketVision was developed in 1994 as a software package consisting of 34 programs to be used in trading currency and financial futures contracts. In 1995 the partnership reported a loss based substantially on the capital cost allowance taken on the software. The Minister of National Revenue reassessed Mr. McCoy, disallowing his claimed pro-rata share of the loss.

The Minister had reassessed the partners on a number of different issues but, at trial, the decision ultimately came down to a determination of the value of the software. The initial value used by the partnership had been determined to be in a range of $55,500,000 to $59,980,000 for a 100% interest in the program. The taxpayer's initial valuation report, which supported this value, was not allowed into evidence as an expert report because the Court did not accept that the report's author was qualified to speak on valuation issues. The report was allowed to be introduced into evidence only as a document that was before the vendor and purchaser and had formed part of the material on which the purchase price was based.

At the Tax Court of Canada proceedings the taxpayer retained an experienced valuator who was accepted as a qualified expert. He did not enter an opinion report but instead presented a review appraisal which was essentially a commentary on the initial valuation report. His conclusion was that the initial report was appropriate and reasonable. He stated that, in his opinion, the work reviewed in the development of the initial report was generally complete, the data used appeared to be adequate and relevant, the valuation approach adopted and methods used were appropriate and the analyses, opinions and conclusions in the initial report were reasonable.

Mr. Justice Bowman did not accept that the expert's testimony concerning the initial report was sufficient to give that report any evidentiary value. In the opinion of the Court one expert could not support another valuator's opinion and make it evidence. For an expert's opinion to carry any weight he or she must set out facts from which the opinion may be formed, the premises and assumptions on which the opinion is based, and the conclusions flowing from the premises or assumptions. Each of these steps requires that the expert bring to bear his or her experience and judgment and that each of these components used in arriving at a

conclusion be tested by cross-examination. As none of the underlying premises, assumptions and selection of facts on which the initial report was based could be tested indirectly through the qualified expert his conclusions regarding the initial report could given no weight.

Having rejected all of the taxpayer's valuation evidence, the Court considered the evidence entered by the Crown. The Crown had retained an expert valuator to give an opinion. The expert testified that a 100% interest in the MarketVision software had a fair market value of $100,000. The valuator relied, in part, on the evidence of a successful and recognized commodity trading adviser. In the adviser's opinion, the MarketVision Suite would have been of little interest to trading professionals at the valuation date because there were already numerous good quality trading programs available with established real-time track records at prices much lower than the claimed value of MarketVision.

Although the judgment of the Court did not use the word "hindsight", it appears that the Court concluded that the Crown's expert had relied on hindsight in coming to his conclusion of value. Mr. Justice Bowman stated that he considered fair market value to be in some measure a function of perception at the time whether "that time" was the real estate boom in the late 1980s, stocks in 1929 before the crash, or the price of exotic tulips in 17th century Holland. Irrational or overly optimistic expectations might well have played a part in a contemporaneous valuation review of MarketVision. An analysis five years after the event might be scientifically defensible but it might not reflect the true state of the market at the time. For this reason the Court stated that it was not prepared to treat the valuation by the Crown's expert as determinative. The Court said that common sense indicated that when a group of businessmen and professionals invested substantial amounts of cash for property that they reasonably expected would yield income it was as unreasonable to say that the property was worth nothing or virtually nothing as it was to say that it was worth $55,000,000.

Given the lack of any acceptable valuation evidence Mr. Justice Bowman decided to value the software on the basis of what he considered the true cost to the partnership, namely the fair market value of the consideration paid by the partners. The $12,140,000 price for the subject interest had been satisfied by $8,619,400 in promissory notes maturing December 1, 2005 with the balance of $3,520,600 paid in cash. The Court gave the cash its full value but was skeptical about the fair market value of the notes.

The original software acquisition note had been paid off immediately after the transaction by exchanging it for individual promissory notes from each of the partners. Mr. Justice Bowman concluded that the partner's notes, rather than the original acquisition note, best represented the actual debt consideration. These notes had unusual terms which led the court to conclude they were not worth their full face amount. The notes were held by Trafalgar Capital Ltd. ("Capital"). A clause in the Software Acquisition Agreement allowed the Trafalgar II partners to replace the board of directors of Capital if the software did not achieve an average trading profit of at least 16% on the pledged trading capital. Mr. Justice Bowman concluded that the partner's potential ability to take over the board of directors of Capital would be a formidable obstacle to Capital collecting on the promissory notes. Moreover, any Trafalgar II partner could, at any time, sell, transfer, or assign his partnership units to a third party and also transfer his liability under the note to this party. Capital's approval was not required for any note transfer. This meant that the partners could effectively escape liability for the notes by transferring them to "*a shell company of a man of straw*".

The Court concluded that the value of the notes must be taken into account in determining the cost of the software but that it was possible the notes may have had little or no value. Rather than determine a value the court instructed the parties to the appeal to try to come to an agreement on their value. After negotiations the parties settled on a value equal to 15% of the notes' principal amounts. This resulted in a total determined software value of approximately 40% of the original claimed software price to be used for capital cost allowance purposes.

CIT Financial Ltd. v. Canada
[2004] S.C.C.A. No. 337 (Supreme Court of Canada)
Leave to appeal refused August 4, 2004
2004 D.T.C. 6573 (Federal Court of Appeal)
May 20, 2004
2003 D.T.C. 1138 (Tax Court of Canada)
September 5, 2003

A software valuation case in which the taxpayer's claimed value was supported by two expert reports. The Court rejected the first report because of numerous

This was an appeal from a reassessment for the 1993 taxation year of Commcorp Financial Services Inc. ("Commcorp"), a predecessor company to the appellant, with respect to capital cost allowance claimed on the purchase price of software. The software in question was designed and developed by BHP New Zealand Steel Limited ("BHP"), a steel manufacturing company resident in New Zealand. This was

computer applications software that BHP used in operating its own integrated steel-making facility. Commcorp acquired the software through a complex series of transactions which ended with the software being leased back to BHP. The purchase price of NZ$50,000,000 (Cdn$33,091,255) was based on a valuation by an Australian valuator. Commcorp financed the purchase with Cdn$27,770,897 borrowed from Barclays Bank and Cdn$6,420,358 from internal sources. Before entering into the purchase Commcorp knew that BHP would make lease payments sufficient to cover Commcorp's loan obligations to Barclays Bank. Essentially, the series of loan repayments made by Commcorp were offset by the leasing revenue from the software leaving no net cost or risk in the transaction.

There were initially two issues at trial. The Minister of National Revenue characterized the series of transactions whereby Commcorp purchased software and then leased it back ultimately to the vendor as an "avoidance transaction" within the meaning of the General Anti-Avoidance Rule ("GAAR") and denied any claim for capital cost allowance on the software. The alternative position was that Commcorp acquired the software from a person with whom it was not dealing at arm's length and the cost to it should be reduced to the software's fair market value which the Minister claimed was not greater than Cdn$13,100,000. The Tax Court of Canada rejected the GAAR argument and concluded that Commcorp was entitled to claim capital cost allowance based on the fair market value of the software. This left the valuation of the software as the remaining issue before the Court.

Two valuations were entered into evidence by the taxpayer, the initial Australian valuation and a Canadian report prepared by a professional valuator. The Crown relied on a report prepared by a Canadian valuator. The Crown's valuation report was a critique report of the taxpayer's two reports.

Mr. Justice Bowman started his valuation review by commenting that the difficulty with attempting to determine the fair market value of the software was that there was no evidence that software designed and developed to run a specific steel mill in New Zealand was likely to be bought and sold on the open market. He found it difficult to believe that a steel company in some other part of the world would pay $33,000,000 or any other amount for software designed and developed specifically for BHP's steel mill because it could not be readily adapted to any other business. Any company that wanted to install a computer system to run a steel mill would find it easier and cheaper to develop its own system rather than try to adapt BHP's software.

errors and the Court's opinion that the conclusion was overstated based on factual evidence of the software's actual development cost. The second expert report was rejected because it valued a lease of the subject software which relied on the first report's determination of the software's value which the Court had found to be greatly overstated. The Court calculated a value based on the software's actual development costs. On appeal the trial decision was sustained because there was no palpable or overriding error in the Tax Court of Canada decision.

Given the lack of any apparent market for the software both the Australian valuation report and the Minister's critique report had relied on the replacement cost method. The Court commented adversely on the relevance of this method to the subject software. The replacement cost method ignored the issue of buyers and sellers in an open and unrestricted market. Therefore the valuation conclusions based on it did not, in the opinion of the Court, meet the definition of "fair market value". However, the Court accepted the use of the replacement cost basis because it was the only available method that would yield any value. Mr. Justice Bowman stated that "*Since all the experts agree that replacement cost is an acceptable test and since I have nothing else to go on, I shall deal with the evidence of value on that basis.*"

The Court commented on one piece of evidence which it said "*sticks out like a sore thumb*". Two weeks prior to the Commcorp software purchase a lawyer, acting on behalf of BHP, sent a letter to the Commissioner of Inland Revenue of New Zealand setting out the development costs for the subject software. This came, in total, to Cdn$7,405,823. Mr. Justice Bowman referred to evidence in the Australian report, called by the Court the "Capers Jones slippage factor", which indicated that most companies developing their own software do not record between 30 and 70 percent of the total costs, direct and indirect, that are incurred. The Court commented that these percentages were unsubstantiated and possibly arbitrary. However, for the purpose of analyzing the actual price of developing the software, the Court applied these percentages against the reported development costs given in the letter. After increasing the Cdn$7,405,823 claimed development costs for assumed unrecorded costs as per the Caper Jones percentages the Court arrived at a range of Cdn$9,627,204 to Cdn$12,589,421. The Court stated that while it did not intend to use this calculation as a stand-alone valuation, it demonstrated how far out of line the Australian report's conclusion of Cdn$33,000,000 was.

The Crown's report criticized the Australian valuation in a number of areas and concluded that adjusting for the apparent errors and inconsistencies in the Australian report resulted in a fair market value of the software at in the range of approximately Cdn$12,000,000 to Cdn$18,000,000. The Court was impressed by the Crown's valuator and accepted all of his conclusions regarding errors in the Australian report. After stating that it was not bound to accept the opinion of any of the experts the Court decided the cost figures provided to the New Zealand tax authorities were the most reliable starting point to determining value. Mr. Justice Bowman added a 70% premium to the actual cost amounts to reflect

possible unrecorded costs for a final value of $13,100,000. The Court considered this a reasonable amount because it resulted in a substantial convergence of the amounts in the Crown's reply on appeal, the value range suggested by the Crown's valuator, and the figure arrived at by taking BHP's own recorded costs and adding the high end of the Capers Jones slippage factor.

The second report submitted by the taxpayer in support of the Commcorp purchase price was prepared by a Canadian valuator. This valuation was based on a discounted cash flow calculation which relied on the payments to be made by BHP under the terms of the lease agreement which, in turn, were based on the $33,000,000 software value determined in the Australian report. The Court gave this report no credibility because it did not value the subject software. It valued a lease which had payments determined from a valuation of the software which the Court had concluded was about $20,000,000 too high. The Court considered that it was not surprising that a lease valuation which started from a software value of $33,000,000 and which based the lease payments on this amount ended up with a value for the lease that was equal to $33,000,000. The Court pointed out that this basis of valuation would support any claimed software value. As an example the Court said that if the valuator had started with a software value of $100,000,000, and based the lease payments on that amount, he would have determined the discounted cash flow and lease value to be $100,000,000. In the Court's opinion the valuator's report confirmed the mathematical accuracy of the arrangement but did not prove anything about the fair market value of the software.

Commcorp appealed the decision to the Federal Court of Appeal on the basis that the Tax Court of Canada had erred by relying on the replacement cost method rather than the discounted cash flow method determined from the present value of the lease revenue. According to the taxpayer, in the absence of sham, the legal effects of a transaction must be respected. In the transactions at issue the software was subject to a lease which entitled Commcorp to receive lease income which had a fair market value of approximately $33,000,000. As there was no sham, and all of the transactions in the series of events surrounding the subject purchase were legally binding, this value was correct.

The Federal Court of Appeal stated that the jurisprudence was clear that the determination of fair market value was a question of fact rather than law. The Court referred to *Housen v. Nikolaisen* for setting the standard of review in respect to findings of fact to be palpable or overriding error. The Court stated that the Tax Court of Canada was clearly aware of the fact that the software was subject to the lease at the time that Commcorp acquired it and that the lease was a legally

effective transaction and not a sham. However the value of the lease was completely dependent upon the flawed software value in the Australian valuation report. To the extent that the Australian report over-valued the software, the value of the lease income did not provide an accurate picture of the software's value. Accordingly, the Tax Court of Canada had correctly rejected any valuation based on the lease revenue. The Federal Court of Appeal stated that the Tax Court of Canada had considered the reports of the experts, accepted parts of their evidence and rejected others as it was entitled to do, and the Court's reasoning in arriving at fair market value based on the replacement cost method was sound. The Federal Court of Appeal concluded that the Tax Court of Canada had not committed any palpable or overriding error.

CIT applied for Leave to Appeal to the Supreme Court of Canada. The basis for appeal was whether the rental income from the software could be ignored in valuing the software and whether a finding made by a trial judge is reviewable as a question of law where the trial judge has ignored the proper principles in arriving at his determination of value. The application for Leave to Appeal was dismissed.

Petro-Canada v. Canada
[2004] S.C.C.A. No. 315 (Supreme Court of Canada)
Leave to appeal refused
2004 D.T.C. 6329 (Federal Court of Appeal)
April 23, 2004
2003 D.T.C. 94 (Tax Court of Canada)
December 6, 2002

The valuation conclusions of the appellant's witnesses were rejected by the Court because they did not consider actual transactions in the marketplace. The opinion of an expert for the Crown was rejected because of his reliance on the opinions of others who were not in court to testify. The trial judge's valuation conclusion was sustained on appeal because there was no palpable or overriding error in his decision.

A principal issue in this appeal was the valuation of three blocks of seismic data. Petro-Canada ("PC") appealed from a 1992 reassessment in which the Minister of National Revenue disallowed $37,867,255 of claimed Canadian Exploration Expense. This expense had been incurred through the purchase of seismic data. The reassessment was based upon the assumption that the total fair market value of all of the seismic data purchased was only $8,884,497, not the $46,751,752 agreed on and paid.

The taxpayer had three geologists testify as to the cost to replicate the seismic data at the valuation date. This consisted in developing a theoretical value based upon the estimated cost to produce the data adjusted for factors such as the quality of the data and its geographic location. This replacement cost amount was used to support the purchase prices. The Court did not accept these valuation conclusions. The Court stated that this method was clearly one of value to the

owner which did not take into account actual sales in the market or the negotiations that take place between buyers and sellers. The Court considered this method to have no validity in the determination of fair market value.

The Court referred to evidence produced by the Crown of actual open market sales of seismic data negotiated at arm's length and compared these sales to the conclusions of the appellant's witnesses. One witness had valued seismic data at dates very close to those of actual market transactions of the same data. These open market sales were all made at a fraction of the witness's opinion of value. In one instance, where the entire selling price was in cash, the witness had appraised the data at $2,946,860 when the data had sold in an arm's length transaction for $163,907 on the previous day. The Court considered it startling that a witness would defend a value about eighteen times greater than the consideration given in a contemporaneous arm's length sale. Even more startling, in the opinion of the Court, was the witness's evidence that had he known of the sale it would not have affected his opinion of value.

Another witness for the taxpayer was a geological engineer who had practiced as a consulting geologist since 1978. While he had no valuation training he had some experience acting for clients purchasing seismic data in small quantities. The Court permitted him to testify, over the objection of counsel for the Crown, because he had some limited experience in the marketplace. However the Court did not consider him to be any more than marginally qualified to give opinion evidence. The court commented that the witness brought no valuation training or market experience to one of the most contentious of the valuation issues; whether the value should be discounted because of the large volume of data that was purchased.

The court also rejected this witness's valuation conclusions. Again the value had been determined without regard to what had actually happened in the open market. The witness had stated, in his evidence, that his opinion as to value would not have been affected by sales of comparable data had he known of them. The Court cited one example where a block of seismic data had been sold in an arm's length, open market transaction for about 20% of the value the witness had placed on it.

The Crown then presented valuation evidence in support of its position. While the Court accepted the Crown's valuator as an expert it noted that he had no practical experience either buying and selling seismic data or advising those who did. The valuator's methodology to evaluate purchased data was to multiply the

copy price that had been otherwise established by the number of kilometers and then apply a volume discount. He relied on consultants to determine the magnitude of the volume discounts.

The Court rejected the Crown valuator's testimony because of his reliance on consultants for both factual information and matters of opinion judgment. The Court stated that, whatever the level of expertise these consultants might have, they did not testify at the trial and the Court knew nothing of their qualifications. As they had not given any evidence the Court could not assess their competence and counsel for the taxpayer had no opportunity to cross-examine them. While the Court agreed that opinion witnesses have a certain latitude to base their opinions upon information which is not formally proven, no such latitude is available in respect to matters of judgment or opinion. Witnesses who give opinion evidence as experts may not simply reiterate the opinions of others, with or without attribution. The Court considered the Crown valuator's evidence to be tainted by his adoption of the advice of those he had consulted, not simply as to the facts of transactions, but as to matters of judgment. In the Court's view the opinions of the consultants pervaded the valuation evidence to such an extent that it eliminated any probative value that it might otherwise have had. After a review of all of the opinion evidence the Court concluded it had no acceptable expert evidence on the valuation issue.

Given this lack of any evidence that it considered probative, the Court decided that the best approach it could take was to make an estimate of value from the factual evidence presented during the trial. This evidence was information on actual market sales of seismic data. This information had been submitted by the Crown as part of their expert's report. The Court acknowledged that there were very serious shortcomings in this approach. The comparability of the data was largely unknown, the submitted sales were obviously only a few of the actual market sales which had taken place and nothing was known of the age, the quality, or the location of the data in most cases.

The Court determined that while the evidence regarding appropriate discount rates for large volume sales of seismic data was slight, it was apparent that the larger the volume of data changing hands, the more insistent a potential purchaser would be on a large discount from the price per kilometer determined in smaller volume transactions. The Court then concluded, from the evidence, that the subject seismic purchases would have been considered large transactions and very substantial discounts would have been negotiated by an arm's length

purchaser. After an analysis of the available sales information the Court decided that the total fair market value for all of the seismic under consideration could not exceed $4,759,464. This was about 10% of the value claimed by the taxpayer.

Petro-Canada appealed to the Federal Court of Appeal. The Court dismissed the appeal based on the palpable and overriding error standard established in *Housen v. Nikolaisen*. While it was argued that the Tax Court of Canada erred in conducting his own valuation of the seismic data, the Federal Court of Appeal could not find that the Tax Court of Canada had committed a reversible error. The fair market value of the seismic data at the time of acquisition was a question of fact. The Tax Court of Canada Justice was free to accept or reject, in whole or in part, any valuation opinions that were offered. He was free to make his own estimate of value based on what remained of the acceptable evidence. His conclusion as to value stood in the absence of any palpable and overriding error and the hearing record before the appellate court disclosed no such error.

Malette v. Canada 2003
2004 D.T.C. 6415 (Federal Court of Appeal)
May 18, 2004
2002 D.T.C 1078 (Tax Court of Canada)
August 13, 2002

In issue was the fair market value of a large block of donated artworks. These were 981 paintings and prints by the Canadian artist Harold Feist which were donated by the taxpayer and two others to the Art Gallery of Algoma on July 22, 1998. The works qualified as Canadian Cultural Property under the *Cultural Property Export and Import Act* ("Cultural Act"). Under the Cultural Act taxpayers who choose to donate property that qualifies as Canadian Cultural Property may request that the Canadian Cultural Property Review Board "(Review Board") determine the fair market value of the property. The value determined by the Review Board is deemed to be the donation amount for income tax purposes. A donor who disagrees with the value determined by the Review Board may appeal the board's decision to the Tax Court of Canada.

This case involved the value of 981 donated artworks in a "buy-low, donate-high" arrangement. The issue was whether or not a bulk or volume discount was applicable to the value otherwise determined. The Tax Court decided that a discount was not warranted. On appeal the Tax Court decision was reversed and the value was determined to be the Crown expert's discounted amount.

The Review Board gave the donated artworks a total fair market value of $293,246. This value included a very significant blockage discount because of the large quantity of works under consideration. The taxpayers appealed to the Tax Court of Canada for a re-determination of the value on the basis that a discount was not appropriate. At trial, the parties to the appeal agreed that, on an undiscounted basis, the artwork had a fair market value of $828,000 The

taxpayer also conceded that if, as a matter of law, bulk discounts could be applied to donations of cultural property, this was an appropriate situation to apply a bulk discount and the discounts applied by the Crown's expert were correct.

At trial the expert for the Crown valued each object individually and then gave each item a bulk discount of 90 percent. The discount was based on the premise that the disposition occurred in the tax shelter market in which the value consisted of 8 percent to 15 percent of the individual objects' fair market value. The expert justified the application of this discount both by reference to the volume of works involved and the sales history of Feist's art work which revealed that, on average, he sold two works on paper and six paintings on canvas annually. The expert noted in her report that, given this rate of absorption, it would have taken more than 400 years to sell all the donated works. She determined a discounted value of $141,402.34 for all 981 artworks. This opinion, and the opinion as to the bulk discount to be applied, was supported by the opinion of a second expert.

Given the agreed facts in respect to value, the only issue considered by the Tax Court of Canada was the relevance of a discount. The Court concluded that the question was whether the fair market value of each donated work was to be valued separately without reference to the other gifted artworks or whether the artwork was to be valued as one bulk donation. The Court placed reliance on to *Pustina, Whent and Zelinski v. The Queen, 96 DTC 1594* (reviewed in VLR-Taxation volume 6 edition 1, April 2001) in which the Tax Court of Canada also considered the issue of a discount on a large art donation. In *Pustina*, the Court rejected the discount argument on the basis that the hypothetical open market in which fair market value is determined contemplates purchasers and vendors acting without pressures to buy or sell. The fact that the *Pustina* donors gave away all of the art within a 24-month period did not mean that they would have attempted to sell it within the same period if they had decided to sell rather than donate. This decision was confirmed by the Federal Court of Appeal in *Whent v. Canada (1999), 2000 D.T.C. 6001 (F.C.A.)*.

The Court in *Malette* also referred to the wording of the relevant sections of the Cultural Act. Each reference to a disposition in the Cultural Act was in respect to the donation of an individual object. The Court decided that the term "object" in the Cultural Act was to be construed in the singular. In the Court's view donations of art to public galleries often consist of a large number of works and

such donations were to be encouraged so that the works could be made available to the public. The Court concluded that it was doubtless for this reason that the governing Canadian legislation made individual references to each "object". The Court found that there should be no discount applied for volume or bulk and determined a value of $828,000 for the works of art in question.

The Minister appealed this decision to the Federal Court of Appeal. The Federal Court of Appeal said that the need to apply a discount was a function of supply and demand. The difficulty usually lay in determining whether the circumstances justified the application of a discount and, if so, the extent of the discount to be applied. However, in this case, the need and extent of a discount had already been determined. The Tax Court of Canada appeared to have overlooked the taxpayer's concession that, if a blockage discount could be applied as a matter of law, the subject donations were an appropriate situation in which to apply a discount. Therefore the only issue before the Tax Court was whether, as a matter of statutory construction, blockage discounts could be applied in ascertaining the fair market value of cultural property.

The Federal Court of Appeal stated that it is undisputed that blockage discounts are an accepted principle of proper valuation methodology. This conclusion was supported by the testimony of the Crown's two experts, the three major accrediting bodies for the appraisal profession, and the Appraisal Foundation. It seemed clear that when the circumstances were such that a blockage discount was relevant, the fair market value of the individual works could not be determined without a discount being applied. The Court then commented that the taxpayer's argument appeared to be that, in enacting section 118.1 of the *Income Tax Act*, Parliament had contemplated a "fair market value" that differed from that notion as it is commonly understood by directing, in effect, that the fair market value of gifted cultural property be determined without regard to the depressive effect of volume on the relevant market.

The Court then considered, and rejected, the taxpayer's argument that the numerous references to an "object" in the singular throughout the relevant legislation indicated that the scheme of the legislation was to support a more generous incentive than that which would result from the application of accepted valuation principles and methodology. The Court did not believe that anything turned on this issue having regard to section 33(2) of the *Interpretation Act*, R.S.C. 1985 which provides that, in construing federal statutes, "[w]ords in the singular include the plural, and words in the plural include the singular." The Court was

unable to see how the legislation authorized a departure from accepted valuation principles and methodology and noted that when Parliament wished to depart from the accepted meaning of "fair market value" it did so in express terms. Nothing supported the taxpayer's contention that Parliament had intended to enhance incentives to donations by attributing to gifted objects a fair market value beyond that determined in accordance with accepted valuation principles and methodology.

The Court therefore came to the conclusion that a blockage discount was not precluded by the Act, and the Tax Court of Canada Justice had erred in law in holding otherwise. Having so concluded and given the taxpayer's concession, the Federal Court of Appeal set aside the Tax Court of Canada decision and confirmed the fair market value certified by the Review Board.

Klotz v. Canada
2004 D.T.C. 2236 (Tax Court of Canada)
February 13, 2004

This case involved a pre-arranged "buy-low, donate-high" charitable donation of limited edition art prints. The Crown did not present any expert evidence. The Court was not impressed by the qualifications or evidence of the taxpayer's principal witness. The witness valued the artwork on the basis of assumed retail prices in New York art galleries. The Court was sceptical of this evidence given that the taxpayers had acquired at least some of the artwork from New York galleries at much less than the claimed values. The judge considered the best reference market to be the actual transactions in which the taxpayers purchased the artwork and therefore allowed only the donor's actual cost.

Mr. Klotz was one of about 660 individual taxpayers who participated in a program called Art for Education ("AFE"). Under the AFE program, taxpayers acquired limited edition prints that were prescribed for the purposes of paragraph 118.1(1)(f) of the *Income Tax Act* which they donated to colleges and universities. They bought the prints from the promoters of the program for about $300 per print and received a tax receipt for approximately $1,000 per print. The prints acquired in the AFE program were acquired in bulk from artists and dealers at prices ranging from US$5.00 to US$50.00 per print. In total 63,704 prints were donated through the AFE program. All of the donors were provided with appraisal reports supporting a value of $1,000 or higher per print. Mr. Klotz claimed deductions of $258,400 for 1999 based on the appraised fair market value of 250 prints. The Minister of National Revenue reassessed Mr. Klotz on the basis that the fair market value of the prints was, at most, Mr. Klotz's purchase price of $300 per print.

The Crown did not present any expert evidence. The taxpayer entered two experts in art appraisal. The Court was not impressed by the qualifications or evidence of the taxpayer's principal witness. The second witness, described by the Court as a highly qualified expert, was called on to comment on the methodology of the principal appraiser but he was not able to give her an unqualified endorsement. He noted a number of inadequacies in her report and

commented that, in certain respects, the report did not conform to the standards set by the Uniform Standards of Professional Appraisal Practice. The Court considered that this witness was giving the principal appraiser's report only very lukewarm support and was not endorsing the report's conclusions.

The principal appraiser testified that she was aware that the prints had been acquired just prior to her appraisal date at prices which were much less than the $1,000 per print amount she had placed on them. She explained that this discrepancy resulted from the different markets in which she assumed the artwork would be purchased and sold. Mr. Klotz had purchased the subject prints at reduced wholesale prices based on the size of his purchase. Such wholesale opportunities were only available to consumers who were buying large amounts and were not available to the average consumer. However, a seller wishing to attain the highest price, would not sell on at a discounted wholesale basis. In her opinion, the value of the prints should be based on the prices realized by individual prints sold in the American retail market because this was the largest market for prints. The appraiser therefore used purported New York city art gallery retail prices for individual prints to determine fair market value. The appraiser stated that the $1,000 per print value could be realized on this market if the prints were sold in an orderly manner over a reasonable period of a few years.

While the Tax Court of Canada conceded that "on paper" the appraiser's report had a certain plausibility, the Court was not prepared to accept the appraiser's opinion of value. Even if the Court agreed that New York Art galleries were the proper reference market, the evidence presented by the appraiser did not support her conclusion. The Court commented that the evidence of actual sales of identical or similar prints was virtually non-existent and price lists of dealers were not a reliable guide to the price that a willing purchaser and a willing vendor would agree upon. In any case, the Court did not think that the amount that a New York art dealer might be asking for a similar print by one of the artists proved anything about what scores of the same work would fetch if they were all dumped on the market at the same time. In addition, no differentiation was made in the appraisals with respect to the identity of the artist, the medium used, the number of prints in a series, the age of the prints, or how long they had been unsold prior to being acquired by AFE.

The Court found it suspicious that over 80% of the prints involved in the Klotz donation had been valued at precisely Cdn$1,000. This was the maximum amount per print which could be donated tax free as a "personal use property"

as defined in the Income Tax Act. The Court also found it hard to believe that there was no difference in value between the multiplicity of prints valued. The evidence also indicated that some of the prints were purchased from New York art dealers, the claimed reference market for the sales prices. The Court found it "strange" that dealers would sell the prints to AFE for US$50 or less if there was a retail market ready to buy the same prints for CDN$1,000 each. While the Court was willing to accept that one of a particular artist's prints might be offered for sale in a New York gallery for $1,000, the Court was not willing to agree that this was relevant for valuing the large volume of prints under consideration. The Court was willing to assume, without any real evidence, that "*had we but world enough and time*" the odd print of a particular artist might eventually sell for $1,000. However, the Court was not prepared to leap from that speculative assumption to the conclusion that, at the valuation date, one hundred of that artist's prints would sell for $100,000 in the open market.

The Court considered that the appraiser's conclusion that the prints of some artists would fetch the prices she determined if exposed for sale over a period of years proved nothing about the fair market value of all the prints under review as of December 30, 1999. The Court said that the issue was not the valuation of an individual print. The Court had to look to what 250 prints would obtain on the open market. The best evidence of what the 250 prints would sell for was what they in fact sold for, namely the $75,000 price paid by Mr. Klotz. The sale to Mr. Klotz was a sale of 250 prints between two arm's length parties. The donation was a virtually contemporaneous disposition of the same 250 prints. The Court asked "*Why chase the will o' the wisp of an elusive and largely hypothetical fmv through the trendy up scale art galleries of New York and ignore the best evidence that is right there before your very nose?*"

The Court stated that it was "*simply looking at the best evidence available to determine what the fmv of the gift of 250 prints is. The most contemporaneous and most comparable figure is what Mr. Klotz paid Curated for them. One might question whether even this figure is too high considering that the reason Mr. Klotz paid even as much as he did was that he believed that an expenditure of $300 would yield him a tax credit based on $1,000. It is an interesting question that I need not consider here whether the price paid for something is truly indicative of fmv where the predominant component in the price paid is the tax advantage that the purchaser expects to receive from acquiring the object.*"

The Court considered the Crown's decision not to present any expert testimony a risky manoeuvre however it accepted the Crown's position as being more realistic than that of the taxpayer. The Court concluded that an opinion giving a value of $1,000 per print for artwork just purchased on the open market for $5 to $50 per print and then sold as part of a tax arrangement at $300 per print was devoid of common sense and out of touch with ordinary commercial reality. The Court commented that, although the taxpayer's lawyer had presented his case with skill and persuasiveness, the case ultimately foundered on the shoals of common sense.

At the time the *Klotz* decision was released the *Malette* decision had been decided by the Tax Court of Canada but had not yet been heard by the Federal Court of Appeal. The Court said that the decision to use Mr. Klotz's cost for the artwork might be objected to as being contrary to the *Malette* and *Pustina* decisions which did not discount for volume. However, the Court said that it was not applying a blockage discount to an otherwise determined value. Mr. Justice Bowman did not regard the value of $1,000 per print value as determined by the taxpayer to be reliable enough to serve as the starting point for a discount even if he was inclined to do so. *Klotz* has been appealed to the Federal Court of Appeal.

Quinn v. Canada
2004 D.T.C. 3328 (Tax Court of Canada)

Tolley v. Canada
2004 D.T.C. 3360 (Tax Court of Canada)

Nash v. Canada
2004 D.T.C. 3391 (Tax Court of Canada)
All September 24, 2004

This was an art donation case similar in structure to *Klotz*. Mr. Nash was one of three taxpayers in a joint appeal. In 1999 Mr. Nash donated 84 limited edition prints and received a donation receipt for $29,400. Mr. Nash acquired the prints from CVI Art Management Inc. at a total cost of $8,571. The Minister of National Revenue reassessed the appellant to disallow a portion of the tax credits on the basis that the fair market value of the prints at the time of the donation was his cost amount of $8,571.

These were joint appeals of a reassessment from a "buy-low, donate-high" limited edition print case similar to *Klotz*. The Court was very impressed by the qualifications and testimony of the taxpayer's two witnesses. In their opinion the correct reference market for value was the retail market. This argument had been rejected in Klotz. However, given the quality of the expert evidence

At trial, the Minister did not introduce any valuation evidence. The taxpayer's claimed value was supported by opinions from two appraisers who qualified as an experts in the limited edition art print industry. The Court considered the

presented in these three cases, the Court agreed with the taxpayer's appraisers that the retail market should be used as the reference market for determining value and that a discount for blockage was not appropriate. Given the Court's acceptance of the appellant's expert evidence the burden of proof passed to the Minster. As the Minister had not entered any expert evidence, the appeal was allowed.**not appropriate. Given the Court's acceptance of the appellant's expert evidence the burden of proof passed to the Minster. As the Minister had not entered any expert evidence, the appeal was allowed.**

credentials of the first expert to be very impressive. He stated that he was the vice president of sales and marketing at Mill Pond Press, a publisher of limited edition art prints, and this position required him to maintain a very high level of knowledge of the limited edition print industry, the players, the product, and the wholesale and retail markets. The appraiser gave an extensive review of the business of producing, distributing, marketing and selling limited edition prints. He said that the limited edition print market was extremely strong in the early to mid 1990s and was moderately strong in the late 1990s. The limited edition print market was not, to his knowledge, affected by large charitable donations of prints made in either Canada or the United States. He testified that, in his opinion, the values established in the original appraisals for the prints under consideration were lower than, or equal to, the prices paid for similar types of prints that were sold at the retail level in North America at the end of 1999.

The report of the second appraisal witness included a very detailed description of each of the 233 prints involved in the joint appeal and supported their claimed fair market values. She stated that the taxpayers had purchased the prints at a reduced price based on an opportunity provided by CVI Art Management. The prints were not purchased in the open market, a requirement for concluding that the actual purchase price was the fair market value of the works. She testified that the market that determined fair market value for individual works of art was the retail market where an asset is reasonably expected to bring the highest price to a seller from a buyer and is the market in which such property is sold "*in the normal method*" in the "*ordinary course of business*". She then discussed blockage discounts and concluded that there was not an adequate number of prints in any one of the donations to require a discount in value due to quantity. The total number of prints in all the editions by these artists would not have overloaded the huge North American market.

The Court considered the second witness to be extremely well qualified and knowledgeable in the area of appraising limited edition prints. The Court was impressed with the professional manner in which she testified, both in direct examination and cross-examination. Her report was exceptionally well prepared and presented. In the Court's view, her evidence was not compromised on cross-examination. The Court said that she and the first expert presented not only a prima facie case, but an impressively strong case.

Given that the basic facts of this case were very similar to *Klotz*, the taxpayer's counsel took great care to point out the differences between *Klotz* and *Nash*. In *Klotz*, the taxpayer's appraiser had based her conclusions on the assumption that

the market in which the subject prints would bring the highest price was the New York retail art gallery market. Counsel suggested that, in *Klotz,* the Court was troubled by the fact that many of the prints had been acquired by the promoter from those very retail galleries at huge discounts from their usual list prices. The fact that many of prints in *Klotz* had been purchased at between 1/200th and 1/20th of their purported fair market value from the sort of galleries where that fair market value would in theory be obtained was an indication that these were remaindered prints, or unsaleable inventory and that they had failed to sell in the retail market. The taxpayer's counsel argued that the facts before the Court in *Nash* were quite different in this respect. The expert evidence demonstrated that the prints donated by Mr. Nash and the other two taxpayers were newly published, had mass appeal, and could readily be sold in the retail market. Rather than scouring the market to pick up cheap unsold prints like the promoter did in *Klotz*, CVI Art Management effectively became a print publishing company, commissioning or purchasing the right to reproduce new works from established artists or their agents and arranging for their reproduction.

Counsel also commented that the taxpayer's expert in *Klotz* had not been considered credible by the Court. However, in *Nash*, the value was supported by two highly qualified witnesses who had not been discredited in cross-examination. Counsel also suggested that that the Court should draw a negative inference from the failure of the Crown to produce expert evidence in support of its position. Counsel suggested that the Crown could not find anyone who would testify in court that the prints did not have a fair market value higher than the price paid by the taxpayers.

The Tax Court of Canada agreed with this analysis of the *Klotz* case. It was the Court's opinion that the evidence in *Klotz*, as described by Mr. Justice Bowman, was so inferior to that presented in the case at bar that the Court found it extremely difficult to disagree with Mr. Justice Bowman's decision. However, given the higher quality of evidence given in the present case, the Court had no difficulty in agreeing with the taxpayer's appraisers on two critical points; that the retail market should be used as the reference market for determining value and that a discount for blockage was not appropriate. Given the Court's acceptance of the taxpayer's expert evidence, the burden of proof passed to the Crown. As the Crown had not entered any expert evidence, the Court concluded that the taxpayer was entitled to succeed and the appeal was therefore allowed. *Tolley, Quinn,* and *Nash* have been appealed to the Federal Court of Appeal.

Nash and *Klotz* were essentially identical cases from a tax perspective. Both involved pre-arranged "buy-low, donate-high" charitable donation arrangements. The taxpayers acquired artwork at a price equal to about one-third of its appraised value and, in both cases, the appraisals assumed that the reference market for the art's value was the retail market. It was the position of the Minister of National Revenue that the fair market value of the artwork was, at most, the taxpayer's cost. The Minister did not present expert evidence in either case to support this position.

The Crown won *Klotz* and lost *Nash* largely because of the Court's opinion of the quality of the expert evidence presented by the witnesses acting for the taxpayers. In *Nash*, the witnesses presented appraisal evidence sufficiently credible to shift the burden of proof over to the Crown. As the Crown had not entered any appraisal evidence, the Crown could not refute the opinion of the taxpayer's expert. In *Klotz*, the evidence of the taxpayer's experts was not sufficient to shift the burden of proof from the taxpayer.