THE VALUATION LAW REVIEW

volume 12 / issue 3
May 2006

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

PRICE AND FAIR MARKET VALUE IN TAX COURT DECISIONS

The majority of valuation cases that have been heard in Tax Court recently, and reviewed in the Valuation Law Review – Taxation, were essentially disputes on price vs. value. In the software tax shelter transactions the stipulated price equalled the claimed value however the cash component of the purchase price was much less than the non-cash consideration. In donation cases taxpayers, relying on expert opinion support, claimed fair market values greatly in excess of their actual purchase prices. With a few exceptions the Tax Court has not been willing to fully accept opinion based values in preference to actual costs or market comparables.

In this, and the previous edition of the Valuation Law Review, the cases reviewed include judgements where the Tax Court based its decision on comparisons to prices in open market transactions (*McClintock, Noble, Petro-Canada*), the actual cash price paid to acquire the property (*Klotz, Nash*), the value of the consideration paid for the property (*McCoy*), and the original cost subjectively adjusted for market fluctuations (*Maréchal*).

The issue of price vs. value has been particularly significant in the artwork donation cases where artwork was purchased arm's length just prior to the donation. *Klotz* was an art donation case in which a formal organized structure existed whereby taxpayers purchased blocks of artwork at arm's length and then donated them to charities for appraised amount approximately three times greater than their actual cost. In Tax Court the taxpayers defended their position with expert appraisal evidence. The Tax Court determined that the fair market value was the price paid by the taxpayers. This decision was sustained on appeal to the Federal Court of Appeal (FCA) and leave to appeal was denied by the Supreme Court of Canada.

The Tax Court decision in *Nash*, a case heard subsequent to *Klotz*, was at variance with *Klotz* although the two cases were factually very similar. *Nash* also involved donated groups of artwork with claimed fair market values for donation purposes which were much greater than their recent arm's length purchase prices. In both cases the taxpayers relied on expert testimony while the Crown based its position on the taxpayer's actual costs. In both cases it was the taxpayer's position that the art should be valued on the basis of the prices of individual prints at the retail market level rather than the wholesale bulk prices actually paid. While the Tax Court, in *Klotz*, did not accept this position the Tax Court Justice in *Nash* found the taxpayer's expert evidence to be credible and allowed the appeal.

The Crown appealed the *Nash* decision to the FCA. The FCA allowed the appeal and determined that the fair market value of the artwork was the taxpayer's actual cost. The basis for this decision was the FCA's determination that the Tax Court had erroneously accepted the taxpayer's opinion evidence on the relevance of the retail

market to the artwork's value when there was an actual, more relevant market for the art. This was the wholesale market where the art had been purchased by the taxpayers. The FCA cited, with approval, a portion of the *Klotz* decision rejecting the use of the opinion evidence on the retail market in favour of basing the value on the taxpayer's actual cost. Leave to appeal in *Nash* was denied by the Supreme Court of Canada.

Nash is an important case for valuators and tax practitioners. The Federal Court of Appeal went into considerable detail on the definition of "fair market value" in respect to the relevant market to be used for comparable purposes. The analysis of the Federal Court of Appeal on comparable markets is applicable to other donation cases where property was purchased in bulk, at wholesale prices, but value was based on the retail prices of individual units. In the prior edition of the Valuation Law Review-Taxation we commented that;

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

The above comment on the Crown's "mixed success" was largely based on the Crown's loss of the *Nash* case at the Tax Court. The Federal Court of Appeal's reversal of this decision has, to a significant extent, ended the ambiguity on this issue. The cumulative weight of the decisions on price Vs. value appears to indicate a judicial preference for fact over opinion in donation valuations. It can be assumed that the *Nash* FCA decision will be given weight by the Tax Court in cases where there have been recent arm's length transactions in the subject property at prices which are significantly less than claimed values based on opinion evidence.

Corner Brook Pulp and Paper Ltd. V. The Queen

Corner Brook Pulp and Paper Limited v. The Queen 2006 D.T.C. 2329 (T.C.C.)

The Court considered the issue of whether a legally binding but non arm's length contract should be ignored in order to determine the "highest" value under the fair market value definition. The Court concluded that, to meet the fair market value definition, the contract had to be ignored or revised to arm's length terms.

The valuation issue in this case was very simple. Should a non-arm's length contract that was unfavourable to the company be taken into account in the valuation or should it be disregarded?

On February 1, 1995 Corner Brook Pulp and Paper Limited (Corner Brook) was owed $20,000,000 by its 100% owned subsidiary Deer Lake Power Company Ltd. (Deer Lake). On that day Corner Brook subscribed for 4,000,000 common shares of Deer Lake at a price of $5.00 per share. The consideration was the extinguishing of the $20,000,000 debt. In December 1998 the two companies amalgamated. Corner Brook attempted to deduct the non-capital losses of Deer Lake that had accrued prior to the amalgamation. The CRA reassessed Corner Brook denying Corner Brook $2,948,000 of these losses because the losses of Deer Lake had been reduced under section 80 of the Income Tax Act.

The CRA's position was that the fair market value of Deer Lake was $17,984,000 immediately after the share issue. There had been a $20,000,000 reduction in Deer Lake's debt to Corner Brook as a result of the transaction The provisions of section 80 required that Deer Lake's non-capital losses be reduced by the difference between these two amounts. If the fair market value of all of the issued shares of Deer Lake had equalled, or exceeded, $20,000,000 immediately after the share for debt exchange, there would have been no reassessment of the losses available to Corner Brook.

Corner Brook was in the business of manufacturing and selling newsprint. Deer Lake owned and operated a hydro-electric generating facility which included significant water rights. All of the electricity produced by Deer Lake was sold to Corner Brook under a power supply contract "the Electricity Contract". This contract had been entered into on June 1, 1955 for a term of 30 years which could be extended for two additional 30 year terms at Corner Brook's option. It had been extended at the 1985 expiry date and could be extended once more in 2015.

The Electricity Contract stipulated that Deer Lake would charge Corner Brook at the rate of $2.80 per kilowatt per month during the term of the agreement, including the extension periods. While it was accepted by the Crown that this price was the commercial market rate for bulk electrical power when the contract was signed in 1955 the rate was about one-tenth of the current commercial market rates at the valuation date. Essentially the terms of the

contract required Deer Lake to sell electrical power to Corner Brook at rates greatly below what could be realized in the absence of the contract and this reduced price could be reasonably assumed to be in effect until the termination of the contract about fifty years after the valuation date.

The CRA's valuation of Deer Lake was based on the assumption that the terms of the contract had to be considered in a fair market value determination. If this assumption was correct the shares of Deer Lake had a nil fair market value at the valuation date because Deer Lake's $20,000,000 liability to Corner Brook was greater than the value of Deer Lake's electrical generating assets when valued on the basis of the discounted after tax cash flow from electrical power sales at the contract price. The excess of liabilities over assets was calculated by the CRA to be $2,984,000 which, under section 80, was the amount of the debt deemed to be forgiven.

The taxpayer did not question CRA's valuation methodology. However it disputed the conclusion that the shares of Deer Lake had a value of only $17,016,000. The taxpayer did not present a precise value. It took the position that the value exceeded $20,000,000. This conclusion was dependant on the assumption that the electricity contract would be revised to reflect the current bulk electrical rates prior to an assumed arm's length sale.

The taxpayer's valuator submitted an Expert Report which relied on a report prepared by Simons Engineering Inc. for BT Securities Corporation. This report was put into evidence on the consent of both parties. The Simons report, prepared as of April 1995, valued Deer Lake at $175,000,000 to $195,000,000 on the basis of the then-current commercial market electricity rates.

The taxpayer's valuation report considered the question:

In determining the fair market value of DLPC's (Deer Lake) shares, should the CCRA consider power rates included in the Electricity contract?

The taxpayer's expert first gave the generally accepted definition of "fair market value" and pointed out that the definition included two important concepts that had a direct bearing on answering the question:

"Highest Price"
"Informed and Prudent Parties"

In respect of the concept of "Highest Price" the taxpayer's valuator noted that the Simons' valuation report did not consider the terms of the existing Electricity Contract and assumed that the power could be sold at current market rates.

In respect to the concept of "Informed and Prudent Parties" the taxpayer's valuator concluded that a prudent and informed vendor would modify the electrical contract prior to a sale and as a result get full value for the Deer Lake shares.

The valuator pointed out that modifying the contracts to current rates made economic sense because the additional value accruing to Deer Lake would more than offset the reduction in value that Corner Brook would suffer because of the higher electrical rates it would pay. This conclusion was based on the fact that the risk profile of an electricity company is less than that of an operating newsprint mill. Therefore the same cash flows have a higher value in an electricity company than they do in a newsprint company.

The Simons report had considered this same point and concluded that Corner Brook would be better off from both a financial and valuation point of view by modifying the electrical contracts, paying higher future electrical expenses and getting a higher value for the Deer Lake shares. The Simons report calculated that the additional combined values of Corner Brook and Deer Lake that would result from the revised contract was US$105,000,000. Corner Brook would face a decrease in value of $80,000,000 by having to pay for power at the revised rates but Deer Lake's higher revenues would increase its value by $185,000,000.

The taxpayer's valuator concluded that *"the Electricity contracts should be modified to reflect arm's length conditions when valuing DLPC's shares on a stand alone basis."*

Chief Justice Bowman of the Tax Court agreed with the position that the shares of Deer lake would have a value greatly in excess of $20,000,000 if the contract terms were ignored or re-written to current commercial market terms. The Tax Court's analysis was relatively brief. Chief Justice Bowman said that valuation involves skills that go beyond the mechanical application of rules. Valuation skills involve judgment, intuition, experience and common sense. He agreed with the taxpayer's valuator's overall conclusion on the issue of ignoring the terms of the electrical contract and commented:

[29] My conclusion that the non arm's length electricity contract between Deer Lake and Corner Brook should not be considered in determining the fmv of the Deer Lake shares is not a conclusion of law nor is it based particularly on expert opinions. It is, rather, simply a common sense appreciation of the fact that the valuation of business assets is not a theoretical exercise. It takes place in the real world and in a commercial context. Conclusions that a valuator reaches must be tested against the touchstone of common sense or, if you will, by reference to what the man on the Clapham omnibus might think.

[30] Here we have a company owning assets with a value that ranges between $150,000,000 and $300,000,000 and yet because of a long term contract with the company's sole owner to supply electricity at a price that is substantially below market it is asserted that this reduces the value to about $17,000,000. I agree that if that contract

were unbreakable - for example if it were with some arm's length third party, this could affect the value significantly - indeed it might even render the shares unsaleable. The enquiry is to determine what sort of a deal would be struck by an informed buyer and seller. No intelligent buyer would even consider buying the shares of Deer Lake if the 1955 electricity contract with Corner Brook remained in place. Therefore, what would Corner Brook do if it wanted to sell the shares of Deer Lake? Obviously, get rid of the contract, which it could do with the stroke of a pen. This is not a legal conclusion nor is it a matter of appraisal expertise. It is just plain common sense.

The taxpayer's valuator had determined that the electrical contracts should be modified to reflect arm's length conditions. The Tax Court Justice commented that he did not entirely agree with this approach. Chief Justice Bowman stated, in footnote 3 to the decision, that it was his conclusion that the contract should simply be ignored;

Mr. Labrèche, in the passage quoted above (para. 4.4 of his report), states that the Electricity Contracts should be modified to reflect arm's length conditions when valuing DLPC's shares on a stand alone basis. This is not exactly what I have said. I suggested that they should simply be ignored. In the final analysis it does not make much difference in this case - whether the contracts are rewritten or ignored. In either case we end up with a sufficiently high figure that no forgiveness of debt occurs. Nonetheless, it must be recognized that a secure supply contract at arm's length prices may result in a different value from one where there is no contract, I do not, however, intend to decide the point. It can be decided another day when the question is relevant.

Larochelle v. The Queen

Larochelle v. The Queen 2004 D.T.C. 2796 (T.C.C.)
Larochelle v. The Queen 2005 D.T.C. 5197 (F.C.A.)

This case was decided by the Tax Court in 2002. However it was not translated into English until May 2004. The Federal Court of Appeal gave reasons for judgment in 2005.

In issue was the fair market value of the single issued share of Les Assurances Gérard Pelchat Inc. The share had been transferred to the taxpayer by her spouse on November 28, 1996 for a total consideration of $10. At the time of the transfer the husband had an outstanding tax debt to the Minister of $116,940. The taxpayer was assessed under section 160 of the Income Tax Act on the assumption that the share had a fair market value in excess of the $10 consideration. At the Tax Court of Canada the taxpayer presented a valuation supporting the $10 value. The Crown submitted a report, prepared by a valuator employed by the CRA, showing that the share had a value of $190,000 based on capitalized earnings.

The Tax Court considered whether or not to assume the existence of a non-compete agreement. The Court concluded that, in an arm's length transaction, a non-compete agreement would have been required by the purchaser and was therefore a valid assumption in order to realize the "Highest" price under the fair market value definition.

The company was involved in investment advising. Gérard Pelchat, the taxpayer's spouse, was its principal employee. The clients, as described by Mr. Pelchat, were mainly seniors who gave him their savings which he invested in various ways, concentrating mainly on low risk investments such as term deposits, pooled investment funds, and mutual funds. He claimed a close relationship with the clients who considered themselves to be dealing with him personally rather than with the corporation. Mr. Pelchat asserted that, without his personal participation and involvement, the corporation would have no fair market value. He maintained that he could have taken all of the client base from the corporation and, because of this, the company had no value based on an earnings approach.

The Tax Court did not accept this argument. The Court said that accepting the Appellant's claims would be tantamount to accepting the principle that the parties to a transfer of property subject to the provisions of section 160 of the *Act* could agree upon a whole series of assumptions that would have the effect of considerably reducing or eliminating the fair market value of the transferred property. In the opinion of the Tax Court, this approach was contrary to the letter as well as the spirit of section 160.

The Court concluded that section 160 of the *Act* required a determination of the fair market value of the share based on the assumption that the business was being conducted in a normal, everyday business context. "Fair market value" required that the seller do everything possible to realize the highest price. This included the assumption of a non-competition clause.

The taxpayer retained a lawyer to testify in respect of the value of the share. The Tax Court noted that he had very little experience in valuations. He used a simplistic and undocumented approach which accepted, at face value, the information provided by Mr. Pelchat, an obviously interested party. His valuation was described by the Court as confusing, arbitrary, and based on erroneous information. The Court therefore did not accord any value or probative force to the lawyer's "utterly incredible" conclusions.

The Crown's expert witness was a valuator employed by the CRA. While the Tax Court considered her qualified, it commented on the fact that she was a long-term employee of the Crown and had worked on the valuation at the initial assessment stage. Being an employee of the CRA did not, in the Court's opinion, preclude her from testifying. However this factor required a very high quality report to avoid the possibility that the value conclusion on value was affected by her initial determination for the purpose of the assessment.

Mr. Justice Tardif of the Tax Court conclude that the CRA valuator's work was of better quality than that of the taxpayer's witness and she had submitted reliable work with a real concern for objectivity. However the cross-examination drew out some weaknesses and deficiencies in the CRA valuator's report. Therefore the Court modified her report to reflect adjustments based on the cross-examination evidence. The Court reduced the expert's earnings value to $128,304 and added the amount of the corporation's net assets for a total value of $138,596.

The taxpayer appealed the decision to the Federal Court of Appeal. Counsel for the taxpayer asked the Court to review and reverse the decision by the Tax Court on the basis that the Federal Court of Appeal accept the testimony of the expert witness called by the taxpayer rather than that of the Crown's expert witness.

Mr. Justice Létourneau of the Federal Court of Appeal stated that the Tax Court Justice was careful to give the reasons why he accepted the testimony of one witness rather than the other. He explained the strengths and weaknesses of each of the two expert reports submitted to him. He had the benefit of seeing and hearing the two expert witnesses and assessing their credibility. The Federal Court of Appeal was not willing to substitute its assessment of the credibility of these two expert witnesses for that of the Tax Court Justice. The Federal Court of Appeal considered that, apart from the credibility of the testimony by the two expert witnesses, the assessment of the credibility of the transferor was also at the heart of the matter in view of the circumstances surrounding the transfer. Here again, the Federal Court of Appeal chose not to interfere in the factual findings of the Tax Court Justice when questions of credibility were in issue.

Given the circumstances of a transfer between persons not dealing at arm's length, and in view of the Tax Court judge's conclusion that "the purpose and goal of the transfer of the share was indubitably to avoid payment of the tax debt", the Federal Court of Appeal concluded that the Tax Court had properly presumed the existence and presence of a non-competition clause, as if the transaction had been made between a seller wanting to sell at the best price and a buyer wanting to buy with the best possible guarantees. The Court concluded that the method used by the Tax Court Justice to arrive at the fair market value of the transferred share and the amount determined for that value were not vitiated by any palpable and overriding error that would warrant its intervention.

Klotz V. The Queen

Klotz v. The Queen D.T.C. 2236 (T.C.C.)
Affirmed by 2005 D.T.C. 5279 (F.C.A.)
Leave to appeal to S.C.C. denied with costs

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

Mr. Klotz claimed charitable donation deductions made as part of a "buy-low, donate-high" charitable donation arrangements. His case was heard by the Tax Court in 2004 and this decision was reviewed in the Valuation Law Review - Taxation, Volume 11, issue 2. Mr. Klotz was one of 660 taxpayers who purchased approximately 63,000 prints from promoters and claimed about $63,000,000 in deductible donation amounts. Their actual cost was about one-third of this amount. The difference between the purchase price of the prints and their claimed fair market values for donation purposes was supported by an expert opinion from an art appraiser.

Evidence presented at the Tax Court hearing showed that the promoters paid between US$5 and US$50 per print, sold them to investors at CN$300 per print, and gave the investors appraisals supporting a value of CN$1,000 per print. The main issue was the relevant "market" used for comparable purposes. The appraiser testifying as an expert in the art market used the price of individual prints sold at the retail level in New York and multiplied this by the number of prints being valued. The Tax Court did not accept this position and instead determined that the actual price the taxpayers had paid for the prints was their fair market value.

Mr. Klotz appealed the Tax Court decision to the Federal Court of Appeal. He argued that the Tax Court Justice made a legal error in refusing to find fair market value based on the retail market, specifically the sales of single prints by art galleries. Mr. Justice Sexton of the Federal Court of Appeal did not accept this argument. He stated that "fair market value" and how it is calculated are questions of fact. The determination of the appropriate market is part of determining fair market value and is a question of fact. The Court was unable to conclude that, in determining the fair market value of the prints, the Tax Court Justice made any error of law, or any palpable and overriding error in his findings of fact. Based on this the appeal was dismissed with costs.

Attorney General of Canada v. Nash, Quinn and Tolley

Barbara Quinn v. The Queen, 2004 DTC 3328 (Tax Court of Canada)

A.G. of Canada v. Nash et al. 2005 D.T.C. 5696 (F.C.A.)

Leave to appeal to S.C.C. denied with costs

This case was an appeal from a Tax Court decision (*Nash* 2004 D.T.C. 3360, 3328 and 3391). The Tax Court judgment was reviewed in Valuation Law Review - Taxation Volume 11, issue 2. The Tax Court found in favour of the taxpayers. The Court preferred the opinion evidence of the taxpayer's experts on the value of donated art prints over the argument advanced by the Crown that the value of the prints was the actual price paid for them. As in Klotz, the taxpayer's experts used the retail price of individual prints as a reference point in determining value. The Crown appealed this decision to the Federal Court of Appeal and was successful.

The issue was the identification of the relevant comparable market for the purpose of meeting the fair market value definition. There were two possible markets for comparable purposes, retail and wholesale. The trial judge's decision was reversed on appeal because he based his value conclusion on the wrong market and did not use the evidence from the market where sales of the property would normally be transacted. The decision was reversed on the palpable and overriding error standard.

Appeal courts review trial court decisions for errors in law. Valuation issues, once decided, legally become facts. Appeal courts give a high level of deference to the decisions of trial courts in the determination of facts. The standard was established by the Supreme Court of Canada in *Housen v. Nikolaisen*, [2002] 2 S.C.R. 235 (reviewed Valuation Law Review-Taxation, Volume 11, issue 2). It was the Supreme Court's conclusion in *Housen v. Nikolaisen* that appellate courts are not free to interfere with a factual conclusion of a trial court when the appellate court has a difference of opinion with the trial court over the weight to be assigned to the underlying facts. The Supreme Court set the standard of "palpable and overriding error" as the level of reviewable error necessary to allow an appeal on opinion based decisions. This is a high standard and accordingly reversals of trial level valuation decisions are rare.

In *Nash*, the Federal Court of Appeal first reviewed the facts put into evidence at the Tax Court hearing. CVI Management Inc. (CVI) had sold 483 groups of limited edition prints as part of an arrangement whereby CVI arranged for the subsequent donation of the prints to charitable organizations and provided appraisals supporting values approximately three times greater than the taxpayer's actual cost. The transactions between CVI and the taxpayers were done on an arm's length basis.

The Federal Court of Appeal reviewed the definition of "fair market value" established in *Henderson Estate v M.N.R.* 73 D.T.C. 5471:

[8] The well-accepted definition of fair market value is found in the decision of Cattanach J. in Henderson Estate and Bank of New York v. M.N.R. 73 D.T.C. 5471 at 5476:

The statute does not define the expression "fair market value", but the expression has been defined in many different ways depending generally on the subject matter which the person seeking to define it had in mind. I do not think it necessary to attempt an exact definition of the expression as used in the statute other than to say that the words must be construed in accordance with the common understanding of them. That common understanding I take to mean the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in a market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell.

The Federal Court of Appeal stated that this definition, through usage over some thirty years, has become the standard working definition of fair market value.

The Federal Court of Appeal considered the applicable standard of review to be the deferential standard of palpable and overriding error. The Court cited *Housen v. Nikolaisen* as the basis for this finding. The Court concluded that, while fair market value has been referred to as a question of fact, it is more accurate to say that fair market value is a determination of mixed fact and law (editor's emphasis). In a determination of mixed fact and law a legal standard must be applied to a set of facts and, in fair market value cases, the judge must apply the legally accepted definition of "fair market value" to the facts found from the evidence adduced before him.

The Federal Court of Appeal started its analysis of the Tax Court decision by commenting that the determination of "fair market value" typically depends at least in part on evidence of comparable transactions. However, to give effect to the Henderson definition, the comparables must be sound. The Federal Court of Appeal quoted the Tax Court Justice's understanding of fair market value as it applied to the evidence before him:

[12] The Tax Court Judge summarized the Henderson definition of fair market value and found that it had been applied by Ms. Tropper:

The meat of that definition (Henderson) is the highest price reasonably expected if an asset is sold in the normal method in the ordinary course of business in a market without undue stress composed of willing buyers and sellers. That describes precisely the mode of valuation made by Tropper. (the taxpayer's expert).

The evidence in the Tax Court case was that Ms. Tropper did not consider the purchase price of the prints as relevant to the determination of their fair market value. She stated that the relevant market for individual works of art was the retail market where the prints were sold in the ordinary course of business. She said that the financial planner market in which the taxpayers purchased their prints was

not open to the public. In particular, she said that *"one does not go to purchase artwork from one's financial planner"*. Ms. Tropper apparently concluded that the actual sales of the blocks of prints to the taxpayers did not reflect the relevant market in which to determine the fair market value of the prints.

The Federal Court of Appeal stated that it was fundamental to Ms. Tropper's analysis that the assets being valued were individual prints. She determined the value of the groups of prints being reviewed by aggregating the value of the individual prints in each group based on the individual print's claimed retail market price. The Federal Court of Appeal stated that Mr. Justice Bell of the Tax Court had approved of Ms. Tropper's method of valuation and therefore had agreed with her assumption that the fair market value of each group of prints was based on the sum of the values of the individual prints at the retail price level.

The Federal Court of Appeal disagreed with this conclusion. Mr. Justice Rothstein stated that the first step in applying the *Henderson* definition was the accurate determination of the asset being valued. The evidence before the Tax Court Justice was that CVI sold only groups of prints and that it arranged for the donations of groups of prints. The donating taxpayers acquired their prints only in predetermined groups. There was no evidence of individual prints being either sold or donated. Therefore, the relevant asset being valued was the groups of prints and not the individual prints in the group. The Court therefore considered it wrong to assume, as did Ms. Tropper and the Tax Court Justice, that the fair market value of a group of items was the sum of the price that could be realized for each individual item. While this might be so in some cases, it is necessary to carefully consider the circumstances in which the groups are being acquired and disposed of in order to make that determination.

The Federal Court of Appeal further responded that, if the evidence was that groups of prints were not sold in the same market as individual prints, the value of the groups should not be based on the retail prices of individual prints. The Court said that the individual unit prices of items sold in large volume on the wholesale market are less than individual prices on the retail market. If this were not the case, wholesalers would sell at retail prices. The Court compared the prints to the sale of a one-time disposition of a group of paintings. In the absence of a market for the sale of large groups of paintings, the ordinary retail market for individual paintings might be considered a proxy. However, it would still be necessary to determine whether any adjustment need be made to account for the disposition of the group. For example, a blockage or volume discount may apply to take into account of the depressive effect on the retail market price caused by the availability of the large number of paintings at one time. Based on this analysis the Court concluded:

[24] When a court is required to determine the fair market value of an asset for which there is no market that permits a direct comparison, it may be necessary to consider the transactions in some other market, subject to such adjustments as may be appropriate to the case, such as a blockage or volume discount. But where there is a market in which assets of the description of the asset being valued are traded, there is no need for the use of a proxy.

[25] In this case, there was a market in which the specific groups of prints were traded. In 1997, CVI sold 35 out of 35 available groups, in 1998, 150 out of 155 available groups and in 1999, 298 out of 300 available groups. These sales indicate that there was a market for the specific groups of prints. Indeed, almost all the groups CVI had available for sale were sold. This was CVI's normal course of business. CVI and the taxpayers were dealing with each other at arm's length. There was no compulsion. CVI freely sold the groups and the taxpayers freely bought them. Contrary to Ms. Tropper's assertion, there was no evidence the market was not open. Approximately 480 transactions occurred over a three year period. There was no evidence of any qualification necessary to acquire prints from CVI or to donate them to the charities or universities.

In the Federal Court of Appeal's opinion, had the taxpayers sold their groups of prints rather than donating them, the most they could have expected to realize was their original purchase price. If they had demanded a higher price, a purchaser could have bought from CVI instead. Therefore CVI's price was the highest price that each group of prints could be expected to bring. The Court said:

[27] If Ms. Tropper's appraised values were the fair market values of the groups as the judge determined, the obvious question is why CVI did not sell for those prices. CVI dealt with the taxpayers at arm's length. It would make no sense for CVI to offer to sell to the taxpayers at one-third of the fair market value, if indeed, the fair market value was as determined by Ms. Tropper and the judge.

[30] In the present appeals, Ms. Tropper ignored the prices paid for the groups of prints. In doing so, she failed to take account of the most probative evidence of the fair market value of the groups.

The Federal Court of Appeal therefore determined that Mr. Justice Bell had made two palpable and overriding errors in arriving at his decision. Firstly he had accepted Ms. Tropper's opinion evidence based on the retail market for individual prints when there was a normal market for the group of prints, the specific property he was required to value. The second was to find the fair market value of the property to be approximately three times the amount paid for the property with no creditable explanation for the apparent three-fold increase. The appeal was allowed with costs and the reassessments were remitted to the Minister for reassement on the basis that the fair market value of the groups of prints were the actual prices that CVI had obtained in selling groups of prints to the taxpayers.

Because of the similarity of facts in this case and Klotz, the Federal Court of Appeal found it instructive to consider the analysis of Bowman A.C.J. (as he then was) in Klotz. That decision had been earlier reviewed and upheld by the Federal Court of Appeal. The Federal Court of Appeal cited, with approval, the following paragraph from Klozt:

> *46 The respondent's approach is in my view more realistic. Mr. Alasko described the sale to the appellant by Curated as a wholesale or bulk transaction. No doubt the respondent would have preferred to have him say it was a retail sale but in the final analysis it does not really matter what one calls it. It is what it is. It was a sale of 250 prints for $75,000 between two arm's length parties. The gift was a virtually contemporaneous disposition of the same 250 prints. What better evidence is there of what the 250 prints were worth at that time? Why chase the will o' the wisp of an elusive and largely hypothetical fmv through the trendy up scale art galleries of New York and ignore the best evidence that is right there before your very nose? The problem with the claim here, whereby property is acquired for $5 to $50, sold to the appellant for $300 and claimed to have a fmv two days later of $1,000, is that it is devoid of common sense and out of touch with ordinary commercial reality.*

The Federal Court of Appeal stated that the logic used in the *Klotz* decision, although colourfully expressed, was self-evident.

Leave to appeal to the Supreme Court of Canada has been denied.

Maréchal v The Queen

Maréchal v. The Queen 2004 D.T.C. 3227 (T.C.C.)
affirmed by 2005 D.T.C. 5223 (F.C.A.)

The amount of tax at issue in this case was trivial. However the Tax Court concluded that the case raised important questions of principle that went beyond the monetary amounts involved.

The issue was whether to base the fair market value of artwork on opinion evidence or the original cost. The Court's decision was based on a modified cost basis.

The issue was the fair market value, on November 10, 2000, of a ceramic sculpture created by the Quebec sculptor, Louis Archambault, which the taxpayer had donated to the Montreal Museum of Fine Arts. The taxpayer had acquired the sculpture in December 1999 for $1,719. The Canadian Cultural Property Export Review Board (the Board) determined the fair market value to be $5,000. The taxpayer contended that the value was $8,000. This $3,000 difference of opinion was the subject of the review at the Tax Court hearing.

The taxpayer, relying upon a definition of "fair market value" which includes the phrase "the highest price" which a willing and knowledgeable vendor and purchaser would agree upon, initially argued that his value should be chosen because it was the highest of the two values under review ($8,100 vs. $5,000). The Tax Court disposed of this point by commenting that, when faced with several different figures, it does not fulfill that obligation by picking the highest number. It is not bound by any valuation and is not obliged to choose any valuation supported by either side. Chief Justice Bowman stated that the Tax Court's obligation and role is to do the best job it can to arrive at a "true" value. This may involve rejecting all valuations, or taking material from some or all of them and arriving at a conclusion that differs from all of the valuations. It is not a mechanical process but is one that requires the Court to weigh all of the material before it and apply the best judgment it can to arrive at a correct result.

The taxpayer entered two appraisals into evidence. The Crown objected to their entry because the experts who had prepared the reports were not in court to face cross-examination. The Court chose to exercise its discretion to permit the taxpayer to put them in evidence because the taxpayer was self-represented and the amount of money at issue was not large. It was the Tax Court's position that self-represented litigants are entitled to expect that they will be given every opportunity to put their case in as fully as possible without being impeded with technical and evidentiary obstacles.

Both of the taxpayer's appraisals were done on the basis of comparable sales. However, given the limited amount of contemporaneous sales of ceramic works by Quebec sculptors, the appraisers had to make very significant assumptions in respect of the adjustments from the chosen comparables.

The expert witness called by the Crown concluded that the value of the work was, at a maximum, $3,500. She started from the price paid by the taxpayer for the sculpture in 1999 and added what she described as a "fluctuation factor of the open market" to arrive at a value of $3,500. The Court said in respect of this method:

[23 Ms. Millar starts from the price paid by the appellant for the sculpture in 1999 (which is either $1,300 or $1,719 depending upon whether one adds the taxes and commission) and adds what she describes as a "fluctuation factor of the open market" to arrive at a value of $3,500. Such an adjustment may be seen as arbitrary and I daresay it is in some measure. One cannot entirely escape an element of arbitrariness in valuing artistic works. Nonetheless, what one person may call arbitrariness, someone else may call informed discretion and someone else may call judgement based on experience. It depends on who is making the call.

The Crown's counsel referred to a number of prior Tax Court cases, including *Aikman et al. v. The Queen*, 2000 DTC 1874 and *Klotz v. The Queen*, 2004 T.C.C. 147. The Tax Court said that the approach used in those cases was a very useful starting point in valuing what was paid for property in the absence of reliable market comparables. The Tax Court, in reviewing the Crown's appraisal, stated that the Crown's expert report was a thorough and careful analysis of the problem of determining for Canadian tax purposes the value of works of art that are donated to art galleries. Chief Justice Bowman quoted a portion of the report with which he said he was in complete agreement:

[17] Ms. Millar's expert report is a thorough and careful analysis of the problem of determining for Canadian tax purposes the value of works of art that are donated to art galleries. Although all of her observations probably merit reproduction I shall set out one paragraph in particular with which I am in complete agreement.

> *19. Therefore, in my opinion, the best evidence of true "fair market value" is the price the donor paid for the work in conjunction with a certain appreciation factor depending on the fluctuation of the open market. This removes the problem of "artificially inflated evaluations" that are in excess of the price at which the work was actually bought. The only way an elevated price can be justified following a "bargain purchase" is if at the same time of the donation, a similar work is sold by an established gallery/dealer (or other appropriate market including auction) at the established higher price and reliable invoices made available.*

The Tax Court's conclusion was:

[24] Ms. Millar (the Crown's expert), an experienced art expert, has taken the price paid in 1999 and has arrived at a value that is approximately double that a year later. The Board has trebled or quadrupled it and the appraisers Devlin and Blais have quintupled or sextupled the original cost depending upon what figure one starts with. I do not think that the reports of Devlin and Blais contain within themselves the type of evidence that would justify the conclusion that this work of art has appreciated in value by 500 percent. It may be that so dramatic an increase is theoretically possible in extraordinary circumstances but in the real world it seems highly improbable and it has not been established here.

[25] In the result it has not been shown that the value of the sculpture is greater than the figure of $5,000 determined by the Board. The appeal is therefore dismissed.

The taxpayer appealed to the Federal Court of Appeal which upheld the Tax Court decision. Mr. Justice Noël of the Federal Court of Appeal concluded that the Tax Court had not made any reviewable errors and concurred with the Tax Court's position that the best indication of value was the price paid for the property increased by an arbitrary multiple of three.

Morley v. The Queen

Morley v. The Queen 2004 D.T.C. 2604 (T.C.C.)
Additional reasons at 2004 D.T.C. 3567 (T.C.C.)

The Tax Court, on the basis of hindsight, determined that the debt component of a software purchase price was a sham. After a review of the discounted cash flow valuations prepared by both parties the Court allowed the taxpayers a fair market value for the software at issue based only the cash component of the purchase price. The cash portion comprised less than 8% of the total claimed fair market value.

The issue in this case was the value of rights to exploit software. These were purchased in December 1993 by the Agensys Limited Partnership (the Partnership) for a price of $12,150,000. The purchase price was satisfied with $960,000 in cash and an $11,540,000 Acquisition Note. The Partnership purchased the rights to exploit the software in Canada.

Eleven other partnerships were created to sell the software rights elsewhere in the world. In total the rights owned by these various partnerships were assigned a gross value of $228,650,000. The majority of the units in these partnerships were never sold. In total, these twelve partnerships raised $69,000,000, of which $13,000,000 was paid in cash. The vendor of all of the various software rights was Agensys Corporation (Agensys), a Turks and Caicos Islands company.

The Acquisition Note bore simple interest at bank prime plus ½%. Interest was accrued until December 20, 2002 at which time the accrued interest was to be capitalized into the outstanding debt. Subsequent interest was to be paid quarterly. Principal repayments were to commence on a quarterly basis commencing March 20, 1994. Principal payments prior to December 20, 2002 were to be limited to 50% of "net distributable partnership cash". As of the March 20, 2003 quarterly payment date, all principal repayments were to be made on a quarterly basis regardless of the Partnership's cash position. The loan was to be paid in full by December 20, 2012.

The Partnership signed an Acquisition Agreement with Agensys which required Agensys to undertake various responsibilities to develop the software to a marketable condition and to continue developing the software to keep it competitive. The software was a complex information management system which was not fully functional at the time of the purchase and was still not commercially functional when the Partnership collapsed in 1998.

There were two relevant valuation issues. The first was whether the value of the consideration paid for the software was, at most, the $960,000 cash component of the purchase price. It was the Crown's position that the Acquisition Note never constituted a legal liability of the partners and that there was never any intent by any of the parties that either the principal or accrued interest would ever be paid. The second issue was the fair market value of the software. These two issues will be considered separately.

Validity of the Acquisition Note

Based strictly on the terms of the Acquisition Note the debt was full recourse with a reasonable commercial rate of interest. According to the documentation the partners were legally bound by the terms of the Acquisition Note. At trial the taxpayer's representative argued that the documentary evidence constituted a prima facie case that the software purchase was for $12,150,000 because the Software Acquisition Agreement, which contained the terms of the note, constituted the whole agreement between the parties and there were no secret covenants not to honour the note. However, after a review of the events subsequent to the subject software purchase date, Mr. Justice Archambault of the Tax Court concluded:

[63] On a balance of probabilities, considering all the evidence introduced before me, I come to the conclusion that Agensys T&C and the Partnership never intended to create a legal liability under the Acquisition Note and that the former never intended to collect on the Acquisition Note and the Subscription Notes which were assigned to it. The Acquisition Note, and the Subscription Notes which replaced it, can be described as a sham. They do not reflect the "actual legal rights and obligations (if any) which the parties intend[ed] to create." I believe that the price paid for the Software is limited to $960,000, being the amount of money actually transferred to Agensys T&C in December 1993.

The two principal reasons given for this conclusion were that the partners never made any payments on the notes and the fair market value of the software, as determined by the Court, did not exceed $960,000.

The taxpayer testified that there had been no payment on the note because all of the various software partnerships had been wound up into Agensys International (International), a Turks and Caicos Island corporation, in January 1997. The partners received International shares in exchange for their partnership units. As part of this transaction the terms of the various Acquisition Agreements were changed by modifying Agensys' recourse for non-payment on the Acquisition Notes. In the case of default, Agensys was limited to seizing the International shares that had been issued to the various partners on the windup. The taxpayer claimed that the windup into International had been done as part of a settlement of a legal dispute.

The Tax Court was extremely sceptical that a legal dispute had ever actually existed. It purportedly arose from Agensys' failure to provide the software development services as stipulated in the Acquisition Agreement. These services were only to be provided at such time as the Partnership made a "written request" for them. There was no evidence entered in Tax Court to show that the Partnership had ever made such a request. Nor was there any evidence of any negotiations or discussions with respect to a legal dispute prior to a 1996 court filing. This occurred on September 23, 1996 when all twelve partnerships had filed a Notice of Action in the Ontario Court of Justice. The notice claimed damages of $155,000,000 for alleged breaches of the Acquisition Agreements. The filing of the Notice of Action was the only legal step taken in the entire dispute.

The Tax Court made an exhaustive review of the events from the signing of the Acquisition Agreement in 1993 to the alleged dispute in 1996 and concluded that a breach, if it had indeed occurred, had taken place in March 1995. However none of the parties took any action with respect to any breach until the September 1996 filing, a year and a half later. The Court was suspicious of the speed at which the alleged dispute was resolved. A settlement agreement had been negotiated within ten days of the filing of the Notice of Action. A signed settlement was made 38 days after the notice of action. The settlement effectively forgave all of the various partnership notes by modifying their terms and changing them from full recourse notes to limited recourse notes. This included the waiving of all accrued and future interest. The partners purchased, for apparently a nominal price, shares of International. Agensys, the note holder, relinquished its right to demand repayment from the partners and, instead, limited its possible recourse to the shares of International held by the partners. In addition Agensys transferred all rights to all of the software not yet held by any of the partnerships into International for $1. Mr. Justice Archambault of the Tax Court concluded:

[95] In my view, no such serious breaches existed because I believe that there was no serious undertaking to provide the Support Software. Given that the Software lacked at the time of its purchase so many of the functionalities that made it so singular and attractive, one would have expected the purchaser to require that the vendor provide all the Support Software according to an agreed delivery schedule. Here, the parties only stipulated that the Support Software was to be supplied on "written request" by the Partnership and no such written request was ever made!

[103] . . . It should be recalled that Agensys T&C's Operational Plan attached to the February 8, 1995, Batton Memo shows a value of approximately $95 million just for the U.S. rights of the Software. The total price contemplated aggregated more than $228 million. So the transfer for $1 of Agensys T&C's residual world rights to the Software and Kammand does not make any sense. The whole thing is just unreal. It has no commercial reality!

[106] To me, this whole dispute saga does not make any sense. I draw two conclusions from the evidence on the dispute and the settlement. First, I do not believe that Mr. Gamble, as the controlling partner with respect to the affairs of the Partnership and as one who had made a substantial investment as a limited partner, and Agensys T&C ever intended that Agensys T&C be required to deliver the Support Software to the

Partnership and to launch a national marketing campaign. In addition, there was established no serious breach that would justify the claim for $155 million, the legal action and the subsequent settlement. I believe rather that the lawsuit represents window dressing intended to support a conversion of the general recourse Subscription Notes into limited recourse notes and the waiver of interest.

Valuation Review

The Tax Court's review of the valuation evidence supported its conclusion in respect of the value of the consideration paid through the Acquisition Note. The Taxpayer had entered a valuation report in evidence by an individual knowledgeable in the software industry but who had no accounting or valuation credentials. His valuation report confirmed a fair market value of $14,300,000 for the Canadian rights to the software based on a discounted cash flow calculation. The Crown objected to the filing of the report because, in its view, the witness was not qualified to give expert evidence. The main reason for this position was that the witness was not a chartered business valuator, a chartered financial analyst or a chartered accountant. The Court decided to allow the valuation into evidence and to let the witness testify after the taxpayer's counsel had suggested that the Court defer its decision on the report's admissibility until after it had heard the testimony of the taxpayer's witness. The Court's final conclusion on the report was that the witness should not be recognized as an expert, mainly because of his lack of certification in the field in question. The Court was also far from convinced that he had carried out a thorough evaluation.

The taxpayer's valuator first determined a ten year cash flow based on his "best guess as to what was reasonable." Once a net cash flow had been estimated for the ten-year period, the valuator determined what would be a proper discount rate for calculating the net present value of the future cash flow. He used a 20% discount rate, which represented slightly more than twice the average rate of interest then being paid on five-year government-insured mortgages.

The residual value at the end of the assumed ten year cash flow period was a critical issue since it comprised about 75% of the taxpayer's total calculated value. The Tax Court rejected the entire residual value calculation with the comment:

[113] Mr. Pritchard then computed the residual or terminal value of the Software at

the end of the ten-year period. In order to establish that value, he decided to use the net cash flow generated in the tenth year and determined that this would represent a maintainable cash flow for the future, in perpetuity. He then applied to that maintainable net cash flow a multiple of 20. This multiple was less than the average price earnings ratio for the Standard & Poor's 500 Index of just over 23 in 1993. The value of the future cash flow starting in the eleventh year represented a substantial amount: $11,186,465 out of the value of $14,875,196 determined for the Software, or approximately 75.2% of that value!

[125] In addition, I find it difficult to give much residual value to a software that was purchased by a team that did not have the in-house know-how to build and develop it and was dependent upon a non-resident corporation established in the Turks and Caicos Islands without any employee for ensuring its development. Likewise, consideration has to be given to the fact that the Software was facing competition from well-established companies marketing established software. The Canadian market for programming software such as the Software was, at that time, a crowded market. In my view, it would have been very difficult for a new company with a new software to establish itself in that market and to compete in it against competitors with strong financial backing. The likelihood of there being any residual value after ten years was very slim. The history of software is full of cases of good software that could not survive more than a few years.

The Tax Court was also critical of the taxpayer's projected cash flows. The Court noted that the projections relied on a business plan which had been abandoned very shortly after the valuation date. The taxpayer's valuation assumed the bulk of the sales would be to large and mid-sized enterprises, mainly government. However, because of technical limitations, the Tax Court determined the software was not suitable for this intended use. The Tax Court stated:

[124] So it is quite appalling to find out that, in Mr. Pritchard's projections, 80% of the sales projected by him for 1994 and 1995 are shown as coming from mainframe accounts (government and other) and mid-range accounts (government and other). Needless to say, this does little for the credibility to Mr. Pritchard's work.

Based on these reasons the Tax Court rejected the taxpayer's valuation.

The Crown also entered opinion evidence through a valuator who was accepted as an expert by the Court. One reason that the Tax Court had allowed the taxpayer's valuator to testify was that the Crown's expert had relied on some of the projections prepared by the taxpayer's valuator. The Crown's valuation was in a range of $900,000 to $2,100,000 with a mid point value of $1,500,000. This value was also based on a discounted cash flow calculation. While the Court was in general agreement with the Crown's valuator it concluded that he was too optimistic and, after making adjustments, concluded that the software value fell into a range of $548,000 to $1,135,000. The cash portion of the purchase price paid by the Partnership for the software was $960,000. Since this amount was within the range determined by the Court this was chosen as the fair market value.

While the Tax Court allowed the Partnership the cash portion of the software purchase price, this was not the amount of the total cash investment made by the partners. The partners had actually invested $1,984,750 in their partnership units. The Crown had offered this as a settlement amount just prior to trial but this was rejected by the taxpayers who made a counter-offer of $9,000,000. The Court, stating that "the gamble taken by the appellant in prosecuting his appeal turned out to be a very bad decision" awarded the Crown costs for the valuation portion of the appeal. The Court said that the failure of the taxpayer to accept the Crown's settlement offer resulted in a three week trial which determined a value less than half of the Crown's proposed settlement amount.

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