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THE VALUATION LAW REVIEW

Taxation Decisions and Legislative and Administrative Developments

The Valuation Law Review is a publication of the Canadian Institute of Chartered Business Valuators written by Dennis Turnbull and Ed Kroft. 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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THE CANADIAN INSTITUTE OF CHARTERED BUSINESS VALUATORS

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Baxter v. The Queen

2006 TCC 230; 2006 D.T.C. 2642
2007 FCA 172

The case dealt with the deductibility of the purchase price of software licenses. The case was initially heard in the Tax Court and was decided in the appellant's favour for a number of reasons including the fair market value of the software. On appeal to the Federal Court of Appeal the Crown argued only two issues, whether the software licence that Mr. Baxter acquired constituted a tax shelter, and whether the promissory note he signed for the purchase constituted a contingent liability. The Federal Court of Appeal determined that Mr. Baxter had acquired a tax shelter. Since the shelter's promoters had not obtained the required tax shelter identification number Mr. Baxter was not allowed any deduction for his purchase price. Given this conclusion it was not necessary for the FCA to consider the contingent liability issue.

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Glaxosmithkline Inc. v. The Queen

2008 TCC 324

The appeals were from reassessments made under Subsection 69(2) of the Income Tax Act with respect to the failure of Glaxosmithkline Inc. to withhold tax on dividends deemed paid to its non-resident parent. The deemed dividends were based on the excess price the Minister of National Revenue claimed Glaxosmithkline paid a non-arm's length party for ranitidine hydrochloride ("ranitidine"), a pharmaceutical ingredient in Zantac, a drug produced and marketed by the appellant. During the period under appeal other Canadian pharmaceutical companies purchased ranitidine arm's length for prices ranging between $194 and $304 per kilogram while the appellant paid from $1,512 to $1,615 per kilogram. The Minister of National Revenue allowed the appellant a purchase price for ranitidine which did not exceed the highest amount paid in the arm's length transactions. The Tax Court was required to determine the fair market value of the ranitidine.

After an extensive review of the evidence the Court determined that the prices paid by the generic companies in Canada were the appropriate CUP comparators and agreed with the Crown's position subject to a minor adjustment of $25 per kilogram. This decision has been appealed to the Federal Court of Appeal.

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Nguyen v. The Queen

2008 TCC 401

This case involved a pre-arranged "buy-low, donate-high" charitable donation of original art works. Neither the appellant nor the Crown presented expert evidence. The appellant's principal basis of value was the claimed gallery list prices of a few works by the program's artists. The Court rejected this argument for a number of reasons and agreed with the Crown's position that the value was the appellant's actual cost less a 15% fee paid as part of the artwork acquisition.

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Sherman et al

208 TCC 186
Affirmed 2008 FCA 9

The Tax Court was asked to determine the fair market value of software. Additional issues were whether the software purchase price was contingent at the time of the purchase and whether the software was purchased for the purpose of earning income. The Court decided against the appellant on all three issues. A factor in the Court's determination of the value of the software was the reliability of the valuation report prepared by the appellant's expert witnesses because it was based on "*self-interested*" projections prepared by the appellant.

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Diotte

The issue was the fair market value of shares in a small unlisted American company involved in research to develop diagnostic testing for veterinarians and the agri-food industry. Both parties presented valuations. The appellant prepared and supported his own valuation while the Crown relied on an expert. The Court found problems with both reports, self-interested optimism on the part of the appellant and undue pessimism on the part of the Crown's witness. The Court criticized the Crown's expert for not meeting with either the appellant or anyone in the company's management to get their insights into the company and its operations. The Court chose a value between the two claimed values.

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Husky Oil Ltd. v. The Queen

2009 TCC118

Amongst other issues the Tax Court was asked to determine the fair market value of 15,500,001 preferred shares issued by Mohawk Lubricants Ltd. (Amalco) on July 8, 1998 as part of an amalgamation. These shares were issued in exchange for shares of Mohawk Lubricants Ltd., the predecessor company. It was the Crown's position that the Amalco preferred shares were worthless while the Mohawk Lubricant shares had a fair market value of $15,500,000. Neither side presented expert evidence in respect to the valuation issues. The Court agreed with the Crown's position and dismissed the appeal. This decision has been appealed to the Federal Court of Appeal.

Class A Voting Non-Participating Shares/Class B Non-Voting Participating Share Structure - Part 2

Dennis Turnbull, CBV

The previous edition of this publication included an editorial by this writer on the valuation of voting non-participating shares and non-voting participating shares. These shares have been much used in estate planning transactions and in family shareholdings. The article pointed out that the CRA's Vancouver Valuations team (of which this editor was a member at that time) had taken the position that voting non-participating shares had significant value, a break from the generally ascribed position that they were worthless. Since that editorial was published the issue of the valuation of voting non-participating shares has moved past being a local Vancouver concern and has been considered in a number of articles nationally.

Canadian Tax Highlights Volume 16 Number 6, June 2008 included an article by Jack Bernstein and Elisabeth Atsaidis where they noted that, in the Vancouver TSO, the CRA was assessing a "premium" on the value of non-participating shares. They claimed that "Assessing a premium in such circumstances is an unannounced change in policy". The article suggested a number of possible changes to the share's rights or to the ownership structures under which they were held to avoid the possibility of the CRA assigning value to them.

Tax Hyperion, Volume 5, No. 11, November 2008 had an article by Karen Yull, Tax Principal, Grant Thornton LLP. Titled "What's the "Skinny on Voting, Non-participating Shares?". Ms. Yull said that the CRA had, in the past, agreed with the nil value position for these shares but that position had changed.

It was widely accepted that these attributes would avoid the attraction of any additional value to the shares. Indeed, hundreds, if not thousands of estate freezes were implemented using skinny shares and, until recently, the CRA has consistently issued assessments on the basis that no value accrued.

Unfortunately, the Vancouver Tax Services Office (TSO) of the CRA has reconsidered their assessing policy for valuing skinny shares on the assumption that a hypothetical purchaser would be willing to pay a premium for the voting control of the company and such shares may in fact have considerable value. One official (note – this editor) *of the Vancouver TSO had suggested that 30% or more of overall value might be allocated to the skinny shares, and in this regard, at least one file appears to be headed to Tax Court in an attempt to settle the matter. Some noted valuations experts even agree that the CRA's position has some merit and supports the notion that even if the freezor has no other rights other than to vote, a control premium could apply to the voting shares, although they are quick to point out the amount of the premium is likely*

far less than what the CRA is asserting in the Vancouver situation.

Ms. Yull noted that the CRA had recently released answers to the 2007 Round Table questions and one of these questions dealt with the CRA's position on the valuation of voting, non-participating shares (more on this below). Ms. Yull concluded with the comment that:

In the meantime, caution should be exercised until the outcome of any court case dealing with this issue is known… It is clear that there may be no black and white answer and that each case will have to be evaluated based on the particular facts, giving recognition to all of the attributes of the various classes of shares, as well as the impact of any shareholders' or other agreements… In most situations, there will not be a "right" answer; just that one position may be more supportable than another. It remains to be seen what the courts will decide and time may tell what premium (if any) will apply to low redemption value preferred shares that simply give voting control.

Ms. Yull's article had been preceded by one in the October 16, 2008 edition of CCH Tax Topics No 1910, by David Louis, of Minden Gross, Toronto, titled "Valuation and Family-Business Share Structures — Some Musings" His opening comments are worth quoting in some length:

In recent weeks, there has been a growing buzz about the control premium issue in respect to family-held private corporations. The genesis of this is mainly from the so-called ''Vancouver Control Premium'' tax file, where the CRA is attempting to assert that there is additional death tax exposure based on a substantial control premium, apparently retained as part of an estate freeze.

While estate planners were certainly aware of the issue, many had felt that with the acceptance over the years of estate freezes as a legitimate tax planning tool, the CRA would not press this point. Until quite recently, it was unclear whether the Vancouver file was a manifestation of local CRA views, or the CRA's assessing position was a harbinger of things to come. It's beginning to look like the latter. In a statement tucked away at the end of last year's Round Table summary, the CRA weighed in on the control premium issue, indicating that, while the amount would depend on the particular facts and circumstances, ''a hypothetical purchaser would be willing to pay some amount for the voting control of a company''. We're all on notice. Because of the impact of this issue on standard estate planning structures for family businesses, our Meritas Tax Group recently sought input from two of Canada's leading valuators in this area. Based on these discussions, it appears that even if a family member has only ''thin-voting shares'' — that is, shares which have virtually no rights other than to vote, a control premium may be applicable (stemming from the controlling shareholder's ability to control the business, pay bonuses, and so on), but probably not nearly as high as is apparently being asserted by the

CRA in the Vancouver file.

Until very recently the only official CRA statement on this issue was a response given to a question at the Canadian Tax Foundation Conference round table held in Montreal in November 2007. The question, and answer, were;

Question

What is the CRA's position on the value of a private company that is attributable to voting non-participating shares?

Response

The CRA does not have an established position on valuing different types of property. Information Circular 89-3 (IC 89-3), Policy Statement on Business Equity Valuations, outlines the valuation principles and policies that CRA generally considers and follows in the valuation of securities and intangible property of closely held corporations for income tax purposes. IC 89-3 discusses, in general terms, the approaches applicable to closely held or private corporations, recognizing that the facts and circumstances of each case will be determinative of fair market value. The valuator must use reasonable judgment and objectivity in the selection and analysis of the relevant facts of each case.

For the above-noted reasons, it is not the intention of the CRA to write a policy or state a formal position regarding this issue. When we value different classes of shares in a company, we generally determine the "en bloc" fair market value and then allocate the value to each class in isolation. The fair market value of each class of shares must be determined on its own merits according to the individual rights and restrictions of each class. In other words, we consider what a hypothetical arm's length purchaser would be willing to pay for a particular class of shares based on the rights, restrictions and conditions, which ultimately affect the economic benefits to be derived from ownership. Given the above, there may be many factors, which might influence the value of voting control. We are not aware of any case law that deals specifically with the allocation of value amongst various classes of shares where voting rights were separated from participation.

It is the opinion of the CRA that a hypothetical purchaser would be willing to pay some amount for the voting control of a company. It is difficult to ascertain what a pure voting right would be worth. However, the answer to this question will depend upon facts and circumstances of each case.

Very recently the CRA presented yet another position on this issue. The occasion was the September 2009 British Columbia Tax Conference and, as part of a round table questions and answers session, the CRA was asked three questions in respect to the valuation of voting non-participating shares:

- *Is there a difference between the CRA's opinion and a CRA policy on this issue?*

- Many estate freezes rely on assumptions about hypothetical purchasers and share values such as the assumption that "freeze shares" hold all the value of a corporation at the time of a freeze. Is the CRA proposing to recommend that a premium be placed on new common shares issued after a freeze?

- Assuming that the CRA "control premium" opinion is a relatively new assessing position, what steps will the CRA take to ensure that a tax premium is not assessed against estate plans that relied on the assumption that voting non-participating preference shares do not have a premium in value?

In response the CRA representative indicated that, in certain limited specific circumstances, the CRA would not place a value on voting non-participating preference shares.

As stated in Income Tax Technical News No. 38, the CRA does not have an established position on valuing different types of property, including shares, as the valuation is dependent on the facts and circumstances of each situation. Information Circular 89-3 (IC 89-3), Policy Statement on Business Equity Valuations, outlines the valuation principles and policies that the CRA considers and follows in the evaluation of securities and intangible property of closely held corporations for income tax purposes. In determining the fair market value of a class of shares, the CRA determines the fair market value of the corporation ''as a whole'' or ''en bloc'' and then allocates the value to each class of shares in isolation. The fair market value of each class is determined according to the rights and restrictions of each class and voting control is a right that may have significant value.

The CRA's position is that non-participating controlling shares have some value and may therefore bear a premium. However, in the context of an estate freeze of a Canadian-controlled private corporation, where the freezor, as part of the estate freeze, keeps controlling non-participating preference shares in order to protect his economic interest in the corporation, the CRA generally accepts not to take into account any premium that could be attributable to such shares for the purposes of subsection 70(5) of the Income Tax Act at the freezor's death.

It is not clear why this new CRA position is limited to the valuation of preferred shares in date-of-death situations, or what "generally accepts" means in this context. Nor has the CRA explained how the freezor's intent at the issuance of the shares can affect value at a subsequent date. An Ernst and Young commentary on the CRA statement by Hugh Neilson, dated November 5, 2009, states some of the risks of relying on the CRA statement as it presently stands:

This statement may, however, be of limited benefit in practice. Purposes other than protection of a freezor's economic interest are common and CRA's inclusion of the word "generally" suggests this policy will not be universally

applied. Further, the entire statement is limited to valuation on death, indicating CRA likely would assert a value to control during the shareholder's life, as for example on a sale of the corporation or on transfer of voting control to the next generation. With this in mind, taxpayers wishing to maintain voting control will need to accept that this comes with a risk of CRA asserting they have also maintained a premium interest in the ongoing value of the corporation.

The CRA is apparently planning to release a more detailed statement in the near future in an attempt to clarify the position as given at the 2009 British Columbia Tax Conference. Unfortunately it will not be available in time to meet the publication deadline of this edition of the Valuation Law Review.

As the articles reviewed in this editorial demonstrate, there is currently considerable uncertainty as to how the value of voting non-participating shares should be determined. While there may never be a consensus on the issue some direction may eventually be given by decisions from the Tax Court. Alternatively the CRA may come up with an overall position that will give outside practitioners guidance as to how the CRA, rather than individual CRA valuators, intends to approach this issue.

Baxter v. The Queen

2006 TCC 230; 2006 D.T.C. 2642
2007 FCA 172

The case dealt with the deductibility of the purchase price of software licenses. The case was initially heard in the Tax Court and was decided in the appellant's favour for a number of reasons including the fair market value of the software. On appeal to the Federal Court of Appeal the Crown argued only two issues, whether the software licence that Mr. Baxter acquired constituted a tax shelter, and whether the promissory note he signed for the purchase constituted a contingent liability. The Federal Court of Appeal determined that Mr. Baxter had acquired a tax shelter. Since the shelter's promoters had not obtained the required tax shelter identification number Mr. Baxter was not allowed any deduction for his purchase price. Given this conclusion it was not necessary for the FCA to consider the contingent liability issue.

Baxter was initially a Tax Court of Canada ("the Tax Court") case which allowed the appeal of Mr. Baxter in respect to the fair market value and deductibility of a software licence. The Baxter Tax Court decision was not reviewed in the prior edition of this publication because the Tax Court's written decision gave a very fragmented review of the contending valuation positions making it difficult to explain the basis of the opposing expert's opinions or to prepare an analysis of the reasoning behind the Court's valuation conclusion. However Baxter is included in this issue because of the possible significance the subsequent Federal Court of Appeal (FCA) decision might have on similar valuation-based tax shelter structures.

Tax Court Decision

In 1998, Mr. Baxter acquired a licence to use the Trafalgar Index Program, which was computer software used to trade futures contracts. The acquisition cost of the licence was $50,000, which was paid by the delivery of four cheques totaling $17,500 and a promissory note with the principal amount of $32,500. In his income tax returns for the 1998 and 1999 taxation years, Mr. Baxter claimed deductions totaling $50,000 as capital cost allowance in respect of the acquisition cost of the licence.

The Tax Court heard valuation evidence from contending expert witnesses. The Crown's witness concluded the licence had only nominal value while

Mr. Baxter's witness supported the $50,000 purchase price. The Tax Court accepted the taxpayer's valuation conclusion.

Another issue considered by the Tax Court was whether Mr. Baxter had acquired a tax shelter when he purchased the licence. The issue of whether a tax shelter existed was critical. "Tax shelter" is a defined term under section 237.1(1) of the Income Tax Act (the Act). If a "tax shelter" exists under the definition in the Act, the promoters of the shelter are required to register it with the Canada Revenue Agency and obtain an identification number. If this is not done, subsection 237.1(6) of the Act prohibits a taxpayer from taking any capital cost deduction for a property or right acquired from the arrangement. The software licence purchased by Mr. Baxter had not been registered as a tax shelter. Therefore, if the licence was determined to be a tax shelter property, Mr. Baxter would be denied any tax deduction for the acquisition cost regardless of its value or the amount he actually paid for it. The Tax Court determined that Mr. Baxter had not acquired a tax shelter.

Federal Court of Appeal ("FCA")

The Crown appealed the Tax Court decision to the FCA. While the Tax Court case involved five separate legal issues and the valuation dispute, the Crown limited the FCA appeal to only two issues; whether the software licence that Mr. Baxter acquired constituted a tax shelter, and whether the promissory note he signed for the purchase constituted a contingent liability.

After a detailed review of the definition of "tax shelter" as it applied to the specific facts of the case, the FCA allowed the appeal by the Crown, concluding that the property that Mr. Baxter acquired constituted a tax shelter. As neither TCL Trafalgar (the promoter) nor any other promoter had applied to the Minister for an identification number with respect to the subject licences, Mr. Baxter was precluded from claiming any deduction in respect to his software purchase. This included the cash portion of his payment. Given this conclusion on the tax shelter issue it was not necessary for the FCA to consider the contingent liability issue.

The FCA noted that it would have been a relatively simple matter for TCL Trafalgar to have obtained an identification number before marketing the subject licences but also noted that the existence of an identification number in relation to the licences may have caused the licences to fall within the definition of "computer software tax shelter property" in subsection 1100(20.2) of the Income Tax Regulations. If so, this would have limited the amount of capital cost allowance that would have been deductible by Mr. Baxter to the amount of income from the business in which his licences were used. The Court commented:

"Whether these provisions of the ITR were a factor in the decision of TCL Trafalgar not to apply for a tax shelter identification number in respect of the

TIP licences that were marketed by or on its behalf is a matter of speculation."

Glaxosmithkline Inc. v. The Queen

2008 TCC 324

This was a major transfer pricing case with 47 days of trial in which 10 expert witnesses testified. The case was heard in 2006 with the decision given nearly two years later.

The appeals were filed in respect to reassessments made for the 1990, 1991, 1992 and 1993 taxation years, under Subsection 69(2) of the Act. Glaxosmithkline Inc. ("Glaxo Canada" or "the Appellant") allegedly failed to withhold tax on dividends deemed paid to its parent company, a non-resident shareholder. The deemed dividends were in respect to the excess price the Minister claimed that Glaxo Canada paid to Adechsa S. A. ("Adechsa"), a related Swiss corporation, for ranitidine hydrochloride ("ranitidine"). Ranitidine is the active pharmaceutical ingredient in Zantac, a prescription drug marketed in Canada to relieve stomach ulcers. Ranitidine was discovered in 1976 and approved as safe for use in Canada in 1981. Zantac was sold in Canada starting in 1982.

Glaxo Canada was a wholly owned subsidiary of Glaxo Group Ltd. ("Glaxo Group"), a United Kingdom corporation, which in turn was a wholly owned subsidiary of Glaxo Holdings PLC ("Holdings"), also a United Kingdom corporation. Glaxo Holdings headed an integrated multinational group of entities, which discovered, developed, manufactured and distributed pharmaceutical products throughout the world. These products were sold through subsidiaries and unrelated distributors in local markets.

During the period under appeal other pharmaceutical companies were selling generic versions of Zantac in Canada. The prices these companies paid for ranitidine during this period declined significantly, from a high of $304 per kilogram in 1990 to a low of $194 per kilogram in 1993. During the same period the price Glaxo Canada was paying Adechsa for ranitidine increased annually from $1,512 per kilogram in 1990 to $1,615 per kilogram in 1993. In 1993 the price Glaxo Canada was paying for the drug was about eight times higher than the price paid by other Canadian pharmaceutical companies for generic ranitidine. In making the assessments the Minister denied a deduction for the purchase price of ranitidine in excess of the highest amount paid by the generic companies at the appropriate time. The Appellant's position was that the price it paid for ranitidine "closely mirrored [the price paid by] . . . independent third parties in comparable circumstances" and that the amounts paid by the Appellant were reasonable in the circumstances. It was the Crown's position that Glaxo Canada was charged an excess amount for ranitidine in order to minimize Glaxo's profits in Canada by moving these profits to Adechsa, a

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After an extensive review of the evidence the Court determined that the prices paid by the generic companies in Canada were the appropriate CUP comparators and agreed with the Crown's position subject to a minor adjustment of $25 per kilogram. This decision has been appealed to the Federal Court of Appeal.

related corporation in a lower tax jurisdiction.

Evidence at trial demonstrated that Holdings had total control of the pricing of ranitidine from initial manufacturing to the purchase by the Appellant. The drug was manufactured by Glaxo Pharmaceuticals (Pte) Ltd., a corporation incorporated in, and carrying on business in Singapore. After manufacture, the ranitidine was sold to Adechsa, which was one of two clearing companies used by the Glaxo group to sell the drug to local companies in various countries at a variety of prices. Evidence showed that the transfer prices controlled by Holdings resulted in the Singapore manufacturer realizing gross profits of around ninety percent on its sales to Adechsa in the 1990-1993 period.

One reason given for this large mark-up to the clearing companies was based on government regulations. In some countries the retail price of drugs is government regulated based on the cost of the drug to the local distributor. A high transfer price from the clearing company would result in a higher allowed local market price and would set a reference price in other countries that based local prices on market prices elsewhere. Evidence showed that this practice resulted, in some instances, in attempts to maintain a high stated local transfer price when sales actually occurred to local companies at a much lower net price. An example given was for ranitidine sales in Austria where a promotional allowance was paid to the licencee through deposits to a Singapore bank account without the knowledge of the Austrian government. Other companies in European countries received similar offsets through various promotional allowances, discounts, and free goods. These practices were not utilized in Canada because there were no government controls restricting drug prices.

Glaxo Canada was party to two contracts involving Zantac: a Licence Agreement dated July 1, 1988 with Glaxo Group and a Supply Agreement with Adechsa. The Licence Agreement required Glaxo Canada to pay a six percent royalty to the Glaxo Group on net sales of Zantac in exchange for various services such as the right to use trademarks, marketing support, and the right to sell Zantac. The Supply Agreement set out the price that Glaxo Canada was required to pay Adechsa for ranitidine. This price was set by Glaxo Group. While the Supply Agreement included other items the Tax Court determined that the only item of value which Glaxo Canada received under the Supply agreement was the ranitidine.

The Court reviewed the federal government's oversight of the Canadian pharmaceutical industry, including the regulatory requirements for evaluating drugs prior to market introduction. Health Canada has the responsibility of assessing new medicines to ensure that they conform with the Food and Drugs Act and Regulations. Formal authorization to market or distribute a medicine is granted through a Notice of Compliance. This is given after the drug passes rigorous clinical testing. Once Glaxo Canada had received a

Notice of Compliance for ranitidine, any other pharmaceutical companies wishing to make a generic version of ranitidine did not need to go through the same level of testing if they were able to demonstrate that their drugs were pharmaceutically equivalent and bioequivalent to ranitidine. Competition from generic manufacturers was a significant issue to Glaxo Canada because a compulsory licensing system existed in Canada which allowed the marketing and sale of generic versions of patented pharmaceutical products, including ranitidine products, in exchange for a royalty of four percent paid to the patent owner. As a result generic versions of ranitidine could be legally sold in Canada while Glaxo's patent for the drug was still in effect. Two companies, Apotex Inc. and Novopharm Ltd., therefore began selling generic ranitidine in Canada during 1987 and 1989 in direct competition with Zantac. This had a negative effect on Zantac sales and resulted in Glaxo Group ceasing promotion of Zantac in Canada in 1993.

During the taxation years under review, the Glaxo Group marketed ranitidine on a country by country basis because of local factors such as the differing levels of government oversight on drug pricing and the competition from generics. In some countries the Glaxo Group had a monopoly which gave an opportunity to charge high prices for ranitidine, although government price controls and the end-user's ability to pay could affect the pricing. Examples were given of the various prices charged. In 1992 the Glaxo Group sold ranitidine to a Hungarian company for US$550 per kilogram, to an Egyptian company for US$630 per kilogram and, starting in 1986, it sold the drug to an Indian company for US$225 per kilogram.

Value Review

Subsection 69(2) of the Act is analogous to Article 9(1) of the OECD *Model Double Taxation Convention on Income and Capital*. The Organisation for Economic Co-operation and Development (OECD) issued a commentary on transfer pricing analysis in 1979. The Canada Revenue Agency relies on the OECD commentary when assessing.

The OECD Commentary in Article 9(1) refers to the arm's length principle to determine the prices that multinational enterprises ("MNEs") charge for goods and services sold from one jurisdiction to another. The arm's length principle recognizes that independent enterprises charge prices according to market forces when dealing with each other but transfers between MNEs do not necessarily represent the result of free market forces. These may instead have been adopted for the overall convenience of the MNE. Consequently, prices set by an MNE may differ significantly from the prices agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions.

The OECD Commentary sets out a hierarchy of methods that can be used

to determine a transfer price. The Commentary mentioned three "traditional transaction methods" in use at the time of the subject transactions. These were:

The comparable uncontrolled price ("CUP") method - This offers the most direct way to determining an arm's length price. The transfer price is set by reference to comparable transactions between a buyer and a seller who are not associated enterprises. In these sales at least one party to the transaction is not a member of the taxpayer's affiliated group. This method requires the uncontrolled transactions to be carefully reviewed for comparability with controlled transactions.

The cost-plus method - This is based on the supplier's cost to which an appropriate profit-mark-up is added. It is a method that raised problems both in respect of determining costs and the appropriate mark-up for profit. However the method may be useful as a means of verifying prices determined by other methods.

The resale price method ("RPM") – The starting point for this method is the price at which a product, which has been purchased from a related seller, is resold to an independent purchaser. This price is then reduced by an appropriate mark-up representing the amount out of which the reseller would seek to cover its costs and make a profit. The residual, after the subtraction of the mark-up, can be regarded as an arm's length price of the original sale.

Both parties called expert witnesses to testify as to the most appropriate method of establishing the transfer price between the Appellant and Adechsa. Both parties' experts agreed that the CUP method was the preferred method for determining transfer prices. The Court also agreed that the CUP method was the preferred method, stating that only in the absence of useful evidence of an uncontrolled transaction would it be necessary to use another method.

It was the Crown's position that the Canadian generic companies' purchases of ranitidine from arm's length manufacturers were comparable transactions for a CUP analysis. The Crown argued that the price that Glaxo Canada would have paid Adechsa, had they been dealing at arm's length, would have been the price that Apotex Inc. and Novopharm Ltd. paid to their suppliers. The Crown relied on the cost-plus method to support its CUP analysis. While the appellant agreed that CUP was the preferred method, it wanted the Tax Court to use the prices that independent third party licencees in Europe paid the Glaxo Group for ranitidine, claiming that these licensees had purchased the drug under the same set of business circumstances as Glaxo Canada. The Appellant attempted to persuade the Tax Court to reject the Canadian generic prices as an appropriate comparable for two reasons:

a) The Appellant's actual business circumstances were wholly different

from those of Apotex and Novopharm, such that the transactions were not comparable for purposes of subsection 69(2) of the Act and the application of the CUP method and;

b) The ranitidine purchased by the Appellant from Adechsa was manufactured under Glaxo World's standards of good manufacturing practices ("GMP"), granulated to Glaxo World standards, and produced in accordance with Glaxo World's health, safety and environmental standards ("HSE"). The Appellant contended that the ranitidine purchased by the generic companies was not a comparable good because it was not manufactured to these standards. Instead the Appellant submitted that the independent third party licencees in Europe were the best comparables because they purchased the same ranitidine as Glaxo Canada had manufactured in accordance with the Glaxo standards.

Before the Tax Court could make an analysis under CUP, it had to consider three key differences between the parties. These were (1) whether the Supply Agreement and the Licence Agreement should be considered in determining a reasonable transfer price; (2) the meaning of the phrase "reasonable in the circumstances" in subsection 69(2) of the Act; and (3) the impact of the differences in GMPs and HSEs on the comparability of the ranitidine purchased by the Appellant with that purchased by the generic companies.

1 - Relevance of the agreements to a Transfer Price – This argument addressed the issue of what was actually purchased by Glaxo Canada. The Appellant argued that the transfer price covered more than just the ranitidine and included intangible benefits stipulated in the two agreements, principally a royalty to the Glaxo Group included in the Licence Agreement. The Crown argued that these were independent agreements with no connection between them. The Tax Court agreed and said the ranitidine had to be valued strictly on the basis of the Supply Agreement.

2 - The impact of the differences in GMPs and HSEs on the comparability of the ranitidine purchased by the appellant with that purchased by the generic companies – This was covered by the Tax Court in its consideration of the term "Reasonable in the circumstances", reviewed below. It was the Tax Court's conclusion that these factors had no bearing on the comparability of Glaxo's ranitidine and the generic versions.

3 - "Reasonable in the circumstances" – The Appellant gave a number of arguments why the circumstances under which it acquired ranitidine were not comparable to those of the Canadian generic companies and that the price that it paid Adechsa was "reasonable in the circumstances". The OECD Commentary explains that, for the prices of goods to be comparable, it is necessary to have economic comparability and for the goods to be sold at the same point in the chain from produce to consumer. The Appellant submitted that its "actual business circumstances were wholly different from those of the

. . . [Canadian generic companies], but similar to those of the Glaxo Group's independent licencees in a number of countries." This argument was a key point in the Appellant's argument. The Appellant listed the conditions or business circumstances that distinguished the Appellant's transactions from those of the generic companies. While there were numerous claimed distinguishing factors put forward in argument, this review will only consider the principal ones:

(a) Glaxo Canada had to buy ranitidine from sources approved by Glaxo Group and could not freely determine its own sources. Glaxo Group's independent licencees were similarly constrained. Apotex and Novopharm were not.

The Tax Court dismissed this argument. It stated that the Crown had not argued that the Appellant should have purchased ranitidine from a different supplier. It claimed only that the price charged by Adechsa was not reasonable. The Tax Court concluded that, had the legislature intended that the phrase "reasonable in the circumstances" could include all possible contractual terms, there would be no purpose to subsection 69(2) since any multinational company would be able to claim that its parent company would not allow it to purchase from another supplier. This would result in the parent being able to charge whatever price it wished without having to face the prospect of a CUP analysis. There was no question that the Appellant was legally required to purchase Glaxo-approved ranitidine. The issue was whether a person in Canada dealing at arm's length with its supplier would have accepted the same contractual conditions and paid the same price as the Appellant.

(b) Glaxo Canada was required to conduct its business in accordance with Glaxo Group's standards.

The Appellant argued that Glaxo's adherence to its own GMP, HSE, and granulation standards meant that its ranitidine was not comparable to that used by the generic companies. It was the Crown's position that, while there may have been differences in the Glaxo Group's manufacturing, health, safety, and environmental standards compared to other ranitidine manufacturers, these should have no bearing on the purchase price the Appellant paid for ranitidine because the generic versions were chemically and pharmaceutically equivalent to the Glaxo product and were approved for sale by Health Canada.

The Tax Court did not accept the Appellant's argument. The Tax Court concluded that Glaxo's standards did not change the nature of the good. An expert testifying on behalf of the Crown had concluded that any differences in company safety and manufacturing standards were irrelevant because companies could establish whatever internal standards they liked but drug products were approved based on the regulatory standards in each country. The only issue, according to this expert, was whether the ranitidine, generic or Glaxo-manufactured, met the Canadian standard and the Appellant

had admitted that the generic ranitidine was bioequivalent and chemically equivalent to Glaxo's ranitidine as required by Health Canada. While the Tax Court accepted that Glaxo's manufacturing and safety standards may have conferred a certain degree of comfort that the drug had minimal impurities and was manufactured in a responsible manner, this did not affect its comparability with the ranitidine used by the generic companies.

(c) Glaxo Canada received regulatory approval and marketing assistance from Glaxo Group, as did the independent licencees. Apotex and Novopharm did not.

The Tax Court considered this argument irrelevant because intangibles were covered under the Licence Agreement and the Tax Court had already determined that this was a separate issue from the purchase of ranitidine under the Supply Agreement.

After this analysis, the Court moved on to a review of the CUP method. It stated that the 1979 and 1995 OECD Commentaries applied the following criteria in analyzing transactions under the CUP method: economic comparability, comparability of goods, comparability of point in the chain where goods are sold, comparability of functions of the enterprises, comparability of contractual terms and comparability of business strategies. The Tax Court reviewed each of these criteria in detail.

I. Economic Comparability

The Appellant argued that the generic products should not be considered as comparables to Zantac because the real competitors in Canada were not the generics, they were the other brand-name anti-ulcer medications such as Tagamet. It was the Crown's position that generic ranitidine was a substitute for Zantac and that the market for Zantac was not independent of the market for generic ranitidine. After generic ranitidine was introduced at a lower price than Zantac, many consumers changed from Zantac to a generic product. The Tax Court agreed with this concluding that:

[125] There is no question in my mind that the generic corporations and the appellant were competing in the same economic market. The appellant itself acknowledged that it was losing market share to the generics and it came up with a marketing strategy specifically to fight the generic companies. The fact that the appellant and the generic companies charged different prices for their respective ranitidine products is not relevant to this question.

The Tax Court said that Glaxo Canada and its two generic competitors were engaged in the sale of prescription pharmaceutical products in Canada and all sold their ranitidine products throughout Canada during the period in appeal. The three companies were comparable in size, were subject to the same government regulations and were competing with each other and other

ulcer medications for market share. This made the generic manufacturers economically comparable for CUP purposes.

II. Comparability of Goods

The Appellant had argued that the ranitidine it purchased from Adechsa was not comparable to the ranitidine purchased by the generics because it was manufactured under Glaxo World's standards of GMP, granulated to Glaxo World standards, and produced in accordance with Glaxo World's HSE standards and the ranitidine purchased by the generics was not. Since the Court had previously concluded that Glaxo World's GMP and HSE standards did not change the nature of the ranitidine, it considered the generic ranitidine comparable.

III. Comparability of Point in the Chain Where Goods are Sold

For CUP purposes, it is necessary to compare goods sold at the same point in the chain from producer to consumer or to be able to quantify easily the different points in the chain. The Appellant and the generic companies both purchased ranitidine at the wholesale level and the parties agreed that this factor was comparable.

IV. Functional Analysis

A comparison of the functions taken on by the parties was necessary to determine if the economically significant activities and responsibilities undertaken by the Glaxo Canada was similar to those of the generic companies.

The Appellant and the generic companies performed similar functions, namely secondary manufacture, sales and distribution, and research and development. All three companies had regulatory affairs divisions whose purpose was to obtain approval for their respective drugs from the HPB. All three companies had, as the ultimate purchasers of their drugs, Canadian consumers. More specifically, with respect to ranitidine, the Appellant and the generic companies all performed very similar functions in terms of purchasing bulk ranitidine from primary manufacturers, conducting secondary manufacturing in Canada and undertaking marketing activities and distribution. Based on this analysis the Tax Court concluded that the Appellant and the generic companies were functionally similar.

V. Comparability of Contractual Terms

The contracts between the generic companies and their suppliers were not put into evidence. One witness testified that Apotex's contract with its suppliers was for ranitidine only and did not include any assistance with marketing or secondary manufacturing, nor did it include exclusivity or the right to purchase future drugs. There was no evidence that the Appellant's Supply Agreement with Adechsa was any different from the generic companies' agreements with their suppliers; the contract was for the simple purchase and sale of ranitidine.

VI. Were the European Licencees Valid Comparators Using the CUP Method?

The Appellant submitted that the European licencees were similar to Glaxo Canada in that they were selling ranitidine products in the local markets under licence from the Glaxo Group. The European licencees were subject to the same types of restrictions as Glaxo Canada, including restrictions as to the use of the trademark owned or controlled by the Glaxo Group and the requirement to buy ranitidine from a Glaxo approved source. The Crown disagreed with the use of local European ranitidine prices as comparisons. The Tax Court agreed with the Crown. The European markets and the European transactions differed significantly from the Canadian market and the Canadian transactions, it was not possible to compensate for those differences.

The Tax Court stated that, even if it had agreed that the European co-marketers were the most appropriate comparators, the Appellant had not satisfactorily established the claimed European transfer prices. The Tax Court noted comments regarding the undisclosed price reductions to European licencees, such as the payments made to the Austrian licencee through deposits into a Singapore bank. These payments had effectively reduced the transfer prices, while not resulting in a price reduction for government price regulation purposes. Without reviewing the complete records from the licencees the Tax Court concluded it was not possible to accurately determine the actual net transfer prices paid in Europe.

VII. Economic Circumstances not Comparable

The OECD Commentary cautioned against using comparables in different jurisdictions, stating:

Only in very few cases is it possible to determine directly an arm's length price in one country on the basis of market prices in another country. Geographically different markets therefore can be satisfactorily compared only if the economic conditions are the same or differences in conditions can be easily eliminated. …On the other hand, an enterprise enjoying a monopoly or other dominant position in the market can, and often will charge uniform prices to all its unrelated customers or to all of them in particular areas…

The Tax Court concluded that, during the years in appeal, there were significant differences between the Canadian markets and the European markets. While the Appellant attempted to adjust for them, the Tax Court did not accept the Appellant's analysis. There was no adjustment for the monopoly situations in Europe as opposed to the competition amongst vendors to Canada or the price competition amongst the Canadian ranitidine sellers.

VIII. Contractual Terms not Comparable

The transactions between Glaxo Canada and Adechsa were for a kilogram of ranitidine with no intangibles included in the purchase price. The transactions with the European licencees between 1990 and 1993 generally included the

ranitidine and a variety of intangibles. The Appellant attempted to adjust for the differences in the contracts by re-characterizing the issue to be one of what Glaxo Canada was required to pay to sell Zantac in Canada. The Tax Court did not agree with this approach stating the issue was not what would have been a reasonable price for Glaxo Canada to pay to sell Zantac in Canada. The issue was what was a reasonable price for Glaxo Canada to have paid for a kilogram of ranitidine. The Appellant's CUP analysis did not address this issue.

The Tax Court's final review was on the applicability of the transfer pricing methods apart from CUP. It concluded that none were valid as a primary basis for the transfer price analysis and agreed with the Crown's argument that CUP was the preferred method. The Tax Court determined that the generic companies in Canada were the appropriate CUP comparables. Accordingly the price for ranitidine, that would have been reasonable in the circumstances, was the highest price the generic companies paid for a kilogram of ranitidine in the years under review subject to a minor adjustment. The ranitidine purchased by Glaxo Canada was granulated, while the generic ranitidine was not. The court added $25 per kilogram to the otherwise determined price to adjust for the cost of granulating the drug.

This case involved a pre-arranged "buy-low, donate-high" charitable donation of original art works. Neither the appellant nor the Crown presented expert evidence. The appellant's principal basis of value was the claimed gallery list prices of a few works by the program's artists. The Court rejected this argument for a number of reasons and agreed with the Crown's position that the value was the appellant's actual cost less a 15% fee paid as part of the artwork acquisition.

Nguyen v. The Queen

2008 TCC 401

The issue under appeal was the fair market value of art works. This was an art donation case very similar to *Klotz* (Klotz v. Canada [2004] T.C.J. No. 52 (TCC) aff'd F.C.J. No. 745 (F.C.A.) and *Nash* (Nash v. Canada, [2005] F.C.J. No. 1921), both reviewed in prior editions of this publication. In all three cases taxpayers purchased artwork in bulk at prices much lower than the claimed fair market value determined by pre-arranged appraisals. The artwork was donated to charitable organizations and tax deductible receipts were issued based on the appraised values. The only significant difference between *Nguyen* and the other cases was that in *Klotz* and *Nash* the artwork was prints. In *Nguyen* the art was original paintings.

The appellants were spouses who purchased the paintings from Canadian Art Advisory Services Inc. ("CAAS") and very shortly thereafter donated them to charities identified by CAAS. Each work was accompanied by two independent appraisals provided by CAAS. In total, over the three year period from 1999 to 2001, the taxpayers donated 126 paintings at a claimed fair market value of $177,000. They paid a total price of $36,913 for the paintings, giving an average appraised value about 4.8 times greater than their cost. This ratio was not constant. The appraised values of individual paintings increased significantly between years, from $1,000 per painting in 1999 to an average of $1,515 per painting in 2001. This appraisal increase was not matched by an increase in the price charged to the taxpayers. The average price per painting decreased

from $294 in 1999 to $225 in 2001.

The CRA reassessed the taxpayers on the basis that the fair market value of the paintings was, at most, their actual purchase price less a 15% fee paid pursuant to a retainer agreement. The taxpayers argued that their actual purchase price did not represent fair market value. They claimed that CAAS acted as a wholesaler using volume purchasing to acquire artwork directly from artists at reduced pricing and then passed this savings on to the taxpayers. It was their position that the paintings should be valued by comparison to what similar works were selling for in retail galleries at the time.

Neither party called expert witnesses. Mr. Nguyen testified with respect to his purchase history. He said that the artwork was produced specifically for the donation program and gave his understanding why the artwork decreased in price in the later years of his participation. Proposed amendments to the Income Tax Act would have made the difference between the purchase price and the claimed fair market value taxable as a capital gain. The purchase prices and appraised values were apparently adjusted to offset the effect of this new tax.

The Tax Court Justice quoted the standard judicial definition of “fair market value” found in *Henderson Estate and Bank of New York v. M.N.R.* 73 DTC 5471, noting that this definition was quoted with approval by the Federal Court of Canada in *Nash*. The Tax Court then made reference to *Klotz*, commenting that it was an artwork case similar to the present appeal, and cited the statement in the jurisprudence that the best evidence of fair market value was the price paid for the art.

The Tax Court determined that the appraisals supporting the values used by the taxpayers were of no assistance because they were completed on an individual basis whereas the prints had been purchased in bulk, and they were arranged by CAAS as part of the tax donation program. While the taxpayers bore the burden of proof they provided the Tax Court with little evidence of value. The taxpayers had initially decided not to provide expert testimony but requested, after the hearings had started, that they be allowed to submit expert reports in support of their position. This request was denied. The Tax Court noted that, in any case, it would not have accepted any expert report based on the value of individual paintings rather than on the volume basis the works were actually acquired.

The Tax Court found it “particularly troublesome” that the claimed value of the individual paintings increased substantially over the 1999 to 2001 period although the market was being flooded with such artworks. This value increase coincided with the change in the tax law making the gifting of the works taxable.

The principal basis of value used by the taxpayers was that the gallery listed

prices of a few works by the program's artists were a good indicator of the fair market value of the artworks under review. The Tax Court rejected this argument. These prices applied to individual works only whereas the Tax Court had to determine the contemporaneous purchase and donation of large blocks of artwork. The Tax Court noted that, even with expert testimony, it would have been difficult, if not impossible, to accept that gallery sales represented the dominant sales channel for the artwork, given the large volume of artwork being produced solely for the donation program. In addition, the Tax Court expressed the following reservations about the quality of the donated artwork compared to the quality of the gallery pieces claimed as equivalents.

By this I mean: is the art of the same quality and therefore comparable if the artist is producing one or two pieces for a gallery but hundreds of pieces in one year for this program. This was the case, for example, in respect to Stephen Snake who produced over 800 pieces in 2001.

The Tax Court also said that the definition of "fair market value" speaks of informed buyers and sellers who, the Court assumed, would have to take into consideration "a large supply overhang when hammering out a fair and reasonable price". Therefore, isolated gallery sales would not give a good indication of value, unless the market at large for individual paintings was aware of the huge volume of works being produced for the donation program.

Finally, it was the Tax Court's position that gallery sales were not to be considered in this case because the taxpayers had produced no evidence of such sales apart from some information provided by interested parties to the transactions. None of these parties were qualified to give expert opinions on the matter and the Tax Court suspected bias on their part.

After this review of the available evidence of value, the Tax Court quoted a comment by Justice Bowman in the *Klotz* decision. "The most contemporaneous and most comparable figure is what Mr. Klotz paid Curated for them.". The Tax Court then quoted a statement by Justice Rothstein in the Federal Court of Appeal decision on *Nash. "Where the dates of acquisition and disposition are very close in time . . . the cost of acquiring the assets will likely be a good indicator of its fair market value".*

Based on the reasoning reflected in these comments the Tax Court decided that the analysis applied in *Klotz* and *Nash* was the correct basis for deciding the current appeals. Without evidence to the contrary, the only value that could be reasonably attributed to the donated artwork was the amount that someone was willing to actually pay for it around the time it was donated. The value was therefore the taxpayer's purchase price less a 15% fee the taxpayers paid CAAS as part of the purchase price but which was actually a retainer fee. The issue came back to the same question which Judge Rothstein asked in *Nash.*

…In deciding these appeals, I come back to the same question which Rothstein, J.A. (as he then was) asked in Nash at paragraph 26 and that is, as it applies to these facts, if the Appellants, instead of donating the group of artwork, had tried to sell the group within the same timeframe, what could they have sold the group for? The inevitable answer is that the Appellants could not have fetched more for the group than what they paid, since a potential informed purchaser would simply have purchased the group from CAAS instead of the Appellants.

Sherman et al

208 TCC 186
Affirmed 2008 FCA 9

The Tax Court was asked to determine the fair market value of software. Additional issues were whether the software purchase price was contingent at the time of the purchase and whether the software was purchased for the purpose of earning income. The Court decided against the appellant on all three issues. A factor in the Court's determination of the value of the software was the reliability of the valuation report prepared by the appellant's expert witnesses because it was based on "*self-interested*" projections prepared by the appellant.

The issue in this appeal was the fair market value of software. The two married appellants attempted to deduct a total of $900,000 in capital cost allowance in respect to the purchase price of a software program although the software had no actual net cost to them.

Under the arrangement, the Shermans jointly purchased the software on October 31, 1994 for $1,800,000. The vendor was Peter Hart, the software's developer. The purchase price was entirely financed by an interest bearing promissory note due on the third anniversary of the purchase. On December 7, 1994, the Shermans transferred the software to 1108025 Ontario Inc. ("Holdco") utilizing section 85 of the Act. As payment for the software, Holdco issued common shares to the Shermans and assumed responsibility for 50% of the promissory note. This left the Shermans personally liable for $900,000 of the note and 100% ownership of the common shares of Holdco. On December 15, 1994, Mr. Hart agreed to take back the software by purchasing the shares of Holdco for $900,000. The purchase price of the Holdco shares was satisfied by Mr. Hart assuming liability for the $900,000 promissory note held by the Shermans. A few months after the sale of the Holdco shares to Mr. Hart Holdco defaulted on its portion of the loan. Mr. Hart then realized on the security on the loan and took possession of the software. This left all of the parties effectively in the same position they had been in prior to the commencement of the series of transactions. Mr. Hart again owned the software and the Shermans had no liabilities or obligations in respect to it.

The $900,000 promissory note was interest bearing on a quarterly basis however no interest was to be paid for any portion of a quarterly period unless the period was completed. Since the Sherman's $900,000 note was assumed by Mr. Hart prior to the expiration of the first quarter, they paid no interest on the note. The only cash payments between the parties were two payments made to Mr. Hart by the Shermans in respect of consulting services he was to provide. The consulting fees, totaling $99,000, were to be paid whether or not he provided any services. It appears that he provided none.

Based on these transactions the Shermans each claimed a $450,000 capital cost allowance deduction for the software. This was, in total, one-half of the claimed $1,800,000 purchase price for the software. The Shermans both reported a $450,000 capital gain on the sale of Holdco shares to Mr. Hart. These capital gains were almost entirely offset by their individual $500,000 lifetime capital gains exemption available under section 110.6 of the Act. The CRA disallowed the entire claimed CCA deductions in respect of the software purchase price. The Crown made three principal arguments in Court supporting its position. These will be considered separately.

I. - Fair Market Value of the Software

The Crown argued that Section 69 of the Act applied to reduce the cost of the software to the Shermans to nil because the software had no value and was acquired by a non-arm's length person. There was no expert evidence introduced in Tax Court to support this assumption of value.

The software had been initially developed for Clark Boardman, an American publisher of legal material. Clark Boardman was interested in developing software which could convert its books into electronic form and retained Mr. Peter Hart for this purpose. Mr. Hart was a former lawyer who specialized in the development of computer applications for the legal profession. Clark Boardman provided funding but Mr. Hart retained ownership of the software. In 1990 Clark Boardman discontinued its involvement in the project. After finding another funding source, Mr. Hart completed the program which he named The Complete Desktop for Lawyers. The program went through a successful pilot project but the funding source withdrew from the development. Mr. Hart made extensive efforts in the 1992 to 1994 period market the software. According to Mr. Hart's testimony, he made at least fifty serious demonstrations of the software but failed to find a buyer. At the time of the sale to the Shermans the total development costs exceeded $1,000,000.

In confirming the assessments, the Minister assumed that the fair market value of the software was nil at the time it was acquired by the Shermans. The Shermans introduced expert testimony at trial from two qualified valuators. The experts estimated a fair market value range of between $1,300,000 and $1,900,000. A valuation report was prepared on the basis of a Marketing Plan given to them by Mr. Sherman.

Mr. Hart testified that the Marketing Plan was a reworking of material that he would have prepared for himself over the years, with modifications for the transaction with the Shermans. The plan contemplates that the software could be marketed to lawyers, accountants and consultants throughout North America with anticipated revenues of US$25,200 in the first year and rising to US$29,119,800 in year eight. The plan projected that over US$55,000,000 of cumulative revenues would be earned in the eight year period through the

North American licensing of 135,496 copies.

The Tax Court rejected the expert report stating:

[67] The respondent submits that this valuation is not reliable because it is based to a great extent on Mr. Sherman's own view as to the potential market for the software. I completely agree with this. Whether there would be a market for the software is a key factor in the valuation of the software, and the considerable reliance that the valuators placed on Mr. Sherman's self-interested views renders their opinion virtually worthless, in my view.

[69] I find that the evidence as a whole is not sufficient to rebut the Minister's assumption that the value of the software at the relevant time was nil.

The Tax Court was skeptical that there was any significant market for the software, commenting that Mr. Hart had not been able to successfully market the software in the 1992 to 1994 period after his second funding source pulled out of the project. It was further noted that Mr. Hart had no apparent intent to do anything with the software after he reacquired it from the Shermans.

II. - The Software was not Purchased to Produce Income

It was the Crown's position that Paragraph 1102(1)(c) of the Income Tax Regulations prohibited CCA from being claimed because the computer software was not acquired for the purpose of gaining or producing income. The Tax Court concluded that it was likely the acquisition of the software was tax-motivated only, with no ancillary income-earning purpose. The Tax Court found it significant that: (a) the entire series of transactions took place in just six weeks, (b) there were no expenses incurred by the Shermans apart from the consulting fee, (c) they paid no interest on the loan because of the completed three month period stipulation, and (d) the $1,800,000 purchase price seemed chosen to allow the Shermans to claim an amount very close to their maximum capital gains exemption.

The Shermans asserted in court that they had purchased the software program as a potential income source because uncertainty regarding the future of Mr. Sherman's current paid employment had made them receptive to other business opportunities. The Shermans had attempted to market the software but personal circumstances necessitated abandoning the effort. The Tax Court acknowledged that some marketing efforts had been made but gave little weight to them because they had been of very short duration and were all just preliminary discussions not followed-up by the taxpayers.

III. - The purchase price of the software was contingent at the time of purchase and consequently the software had no cost for CCA purposes

The Crown argued that the entire $1,800,000 note was contingent because revenue guarantees made by the vendor in a warranty agreement allowed the appellants to walk away from the deal at any time in the first year. The

Shermans responded that, at the time they purchased the software, they were unconditionally obligated to pay Mr. Hart $1,800,000 in three years.

The revenue representation in the warranty agreement was based on gross sales and net revenue assumptions, specifically:

2.1 SALES REVENUE – Amanuenses (note - Mr. Hart) *represents and warrants (the "Commercial Value Warranty") that the Shermans can reasonably expect a business that used the Software as contemplated by the Marketing Plan to generate the sales revenues projected in the Marketing Plan.*

If the projections in the Marketing Plan were not met in the first year of the agreement, the Shermans had the right to terminate the purchase agreement by returning the software licence to Mr. Hart. This was the same Marketing Plan that was used as the basis for the Sherman's valuation which the Tax Court had already rejected. The Tax Court agreed with the Crown that the Marketing Plan was bereft of commerciality. As the Court stated:

[126] Further, even if the software was to be used in the manner contemplated by the Marketing Plan, the sales projections are so unrealistic that the parties could not possibly have anticipated that the representation could be satisfied within a one-year time frame… The revenues that were projected were over US$55,000,000 on a cumulative basis over eight years. It is implausible that any of the parties would think that this business would show indications of producing potential revenues of this magnitude within the first year, which is the period in which the warranty could be invoked.

[129] For these reasons, I cannot accept that this warranty was intended by the parties to be enforced by Mr. Hart. The only reasonable interpretation is that the agreement was intended by the parties to give the appellants the right to walk away from the arrangement at any time within the first year.

[136] In these circumstances, the maximum amount that the appellants are committed to pay to satisfy the purchase price obligation is $1,800,000 or the value of the software, whichever is less. Accordingly, if the software has a nominal value, the appellants cannot be considered to have incurred an absolute obligation to pay $1,800,000.

Overall the Tax Court concluded that the entire purchase price was contingent and that the cost of the software to the Shermans was nil. The Shermans then appealed this decision to the Federal Court of Appeal. Their appeals were dismissed because the Court determined that the Tax Court had made no palpable or overriding error.

Diotte

On January 29, 1999, Marie-France Rouleau transferred 65,591 common shares of Novamex USA Ltd. ("Novamex") to Profilec Inc. ("Profilec") for US$1.00 per share. At the prevailing exchange rate this was equivalent to CN$1.51 per share. On the same day, her husband, Richard Diotte, transferred 154,656 Novamex common shares to Profilec at the same price. On February 1, 1999 Mr. Diotte transferred another 169,200 Novamex common shares to Profilec at a price of US$1.00 per share. This again corresponded to CN$1.51 per share. Ms. Rouleau and Mr. Diotte owned 40% and 60% respectively of the shares of Profilec and the three share transfers to Profilec were in repayment of advances made by Profilec to Mr. And Mrs. Diotte.

The issue was the fair market value of shares in a small unlisted American company involved in research to develop diagnostic testing for veterinarians and the agri-food industry. Both parties presented valuations. The appellant prepared and supported his own valuation while the Crown relied on an expert. The Court found problems with both reports, self-interested optimism on the part of the appellant and undue pessimism on the part of the Crown's witness. The Court criticized the Crown's expert for not meeting with either the appellant or anyone in the company's management to get their insights into the company and its operations. The Court chose a value between the two claimed values.

The CRA reassessed each taxpayer to add an amount to income as a shareholder's benefit under subsection 15(1) of the Act on the assumption that the Novamex shares had a value of, at most, CN$0.20 per share. Both taxpayers appealed the reassessments to the Tax Court on the basis that the value of the Profilec shares was the US$1.00 per share stipulated in the original transfers.

The taxpayers and the Crown entered valuation evidence at the Tax Court hearing. The Crown's valuation witness was accepted as an expert. Mr. Diotte asked the Court to recognize him as an expert witness in his own appeal. The Minister objected to Mr. Diotte being so recognized and the Court denied his request stating:

In the case at bar, it is unreasonable to believe that the Appellant Mr. Diotte could have offered an entirely objective opinion uninfluenced by his personal interest. Given his interest in the matter, he definitely could not have provided the objectivity essential to expert status.

The reasons for judgment gave very little information about Novamex. Apparently it was a research and development start-up involved in diagnostic testing for veterinarians and the agri-food industry. Novamex was developing eighteen different tests at the time of the share transfers. Three of the tests were at the marketing stage, four were at the product introduction stage, and five were in the development stage. The decision did not give any information on the remaining six tests. The company was apparently registered on the Pink Sheets public securities market. The "Pink Sheets" is an electronic quotation system that displays quotes from broker-dealers for many over-the-counter securities but is not a stock exchange and companies do not need to fulfill any requirements to be quoted in it. There was no information given in the Tax Court decision on any quoted Pink Sheet price or trading history for Novamex.

The Tax Court found the valuation of Novamex to be a difficult analysis because of the start-up nature of the company at a time when the market was very

speculative. The Tax Court stated that objective markers for Novamex were practically non-existant because of the very early stage of the development of the business.

Although the Tax Court denied expert witness status to Mr. Diotte, he was allowed to testify on how he arrived at the US$1.00 per share value for the purpose of the subject transactions. Mr. Diotte's valuation was based on future discounted cash flows derived from forecasts of sales for the various tests under development. The Tax Court found his methodology to be highly speculative for a start-up without any earnings history. The Tax Court also found that using the discounted cash-flow basis was not realistic given the scarcity of reliable data to support the projections and the lack of any corporate financial history. The Tax Court stated that the basic premises of Mr. Diotte's cash flow basic premises were random, speculative and exaggerated. The Tax Court said also that Mr. Diotte's assessment was shaped by his personal knowledge of the case and that he should have chosen a less intuitive and more rational approach with respect to the criteria on which his valuation was based. Instead, he chose to consider elements that had a positive influence on the share price, an approach that could be characterized as very optimistic. However the Court, while acknowledging that this was a biased approach in which self-interest clearly came into play, did not believe that it was so unreasonable that it should be rejected out of hand. The Tax Court instead accorded it little weight.

Of particular interest is the Tax Court's rejection of the Crown's valuation. The Crown's expert had chosen to use a liquidation basis which the Tax Court thought to have been inappropriate and too pessimistic. The Tax Court commented that this was the first valuation of a start-up research company that the valuator had done and concluded that this affected his expertise in preparing the valuation. The Tax Court also concluded that it was a serious failure for the valuator not to have met with Mr. Diotte, anyone in Novamex's management, or any other shareholders who were active in Novamex at the time to get their insights into the company and its operations. Specifically the Tax Court concluded that the valuator had made an erroneous conclusion in respect of patent protection because the valuator had attributed no value to the potentially promising tests being undertaken by Novamex on the basis that they had not yet been protected by patent. The Tax Court said this “constitutes a clear deviation from accepted practice” and, had the expert spoken with Novamex's management, he would have realized that the tests were not patent protected because the risk of the tests being copied by reverse engineering was minimal.

Having found both valuations to be unreasonable, the Tax Court assigned an arbitrary value of CN$1.00 per share at the time of the subject transactions.

This was a value which the Tax Court said took work-in-process into account as an intangible asset.

Husky Oil Ltd. v. The Queen – Dennis Turnbull, editor*

2009 TCC118

At issue was the fair market value of 15,500,001 preferred shares issued by Mohawk Lubricants Ltd. ("Amalco") on July 8, 1998. These shares were issued as part of a series of transactions which resulted in Husky Oil Ltd. ("Husky") acquiring all of the common shares of Mohawk Canada Ltd. ("Mohawk"). Mohawk's principal business was the ownership and operation of 360 gasoline service stations ("the Retail Business") in western Canada. In addition it also had a number of other businesses and investments which were not related to the retail sale of automobile fuel ("the Residual Assets").

Amongst other issues the Tax Court was asked to determine the fair market value of 15,500,001 preferred shares issued by Mohawk Lubricants Ltd. (Amalco) on July 8, 1998 as part of an amalgamation. These shares were issued in exchange for shares of Mohawk Lubricants Ltd., the predecessor company. It was the Crown's position that the Amalco preferred shares were worthless while the Mohawk Lubricant shares had a fair market value of $15,500,000. Neither side presented expert evidence in respect to the valuation issues. The Court agreed with the Crown's position and dismissed the appeal. This decision has been appealed to the Federal Court of Appeal.

Prior to the Husky takeover Mohawk was a public company listed on the Toronto Stock Exchange. About 42% of Mohawk's issued shares were owned by one individual, Mr. Hugh Sutherland. Another 23% of the shares were owned by Balaclava Enterprises Ltd. ("Balaclava"), a company unrelated to Mr. Sutherland. With almost two-thirds of the issued shares not available for public trading the stock was thinly traded and Mohawk's board of directors decided that the trading price did not reflect the company's inherent value. In 1997 the board of directors set up a committee to review various alternatives to enhance shareholder value and concluded that Mohawk should sell the Retail Business.

After soliciting bids the company received expressions of interest from seven parties and the board determined that Husky was willing to make the best offer with an initial bid of $90 million to acquire the Retail Business through an asset-based transaction. However Husky was not willing to participate in any transaction that would result in it acquiring the Residual Assets. After extensive negotiations Husky agreed to take two of the Residual Assets, an ethanol plant and a life insurance policy, and increased its offer to $103 million. This still left a number of the Residual Assets to be dealt with. The issue of the disposition of the remaining Residual Assets was finally resolved by Balaclava agreeing to acquire them.

In June 1998 Husky and Balaclava entered into a joint bid agreement on a takeover bid of all of the outstanding shares of Mohawk apart from those owned by Balaclava. Husky purchased 9,420,050 Mohawk shares in this public offering. Although the form of the joint bid agreement included Balaclava as a party to the takeover offer its final goal was to also sell its Mohawk shares to Husky. This was done immediately subsequent to the public offering through a series of transactions which left Husky owning all of the Mohawk shares and Balaclava indirectly owning the Residual Assets. This was done through a complex pre-determined sequence of steps involving multiple subsidiary

* *Ed Kroft has declined to review or comment on this decision as he is the Counsel of Record in the appeal of the Husky Oil Ltd. Tax Court decision.*

corporations, an amalgamation, a put and option agreement, the issuance of preferred and common shares of a number of companies, and the issuance and cancellation of promissory notes. This review will not go through this series of transactions in detail. The valuation issues considered by the Tax Court focused on two stages in the series, the purchase of Balaclava's Mohawk shares by Husky and Balaclava's acquisition of the Residual Assets. These will be reviewed.

Husky's Purchase of Balaclava's Mohawk shares

Balaclava's 2,854,267 Mohawk shares were held by BEL Acquisitions Ltd. ("BAI"), a wholly owned subsidiary. On July 7, 1998, BAI sold all of its Mohawk shares to HB Acquisition Inc. ("HB") in exchange for $5,193,436 in cash, a $5,934,598 non-interest bearing demand promissory note maturing in 2023, and 9,565,403 HB common shares issued from treasury at a value of $1 per share. HB was a subsidiary of Husky set up to purchase the Mohawk shares that Husky acquired in the public offering. On September 29, 1998, BAI transferred the 9,565,403 common shares of HB to Husky Mohawk Long Term Ltd. ("HMLT") in exchange for 9,565,403 preferred shares of HMLT issued from treasury. HMLT was a wholly owned subsidiary of Husky and was apparently a shell corporation prior to these transactions. BAI and HMLT jointly elected to have the provisions of subsection 85(1) of the Act apply to the transfer.

The HMLT preferred shares issued to BAI were non-voting with no dividend entitlement. They were redeemable at the option of the holder for $1.00 per share but the redemption price would be paid through the issuance of a non-interest bearing promissory note maturing on June 1, 2023, twenty-five years after the issuance of the preferred shares.

Balaclava's Acquisition of the Residual Assets

This transaction was effected through an amalgamation. On July 8, 1998 Mohawk agreed to amalgamate its wholly owned subsidiary, Mohawk Lubricants Ltd. (the predecessor company to Amalco) with 3470750 Canada Inc. ("347"). 347 was a subsidiary of BAI which was apparently a shell corporation prior to this transaction. The amalgamated company continued under the name Mohawk Lubricants Ltd (now Amalco). Upon amalgamation, Mohawk received 7,338,740 Class A preferred shares of Amalco for the preferred shares it held in Mohawk Lubricants Ltd. and 8,161,260 Class B preferred shares and one Class C preferred share of Amalco for the common shares it held in Mohawk Lubricants Ltd. Upon amalgamation, BAI received one common share of Amalco in exchange for its common share of 347. This was the only issued Amalco common share. At the amalgamation date Mohawk Lubricants Ltd. held the Residual Assets.

The Amalco preferred shares issued to Mohawk were non-voting with no dividend entitlement. They were redeemable at the option of the holder but

the redemption price would be paid through the issuance of a non-interest bearing promissory note maturing on June 1, 2023, twenty-five years after the issuance of the preferred shares.

Valuation Issues

It was the Crown's contention that the Residual Assets held by Mohawk Lubricants Ltd. had a fair market value of $15,500,000 but were indirectly transferred from Mohawk to Balaclava for no value through Amalco's issue of worthless preferred shares as consideration. It was also the Crown's position that Husky received an offset to this assumed $15,500,000 benefit to Balaclava through Balaclava accepting worthless HMLT preferred shares and a 25 year interest free promissory note as part of the consideration for the 2,854,267 Mohawk shares which Balaclava sold to Husky.

There were two valuation issues to be determined in the appeal.

1 - Was the fair market value of the preferred shares of Amalco received by Mohawk on the amalgamation of Mohawk Lubricants Ltd. and 347 less than the fair market value of Mohawk Lubricants Ltd. immediately prior to the amalgamation? It was the Crown's position that these preferred shares were worthless while Mohawk Lubricants Ltd. had a fair market value of $15,500,000.

2 - Was the consideration paid by Husky to Balaclava for its 2,854,267 Mohawk shares, (being $5,193,436 in cash, a $5,934,598 demand promissory note, and 9,565,402 HB common shares later converted to 9,565,403 HMLT preferred shares), equal to the fair market value of the these Mohawk shares? It was the Crown's position that HMLT preferred shares were worthless.

There was little relevant evidence entered by either party on the valuation issues. Neither side presented expert valuation evidence, a situation commented on by the Tax Court. On the issue of the fair market value of Mohawk Lubricants Ltd.'s shares immediately prior to the amalgamation, the Crown claimed the company had a value of $15,500,000. This was based on the assumption that this was the value of the Residual Assets held by Mohawk Lubricants Ltd. Since Mohawk Lubricants Ltd. had no other assets and no liabilities the Crown assumed that the Residual Asset value was also the company value. The Crown relied on two pieces of evidence in confirming the value of the Residual Assets. The first was the testimony of Mr. Thomas Lindsay, a senior vice-president of Balaclava and a director of Mohawk Canada. Mr. Lindsay admitted in cross examination that the parties had used a Residual Asset value of $15,500,000 in planning the transactions. Secondly, in the offer to purchase mailed to the Mohawk Canada shareholders, the parties declared that shares of Mohawk Lubricants were to be acquired for a purchase price of $15,500,000.

The appellant put what the Tax Court called "a novel argument" to counter the value given in the $15,500,000 stated purchase price. Part of the series of

events leading to the amalgamation of Mohawk Lubricants Ltd. and 347 was the signing, by Mohawk, Balaclava, and BAI, of an option and put agreement and an amended option and put agreement. These bound Mohawk to complete the series of transactions leading to the amalgamation of Mohawk Lubricants Ltd. And 347. The appellant argued that a reasonable person, apprised of the fact that the amended option and put agreement had been entered into, would reduce the value of the Mohawk Lubricants shares to nil. Although the reasoning behind this position was not given in the decision it can be assumed that the appellant's argument was that the pre-determined series of transactions required that Mohawk give up the Residual Assets in exchange for Amalco preferred shares which the Crown contended were worthless.

The Tax Court did not accept this argument. It stated that while Mohawk had chosen to enter into these agreements this did not affect the value of the shares of Mohawk Lubricants Ltd. Although Mohawk could have been compelled to give effect to the agreement or face a lawsuit for damages these actions would have been directed against it, not its subsidiary, Mohawk Lubricants Ltd. The Tax Court commented:

[52] If I were to accept Mr. Crump's submission on this point, bona fide estate freezes would no longer need to be implemented with the protection of valid price adjustment clauses. For example, based on this argument, a father could cause his holding corporation to grant a long-term option to his son to purchase assets from the corporation at their current price or a lower price. On his death, the father's estate could claim that the holding corporation's value is impaired because of the option, thus avoiding, for both the shareholder and the entity, tax on shares that have since increased in value.

After reviewing the evidence the Tax Court concluded that the Minister's assumption that the shares of Mohawk Lubricants Ltd. were worth $15,500,000 must stand. The Tax Court also concluded, in reviewing the value of the Amalco preferred shares issued in exchange for the Mohawk Lubricant Ltd. shares that:

The preferred shares held by Mohawk Canada in Lubes Amalco give no dividend entitlement. The redemption price of the shares can be paid by Lubes Amalco through the issuance of a non interest bearing promissory note maturing on June 1, 2023. It is incontrovertible that an arm's length purchaser of the preferred shares would place a significant discount on the principal amount of the note. The Appellant failed to lead evidence on this point. As a result, the Minister's assumption that the Lubes Amalco preferred shares had a nil value must stand.

On the second valuation issue the Tax Court concluded that, since the 9,565,403 HMLT preferred shares under review had the same rights and privileges as the Amalco preferred shares, they also had a nil value. The Tax Court stated that the appellant, to rebut the Crown's nil value assumption for the

various preferred shares, would have had to call an expert witness to provide the Tax Court with an opinion on their fair market value but did not do so. The Tax Court made an interesting comment in reviewing the rights of the subject preferred shares as compared to the rights of preferred shares normally issued in rollover transactions:

[62] I suspect that Mr. Kopstein faced a significant quandary in designing the terms and conditions of the preferred shares issued by Lubes Amalco to Mohawk Canada. His client, Balaclava, had instructed him that it was prepared to accommodate Husky's desire that Mohawk Canada not pay taxes in connection with the disposition of the Residual Assets provided that Balaclava's commercial objectives were not prejudiced thereby. To make the tax plan more robust from a rollover standpoint, the preferred shares could have been made retractable for fair market value consideration. An annual dividend entitlement could have been added to the shares. These features would have been consistent with what the CRA generally demands in the case of an estate freeze. I assume that the former feature was inconsistent with Balaclava's desire to benefit from a 25-year deferral… I suspect that the annual dividend feature was also rejected because Lubes Amalco would incur Part VI.1 tax if it paid a dividend to Husky. HMLT would incur the same tax when it paid a matching dividend back to BAI. It seems that Balaclava's legitimate commercial considerations prevailed over Husky's desire for a taxfree rollover. This is an understandable result in the circumstances.

This decision has been appealed to the Federal Court of Appeal.