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 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 issue was whether a 50% shareholder held *De facto* control (as defined in subsection 256(5.1) of the Income Tax Act over the company. As part of its evaluation the Tax Court reviewed, and rejected, the terms of a shareholder's agreement between the two arm's length shareholders which denied either shareholder *de facto* or *de jure* control. The Tax Court concluded that where a company had a single director on the corporate board that individual held *de facto* control. The Federal Court of Appeals affirmed these views.

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The issue was whether the taxpayer had avoided tax on the sale of business assets by converting what would have been proceeds of sale into an investment which the Crown regarded as almost worthless preferred shares of holding companies. The Court found that section 245 of the Act, the General Anti-Avoidance Rule ("GAAR"), was applicable. A significant factor in the Tax Court's decision was the fair market value of the various properties involved in the series of transactions under review. The taxpayers appealed to the Federal Court of Appeal but the appeal was discontinued.

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2006 D.T.C . 6340 (FCA), [2006] 4 C.T.C. 16, 2006 FCA 152
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These cases involved the value of seismic data. In both cases the values relied on by the taxpayers exceeded the taxpayer's arm's length purchase price. In both decisions the Courts determined that the taxpayer's acquisition of the data was at non arm's length. In Rainforth the taxpayer lost on a non-valuation issue. In McLarty the taxpayer was first successful in the appeal to the Tax Court but the Crown's appeal was allowed by the Federal Court of Appeal. Leave to appeal was granted by the Supreme Court of Canada.

Family Law Decisions

Canada Revenue Agency Valuation Policies

Dennis Turnbull, CBV

This edition of the Valuation law Review-Taxation will include three editorial commentaries. The first is on the establishment of valuation policies by the CRA. The second commentary is on the valuation implications involved in the "Class A voting non-participating/Class B non-voting participating" share structure much seen in family corporations. These commentaries are to some extent inter-related. The CRA's Pacific Region valuation team has been reviewing transactions involving these share structures. As a result tax practitioners have been suggesting that the CRA has established a new national valuations policy with respect to the valuation of Class A voting, non-participating shares.

This is not the case. The CRA has very few national valuation policies or positions which CRA valuators are expected to consider as part of their valuation reviews. All valuation policies and positions which bind CRA valuators on a national basis are in writing. The main sources are Information Circular 89-3, the paper presented at the joint CBV/ASA Conference in Montreal in September 1998 titled **Tax Valuation Update**, and written comments made in Technical Interpretation Bulletins and Rulings.

The CRA has no national valuation positions or policies apart from those available to the public in published documents. All other valuation matters reviewed by the CRA are the responsibility of the individual valuator assigned to a specific file and any conclusions are based on the valuator's professional opinion.

The CRA deliberately keeps the number of its valuation policies down to an absolute minimum. Mandatory valuation policies and positions can adversely affect the perceived independence of the CRA's valuation staff and can prejudice their position as independent experts in court. The CRA is therefore

reluctant to bind its valuation staff to formal policies without compelling reason. This is why there are no established national policy positions on contentious areas of general valuation concern such as latent taxes, arm's length minority discounts, and blockage/liquidity discounts or premiums.

Apart from published policies, all of the CRA's valuation conclusions are strictly a matter of the opinion of the individual valuator reviewing a specific case. Positions taken by individual CRA valuators in areas which are not addressed in the published policies cannot be assumed to reflect departmental policy. While some CRA valuation groups at the Tax Service Office level may have established local positions in areas not covered by the policies these positions do not bind CRA valuators elsewhere.

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

Dennis Turnbull, CBV

It is not within the scope of this publication to discuss valuation theory. However one recent and possibly significant tax valuation issue is, to some extent, based on a theoretical analysis.

The capital structure in which all voting power resides in a single class of shares, which have no dividend or liquidation entitlement, has been much used for family tax and estate planning purposes. Through this structure the economic value of a company can be passed down inter-generationaly while leaving final corporate control in the hands of the parents. The dividend and liquidation rights can be assigned to one or more classes of non-voting shares. For the purpose of this commentary I will consider the simplest structure: Class A voting non-participating, Class B non-voting, participating.

The Class A shares have generally been given a nil value by taxpayers when used for estate planning purposes or other non-arm's length transactions. This is based on the assumption that votes, without economic entitlement, have no value since they do not give the holder any return on investment. The full value of the company is then assigned, by default, to the Class B shares on the assumption that their entitlement to all of the company's economic return also entitles them to all of the corporate value.

The CRA's Pacific Region Valuation Team has been reviewing transactions involving these share structures and has been assigning significant value to the Class A share on the basis that control, by itself, has value.

It is my opinion that the position of allocating the entire value to the Class B shares is not reasonable. This allocation requires the assumption that voting power is of no value to an arm's length purchaser of the Class B shares and such a purchaser would pay the same price for these shares regardless of the allocation of the votes. Since the timing of both dividend payments and liquidation proceeds (the two economic entitlements held by the Class B shares) are under the control of the voting shareholder it must be assumed, if the entire company value is to be assigned to the Class B shares, that an arm's length purchaser of the Class B shares is indifferent as to whether or not he can access the economic entitlements underlying his purchase price.

There are various arguments, pro and con, on this issue. Apart from arguments based on valuation theory, proponents of the allocation of the full corporate value to the Class B shares have cited decisions by various courts in respect to companies with significantly different share structures and have attempted to demonstrate they are analogous to the subject structure. Practitioners have also stated that the position of full value for the Class B shares is supported by the CRA's family control policy of assigning undiscounted pro-rata value to equivalent right family held shares. This is not correct. The value of the share classes in this structure has never been considered in any CRA publications.

I am not aware of any relevant jurisprudence on this allocation issue. While there have been arm's length sales of companies which had this share structure such sales involved the disposition of all of the outstanding issued capital. Given the lack of jurisprudence, or guidance from actual arm's length transactions involving only a single class of shares, there is no certainty that the current full value allocation to the class B shares would be sustained were the issue reviewed by the Tax Court of Canada.

Pre-Trial Discovery of Experts

Ed Kroft *

The Tax Court of Canada Rules (General Procedure) ("the Rules") permit disclosure of the findings, opinions, and conclusions of an expert, by or on behalf of the party, during the discovery of a nominee.

The information must relate to matters in issue in the proceedings, including the expert's name and address. Yet subsection 95(3) of the Rules states that no disclosure is required where two conditions are met:

(1) the party being examined undertakes not to call the expert as a witness at the hearing; and

(2) the findings, opinions, and conclusions were made or formed in preparation for contemplated or pending litigation, and for no other purpose.

Generally, the expert is not discovered, so the first glimpse of the expert in person will occur at the hearing in the Tax Court. Section 145 of the Rules, however, does contemplate an exchange of expert reports before the hearing, provided certain time limits and conditions are satisfied. Yet, subsection 145(5) states that an expert shall not be cross-examined before the hearing on a report without leave of the Court. Should leave be granted, the witness need not testify at the hearing unless the Court permits re-examination or the Court wishes to examine the witness at the hearing.

The first decision dealing with subsection 145(5) was released on May 25, 2006. In *Sandia Mountain Holdings Ltd.*, 2006 DTC 3154, the Crown sought leave to examine the expert on "generally accepted accounting principles" (GAAP) before the hearing, "in the interests of justice" and to "facilitate a shortening of the hearing". The Crown had previously examined before the hearing another expert on GAAP put forward by the taxpayer. Madam Justice Woods noted that there "does not appear to be any precedent as to the considerations" to take into account "in considering whether to grant leave". Two decisions from the Ontario and Nova Scotia courts were considered and

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the Court concluded that there were no "special circumstances" that warranted granting leave to cross-examine to be granted. What is interesting in this case is that the Crown was pushing for leave on the basis that "full discovery" before a hearing is encouraged.

Full discovery of experts well before a hearing may lead to more settlements before the commencement of the hearing. Tactically, however, a party may wish to have the expert give the evidence during the hearing so that the trial judge may form an impression at that time, when other witnesses may well have testified and the Court is engaged in a full consideration of the issues. Given the Crown's position, it will be interesting to see whether the Crown adopts the suggestion by Justice Woods that the Crown might wish to seek amendments to subsection 145(5) of the Rules.

The Tax Court was asked to consider the fair market value of an interest in a mining property. The case was decided on the basis of the reasonableness of the assumptions used in the discounted cash flow calculations and on the Tax Court's analysis of the credibility of the expert witnesses.

Westward Explorations Ltd. v. The Queen – Dennis Turnbull, CBV editor*
2006 D.T.C. 2443 (TCC), [2006] 3 C.T.C. 2052, 2006 TCC 105
February 20, 2006

The valuation issue was the fair market value, as of September 29, 1995, of an 11.12% interest in the Magnacon mining property. This was a non-operating gold mine. The appellant had a claimed purchase price of $1,922,895 for the subject interest. The Minister's value for the interest was $333,600. The purchase was at non-arm's length because the vendor owned 76.25% of the issued capital of the appellant. The amount of the purchase price was treated as a Canadian Development Expense and was deducted by the appellant to offset income from a prior sale of a mining interest.

At trial both sides presented valuation evidence through the testimony of expert witnesses with extensive experience in the mining industry. The appellant also provided a separate expert to give rebuttal evidence against the Crown's witness. Both experts based their valuations on discounted cash flow calculations ("DCF"). While their methodology was the same they relied on drastically different assumptions with respect to the quantity and quality of mineable ore on the property.

* Ed Kroft has declined to review or comment on this decision as he is the Counsel of Record in other cases which are affected by the issues raised in Westward.

Both experts used two prior estimates of geological reserves as their starting point. These gave a range of ore reserves from 1,366,751 tons to 1,472,698 tons. The estimated recoverable gold ranged from 191,869 to 278,340 ounces.

The Crown's expert calculated total ore reserves of 1,470,000 tons with approximately 246,700 ounces of gold. He did not value all of the gold reserves equally, giving differing per-ounce values to the gold reserves based on the confidence category he assigned them. These were proven and probable, possible, and drill-indicated. The gold reserves in the proven and probable category were given a value of $20-$25 an ounce while the gold in the drill-indicated category, which constituted 78% of his estimated reserves, had a range of only $0-$10 per ounce. It was the expert's overall conclusion that the reserves were generally of poor quality. He considered them highly speculative because of the lack of sufficient reliable exploration results to bring them into the proven and probable category.

The Crown's expert relied heavily on the property's prior development history in arriving at his conclusions regarding its future expectations and the value of the gold reserves. The mine had been in operation from the mid 1980s until its closure in June 1989. During this period it had operated at a loss and had not attained commercial production. The ore reserves had turned out to be of lower quality and quantity and the mining costs higher than had been anticipated at the start of operations. It was concluded that the property could not be mined at a profit. The property had been idle for a five year period between the mine shut-down and the valuation date. During this time the owners had made intensive, but unsuccessful, efforts to either find a buyer for the property or to find partners willing to participate in a resumption of mining activities.

The Crown's expert's conclusion was that the property did not demonstrate a sufficient profit potential to support a DCF based value. However he conceded that there were a number of positive factors to the property which would give it some value. He cited a favourable location to attract personnel, an existing underground mine, and the approved mining permits. Based on these factors he valued the entire property at $1,000,000 to $3,100,000 for a pro rata value of $100,000 to $350,000 for the approximately 11% interest under review.

The appellant's expert took a far more optimistic view of the property's potential. He largely ignored the prior failed attempt to mine the property. He estimated that there were 2,345,000 tons of ore reserves containing 469,000 ounces of recoverable gold. This was greatly in excess of any prior estimate including the ones prepared while the mine was under development. In total, he included about 980,000 additional tons of ore reserves, with an estimated 196,000 ounces of gold, to a prior estimate of 1,366,751 tons of reserves prepared by the mine's developers.

The appellant's expert reclassified all of the reserves included in the prior estimates to proven and probable, eliminating the possible category. He also included his assumed additional tonnage in the proven and probable classification, notwithstanding that it had no support from any prior review of the property. In addition, the expert increased the grades of all the ore reserves from those of the prior estimates. This resulted in greater assumed quantities of gold per ton of ore.

Given these assumptions, the appellant's valuator had no difficulty in arriving at a positive cash flow. After estimating the standard DCF components such as gold prices, extraction rates, per ton operating costs and capital costs the appellant's valuator arrived at a value range for the mine of $11,500,000 to $22,000,000.

The third expert witness was retained by the appellant to provide a rebuttal opinion to the Crown's report. In his original report the witness not only reviewed both of the submitted expert reports but also offered his own conclusion as to the fair market value of the mining interest. The Tax Court stated that a conclusion as to fair market value was not warranted in a rebuttal opinion and required that this be deleted from the report.

The Tax Court rejected most of the conclusions in the rebuttal report because it was apparent that the methodology used by the expert was to simply accept the assumptions made by the appellant's valuator and use them to try and disprove the Crown's expert report. He did not do any independent investigation of the reasonableness of either report. Instead he relied on the "resource numbers" of the appellant's report on the basis that the appellant's expert was employed by a firm with a reputation as an "international firm of geologists and engineers". He agreed under cross-examination that, to the extent that the appellant's report and review were flawed, his report was also flawed.

In argument the appellant's counsel compared the two expert opinions and stated that where points of disagreement existed the appellant's opinion was superior. The Tax Court reviewed these areas of disagreement individually under the headings which follow:

Upgrade and Reclassification of Resources and use of inferred Reserves

The reclassification of the existing reserves and the addition of drill-indicated reserves to the DCF calculation was a critical issue. The appellant's expert had added almost 1,000,000 tons of reserves to the earlier estimates. In addition he upgraded the classifications of the previously determined reserves because he thought them to be too conservative.

It was submitted by the appellant's counsel that the appellant's valuator was justified in upgrading the possible reserves to probable and including "inferred and possible" reserves in his DCF. The classification of reserves was, in his view, to a large extent subjective. The appellant's counsel also stated that the submitted upgrade was supported by the collective years of experience of the expert's firm, derived from reviewing and evaluating mineral properties.

Appellant's counsel further submitted that the individuals who had initially evaluated the reserves when the mine was under development did not have sufficient knowledge in evaluating and classifying reserves as compared with the knowledge of the appellant's expert.

The Tax Court did not accept these arguments. The Court found it "*quite a leap*" to reclassify all of the previously identified possible ore as proven ore. Nor was the Tax Court receptive to the unsubstantiated addition of 980,000 tons to the previous reserve estimates. The Tax Court agreed with the Crown's counsel that much of the appellant's expert's extrapolation of existing ore bodies was based on "*unsubstantiated generalization*" and was not supported by the drilling results at the mine. In the Tax Court's opinion, the drill results indicated that mineralization did not extend to the depth assumed by the appellant's expert and his basis of including additional reserves on such an extrapolation was unreasonable. The Tax Court also agreed with the Crown's counsel that 2,095,000 tons of reserves assumed by the appellant's expert, which constituted some 90 percent of the expert's total determined reserves, were "*too speculative to form the basis of a DCF.*"

Discounted Cash Flow

Appellant's counsel submitted that the Crown's expert had not prepared a sensitivity analysis of his assumptions in arriving at his conclusions although he had determined that the mine could not be profitable. A slight change in his assumptions would have led to the conclusion that the mine could be profitable. The Tax Court agreed that this might well be correct but stated:

[90] There is no question that the DCF method is an appropriate and acceptable method to assist in computing the net property value of a mine. However, a DCF is only as reliable as the veracity of the assumptions used in the calculations. When actual operating data results in a negative cash flow and reliance is placed on subjective data to produce a positive cash flow, one must view with great caution the use of the assumption in creating the positive cash flow. Appellant's counsel accused Mr. Farquharson of not undertaking any sensitivity analysis in his study, arguing that even a small change is (sic) *any of Mr. Farquharson's assumptions would indicate a profit. Counsel proceeded to increase, slightly, items such as ore grade, recovery rate and gold price and to reduce costs. However, while I agree with appellant's counsel that even small changes would demonstrate the Mine's capacity to operate profitably, slight changes reducing Mr. Farquharson's assumptions, for example, as to ore grade, recovery rates, gold price and increasing costs, would indicate an even greater loss from the operation of the Mine. The best indicators to apply to determine the DCF of a mine are the actual historic values, unless, of course, those values are greatly suspect and I have not found the values used by Mr. Farquharson to be suspect.*

Operating Costs

The Crown's expert used a $76 per ton operating cost. This was based on the original mining feasibility study. The appellant's expert used a $66 per ton assumed cost. He supported this with the actual costs incurred in the later period of the mine's production when costs were about $54 per ton.

The appellant's expert's credibility on operating costs was undermined by his inconsistency in prior valuations which he, or his firm, had done on the subject property. As the Court stated:

[98] As respondent's counsel demonstrated, Mr. Lawrence's operating cost assumptions have been inconsistent from one valuation to the next. The

Feasibility Study projected operating costs of $76.10/ton. However, Mr. Lawrence testified that the costs at the Mine increased to around $100/ton in 1989, which he attributed to start-up problems. The evidence discloses that operating costs in 1989 were around $82/ton and increased in 1990 to an average of about $105/ton. I agree with respondent's counsel that the high costs were not attributable to operational start-up problems. Any falling costs in May 1990, the last month of production underground, Mr. Lawrence admitted, was probably due to some cutting of corners.

Other Conclusions of the Tax Court about the Appellant's Report

The Tax Court stated that there were other problems with the appellant's report. The expert had deducted neither royalties from his DCF calculation nor taxes. He failed to include necessary capital costs and did not factor in the additional operating expenses required as the mine workings went deeper. The internal rate of return resulting from the calculation in his report ranged between 49% to 72% although he conceded on the witness stand that a range of 7% to 12% is more usual. He also adopted the most ideal assumptions in his calculations of the mill recovery rate.

The Tax Court also commented that the expert had unexplained discrepancies between his current report and past reports which he or his firm, had done on the property.

[102] On July 29, 1993 WGM sent a draft opinion letter to Citibank NA in New York, with an attachment of a table entitled Magnacon DCF - NPV Model indicating a net present value ("NPV") of $29,132,000, (at 20%) to $50 million (at 5%). In cross examination Mr. Lawrence acknowledged an error in the NPV because the discounted value of $50 million (at 5%) was higher than the cash flow of $43 million, the amount being discounted. The NPV prepared for the Canada Customs and Revenue Agency shows a range of $6.9 million (at 20%) to $27.8 million (at 5%). Mr. Lawrence could not explain the discrepancy.

[104] WGM's June 8, 1995 report valued the Mine at $17,200,000, a drop of about $13 million from the valuation of 1993. Mr. Lawrence did not offer any explanation for the fall in value.

After the review of the appellant's report, the Tax Court had critical comments about the expert's independence as a valuator and about expert witnesses in

general. After rejecting the excessive optimism of the appellant's report, the Tax Court stated:

[107] Respondent's counsel argued that Mr. Lawrence was not an impartial witness, considering the number of valuations the appellant and related corporations engaged WGM to perform over the years. It is obvious that valuators are retained to support their client's claims as to value; they are not independent experts. The Court assesses the merits of the opposing values and arrives at a decision based upon the evidence presented. Frequently, as Mr. Ovens writes, the Courts will decide upon a value somewhere between the figures submitted by the opposing litigants. No judge believes any expert witness is independent or impartial; they are being paid for a reason.(Emphasis added)

[108 Mr. Lawrence had built a successful relationship with the appellant and related corporations. In such a circumstance he, like any professional, wants to help the client maintain that relationship. It is normal and not dishonest for him to search for any potential value inherent in the Mine that could advantage his client. I refer specifically to the addition of 980,000 tons of possible ore when nobody else suggested, let alone recognized, such a possibility.

[109 Mr. Lawrence offered reasons for the possible existence of the additional 980,000 tons but I have concluded he was grasping at straws. I would have been much more comfortable if the appellant had produced another valuator either to review the WGM Report or produce an entirely new valuation confirming the conclusions in the WGM Report.

The Tax Court then rejected the appellant's report with the following comment;

[112] There is a consistency in Mr. Farquharson's (the Crown's expert) *rational that is not present in Mr. Lawrence's valuation. I do not fault Mr. Lawrence in including possible inferred reserves. Even though there is evidence that mining companies consider the inferred reserves in negotiating a price for the purchase and sale of a mining property, there is nothing in Mr. Lawrence's evidence that gives me comfort to support his estimate.*

The Court stated that the property should be valued on the basis of the gold in the ground theory. This assumes that that gold reserves have value even if not currently mineable at a profit. The Tax Court agreed with the conclusions of the Crown's expert apart from an adjustment to the per-ounce value of the gold reserve. The Court concluded that the subject mining interest had a fair market value of $685,826.

The issue was whether a 50% shareholder held De facto control (as defined in subsection 256(5.1) of the Income Tax Act over the company. As part of its evaluation the Tax Court reviewed, and rejected, the terms of a shareholder's agreement between the two arm's length shareholders which denied either shareholder de facto or de jure control. The Tax Court concluded that where a company had a single director on the corporate board that individual held de facto control. The Federal Court of Appeals affirmed these views.

Plomberie J.C. Langlois Inc. v. The Queen
2006 DTC 2997 (Tax Court of Canada) 2006 DTC 6508 (Federal Court of Appeal)

The sole issue before the Tax Court was whether the corporate taxpayer, Plomberie J.C. Langlois Inc. ("Plomberie"), was controlled by one of its two shareholder during its 1995 to 1998 taxation years. Plomberie was owned 50-50 by two arm's length parties. One shareholder of Plomberie was Les Placements René Simoneau Inc. which was 100% owned by Mr. René Simoneau. The second shareholder was Mr. Richard Hallas, an individual at arm's length from both René Simoneau Inc. and Mr. Simoneau.

Plomberie operated a plumbing contracting business. Mr. Hallas was in charge of the operational management of the company. He handled bidding, provided estimates, hired staff and looked after all contracting work. Mr. Simoneau was responsible for office management, banking, corporate finances, wages and invoicing. In addition to sharing equal voting power, the two owners had a shareholder's agreement which provided, amongst other things, that every decision not dealing with the ordinary business of the corporation had to be approved by a unanimous shareholders resolution.

The Canada Revenue Agency ("CRA") reassessed Plomberie and denied it the small business deduction. Allegedly Plomberie and Les Placements René Simoneau Inc., one of the shareholders, were controlled, directly or indirectly, by the same person within the meaning of paragraph 256(1)(b) and subsection 256(5.1) of the Income Tax Act (" the Act"). Mr. Simoneau was the person assumed by the CRA to control both corporations. While there was no question that Mr. Simoneau held *de jure* control of Les Placements René Simoneau Inc. it was the Minister's submission that Mr. Simoneau also controlled Plomberie, in fact, if not in law.

Crown's Arguments

The basis for the Crown's position was that Mr. Simoneau, notwithstanding his lack of legal control of the taxpayer, had always been Plomberie's only director, chairman, and corporate secretary. He treated Plomberie as part of a corporate group which included other companies in which Mr. Hallas held no interest. Mr Simoneau, through his control of the board, involved Plomberie in transactions which benefited other companies in this group but which had no benefit for Plomberie itself.

The Crown introduced evidence showing that Plomberie's office was located in the same premises as another company which was 100% controlled by Mr. Simoneau. Rent was charged to Plomberie on a basis which did not seem determined by normal market rates. Plomberie also co-secured financing of $1,084,000 which had been advanced to Les Constructions René Simoneau Inc. It also guaranteed loans to other private companies. By April 1997 the loans covered by these guarantees totalled $1,969,707. Mr. Hallas held no interest in these companies.

Counsel for the Crown referred to the decision of Bowman T.C.C.J. (as he then was), in *Société foncière d'investissement Inc. v. Canada*, [1995] T.C.J. No. 1568 (Q.L.), particularly paragraphs 8 and 10 of the decision:

[8] Since these decisions, other words have been added for the clear purpose of broadening the concept of control, in particular the words "directly or indirectly in any manner whatever". So far as I know, the point has not been decided, but I would have thought that it could reasonably be argued that these words necessarily include the idea of de facto control of a corporation in the case of a person who does not hold more than 50 per cent of the shares but has a controlling influence, whether economic, contractual or moral, over a corporation's affairs. It is hard to imagine words with a broader meaning.

[10] I am persuaded that the resolutions adopted by the other shareholders had the effect of giving Mr. Allain practically absolute control over the affairs of S.F.I. During the years in which the resolutions were in effect, he had complete authority to manage all aspects of the corporation's commercial and financial dealings. I admit that the other shareholders had the power to divest him of this authority, but as long as he was permitted to exercise it he was in a position of unlimited control.

The Crown argued that, by granting sole directorial authority to Mr. Simoneau, Mr. Hallas had granted him all his authority as 50% shareholder. Crown counsel also noted that Mr. Hallas had admitted he did not know what Mr. Simoneau was doing as the sole director of Plomberie. The evidence further showed that Mr. Simoneau was the one who decided on the allocation of common expenses to the various corporations he managed. He was also the one who committed Plomberie to guarantees and securities when financing the other Groupe Simoneau businesses. In sum, he had full power to manage and bind Plomberie.

The Crown further contended that the shareholder's agreement, while admittedly legally binding, should be given little weight because it was not followed in practice. As an example, sections 5 and 6 of the shareholders' agreement required the joint and equal participation of both shareholders in advancing funds to the Plomberie and in providing personal endorsements and guarantees. These sections were ignored in the years under review.

Appellant's arguments

Plomberie's representation was that the two shareholders held equal power on a *de jure* basis and that neither shareholder had *de facto* control.

Mr. Simoneau testified that that operational control of the company resided with Mr. Hallas because Mr. Simoneau knew nothing about the plumbing business and that Mr. Hallas was actually more important to the business than he was. Mr. Hallas testified that there was no agreement that Mr. Simoneau would be the controlling mind because he considered the company to belong equally to both of them. He said that formal shareholder meetings were unnecessary because he met with Mr. Simoneau daily to discuss jobs, sales, and profits. Mr. Hallas did concede however, that he knew nothing about the activities of Plomberie's board of directors because Mr. Simoneau was the sole director.

Counsel for the appellant noted that it must be determined whether the relationship between the two shareholders was characterized by the existence of a "controller" who had a direct or indirect influence, which, when exercised, would result in the control in fact of Plomberie. He argued that the two shareholders of Plomberie determined the framework of their relationship on the basis of complete equality and that the Tax Court was required to accept

this equality as it did in *Multiview Inc. v. The Queen*, 97 DTC 1489. He referred to the shareholders' agreement which stated that the shareholders were equal.

Tax Court Decision

The Tax Court stated that the evidence disclosed that neither of the two taxpayers held *de jure* control since each had an equal number of shares. The Tax Court cited the *Buckerfield's* decision (*Buckerfield's Ltd. v. Minister of National Revenue*, [1964] C.T.C. 504) where it was determined that control is based on whether the majority shareholder enjoys effective control over the affairs and fortunes of the corporation through the ability to elect a majority of members of the board of directors. The Tax Court then considered *de facto* control test in subsection 256(5.1) of the Act and concluded that *de facto* control was held by Mr. Simoneau by default because of Mr. Hallas' decision not to make effective use of his voting interest.

[36] In the case at bar, did one of the shareholders exercise de facto control of the appellant? I must find that there was, during the years in issue, but a single director. Who could exercise control over the appellant, if not this sole director? Counsel for the appellant referred to Multiview, supra, but there, the two equal shareholders were also equal directors, which the shareholders in the instant case are not.

[38] As its principal manager, Mr. Hallas undoubtedly played a very important role in the appellant corporation. However, that role is not associated with the idea of control over a corporation. It is an operational role, not a decision-making role. The decision-making role belongs to the director of a corporation, and it is the one that is associated with the notion of control in fact of a corporation.

[40] In my opinion, Mr. Simoneau exercised such dominion over the appellant. As the sole director, he had the power that ensured him a dominant influence in the direction of the appellant. The other shareholder, being an equal shareholder, had the power to remove this authority from him, but did not do so during the years in issue. In conclusion, during those years, Mr. Simoneau exercised control in fact of the appellant within the meaning of subsection 256(5.1) of the Act.

Based on this analysis the Court dismissed the appeal

Federal Court of Appeal Decision

Plomberie appealed this decision to the Federal Court of Appeal. Plomberie's counsel criticized the Tax Court Justice for having concluded that Mr. Simoneau had the dominant role as a sole director without taking into consideration the unanimous shareholder agreement signed by the two shareholders. Even if René Simoneau was the sole director, the unanimous shareholder agreement neutralized his ability to exercise either *de facto* or *de jure* control over Plomberie. According to the appellant's counsel the Tax Court erred in law because it failed to take the shareholder's agreement into consideration.

The appellant's counsel further claimed that the Tax Court also misunderstood Plomberie's business plan and the importance of the role played by Mr. Hallas. Mr. Hallas was just as important as Mr. Simoneau as far as the decisions made by the Plomberie were concerned, and he had just as much influence over Plomberie.

The Federal Court of Appeal ("FCA") dismissed the appeal. The FCA stated that it did not think that the Tax Court had failed to consider the unanimous shareholder agreement. The trial judge had understood that this agreement, as drafted, respected the equal division of Plomberie's share capital and did not benefit one shareholder to the detriment of the other. However, the FCA concluded that the Tax Court was of the opinion that this agreement was to be given little importance because the parties did not comply with it. In the FCA's view, the Tax Court properly cited, as an example, clauses 5 and 6 of the unanimous shareholder agreement concerning the financial contribution of the shareholders which had been totally ignored.

While Counsel for the appellant conceded this fact, he submitted that this omission was exceptional and claimed that the rest of the agreement was to be respected. The FCA stated that this was not what the evidence showed. As an example, the unanimous shareholder agreement specified that any decision made that was not within the ordinary course of Plomberie's business had to be approved by unanimous resolution. No such resolution was submitted although René Simoneau made numerous unusual transactions, disguised as large advances, loans and suretyships, on behalf of Plomberie

with the other members of the group of companies he controlled.

The FCA stated that these transactions, which on their face had the effect of diluting Plomberie's assets, were not approved by resolution. In addition, apart from repeating that he trusted Mr. Simoneau, Mr. Hallas did not explain why he was willing to jeopardize Plomberie's assets to guarantee the debts of companies in which he held no shares or why he would have allowed Plomberie to make loans to Mr. Simoneau's companies without interest or repayment terms. The FCA therefore concluded that the evidence clearly showed that the unanimous shareholder agreement had not been respected in its essential aspects and that the judge of the Tax Court of Canada correctly gave it little significance.

With respect to the role of Mr. Hallas in the business, the FCA stated that it was inaccurate to say that the Tax Court misunderstood the role he played in the company's operations. As Plomberie's principal manager Mr. Hallas played a very important role. However, this was an operational role, not a decision-making one.

In summary, the FCA decided that the evidence allowed the Tax Court to conclude that, in spite of the equal division of the Plomberie's share capital, Mr. Simoneau was Plomberie's "controller" within the meaning of subsection 256(5.1) of the Act and exercised *de facto* control over it.

The issue was whether the taxpayer had avoided tax on the sale of business assets by converting what would have been proceeds of sale into an investment which the Crown regarded as almost worthless preferred shares of holding companies. The Court found that section 245 of the Act, the General Anti-Avoidance Rule ("GAAR"), was applicable. A significant factor in the Tax Court's decision was the fair market value of the various properties involved in the series of transactions under review.

Ceco Operations Ltd. v. The Queen
2006 D.T.C. 3006 (T.C.C.), [2006] 5 C.T.C. 2174, 2006 TCC 256

The issue before the Court was the Crown's claim that the appellant, Ceco Operations Ltd. ("Operations"), had avoided tax on recapture of capital cost allowance and capital gains in respect to the sale of property by converting some of the sales proceeds into an investment in preferred shares of holding companies owned by Operations ultimate shareholders. This had been done by a complex series of transactions, all of which were based on the application of sections of the Act.

At the beginning of the series of transactions Ceco Properties Ltd. ("Ceco") was a Canadian corporation carrying on the business of manufacturing and selling logging equipment in Canada and the United States. Ceco was 100% owned by Cypress Equipment Ltd. ("Cypress") which served as a holding company. The shares of Cypress were owned by six holding companies. These companies were owned, directly or indirectly, by six employees of Ceco.

In mid 1996 the Cyprus shareholders (the six holding companies) agreed that they wanted to sell their Ceco shares. In the summer of 1997 the Key Group of companies expressed an interest in purchasing Ceco. Initially the transaction was contemplated as a sale of the Ceco shares. However, as a result of a review undertaken by tax advisors during the interval between December, 1997 and January, 1998, the form of the transaction changed from a share sale to an asset sale. A partnership was to be formed to acquire Ceco's business assets.

In preparation for the sale, two companies were incorporated on February 26, 1998 under the laws of British Columbia as wholly owned subsidiaries of Ceco: Operations and Ceco Holdings Ltd. ("Holdings"). SML Operations (Canada) Ltd. ("SMLO") was also incorporated on February 24, 1998. The shares of SMLO were owned by SML Holdings Corp. ("SMLH"), a Delaware USA corporation that was a direct or indirect subsidiary of the Key group.

Operations and SMLO agreed to carry on, in partnership (the "Partnership"), the business of manufacturing and selling forestry equipment. The Partnership was named Madill Equipment Canada, effective March 1, 1998. On

that date Operations contributed $500,000 (U.S.) and SML contributed $1,500,000 (U.S.) to the Partnership for Class E Partnership Units.

Immediately prior to March 1, 1998, the aggregate fair market value of the business assets of Ceco, other than real estate, receivables, cash and prepaids was $35,461,674. Those assets consisted of equipment, goodwill, and inventory. The cost amount of those assets was $15,831,350. On March 1, 1998 Ceco sold the business assets to Operations for $35,461,674. This was done on a tax deferred basis utilizing Section 85 of the Act. Ceco and Operations jointly elected on a transaction price of $17,123,002 under subsection 85(1).

As payment for the sale of these assets, Ceco received from Operations consideration consisting of promissory notes, assumption of debt, and cash with an aggregate fair market value of $15,972,568 plus preference shares of Operations with an aggregate fair market value of $19,489,106, for a total of $35,461,674. Immediately after the Section 85 rollover the aggregate fair market value of the business assets was $35,461.674 and the cost amount to Operations for the assets was $17,123,002.

Operations immediately sold the business assets to the Partnership, on a tax deferred basis, for $35,461,674 using s. 97(2) of the *Act*. The partners jointly elected an acquisition amount of $17,123,002. However Operations received from the Partnership consideration of $35,461,674 consisting of cash, promissory notes, an assumption of debt, and one Class "F" preferred partnership unit valued at $18,613,074.

The Class F partnership unit had a unique right which played a significant part in the Tax Court's final decision. The partnership agreement stipulated in paragraph 3.1(g) that:

"(g) Notwithstanding anything herein to the contrary, in the event the Partnership receives any payments in respect of any preferred securities held by the Partnership (other than securities of a subsidiary of the Partnership or other securities in which the Partnership has invested excess available cash), the Partnership shall make Distributions to the holders of Class F Units (pro

rata among such holders based on the total number of Class F Units held by each such holder) in the aggregate amount equal to such payments received in respect of preferred securities."

On March 1, 1998, the Partnership held cash of at least $18,726,561 made up of the subscription price paid by SMLO for Class "E" partnership units and equity contributions made by the partners. On March 2, 1998, the Partnership subscribed for 18,726,561 non-voting, non-retractable, non-cumulative, 6% Class "A" preferred shares of Holdings at a price of $18,726,561. The purchase price for these shares was paid in cash. Holdings, it will be remembered, was the newly-incorporated sister company of Operations a wholly owned subsidiary of Ceco.

The Tax Court made two comments related to the issuance of the Holdings Class A preferred shares. The first was in respect of their fair market value:

[4] At the heart of this appeal is a transaction which took place one day after the completion of the sale. That later transaction took the form of a subscription and payment by the Partnership for preference shares of a sister corporation of the Appellant. That price, which was paid in cash, very greatly exceeded the value of the shares.

The second comment related to the Tax Court's conclusion as to the <u>reasonableness of the Partnership purchasing these shares</u> as an investment given the terms of paragraph 3.1(g) of the partnership agreement:

[42] I note in passing that it is rather difficult to imagine why any intelligent person or partnership would pay good money to buy preference shares in a recently formed corporation when that person had already given up the right to retain any payments which might be received in respect of such shares. Moreover there was no suggestion that Holdings had during its brief lifetime carried on any business. There was no suggestion that there was any plan to commence business. It would seem that there was little likelihood that dividends would ever be paid.

This comment related to the requirement, under Paragraph 3.1(g) of the partnership agreement, that the partnership pay out any dividends or any other proceeds received from the Holdings preferred shares as a distribution to Operations as the sole Class F partnership unit holder.

Holdings, in turn, immediately used the funds received from the Partnership to purchase non-voting, non-retractable, non-cumulative 6% Class A preferred shares of the six holding companies which owned Cypress, Ceco's parent. It was the Crown's unchallenged assumption that the preferred shares issued by the six holding companies had a fair market value, at best, equal to 10% of their $18,762,561 price to Holdings.

The net result of the series of transactions was that the six holding companies received approximately 53% of the total fair market value of Ceco's vended assets as investments in their preferred shares. The receipt of this money by the six companies was tax free, or at least tax deferred. Given the non-cumulative, non-voting, non-retractable terms attached to the preferred shares the six holding companies could retain these funds indefinitely without any obligation to pay dividends or redeem them. As the Tax Court commented:

[44] It was admitted that the Holdcos never did pay any dividends to Holdings on their preference shares nor did they ever redeem them. In effect Holdings served as a stepping stone which facilitated the movement of $18,726,561 from the partnership to the Holdcos. It also enabled the Appellant to say that it did not receive any part of the consideration paid by the partnership for the business assets (if the subscription price for the Holdings preference shares were to be viewed as disguised boot).

The determination of value was not directly in issue at trial because of the concessions made by both parties in pleadings. These values, however played a critical role in the Tax Court's analysis and final conclusion. The agreed or uncontested valuation amounts were:

The overall sales price of $35,461,674 for the Ceco assets was agreed to be their fair market value.

The Crown admitted, in its Reply to the Notice of Appeal, that the fair market value of the Class "F" unit when issued, was its $18,613,074 subscription price.

The Appellant did not challenge the Crown's assumption that the preferred shares issued by Holdings were worth, at most, 10% of the amount paid for them.

Operations was assessed under Section 245 of the Act on the basis that the $18,726,561 payment to Holdings for Holdings' preferred shares was an "avoidance transaction" therefore the Crown argued that the following three steps were part of a series of transactions that resulted directly or indirectly, in a tax benefit to Operations and that they were not arranged primarily for a *bona fide* purpose other than to obtain a tax benefit, within the meaning of Subsections 245(1) and 245(3) of the Act:

the rollover of the Assets from the Appellant to the Partnership and the election pursuant to subsection 97(2);

the purchase and issuance of the Holdings Preferred Shares; and

the purchase and issuance of the Holdcos Preferred Shares.

Section 245 of the Act, (GAAR), was implemented to allow the reassessment of transactions which meet the legislative wording of the Act but are considered to be abusive of the intent of the *Act*. GAAR gives the CRA broad powers to challenge perceived tax avoidance activities or abuses of the tax system in situations where no specific anti-avoidance measure exists.

GAAR is an assessing section of last resort. It must be determined that no other sections of the *Act* apply to the issue at hand before GAAR can be utilized. Because of this requirement, the Tax Court analyzed the alternative assessing positions which might have been applicable to the subject transactions. As the Tax Court stated:

[53] There are three issues to be decided:

a) Was the payment of $18,726,561 made by the Partnership to Holdings on March 2, 1998 additional consideration (other than an interest in the Partnership) "received" by the Appellant within the meaning of ss. 97(2) and paragraph 85(1)(b) of the Act.

b) Was the payment made by the Partnership to Holdings required to be included in the Appellant's income pursuant to ss. 56(2) of the Act.

c) Does s. 245 of the Act apply.

Subsection 97(2) Analysis

In support of its position on the first issue, that the $18.7 million payment made by the Partnership to Holdings was not actually made as consideration for the Holdings preference shares, the Crown submitted that the “true nature” of the $18.7 million payment was additional consideration on the Subsection 97(2) rollover.

The Court rejected this argument because of the Crown’s admission that the business assets were sold to the Partnership for $35,461,674 and that, as consideration, Operations received various assets with an aggregate fair market value of $16,848,600 and a Class “F” unit with a fair market value of $18,613,074. As the Tax Court noted:

As a simple matter of arithmetic there is no room for even a penny of additional consideration when the legal form of the transactions governs. There was an additional payment made by the Partnership it is true, but the admission precludes a finding that the payment was consideration for the sale of the business assets.

Subsection 56(2) Analysis

The Tax Court then considered the Crown’s contention that the payment of $18,726,561 by the Partnership to Holdings was required to be included in the income of Operations pursuant to Subsection. 56(2) of the Act. Subsection 56(2) allows the CRA to add to a taxpayer’s income an amount not actually received by the taxpayer if four requirements are met:

- the payment must be to a person other than the reassessed taxpayer;
- the allocation must be at the direction or with the concurrence of the reassessed taxpayer;
- the payment must be for the benefit of the reassessed taxpayer or for the benefit of another person whom the reassessed taxpayer wished to benefit; and
- the payment would have been included in the reassessed taxpayer’s income if it had been received by him or her.

Counsel for the Crown argued that, at the behest of Operations, the Partnership paid the $18,726,561 to Holdings, not to Operations and that amount was equal to the additional proceeds that would otherwise have been paid to the Operations for the business assets.

The Tax Court also rejected this argument. Again the Crown's concession on the value of the Class "F" partnership unit was determinative:

[59] Ss. 56(2) may well apply if a person who has sold property causes the consideration which might otherwise have been received by him as vendor to be paid to a designated recipient and if the forth condition is met. Here, however, as already noted, it was admitted on the pleadings that the total value of the boot and the Class "F" share received by the Appellant on March 1st was equal to the price for which the business assets were sold to the Partnership. I repeat, there was no room for the additional consideration which the Appellant is said to have diverted to Holdings.

<u>GAAR Analysis</u>

This left only GAAR as a possible assessing position and the Tax Court undertook an analysis of whether the provisions of the Act had been abused by Operations in the subject transactions. However, before doing so, the Tax Court considered whether the series of transactions constituted an "avoidance transaction".

The GAAR legislation provides an "Escape Clause" for legitimate transactions which would otherwise be determined to be avoidance transactions. An avoidance transaction does not include a transaction that "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit". If it can be inferred from all the circumstances that the primary or principal purpose in undertaking the transaction is other than to obtain a tax benefit, then the transaction is not an avoidance transaction.

Because of this "escape Clause" counsel for the appellant attempted to convince the Court that there was a valid business purpose to the Partnership investing in preferred shares of Holdings. Counsel argued that the transfer of funds to the six Holdcos through Holdings was done so that the Holdcos would have more money to invest in the Partnership. It was argued that both

the management of Key and Ceco believed that there were significant future growth opportunities for the Partnership that would require the investment of cash and that the primary purpose of the fund's transfer was to permit the reinvestment in the Partnership in a tax-efficient manner. The appellant provided only one witness to testify on the non-tax purpose of the transactions. The Tax Court did not find him to be credible:

[51] A variety of reasons were offered by the Appellant for moving the $18,726,561 from the Partnership to the Holdcos. The Notice of Appeal suggests that it was to protect "cash equal to the fair market value of the Class "F" unit which represented the tax–deferred sale proceeds" from the creditors of the Partnership. That does not explain the use of Holdings to detour the flow of the money around the Appellant and up to the Holdcos. Mr. Schmunk was unable to explain the role of Holdings and the preference shares which it issued to the Partnership except to agree that it was on the advice of his tax advisors.

[52] Mr. Schmunk then pointed out that the money which flowed up to the Holdcos could be held by them and later be reinvested in the Partnership following redemption of preference shares. He agreed that such a procedure would require the concurrence of the Holdcos. There was no written agreement that they would do so, just, he said, an "understanding". The objective fact is however that no such reinvestment has yet been made. This area of Mr. Schmunk's evidence was in my opinion disingenuous, a mere ex post facto rationalization.

In the absence of any non-tax purpose to the series of transactions the Tax Court determined that the "*inescapable conclusion on the evidence*" was that the series of transactions (whereby the assets were transferred from Ceco to the Partnership under subsections 85(1) and 97(2), the Holdings preferred shares were purchased by the Partnership, then Holdco preferred shares were purchased by Holdings) were a series undertaken exclusively to defer the taxation of the portion of the sale price represented by the value of the Class "F" partnership Unit. As it was conceded that the Class "F" Unit was worth its $18,613,074 subscription price, this was the portion of the total sales price that was subject to avoidance.

Operations' counsel argued against this position on the basis that the Crown had conceded that when Operations rolled in $35.4 million worth of business assets, it received back $16.8 million worth of various assets and a Class "F" partnership unit worth $18.6 million. In his view the Crown now wanted to treat Operations as if it had received an additional $18.7 million worth of consideration for the business assets, which would give it $54.1 million worth of consideration for assets worth only $35.4 million. Counsel said that this was self-evidently impossible.

The Court's commented as follows on this argument:

[78] That argument rests on the assumption that the Class "F" Partnership unit was an interest in the Partnership within the meaning of ss. 97(2). Technically it was. In the real world, however, it was symbolic only. In practical terms, it represented nothing more that an undertaking to pay $18.7 million for Holdings preference shares, which were of no practical value to the Partnership by reason of the Partnership agreement.

[79] I infer the existence of that undertaking from the events which took place. The fact that the subscription price paid by the Partnership for the Holdings preference shares and value of the Class "F" unit were almost the same is hardly a coincidence. As already noted, paragraph 3.1(g) of the Partnership Agreement precluded the retention by the Partnership of "any payments in respect of such shares". In that symbolic role the Class "F" share was clearly worth $18.7 million during the brief period prior to the purchase of the Holdings preference shares and the payment of the consideration which replaced the Class "F" share. As I see it the use of the avoidance transactions to secure the rollover and permit the "tax deferred proceeds" to reach the Holdcos results in a patent abuse of ss. 97(2).

Based on this analysis the Tax Court dismissed the appeal apart from a minor adjustment to the total gain. This decision was appealed to the Federal Court of Appeal but the appeal was discontinued.

Rainforth v. The Queen
[2007] T.C.J. No. 61, 2007 TCC 132
March 2, 2007
McLarty v. The Queen
2005 D.T.C. 217 (TCC), [2005] 1 C.T.C. 2875 (T.C.C.), 2005 TCC 55
January 26, 2005
The Queen v. McLarty
2006 D.T.C . 6340 (FCA), [2006] 4 C.T.C. 16, 2006 FCA 152
April 27, 2006

These cases involved the value of seismic data. In both cases the values relied on by the taxpayers exceeded the taxpayer's arm's length purchase price. In both decisions the Courts determined that the taxpayer's acquisition of the data was at non arm's length. In Rainforth the taxpayer lost on a non-valuation issue. In McLarty the taxpayer was first successful in the appeal to the Tax Court but the Crown's appeal was allowed by the Federal Court of Appeal. Leave to appeal was granted by the Supreme Court of Canada.

Rainforth

Rainforth was one of numerous seismic data cases which have been heard, or are in the process of being heard, by the Tax Court of Canada. Rainforth was not decided on the basis of the fair market value of the seismic data. The facts of the case do however illustrate the valuation issues being presented to the court in these cases.

The taxpayer was one of a number of investors in a joint venture seismic arrangement. Mr. Rainforth had invested in seismic data on an annual basis from 1991 to 1998. The Tax Court said there was no significant difference between his annual transactions and picked the 1996 year for review. In 1996 Mr. Rainforth agreed to an investment of $50,000. He paid the cash component of this with a cheque for $8,355. The remainder of the purchase price was funded by a loan from an apparently arm's length numbered company.

In total, the investors in the 1996 seismic program acquired data at a purported price of $962,000 for which they paid $129,870 cash. The remaining $832,130 was funded by numbered company loans. The loans bore interest at 8% per annum which was to be paid, along with the principal at maturity, in fifteen years. The loans were secured by the seismic data. The lender could only seize the seismic data to cover any shortfall on the amount owing at maturity. The purchasers, such as Mr. Rainforth, were not otherwise personally liable for the loan. The lender also received an assignment of 50% of any licensing revenues from the seismic data.

Mr. Rainforth did not lead any expert evidence as to the fair market value of the data for any of the taxation years at issue. The Crown, however, did lead

valuation evidence by providing details of an earlier arm's length sale of the data purchased in Mr. Rainforth's 1997 transaction. The Crown subpoenaed an accountant with Deloitte & Touche who had acted for a bankrupt company with respect to the sale of the seismic data in June 1997. He testified that the data had been for sale for some time, and that until the sale in 1997, no one had indicated an interest in it. The receivers in bankruptcy sold a large interest in the data to NRM Management Ltd. for a total purchase price of $20,000. Later that year an 18.8 percent interest in this data was valued, for purposes of the 1997 transaction undertaken by NRM Management Ltd., at approximately $850,000. In 1998, a 20.2 percent interest in the data was valued at approximately $823,000. The Tax Court commented:

[32] Accordingly, NRM purportedly acquired undivided interests in the same data in two separate transactions for amounts aggregating in excess of $1,673,000, shortly after a much larger interest in the data had been sold in an arm's length transaction for $20,000.

Mr. Rainforth's appeal was dismissed because he could not satisfy the statutory purpose test applicable to Canadian Exploration expenses. He was required to prove that the purchased data had actually been used for the purpose of exploring for natural gas. Without evidence of actual usage of the data Mr. Rainforth's investment could not be deducted as a Canadian exploration expense. Mr. Rainforth could not provide any evidence of the usage of the data and instead relied on his own stated understanding of the intended use. This was not accepted by the Tax Court, which concluded:

[43] As for a credible plan to use the data, the evidence consists largely of the terms of the joint venture agreements and testimony by Mr. Rainforth and Mr. McLeod as to their understanding of the objectives of the joint ventures. Again, neither Mr. Rainforth nor Mr. McLeod had any direct knowledge of explicit plans to use the data.

[44] It is true that the agreements contemplate that exploration activities would be conducted by the operators. However, Mr. Rainforth has not established that these vague objectives ever resulted in a credible plan to use the data in such a fashion. In fact, I would question whether the agreements were anything more than just window dressing.

[51] The evidence as a whole tends to suggest that both Mr. Rainforth and Mr.

McLeod were indifferent as to whether the joint ventures actually conducted any exploration activities.

While the case did not turn on the issue of fair market value the details of the overall transaction are instructive of the issues faced by the Tax Court in reviewing seismic data transactions. The Tax Court is invariably asked to consider a fair market value assigned to the seismic data significantly in excess of the actual price paid for it. Generally, the fair market value claimed by taxpayers is supported by opinion evidence. The purchase price paid by the taxpayers/investors is partly in cash with the remainder financed through debt. The indebtedness never requires that the taxpayers be personally liable for the outstanding balance. Interest and principal is to be paid solely from revenue earned from the seismic data. If this is not sufficient to cover the debt obligation on maturity the only recourse for the creditor is to take title to the data.

McLarty

A prior edition of this publication reviewed *Global Communications Ltd. 97 DTC 1293 Tax Court, 99 DTC 5377 F CA*. In *Global* the cash component was 12% of the claimed total price of the data. In *Rainforth* the cash portion of the price was 16.67% of the claimed value. In *McLarty* the cash component was 15% of the total price.

McLarty was initially heard by the Tax Court in early 2005. There were four issues considered by the Court: whether the note was a contingent liability; whether the use of the seismic data met the statutory purpose test; whether the parties were at arm's length; and the fair market value of the seismic data.

The facts were similar in outline to other cases heard by the Tax Court. Mr. McLarty was one of a number of investors who participated in the purchase of proprietary seismic data through a joint venture. The investors paid a total consideration of $6,373,335 of which $956,002 was paid in cash and the remaining $5,417,333 by way of promissory notes. The terms of the note precluded the holder from any recourse against the individual joint venturers. In the event that the note was not paid out on its due date the creditor was limited to whatever recovery it could make from the sale of the proprietary data.

The Tax Court concluded that the note was not a contingent liability. The Court apparently concluded that, if necessary, the seismic data could be sold for sufficient proceeds to pay out the note:

[46] When we look strictly at the terms of the Note there are a number of apparent uncertainties. However, in the light of Wawang and Canadian Pacific Limited, I find that the Note is not a contingent liability simply because we do not know how much or at what time the promissory note will be paid. However, although there is a provision that requires the noteholder to appoint a trustee to sell the Venture Data the actual sale of the Venture Data could be contingent if there was some uncertainty if the Venture Data can be sold.

[49] Ultimately, to determine whether the Appellant's Note is a contingent liability it is necessary to look at the surrounding facts. The ongoing market for quality seismic data, and relative rarity of such quality (especially at the time the Venture Data was purchased) leads me to the determination that the Venture Data could be sold. I find that at the time the Appellant purchased his interest in the Venture Data there was no contingent liability because the Venture Data was required to be and could be sold upon default.

The Tax Court also concluded that the statutory purpose test relating to Canadian Exploration expenses had been met. The Court's conclusion on the Statutory Purpose test was largely based on the on the testimony of Mr. McLarty, who stated that he believed the joint venture was intended to explore for oil and gas. The Tax Court noted the following:

26] As noted above, the Appellant testified that when he acquired his interest in the Joint Venture his primary purpose was to get in on the ground floor of an oil and gas exploration company. His subjective primary intention is corroborated by the objective evidence of his acceptance of the terms in the Memorandum. It might be that these actions alone are sufficient to meet the purpose test: because the Appellant bought his 1.57% interest in the Venture Data on the "good faith" belief that the Joint Venture would follow through on its planned exploration.

[28] Although, in previous cases involving subsection 66.1(6), courts have looked at what was actually done to the land or with the seismic data, in this case it is not necessary to look beyond the Appellant's purpose in obtaining the Venture Data.

The Tax Court reviewed the transactions involved in the taxpayer's acquisition of the data and determined that the parties were at arm's length. Given this finding, the Tax Court found the expense, as claimed by Mr. McLarty, to be reasonable. It stated:

[73] Given the highly speculative nature of the oil and gas exploration industry, the fact that seismic data is very difficult to value as well as the experience of Mr. Sapieha in the oil and gas exploration industry, this is not an appropriate case to question the participants' business judgment. This is not a situation where paying more than the fair market value would be unreasonable. However, I find that a reasonable businessman in the Appellant's position would have paid at least $100,000.00 in return for the undivided interest in the Venture Data and the unlimited access that the Appellant obtained.

The Tax Court also commented on the three independent appraisals commissioned by the promoter of the joint venture which gave a range for the total seismic data library acquired of between $31,912,000 and $41,930,760.

Given its findings that the transaction was arms length and the amount of the claimed exploration expense was reasonable, the Tax Court concluded that fair market value was irrelevant. However the Court still chose to comment on the Crown's expert's testimony. It stated that it had trouble accepting much of the expert's opinion related to the value of the entire Venture Data for several reasons. In the Tax Court's opinion, the expert failed to take into account the exploration value of the Venture Data and the fact that there might have been a special purchaser. The Crown's expert was also, in the Tax Court's opinion, conservative in his cash flow projections and discount rates.

The Tax Court therefore allowed the appeal with costs.

The Crown appealed this decision to the FCA. The Crown challenged the Tax Court decision on three grounds. First, that the Tax Court had erred in concluding that the use of the seismic data met the statutory purpose test: second, the Crown claimed that the Tax Court had erred in determining that the taxpayer's note was not a contingent liability. The third ground for appeal was that the Tax Court had erred in deciding that the transactions were at arm's length. The FCA decided on these issues as follows:

Statutory Purpose Test

The FCA stated that the Tax Court had "suggested a novel approach" to the question of whether the test had been met or not. The FCA did not agree with the Tax Court's conclusion that it was unnecessary to look past the taxpayer's purpose in obtaining the data, as evidenced by his testimony and reliance on the stated joint venture objectives. The FCA stated:

[28] The TCC admitted that its approach to considering whether the statutory purpose test was met departed from the prior jurisprudence. In Global Communications and Petro-Canada, the courts looked at what was actually done to the land or with the seismic data. In my respectful opinion, the TCC's departure from the prior case law was unjustified. The jurisprudence of this court does not suggest that the statutory purpose test varies with the taxpayer's identity. Instead, it indicates that the court must always examine either what was actually done or what was planned to be done with the seismic data.

However, although the Tax Court had erred in law, the FCA concluded that the Tax Court had committed no palpable and overriding error on this point. The Tax Court's conclusions were based on mixed fact and law. Since the Tax Court had considered factual evidence that there had been some actual usage of the data the Tax Court's decision was based on supportable facts.

Contingent Liability

After a detailed review of the facts and the relevant jurisprudence, the FCA concluded that the Tax Court had reached the correct conclusion when it rejected the position that the note was a contingent liability.*

Arm's Length Transaction and FMV

The FCA stated that the question of the appropriate transaction to analyze for the purposes of paragraph 69(1)(*a*) of the Act is one of law and that the Tax Court was required to answer this question correctly. The FCA stated that:

[45] Unfortunately, it is not entirely clear from the decision below which transaction the TCC considered the relevant one in its paragraph 69(1)(a)

* See *also Baxter vs. the Queen* 2006 TCC 663, reversed on different grounds 2007 FCA D.T.C. 306

analysis. At some points in the TCC's reasons, it seems as if the lower court viewed the significant transaction as that of the respondent subscribing to the Joint Venture and executing the subscription agreement. . . . Then again, other passages in the decision below might be taken as indicating that the TCC considered the respondent's purchase of the Data to be the legally relevant transaction."

The FCA concluded that the Tax Court had made an error in law by failing to determine which transaction to analyze for the purposes of applying paragraph 69(1)(a) of the Act. After a review of the series of transactions the FCA concluded that the purchase transaction was not at arm's length because one common mind dictated the terms of the bargain on both sides. The FCA stated:

[61] In conclusion, then, the court below erred by not considering the relationship between CRC as "agent" and CRC as vendor in its analysis of whether the Technical Data Base Purchase Agreement was the product of an arm's length transaction. Given that Sapieha was the directing mind of both parties on the crucial issue of the Data purchase price, this transaction was not conducted at arm's length. In light of this finding, the burden falls on the respondent to rebut the Minister's assumed FMV of the respondent's interest in the Data.

This was a key determination because it reopened the valuation issue. While the taxpayer's counsel submitted that the Tax Court judge had drawn a conclusion as to the fair market value of the seismic data the FCA disagreed. The Tax Court had found the taxpayer's payment of $100,000 for his interest in the data reasonable within section 67 of the Act. However the Tax Court determination did not indicate fair market value for the purpose of section 69 of the Act.

The FCA decided that the Tax Court judge had reached no conclusion on the issue of fair market value because he had found the transaction to be at arm's length. It was therefore necessary to determine the fair market value of the Venture Data acquired by the taxpayer. This was a factual question that was best answered by a trial court. Therefore the FCA remitted the matter back to the Tax Court to determine whether the taxpayer could discharge his burden to establish on a balance of probabilities that the fair market value of his interest in the Venture Data exceeded the Minister's appraisal of its value.

Therefore the FCA allowed to the Crown's appeal on the issue of "non-arm's length" but dismissed the Crown's appeal on the issue of contingent liability. The Order of the Tax Court of Canada was set aside and the matter was remitted to a different Justice of the Tax Court to determine whether the respondent could prove a higher fair market value for the seismic data than that determined by the Minister.

Although the Crown won its appeal the FCA on the basis of the non arm's length argument, the Crown sought leave to appeal to the Supreme Court of Canada on the issue of contingent liability. Mr. McLarty also sought leave to appeal to the Supreme Court of Canada on the non-arm's length issue. The Supreme Court of Canada granted leave to both parties and a Supreme Court of Canada hearing is tentatively scheduled for January 28th, 2008.

If the Supreme Court of Canada overturns the contingent liability decision and finds in favour of the Crown the fair market value of the seismic data will probably be irrelevant. The taxpayer will only be allowed to deduct the cash portion of his purchase price regardless of the fair market value of the seismic data. This would be about 15% of the total claimed expense. As a result no new trial on the valuation of the Venture Data will occur until after the Supreme court of Canada decision.