THE VALUATION LAW REVIEW

Volume 17, Issue 2
September 2011

Taxation Decisions and Legislative and Administrative Developments

The Valuation Law Review is a publication of the Canadian Institute of Chartered Business Valuators. 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.

Editor:
Dennis Turnbull, CBV

For subscription information please contact:

The Canadian Institute of
Chartered Business Valuators
277 Wellington Street West, 7th Floor
Toronto, Ontario M5V 3H2
Telephone: (416) 977-1117
E-mail: admin@cicbv.ca

THE CANADIAN INSTITUTE of
CHARTERED
BUSINESS
VALUATORS™

assets on the basis that no goodwill exists in a regulated industry. The Appellant argued that the allocation was the result of arm's length hard bargaining. The Tax Court largely agreed with the Appellant's position and allowed a goodwill amount of $140,000,000.

Page 24

Husky Oil Ltd. v. The Queen

2010 FCA 125

This was an appeal from the decision of the Tax Court in Husky Oil Ltd. v. The Queen (reviewed in the prior edition of the VLR-Taxation). Amongst other issues the Tax Court had been asked to determine the fair market value of 15,500,001 preferred shares issued by Mohawk Lubricants Ltd. on July 8, 1998 as part of an amalgamation. It was the Crown's position that these shares had a fair market value of $15,500,000. The Tax Court agreed with the Crown's position and dismissed the appeal. The taxpayer did not raise the valuation issue on appeal to the FCA but instead argued that the anti-gifting rule in subsection 87(4) did not apply to the transactions under review. After an analysis the FCA agreed with this position, allowed the appeal, and set aside the judgment of the Tax Court.

Page 25

Glaxosmithkline Inc. v. The Queen

2010 FCA 201

This was an appeal from the decision of the Tax Court in Glaxosmithkline Inc. v. The Queen (reviewed in the prior edition of the VLR-Taxation). The taxpayer had been reassessed with respect to the claimed failure to withhold tax on dividends deemed to have been paid to its non-resident parent. The Crown claimed that the taxpayer had paid an excessive price to a non-arm's length party for ranitidine, a pharmaceutical ingredient in a drug produced and marketed by the taxpayer. At Tax Court the Crown argued that the fair market value of the ranitidine was the amount paid for Canadian generic equivalents in arm's length transactions. The Tax Court agreed with the Crown's position subject to a minor adjustment. At the FCA the taxpayer argued that the Tax Court erred by relying on a mistaken interpretation of the term "reasonable amount". The FCA allowed the appeal. Rather than deciding on a price for the ranitidine the FCA returned the case to the Tax Court Judge for rehearing and reconsideration based on the FCA findings. On March 24, 2011, the Supreme Court of Canada granted the Crown Leave to Appeal and allowed the taxpayer's cross-appeal.

Valuation Based Charitable Donations

Past editions of this publication have reviewed artwork donation cases in which the claimed values for original artwork or limited edition prints were supported by appraisal opinions. The Courts allowed taxpayers, at most, only their actual cash purchase price. However, as noted in an editorial in Valuation Law Review — Taxation Volume 11, Issue 2, March 2005, the artwork cases were only one variant of numerous valuation-based donation cases then under assessment review or appeal. In that edition we commented that:

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.

Some of these other cases are now being heard by the Tax Court. This edition of the VLR-Taxation reviews *Lockie v. The Queen,* a charitable donation tax shelter case which involved the fair market values of various sundry items such as gel pens, toothbrushes and school packs. Since this was the first donation tax shelter decision which involved tangible property other than artwork it was of interest to see how the Tax Court's analysis would compare to that of the artwork decisions. The Tax Court concluded that the fair market value of the items was their actual cost to the taxpayer, the same position the court had taken in the past with the artwork decisions.

There are numerous other examples of failed valuation-based donation arrangements which have been disallowed by the CRA. The Millennium Charitable Foundation, at one time a qualified donee for tax purposes, issued in excess of $169 million in receipts for cash and property received through its tax shelter arrangement. In this program participants who donated cash to Millennium were given, as the purported beneficiaries of a trust, computer software with a stated value of three to five times the amounts of the cash donations. This software was donated to International Charity Association Network, another qualified donee. The CRA concluded that the donors never owned the software and so could not have donated it to the charity. As a secondary position the CRA held that the software had no fair market value. Based on this the CRA denied the full charitable donation tax credits claimed by participants. The CRA disallowance letters stated that there was a lack of donative intent on the part of donors/participants. The primary motivation of donors was not to enrich charities and assist in fundraising, but to make a profit from the tax credits obtained. The Canada Revenue Agency revoked the charitable registration of the Millennium Charitable Foundation effective January 10, 2009.

The Canadian Humanitarian Trust (CHT) Donation Program involved the donation of pharmaceuticals to third world countries. The Participants in the program made a cash charitable donation and also applied to become capital beneficiaries of a trust. They received a capital distribution from the trust in the form of pharmaceuticals purchased

in bulk by the trust in foreign markets. These pharmaceuticals were then also donated to a registered charity and participants in the program received two charitable tax receipts, one for their cash donation and the other for the claimed fair market value of the pharmaceuticals. This value was apparently based on the Ontario health ministry's wholesale price for the same drugs.

The CRA reassessed all of the individuals who had participated in the CHT Donation Program denying their entire claimed charitable deductions on the basis that there was no donative intent. Internet reports indicate that approximately 25,000 Canadians participated in the CHT Donation Program.

The weakness of these donation in kind arrangements was that they could fail because they relied on subjective opinions of value which had no discernable relationship to the actual price the taxpayers or the program promoters had just paid for the donated property. The scheme employed in *Maréchaux* (reviewed in this edition), avoided the problem of the valuation of the donated property by involving only cash donations. The tax advantage in this scheme lay in the donors personally paying only 30% of their total donation amounts. The remaining 70% of the donations were financed by a third-party through 20 year interest-free loans with no principal repayment until the end of the term. The Tax Court dismissed the *Maréchaux* appeal on the basis of both law and value. This decision was upheld by the Federal Court of Appeal. Mr. Maréchaux sought Leave to Appeal to the Supreme Court of Canada. This was dismissed with costs on June 9, 2011.

Maréchaux is a significant case because it is the first of a number of appeals involving the "levered donation" schemes which used interest-free loans to enhance claimed donation amounts. The determining legal principle in the *Maréchaux* decision, that there was no gift and therefore no charitable donation, might well be applicable to all of the levered donation schemes currently under appeal. These donation programs can involve very large amounts of tax. While Mr. Maréchaux personally claimed only a $100,000 donation amount he was the lead Appellant for a group of taxpayers in the same scheme who, in a three year period, claimed total charitable donations of about $218,000,000.

A similar program was offered by the Ideas Canada Foundation which appears to have involved both interest-free loans and a valuation component. In this plan individuals indirectly donated cash to the Canadian Art Gallery. The donation included both the donor's own money and funds provided through a 25 year interest-free loan. Under the terms of the donation arrangement the art gallery was required to use the funds to purchase twelve bronze sculptures for USD$108,840,000. The CRA determined that the sculptures had been sold for USD$6,000,000 in an arm's length transaction just prior to their purchase by the Canadian Art Gallery. The CRA subsequently held that the fair market value of the bronzes was only $6,000,000 and that the inflated price paid by the art gallery was used to support a circular transfer of funds to provide the interest-free loan financing. The CRA apparently reassessed all of the participants in this program denying them any charitable donation amounts.

Tax Donation Fallout

There have been significant repercussions from the failure of the valuation-based charitable donation tax shelters to have their value claims accepted by the CRA or sustained by the courts. Taxpayers are looking to their advisers and to legal and accounting firms for compensation for their disallowed donations.

There are two non-tax cases reviewed in this edition. In *Lemberg et al. v. Perri*s the plaintiffs were spouses who purchased artwork for donation on the advice of their accountant. They claimed a deduction well in excess of their actual cash price based on appraisal amounts, however the Tax Court allowed them only their cash payment. The plaintiffs later found out that their accountant had received an undisclosed commission for persuading them to become involved in the program and they sued him, and won, for breach of fiduciary duties.

The second case is a decision of the Ontario Superior Court. *Innovative Gifting Inc. v. House of the Good Shepherd et al.*, involving the donation of cash and supposedly valuable shares. The scheme involved a claimed non-resident Swiss philanthropist who would give shares to Canadian donors who would then gift the shares, and cash, to charities. The charities were to issue tax receipts for five or six times the amount of the cash donations based on the promoter's assurances that the donated shares were worth at least four times the amount of the cash donations. The few shares involved turned out to be worthless. Innovative Gifting brought applications for payment of the unpaid commissions. The charities responded by seeking the return of all commissions paid. The court dismissed Innovative Gifting's Application and granted the charities' counter-applications on the basis that the agreements entered into between Innovative Gifting and the charities were void for being contrary to public policy.

Another consequence of the CRA's disallowance of tax credits for donations made through these tax shelters is the ongoing attempts at class action litigation by taxpayers suing the professional firms that gave the legal opinions in respect to the shelters.

On September 18, 2008, a class action was launched seeking $60,000,000 in damages on behalf of all investors in the Donations Canada Charitable Donation program, a program sold and marketed by Parklane Financial Group Limited. Donors were told that for each $250 cash donation they would receive a $1,000 donation receipt allowing them a tax credit of $464 for a claimed 86% return on their $250 investment. The $750 difference between their cash payment and the amount of the donation receipt was based on a purported assignment of a $750 beneficial interest in a trust to a charity on behalf of the donor. All of the claimed donations made under this program, including the cash portions, were disallowed by the Canada Revenue Agency on the basis that the taxpayers had not made a *bona fide* gift. The motion for certification of this action as a class proceeding is scheduled to proceed on August 22-25, 2011. On August 10, 2009, the Canada Revenue Agency revoked the charitable status of Funds for Canada Foundation, the charity involved with the Donations Canada program.

One of the defendants in this proposed class action is the national law firm that prepared the legal opinions on the validity of the program under Canadian tax law.

The class action Statement of Claim argued that the opinion letters and comfort letters produced by the firm were necessary inducements to the promotion and sale of the gift program, had it not been for these documents the gift program would not have been launched. The opinion letters were designed to induce the proposed class of plaintiffs to invest in the gift program without disclosing all of the material risks involved. It was claimed that the firm issued the opinion and comfort letters without due care and consideration when they knew, or ought to have known, that the contents of these letters were inaccurate, untrue, and deceptive.

On April 15, 2009, another class action lawsuit was launched against a Toronto-based law firm. This was with respect to a legal opinion prepared in support of a timeshare program operated and promoted by the Athletic Trust of Canada. The proposed class action is in respect to participants who received timeshare weeks from the Athletic Trust and donated them, along with a cash donation, to registered Canadian amateur athletic organizations. The participants were issued charitable donation receipts for both their cash contribution and the claimed fair market value of the timeshare units. The CRA disallowed the timeshare portion of the donations. The statement of claim alleged that, among other things, the legal opinions prepared by the firm did not meet the appropriate standard of care and contained various expressed and implied misrepresentations. The law firm is the only defendant in this case.

On January 21, 2010, the Ontario Superior Court of Justice certified a class action lawsuit in respect to damages against the promoters of the Banyan Tree tax donation program. The class action also includes a claim for damages against a national law firm that gave opinion letters stating that the Banyan Tree program complied with applicable Canadian tax rules for charitable donations. The plaintiffs alleged that the legal opinions were a necessary prerequisite for the promotion and sale of the gift program without which the gift program could not have been launched and that the law firm that prepared them intended participants to rely on the the accuracy and reliability of the opinions in deciding whether or not to participate in the gift program. The plaintiffs claimed that the law firm owed the donation program participants a duty of care and that it was negligent in the preparation of the opinions.

In allowing the class action certification the court found that the class proceeding might achieve:

> *"behavior modification by holding corporations and law firms accountable for the promotion of allegedly sham investments and facilitates access to justice for litigants who would not bring individual claims".*

Approximately 3,000 individuals had participated in the Banyan Tree Foundation Gift Program charitable donation arrangement between 2003 and 2007. The promotional and marketing material in support of the program indicated that for each $1,000 donation a participant would contribute only $273 in actual out-of-pocket cash and would receive a charitable donation tax credit of $464 resulting in a net benefit of $191. All of the claimed donations under this plan were disallowed by the Canada Revenue Agency. Effective September 20, 2008, the Canada Revenue Agency revoked the registered charity status of The Banyan Tree Foundation.

The March 15, 2011, edition of the National Post reported yet another class action certification attempt. The proposed class action seeks more than $300 million in

damages due to a failed donation tax shelter called "Donation Program for Medical Science and Technology". The defendants include a national law firm and a national accounting firm. The program, set up by a Toronto-based company called Trinity Capital Corp., was designed to fund charitable donations using long term interest-free debt. Taxpayers would put only a portion of their own money into the scheme, but claim a tax deduction based on the sum of both their own donations plus any borrowed amounts. This is the same scheme litigated at the Tax Court and the Federal Court of Appeal in the test case *Maréchaux v. The Queen* (reviewed in this issue of the Valuation Law Review). The taxpayers in *Maréchaux* lost at both levels of court.

The End of the Yellow Brick Road? The Class A Voting Non-Participating, Class B Non-Voting Participating Share Structure — Part 3

The previous two editions of this publication included editorials about the ongoing debate regarding the valuation of voting non-participating shares. The last editorial concluded with the comment:

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

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

The CRA has finally come up with a position on the issue although it has done so in a decidedly informal manner. On December 17, 2009, the Canadian Tax Foundation released Tax Topics Number 1971-72. This publication reviewed the annual Roundtable question and answer session held with the CRA during the Canadian Tax Foundation Conference in November 2009. One question related to the CRA's position on the valuation of voting non-participating shares. The CRA's response, as the Tax Topics related it, was:

Skinny Voting Shares

The CRA was asked for its view on the valuation of skinny voting shares (a separate class of shares that have no right to dividends or proceeds on windup but which give the holder voting control). In two Vancouver cases, the CRA had assessed a premium on the value of a company's skinny voting shares (Lacterman v. The Queen, 2009-498(IT)G and 2009-495(IT)G and Dustan v. The Queen, 2009-1152(IT)G — both cases have been discontinued). Further, at the 2009 British Columbia Tax Conference, the CRA stated its view that non-participating controlling shares have some value and

may therefore command a premium. Of course, as part of a typical estate freeze, over time the freezor's freeze shares are redeemed and the freezor is left with only the skinny voting shares. The CRA stated that, as a matter of fact, the skinny voting shares probably have some value that would generate a premium. However, the CRA stated that it will ''play along'' with the view that the skinny voting shares have no premium value. The CRA referred to the classic movie The Wizard of Oz and stated that if the taxpayer never pulls back the curtain to reveal the Wizard (i.e. a value of the skinny voting shares) then the CRA will proceed on the basis that the shares have no value. However, if the taxpayer pulls back the curtain to reveal the value of the voting shares (i.e. if the value of the shares is demonstrated in a legal proceeding or on a sale for proceeds), then the CRA will assess on that basis.

The CRA's Roundtable answer appears to indicate that the Agency will allow "business as usual" in respect to the valuation of voting non-participating shares utilized in standard rollover and family estate planning transactions. Regardless of any internal CRA opinion to the contrary the Agency will apparently allow these voting shares to be allocated a nil value. However if the shares are given a significant value for any purpose then it appears that the CRA reserves the right to review the transaction without reference to a nil value policy. While it is difficult to make any firm comment on such a vaguely stated position it seems that the CRA has decided to allow tax practitioners to continue employing these shares for tax planning purposes as they have in the past and will not challenge estate freeze or other family succession planning transactions which rely on nil value allocations for voting non-participating shares.

The introduction to the Tax Topics Roundtable questions and answers stated that its comments were based only on notes taken during the question and answer session. It was expected that a complete summary of the Roundtable would to be published later by the CRA as part of their Income Tax Technical News. To date the CRA has not published any further clarification of their Roundtable answer.

A recent edition of Income Tax Technical News (No. 44 April 14, 2011) includes an additional article on the CRA position on the valuation of voting non-participating shares as discussed in the Toronto November 2009 Canadian Tax Foundation conference. The question, and answer, were:

Question

At the Canadian Tax Foundation's 2007 annual conference, the Canada Revenue Agency (CRA) said that, to value different classes of shares in a company, it generally determines the en bloc fair market value (FMV) and then allocates the value to each class of shares in isolation. The CRA said that the FMV of each class of shares must be determined on its own merits according to the individual rights and restrictions of each class. The CRA's opinion is that a hypothetical purchaser would be willing to pay some amount for the voting control of a company, and therefore the FMV of voting non-participating shares is more than nominal right may be difficult to ascertain.

At the Canadian Tax Foundation's 2007 British Columbia conference, a practitioner reported that the CRA was attributing 30 to 50 percent of the value of a company to voting non-participating shares. At the 2009 British Columbia conference, the CRA stated that

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

Dustan v. The Queen involved the allocation of purchase price on a sale to third parties. The CRA's position, as expressed in the pleadings, is that shareholders owning voting, non-participating shares have control over the amount and timing of any economic benefit received by other shareholders and therefore the voting shares have an FMV much greater than a nominal amount.

Can the CRA explain the methodology used to arrive at the FMV of such shares? Does it make a difference if the voting shares control only the timing of payments on the non-voting shares and do not control the value accruing on those shares? Does it follow that, to the extent that the voting shares have value, any separate class of frozen shares will have a value less than its retraction amount? Does the same logic apply in determining the value of being a trustee of a discretionary trust that owns shares?

Response

The question arises in the context of estate freezes of private corporations, where the freezor desires additional security for the value of the freeze shares taken back. Provided that the owners of all the shares of the corporation act in a manner consistent with the assumption that no value attaches to the voting rights, and the rights are eventually extinguished for no consideration, the CRA will generally not attribute value to the rights. If the holder of the rights uses them to run the corporation in conflict with the common shareholders or seeks or is offered consideration for them, it would be difficult for the CRA to ignore this evidence of value.

Essentially this is just a slight variation on the Tax Topics Number 1971-72 Wizard of Oz quote, that the value is situational based on the taxpayer's intent as determined through hindsight rather than on an arm's length fair market value analysis.

Lemberg, et al. v. Perris

Ontario Superior Court of Justice, June 30, 2010 (Docket: 682/07)

The plaintiffs were the sole shareholders of Polymark Manufacturing Inc., a small manufacturer of polyurethane products. Mr. Perris was a chartered accountant acting for both Polymark and the plaintiffs personally from 1985 to 2004. Mr. Perris gave the plaintiffs personal tax advice as part of his function as their accountant. Mr. Perris sent Polymark an annual engagement letter in which the terms of his engagement were outlined. Included in the letter was a statement that the client was aware that a company owned by Mr. Perris would earn a commission on any securities sold through that company. While the engagement letters related to Polymark, it appeared to be recognized that the terms of those letters also applied to any services rendered to Mr. and Mrs. Lemberg personally.

In 1998 and 1999, Mr. Perris spoke with Mr. Lemberg about the charitable donation scheme that was the subject of the litigation. In essence, limited edition art prints would be purchased in bulk and sold to clients such as the Lembergs. They would then be donated to various educational institutions. Individuals who participated in the scheme would be given a tax receipt for the prints with a claimed fair market value which was several times higher than the actual amount the individuals had paid for them.

In 1998 Mr. Lemberg agreed to purchase 100 limited edition prints at $310 each for a total cost of $31,000. Mr. Lemberg testified that he and Mr. Perris had a brief discussion about the transaction and that Mr. Perris had strongly recommended participation in the scheme. He did not question Mr. Perris, except to a limited degree because he assumed that Mr. Perris had done due diligence. Mr. Lemberg received a receipt for income tax purposes which recorded the donation of the prints at a total value of $136,500. Mr. Lemberg claimed a tax credit based on that amount which was initially accepted by Canada Revenue Agency (CRA).

Both plaintiffs participated in the scheme in 1999. In total the Lembergs paid $78,500 for prints and claimed about $250,000 in charitable donations in respect to them.

In 2001 the Lembergs were reassessed by the CRA. Ultimately the CRA allowed them to deduct only their $78,500 purchase price. AFE Consultants, the scheme's promoter, took a test case to the Tax Court which was dismissed (see *Klotz v. Canada*, reviewed in The Valuation Law Review — Taxation Volume 11, Issue 2, March 2005, and Volume 12, Issue 3, May 2006).

In 2006, the Lembergs became suspicious that Mr. Perris had been paid an undisclosed commission on their art purchases. After inquiry they found that this was the case and brought a suit for damages against Mr. Perris and his firm. The Lembergs had a net cost of $39,797 for the artwork after a $38,703 tax credit. They had also paid approximately $75,000 in interest on their outstanding taxes while the case was under appeal and paid an additional $29,000 in interest on the money they borrowed to pay their back taxes. At trial they claimed all of these amounts as damages along with the $7,500 undisclosed commission for a total claim of $151,500.

The issue at trial was whether Mr. Perris was a fiduciary, and if so, did he breach his fiduciary duties? If he did, what was the measure of compensation payable to the plaintiffs? If he was not a fiduciary, was he liable in negligence, and if so, what was the measure of the plaintiffs' damages? The plaintiffs argued that the parties were in

a fiduciary relationship. While not a classic fiduciary relationship, such as trustee and beneficiary, their relationship was fiduciary because of the confidential relationship between them. They had trusted Mr. Perris to act in their best interests. He had been their accountant for years and he had advised them on how to minimize their taxes, both on an ongoing basis and, prospectively, looking forward to the day they would retire. They expected Mr. Perris to at all times act in their best interests rather than his own apart from the normal fees he would charge for his advice. However Mr. Perris, because of his commission, had a financial interest in the transactions which he had not disclosed to the Lembergs. The Lembergs were adamant that they would not have entered into these transactions had they known Mr. Perris was earning a secret fee or commission and the Court found no reason to doubt their evidence in this respect.

The defendant argued that he was not in a fiduciary relationship with the Lembergs. He was retained as an accountant to provide a defined range of services which included advising as to appropriate tax saving vehicles. In doing so he provided options for the Lembergs to consider which they were free to accept or reject as they saw fit. The defendant argued that the Lembergs were perfectly capable of assessing the risk of entering into these transactions, or at least obtaining other advice. With respect to the alleged secret commission, it was submitted that there was nothing secret about the fee Mr. Perris received. Defendant's counsel argued that a reasonable construction of the engagement letters should have been sufficient to put the plaintiffs on notice that Mr. Perris could earn a fee on any transaction he recommended. Furthermore, at trial, Mr. Perris had testified that he advised the Lembergs that he would receive a fee for recommending the art purchase and his evidence should be accepted.

The Court determined that Mr. Perris was a fiduciary and that he had breached his fiduciary obligations. The Court concluded that Mr. Perris had undertaken to act solely on behalf of the Lembergs in relation to their tax planning and had relinquished his own self-interest in that regard except for the normal fees he would charge for providing his advice. The Lembergs were entitled to assume that any advice given to them by the defendant regarding tax matters would be advice honestly given with a view to advancing their interests and not his own. The Court stated that Mr. Perris undoubtedly knew that he was required to disclose any commission or fee earned through a transaction involving a client, over and above his normal professional fees.

The Court considered it significant that the commission was paid by the promoters of the scheme. This meant that Mr. Perris was working for the promoters and he had a financial interest in the transaction which was at odds with the interests of the Lembergs. While the Lembergs had relied on Mr. Perris's advice and his integrity, their trust had been misplaced because his integrity was impaired by self-interest.

Based on this the Court concluded that Mr. Perris must compensate the Lembergs for their losses and awarded them $45,295. This total was based on two amounts, the difference between their cash cost to purchase the artwork and the tax refund they received for their donation, and the $7,500 commission received by the defendant. The trial judge did not agree that the Lembergs' losses included the interest that they paid CRA for their unpaid taxes or the interest on the money they borrowed to eventually pay them. The Lembergs had the use of the funds until they paid their taxes and the Court had no evidence that the Lembergs could not have paid the amounts required out of their own resources rather than borrowing the money. In these circumstances

the Court did not consider that including the claimed interest in the damages was appropriate.

Innovative Gifting Inc. and the House of the Good Shepherd, et al.

Ontario Superior Court of Justice [2010] O.J. No. 2210

Innovative Gifting Inc. ("Gifting"), the applicant, sought to enforce a written agreement with the respondents for the payment of fees for services rendered. Gifting was in the business of fund-raising for charitable organizations through its network of donors. Gifting promised to secure donations of cash and shares for the charities with which it contracted in exchange for a fixed percentage of the donations provided to those charities. The respondents were charitable organizations and their senior officers. All except the House of the Good Shepherd had paid Gifting a portion of the invoiced fees. The respondents that paid fees to the Gifting brought counter-applications to retrieve the monies paid.

The respondents' principal complaints were that Gifting had made material and fraudulent misrepresentations to them about the nature of the donations, the legality of its gift-giving program, and the fees to be charged. They stated, in uncontested evidence, that Gifting had represented orally and in writing that it would raise donations for the charities in the form of cash and shares and that the shares would have a value at least four times the value of the cash. Gifting claimed that the shares would come from a non-resident Swiss philanthropist who would match cash gifts from Canadian donors with an additional gift of shares. The respondents claimed that these representations were false and the shares were worthless. Additionally Gifting had failed to deliver all of the promised shares and had requested that the respondents provide false tax receipts to the donors for the value of shares that were never donated.

While Gifting had represented to the respondents that its fundraising initiatives and agreements were legal and in compliance with Canadian tax laws they found that Gifting's invoices for 90% of the amount of the cash donations were in contravention of the Income Tax Act and well in excess of the respondents' allowable disbursement quota thereby threatening their charitable tax status.

At trial Gifting asserted that its agreements should be enforced and that the evidence submitted by the respondents was extraneous and should be ignored. The Court found otherwise and concluded that the remedy of rescission was available to the respondents. In the reasons for judgment the Court stated that the uncontested evidence established that Gifting had made material misrepresentations to the respondents concerning the nature and legality of its gift-giving scheme, including the form and amount of the donations to be made and the amount of its fees, which were clearly false. The evidence established that Gifting had made those misrepresentations either knowing of their falsity or with flagrant disregard or indifference to their truth or consequences.

The Court stated that Gifting's scheme was clearly in contravention of the Canadian Income Tax Act and put the respondent charities at risk of losing their charitable status. As evidenced by Gifting's invoices, the aim of the scheme was to claw back to Gifting the value of the cash donations on the misrepresentation that shares would also be donated and that Gifting's fee would be taken from the aggregate value of the cash

and shares. As the shares were not donated the applicant's invoices comprised almost the entirety of the cash donations. Finally, the agreements were not fully executed by Gifting because Gifting failed to provide the donated shares. The donation of shares was a fundamental part of the agreements with the respondents and the applicant's failure to perform the agreements disentitled it to any fees.

The Court concluded that the agreements between Gifting and the respondents were void or voidable because they were contrary to public policy. The Court stated that Gifting's scheme of promising to secure donations of allegedly valuable shares which were worthless or never provided was clearly fraudulent. The cash donations received by the respondents were part and parcel of this fraudulent scheme. To allow Gifting any fees would be contrary to the well-established principle that a fraudulent wrongdoer should be deprived of the profits of its fraud. Therefore, in consequence, the Court held that no fees were payable to Gifting and that any fees already paid to Gifting should be returned to the respondents.

Elizabeth M. Russell, et al. v. The Queen
2010 TCC 548

Russell was art donation case essentially indistinguishable on the facts from *Nash*, *Klotz*, and *Nguye*n (all covered in prior editions of the VLR-Taxation). In this case the Appellants took the position that all of the prior artwork cases were incorrectly decided because the Courts had mis-identified the proper reference market for valuing the artwork. As part of its review of this argument the Tax Court came up with an interesting perspective on the correct valuation reference market which had not been considered in prior decisions.

The donation program was marketed by Mr. Barnet Goldberg, the principal of Canadian Art Advisory Services Inc. (CAAS). Mr. Goldberg, through CAAS, arranged to acquire art directly from artists at anywhere from $20 to $100 per original work of art. Mr. Goldberg looked primarily to a Mr. Varley, a well-respected name in the art business, in order to determine a fair market value for the art. Mr. Varley did not personally prepare any appraisals but only advised the appraisers that prepared the opinions of the subject artwork. The Appellants' sole involvement with the program was to pay CAAS for the artwork and sign the various documents donating it to pre-determined charities. The Appellants received a donation receipt for $1,000 for each individual artwork. The CRA reassessed the Appellants on the basis that the fair market value of the donated art was equal to their purchase prices.

The appraisals used by the Appellants in support of their position were prepared by a Mr. McCanse. The Tax Court did not accept Mr. McCanse as an expert on the valuation of contemporary art, but allowed him to testify as to the role he played in providing the appraisals and accepted him as an expert with respect to the overall distribution of art from the artists to the public. Mr. McCanse described the market between artist and agent or gallery as the wholesale market and between gallery and the public as the retail market. He confirmed it was rare for bulk sales of art to occur in the retail market.

The Tax Court noted that this was not the first time this type of matter has come before the Courts. The Federal Court of Appeal (FCA) had addressed similar arrangements in *Nash* and *Klotz* and in both cases have found against the taxpayers on the basis that the amount that they had paid for the art was the best indicator of its fair market value.

Further, the same art donation program at issue in this trial had already been reviewed by the Tax Court in *Nguyen* and Justice Campbell had concluded:

> *I have not been persuaded that the analysis used in Nash and Klotz should not prevail here. Without evidence of comparable sales or a market that permits a direct comparison, the only value that I can reasonably attribute to the donated artwork is the amount that someone was actually willing to pay for it around the time it was donated. ...*

The Tax Court considered these to be difficult precedents to overcome. The Appellants attempted to differentiate their case from prior decisions by arguing that the courts have not correctly applied the definition of FMV, generally accepted as stated in *Henderson v. Minister of National Revenue,* 73 DTC 5471 (Fed. T.D.).

> *.....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 Appellants argued that the highest price the art might reasonably be expected to receive would be in the retail market where such art would be sold in the ordinary course of business. This was the same reference market which had been used by taxpayers in prior appeals and rejected by the courts. However, in this case, the Appellants suggested that their donation to the charity was the correct equivalent to the retail market, rather than the retail level art gallery comparisons used in prior cases. The Appellants also attempted to distinguish the *Nash* and *Klotz* cases on the basis that those cases had provided no information on direct market comparisons whereas, in this case, counsel had entered four invoices into evidence showing sales of individual works of art in the $1,100 to $1,400 range. Mr. McCanse and Mr. Goldberg had testified that their appraisals were based on such invoices, making them an appropriate direct market comparison of actual retail sales. The Appellants also attempted to convince the Tax Court that it was dealing with the valuation of individual original works of art which were generally sold commercially on a piece-by-piece basis, not, as in *Klotz* and *Nash*, blocks of limited edition prints. The Appellants argued that, on this basis, the claimed values were well within the bounds of commercial common sense.

The Tax Court was not persuaded by this argument. In *Nash*, the FCA had valued the art on a wholesale group basis. The Tax Court saw no distinction between the circumstances in Nash and the circumstances at trial that would cause it to conclude that the sale of artwork by CAAS to the taxpayers should be treated any differently.

The Tax Court said that the flaw in taking the approach of using the retail market where the art was sold in the ordinary course of commerce for the highest amount was that it ignored the reality that the buyers/donors had no access to that retail market. The Tax Court concluded that there was no available reference market, either retail or wholesale, which could be used to determine art values when reviewing tax shelter cases:

> *[26]The conundrum in identifying the proper market in which to assess FMV is that the market in which the promoter and buyers/donors were*

operating was not an art market, but it was a charitable receipt market. CAAS' promotional material, the Appellants' own testimony and certainly the Retainer Agreement make it crystal clear that the buyers/donors were acquiring an investment, which would yield a charitable receipt that would result in an approximate 40% return on their money. This was an investment market, not an art market. The Courts have struggled with pigeonholing the art in the appropriate market, presuming that buyers/donors were engaged in the art market, when in reality, they were not.

The Tax Court concluded that when there is no market the best evidence of value is the amount the Appellants had actually paid. Based on this the Tax Court dismissed the appeals and placed a fair market value on the art equal to the Appellants' purchase price.

Robert D. G. Lockie v. The Queen
2010 TCC 142

This appeal was in respect to the fair market value of items gifted to charity. The donated properties were toothbrushes, gel pens, and school packs acquired by the Appellant for $2,850 and donated to In Kind Canada (IKC). The Appellant was issued a donation receipt of $15,078, an amount over five times greater than his cost. The CRA denied the claimed donation tax credits and allowed Mr. Lockie a donation deduction limited to his actual cash cost. While the tax at issue in this appeal was trivial, the Appellant was one of a large number of individuals who had participated in this donation scheme and who had also been reassessed.

Mr. John Groscki, a chartered accountant, testified on the structure of the overall donation plan. He owned or controlled Charitable Enterprises Inc. (CEI), the promoter of the plan. One of his initial steps in establishing the plan was to contact IKC to determine what types of products would be of interest to the charity and then looked for opportunities to acquire these products at a low cost from manufacturers in China. Mr. Groscki's companies imported other products in addition to the items in this appeal however it appears that all of these products were channeled through IKC. Mr. Groscki, through one of his companies, would arrange for a steady supply of products to the charity which would issue receipts to donors for an amount approximately five times greater than the price that the donor had paid to the CEI or a related company. It was important that IKC was part of the structure from the beginning because CEI had to import products that IKC was willing to accept.

IKC, as part of its contract with CEI, agreed to give written confirmation that it would accept goods of a specified type and quantity prior to their being shipped from China. IKC also agreed to confirm, before shipment, the price at which it would provide charitable donation receipts in respect to these products. The products were imported by CEI by the container load. While the donors acquired title to smaller lots the products went directly in bulk from CEI (or a related company) to IKC. The donors appointed Canadian Charity Distribution Inc. (a company related to CEI) as their agent to receive, store, package and deliver the product to the charity. The products were acquired by the donors on behalf of, and for the benefit of, IKC.

There were two main issues in this appeal:

1. Did the Appellant have a donative intent when he gave the products to IKC?

2. If the Appellant did make a gift to IKC, what was the fair market value of the products given to IKC by the Appellant?

In respect to the first issue the Crown had entered into evidence promotional materials distributed by CEI which showed the potential financial return available to donors. For donors who did not have capital losses to apply against the capital gain on the donation, the pamphlet claimed that a $10,000 purchase of the various goods would result in a tax credit of $23,000. After deducting taxes on the capital gain triggered by the donation the net return to the donor was calculated as $3,800 for a 38% return on the cash donation amount. Where the donor had sufficient capital losses to offset the capital gains the net return would be $13,000 for a 130% return on the cash donation amount. It was the Crown's position that the overall scheme, and the advertised returns on the donations, were indicative of a lack of donative intent. The Tax Court concluded that the donor's intent was irrelevant to the deductibility of a gift. This left the Tax Court with the issue of the fair market value of the donated goods.

It was the position of the Appellant that the fair market value of the items that were donated to IKC should be based on the Canadian retail selling price of these items minus a discount to reflect the fact that the Appellant had donated a significant number of the items. The Appellant filed an expert's report related to the methodology applied in determining the fair market value of these products. The report outlined the procedures undertaken by the CEI representatives in relation to the calculation of value. This suggested to the Tax Court that the fair market value was determined by CEI and not by IKC. This conflicted with a term in the agreement that CEI had entered into with IKC which provided that IKC would be the sole and exclusive determinant of the price for which charitable receipts would be issued. The Tax Court concluded that IKC just accepted the value amounts proposed by CEI rather than doing its own value determination as stipulated in the agreement.

The Tax Court stated that the that the critical question in determining the fair market value of the donated products was whether the retail market was the appropriate market to be used for this purpose. The Appellant's expert had assumed that the market in which CEI actually purchased the goods on behalf of the donors, the wholesale market, was not relevant for valuation purposes. The expert's reason for excluding the wholesale market was that the donors were individuals who were not in the business of manufacturing, wholesaling, or retailing of the donated products and they therefore did not have the ability to acquire similar products at prices that would be charged by wholesalers. In order to donate similar products to IKC in the absence of the donation program, the Appellants would have been required to purchase them from retail stores such as Business Depot, Grand & Toy, or Shoppers Drug Mart. Given the relatively large quantities of the toothbrushes and gel pens donated, the expert assumed that the donors could have negotiated a volume discount with the retail stores.

The report's conclusion was that the relevant market for fair market value purposes was the retail market because that was the market it was assumed IKC would have been required to utilize had it directly purchased the donated goods. The expert assumed that the IKC would not have access to the wholesale market.

> *[31] We believe that, in general, the highest price for the Package would be obtained by selling each of the goods (or groups of goods) separately to individual consumers. However, this approach would likely entail higher costs*

> *than by selling the entire Package. Further, the entire Package was donated to IKC to be used by various charities. Accordingly, assuming that IKC (and/or the charity which ultimately utilized the goods) purchased such products from the retail market in similar quantities, we believe that the most appropriate market to be considered in determining the fair market value of the Package is the retail (consumer) market for similar quantities of each product in the Package; in particular, the total cash amount that would be paid by IKC or the relevant charity to acquire a similar Package. Further, we believe it is appropriate to apply volume discounts in calculating the fair market value of each product in the Package and the discounts utilized by CEI are not unreasonable in quantum based on the quantities purchased by the Donors.*

Under cross-examination the expert was asked why the price that the program's donors paid CEI for the goods couldn't be considered as a reference market to determine fair market value. She answered that her underlying assumption was that the donation program did not create a market on its own and the definition of fair market value, which utilized the term "the highest price" would exclude the investment market.

The Tax Court did not agree with the expert's conclusions. Since the subject transaction was the donation of the property to IKC, the Tax Court did not consider it relevant whether the donors would, in the absence of the CEI program, have instead purchased the products in the retail market. The Tax Court did not accept the Appellant's expert's assumption that, in the absence of the donation program, IKC would have replaced the products through its own purchases in the retail market. The Tax Court stated that such a purchase would not have been part of the charity's normal activities. IKC accepted donations but bought nothing in the volumes donated to it under the CEI program. This was supported by evidence given by an employee of IKC who testified that the charity had never purchased any of the items it distributed to its member organizations.

The Tax Court agreed that the correct reference market was the market in which IKC could have acquired products if they had not been donated to it. However, in the Tax Court's opinion, this was neither the retail nor the normal wholesale markets. The Appellant was only a conduit in a pre-existing pipeline for the products which flowed from the Chinese manufacturer, to CEI, to the program donors, then finally to IKC. The Tax Court stated that, contrary to the Appellant's expert's assumptions, IKC did have access to a wholesale market because it had made its arrangement to accept products from CEI, who was the importer, before the Appellant and the other donors were involved in the program. Therefore, had IKC wished to purchase the donated items, it could have done so by buying directly from CEI. CEI might even have preferred to sell the products directly to IKC rather than through donors since CEI would have lower costs dealing directly with IKC. The Tax Court concluded that if IKC was to acquire the products from someone other than the Appellant then CEI would be the alternative source. CEI, in the normal course of its business, sold the package of products at issue to the Appellant for $2,850 and it seemed logical that CEI would have also sold the same package to IKC at the price charged the Appellant. Based on this analysis the Court allowed the Appellant a fair market value for donation purposes of only the actual cost to him of the donated products.

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

Maréchaux v. The Queen
2009 TCC 587
2010 FCA 287
Application for Leave to Appeal to the Supreme Court of Canada dismissed

The first paragraph of the Federal Court of Appeals decision in this case gives a succinct outline the issue at trial:

> *[1] F. Max E. Maréchaux participated in a "leveraged donation" scheme. The essence of the scheme was that, for an expenditure of $30,000, he received a charitable donation tax receipt for $100,000, and claimed a tax credit of $44,218, a potential return on his outlay of nearly 50% in a matter of months. Very little of the money was retained by charities to advance their purposes.*

The question considered by the Tax Court was whether the Appellant was entitled to a charitable donation tax credit under the *Income Tax Act* in respect of a $100,000 payment he made under an arrangement known as the 2001 Donation Program for Medical Science and Technology (the "Program"). The Program involved what were called "leveraged donations." In general, prospective donors were invited to make a donation of at least $100,000 to a registered charity, and were to be provided favourable financing for a large part of the outlay. The Program was implemented on December 31, 2001, and, over the three year period 2001 to 2003, there was a total of about $218,000,000 in donation receipts issued under this one program.

The overall structure of the scheme was very complicated. It involved a Canadian and an American charity, medical technology transfers, a number of intermediary companies, a daylight loan from a Canadian financial services company, and a circular flow of funds that left only a very small amount of the total donated funds retained by the charities. It is not necessary to go into the details of these various transactions for the purpose of this review.

While some features of the Program changed during its lifetime the arrangement in effect at the time the Appellant made his donation was that a donor who made a $100,000 donation was required to contribute only $30,000 from his own funds and would receive a twenty year interest-free loan to finance the remaining $70,000 obligation. The loan did not require periodic repayments but instead required only a single lump-sum repayment at the end of the twenty year period. The donor also received an additional $10,000 interest-free loan which was used for two purposes. The first was to invest $8,000 in a security deposit which was intended, through investments, to increase to at least $80,000 by the end of the twenty year period. These accumulated investment earnings were to be used to pay off the donor's loan. The remaining $2,000 of the loan was to be used to purchase a Bermuda issued insurance policy (the "Put Option") which guaranteed the repayment of the entire $80,000 loan if the return from the security deposit fell short. Donors could, at their option, assign the security deposit and Put Option to the holder of their interest-free loans at any time after January 15, 2002 and the holder would be required to accept the assignment as payment in full for the loan. All of the above steps were pre-determined.

The relevant agreements did not give Mr. Maréchaux a contractual right to be granted a Put Option. While he was entitled to apply to the lender for a Put Option the lender was under no legal obligation to accept his application. However Mr. Maréchaux's

application was accepted and a Put Option was issued to him. On January 16, 2002 Mr. Maréchaux assigned his Put Option and his security deposit to the lender as payment in full for the $80,000 loan. The net result was that Mr. Maréchaux was issued a $100,000 charitable donation receipt after paying out only $30,000 of his own funds. The 20 year term loan which financed the remaining portion of the donation existed for only slightly more than two weeks and was extinguished at no net cost to the Appellant.

Mr. Maréchaux claimed a $44,218 tax credit in his 2001 income tax return. He was later reassessed disallowing the claimed tax credit in its entirety. There were two issues at trial, whether the donation was a gift, and whether the general anti-avoidance rule (GAAR) was applicable to the transaction.

The *Income Tax Act* does not define the word "gift" so the Tax Court was required to give "gift" its general meaning for the purpose of the appeal. The Tax Court considered it sufficient to refer to the description of "gift" as stated by Linden J.A. in *The Queen v. Friedberg*, 92 DTC 6031 (FCA):

> *The word gift is not defined in the statute. I can find nothing in the context to suggest that it is used in a technical rather than its ordinary sense.*
>
> *Thus, a gift is a voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor (see Heald, J. in The Queen v. Zandstra [74 DTC 6416] [1974] 2 F.C. 254, at p. 261). The tax advantage which is received from gifts is not normally considered a "benefit" within this definition, for to do so would render the charitable donations deductions unavailable to many donors.*

It was the Crown's position that none of the Appellant's donated amount qualified as a gift under Section 118.1 of the Income Tax Act because the Appellant had received back valuable consideration. This was the interest-free loan and the Put Option. At trial the Crown entered expert evidence from a valuator giving an opinion on the fair market value of the Appellant's interest-free loan. The Tax Court agreed with the Crown's position and concluded, in applying the *Friedberg* definition to the facts of this appeal, that it was clear the Appellant did not make a gift to the Foundation because the Appellant received a significant benefit in return for the donation. This benefit was the $80,000 interest-free loan coupled with the expectation that the Put Option would be issued. The Tax Court concluded that the financing arrangement had not been provided in isolation to the donation. The two were inextricably tied together by the relevant agreements. The Tax Court said that it was not necessary for the purpose of the appeal to place a value on the benefit, however it appeared to be approximately $70,000 ($80,000 loan received less outlays of $10,000) less a slight discount for the risk that the Put Option would not be effective. The Tax Court commented that, even without the issuance of the Put Option, the financing provided a significant benefit since it was self-evident that an interest-free loan for 20 years provided a valuable benefit to the debtor.

The Tax Court also noted that the $8,000 security deposit could not have been reasonably expected to increase to anywhere near $80,000 in 20 years. The evidence of the Crown's expert clearly showed this even taking into account differences of opinion regarding some of his assumptions.

The Tax Court also considered whether the Appellant had made a partial gift of his $30,000 cash payment but, on the particular facts of the appeal, felt it was not appropriate to separate the transaction. There was just one interconnected arrangement, and no part of it could be considered a gift that the Appellant gave in expectation of no return. Based on these reasons the Tax Court dismissed the appeal and disallowed the entire donation including the Appellant's $30,000 cash amount.

This decision was appealed to the Federal Court of Appeal (FCA) where the Appellant argued that the Tax Court had made four errors in concluding that he had not made a gift.

First, the Appellant claimed that a benefit provided in return for a payment only prevented it from being a gift if the benefit was provided by the donee. In this case the benefits received by Mr. Maréchaux, the interest-free loan and the Put Option, were provided by the lender, not the donee. The FCA was not persuaded that the trial judge had made an error in law. The Appellant's counsel cited no authority for the proposition that only a benefit provided to a donor by the donee could prevent a payment to a charity from being a gift for the purpose of section 118.1 of the Income Tax Act. Nor did the FCA see any principled reason for disregarding a benefit simply because it was provided by a third party particularly where, as the Tax Court found in this case, the donation was conditional on the provision of the benefit.

Second, the Appellant submitted that the interest-free loan did not constitute a significant benefit so as to prevent the payment to the charitable foundation from being a gift. Since this was a question of fact or mixed fact and law, the FCA stated it would only interfere with the Tax Court's conclusion if satisfied that it was vitiated by a palpable and overriding error. However, in the FCA's opinion, there was ample evidence in the record to support the Tax Court's finding that the $80,000 interest-free loan was a significant benefit to Mr. Maréchaux and that it was provided in return for the donation. It seemed self-evident to the FCA that a person who had the use of borrowed money, repayable in twenty years time without having to pay interest, had thereby received a significant benefit. The interest-free loan in this case enabled Mr. Maréchaux to transfer $100,000 to the foundation without having to use more than $30,000 of his own assets or to pay interest on a commercial loan for the balance.

Third, Mr. Maréchaux said that the Judge erred in regarding the Put Option as a benefit that disqualified the payment from being a gift because, at the time he agreed to make the donation, there was no contractual guarantee that he would be issued the option. Hence, any benefit derived from the Put Option was speculative. Again the FCA disagreed stating that even if the promoters had not contractually undertaken that a Put Option policy would be issued to participants in the scheme, the donors, including the Appellant, had good reason to believe that it would. In any case a Put Option had in fact been issued to the Appellant who had assigned it and the security deposit to the lender in full satisfaction of the $80,000 loan. On these facts, the Tax Court could not be said to have committed a palpable and overriding error in finding that the Put Option was a significant benefit provided to the Appellant by the lender in return for the $30,000 payment.

Fourth, Mr. Maréchaux argued that, if the Court concludes that he obtained a benefit in return for the $100,000 payment to the foundation, he was still entitled to receive a tax credit in respect of his cash payment of $30,000. The FCA saw no reviewable error in the Tax Court's conclusion that none of the donation was a gift. For these reasons, the appeal was dismissed with costs.

Mr. Maréchaux filed for Leave to Appeal at the Supreme Court of Canada. The application was dismissed with costs on June 9th, 2011.

Transalta Corporation v. The Queen

2010 TCC 375

under appeal to FCA

This was an appeal in respect to the allocation of the purchase price in the arm's length sale of Transalta Energy Corporation's ("Transalta") assets and business to AltaLink Limited Partnership ("AltaLink") in 2002. In their purchase and sale agreement Transalta and AltaLink had allocated approximately $602,000,000 to net tangible assets and $191,000,000 to goodwill. The CRA, relying upon section 68 of the *Income Tax Act,* allocated the entire value to tangible assets on the basis that no goodwill exists in a regulated industry. The Appellant's position was that the value allocation was the result of arm's length hard bargaining and the amounts determined could not be regarded as unreasonable.

Prior to the sale Transalta held subsidiaries which operated an electrical transmission business with approximately 11,600 km of transmission lines and 260 substations that supply almost 60% of the Alberta population with electricity. Transalta decided to sell the transmission business by way of a sealed bid auction. AltaLink acquired the transmission business through the auction. At all material times AltaLink was owned by four limited partners. Three were already in the electrical transmission industry and the fourth was a wholly owned subsidiary of the Ontario Teachers' Pension Plan Board.

Transalta and representatives of AltaLink's partners negotiated the terms of the sale including the allocation of the purchase price to depreciable property, goodwill, and certain other items, as a result of which $190,824,476 was allocated to the goodwill. The determined goodwill amount was approximately the amount by which the purchase price exceeded the net regulated book value (NRBV) and working capital of the electrical transmission business and was referred to by TransAlta and other parties in to the transaction as the "premium". NRBV was a critical number because the electrical transmission business was subject to the authority of the Alberta Energy and Utilities Board ("the Board"). The Board had regulatory authority over the electrical rates that the transmission business could charge and based the rate structure on the NRBV. The Board's goal was to allow the business to earn a reasonable rate of return on the capital it employed. It did this by setting the allowed electrical rates based on forecasts submitted by the transmission business to permit the business to recover the NRBV of its assets as they depreciated for regulatory purposes, recover the estimates of expenses the transmission business planned to incur, including taxes, and earn a reasonable return on the portion of the NRBV the Board deemed to be equity for this purpose.

At trial both parties presented expert evidence supporting their positions. Before reviewing the evidence the Tax Court stated that it found it interesting that both experts:

> *".....agreed that a valuator's approach to defining goodwill is what I call a residual approach, that is, it is the amount by which a purchase price exceeds the Fair Market Value (FMV) of tangible assets: in effect, it is a plug."*

The Appellant entered expert evidence explaining why AltaLink was willing to pay a premium in excess of the regulatory value of the business assets. The reasons given were:

Income tax allowance — The Board considered income taxes as an expense when determining the allowable annual revenues the partnership would be permitted from the business. However the Board's allowance for tax did not necessarily reflect the actual taxes paid. Since the Ontario Teachers' Pension Plan Board, a 25% partner, had a tax deferred status, the partnership anticipated it would be allowed an allowance for income taxes that would exceed the income tax actually paid by its partners. The Board eventually denied AltaLink the right to a return on the portion of the Tax Allowance attributable to Teachers.

Return on equity — AltaLink believed that the return on equity offered by the Board was attractive relative to other investments available to it, given the risks it was required to undertake to earn that return.

Leverage — In 2002 the Board allowed financing, for rate-making purposes, of 35% equity and 65% debt. The Appellant's expert testified that it would have been reasonable to assume that the partnership would finance their purchase using a minimum of 75% debt and a possible maximum of 90%.

Performance Based Regulation — During the regulatory approval process for the transaction, Alberta ratepayers raised concerns with regard to the premium, including the possibility that AltaLink would try to recover the premium by way of rate increases. As a result, AltaLink represented to the Board that the premium could be justified by AltaLink on that basis that a performance based regulation (PBR) plan could result in a sharing of benefits with customers that would enhance earnings. PBR is a form of regulation that, if implemented, would allow the operator of the transmission business to earn additional returns by creating cost saving efficiencies that would benefit customers. During the auction process Transalta had represented to the partnership that PBR allowed a potential range of $6 to $8 million per year in incremental revenues.

Non-Regulated Sector — Transalta was engaged in non-regulated activities such as tellecommunications, both wireless and fiber optic, merchant transmissions (the transmission of non-regulated power sold at market rates instead of at regulated rates), engineering services, and construction management and maintenance services. AltaLink, in acquiring Transalta, also acquired a specialized experienced workforce which could provide services in the non-regulated sector. Some of the purchasing partners were already in the electrical transmission business and the Appellant's expert stated that they would have realized a strategic benefit in their own merchant transmission businesses by having access to Transalta's employees. In addition the taxpayer's expert held the view that the partnership would have viewed Transalta's potential for future merchant transmission projects as a positive factor.

As part of her analysis the Appellant's expert did a valuation of the tangible assets acquired in the transaction. Using a discounted cash flow approach she concluded that these assets had a value close to the NRBV.

The Crown's expert took the opposing view and testified that it was his conclusion that there was a nominal amount, if any, paid for goodwill. He based his opinion on the following considerations:

1. The income available to an acquirer of the transmission business was regulated and was tied strictly to the regulated asset base.

2. The ability of an acquirer of the transmission business to increase the profitability was very limited because the Board did not allow the business to profit from ongoing cost savings nor was the operator able to command a charge to the public above the rates set by the regulator.

The expert stated that financial synergies and leverage were not pertinent in the purchase and the fact that the purchasers had a lower cost of capital than Transalta was irrelevant. He also considered the value of operational synergies to be minimal because the regulatory authority would ensure that any benefits would flow through to the customer rather than Transalta.

Because of the nature of the transmission business it was the expert's view that the transmission assets were effectively an income producing property similar to a rental property or a bond. It was the expert's opinion that AltaLink was buying access to the $100,000,000 per year of earnings before interest, taxes, depreciation and amortization. This income was directly tied by regulations to the net tangible assets upon which the rate of return on equity was calculated.

The Tax Court determined that the issue under appeal required that three questions be answered. Was goodwill one of the assets sold? If goodwill was sold, was the $190,000,000 amount determined by arm's length bargaining reasonable? If this amount was unreasonable, what was the correct amount? The Tax Court started the analysis with the description of goodwill from the judgment of Lord Macnaghten in the House of Lords decision of *The Commissioners of Inland Revenue v. Muller and Co.'s Margarine Limited.* In this much cited definition goodwill was considered to be "*. . the benefit and advantage of the good name, reputation, and connection of a busines*s."

In answer to the first question the Tax Court concluded that there was no doubt the parties intended to include goodwill as part of the transaction. While the Crown had argued that the premium paid over the NRBV was no more than an increased price for the tangible assets, the Tax Court agreed with the Appellant's position that there were several factors that went beyond just paying more for hard assets and went directly to what would, in commercial circles, be considered goodwill. AltaLink was not simply purchasing Transalta's transmission lines. It was buying all the expertise, efficiencies, and other nebulous traits of a business being sold *in toto.* The Court agreed that considerable value could be attached to goodwill in such circumstances. The Tax Court stated:

> *[63] All other elements that the Appellant contends make up goodwill, I accept. All of them (PBR, EPCM, merchant transmission, new markets/growth and skilled employee base) all have value as they go to what Transalta created or developed to maintain or expand its customer base, and consequently it owned something — goodwill — to sell. AltaLink would do well carrying this business forward because Transalta had created an efficient, cost conscious organization that would flourish under a PBR regime; it had created an EPCM contingent geared to prosper in both a regulated and non-regulated setting; it had positioned itself to take off into the merchant transmission regime and similarly positioned itself by reputation and otherwise to grow and enter new markets; it did all this through*

the creation of a well qualified skilled employee base. That all was significant and it was something Transalta had to sell and was certainly something AltaLink was happy to buy. It had some considerable value.

The Tax Court next considered the reasonableness of the overall value allocation between the tangible and intangible assets. While agreeing that the bargaining process was arm's length between knowledgeable informed parties, it was not satisfied that the Appellant had proven that the bargaining parties had attempted to accurately calculate the goodwill value. Once an overall price had been determined there was minimal bargaining over the allocation, because AltaLink required only that the tangible assets be valued at least up to the amount of the NRBV and was indifferent to the allocation of any value in excess of this amount.

The Tax Court concluded that it could not simply accept the claimed goodwill amount and was required to do an analysis of the values. However the Tax Court did not accept the commonly used residual method of calculating goodwill as being reasonable, considering it *"simply a plugged-in number"* which did not inquire into the real nature of the asset purchased.

The Tax Court considered that the best approach to determining the goodwill value was to take the agreed contractual value as the starting point and deduct any items that were not part of the goodwill. The Tax Court determined the allocation of the asset value through a review of the Appellant's expert's report which had analyzed the various components of the claimed goodwill amount. After a review of the report the Tax Court accepted all of the expert's conclusions with the exception of the amounts attributable to the tax allowance and financial leverage, concluding that these were attributes of the purchasers rather than something which Transalta had to sell. The Tax Court concluded that the tax allowance had a value to the partnership of between $25 million and $50 million, and the financial leverage was worth approximately $25 million, for a range of $50 million to $75 million for the amounts attributable to the premium that did not relate to any goodwill. The Tax Court therefore reduced the claimed $190 million goodwill amount by $50 million for a final goodwill allocation of $140 million.

Husky Oil Ltd. v. The Queen
2010 FCA 125

The previous edition of this publication included a review of *Husky Oil Ltd. v. The Queen,* a case heard in the Tax Court in respect to a reassessment of the 2004 income of Husky Oil Limited ("Husky") to include a 1998 capital gain realized by Mohawk Canada Limited ("Mohawk"), a predecessor company. The underlying event that triggered the assessments was a series of transactions whereby Husky acquired all of the common shares of Mohawk and, as a result of careful tax planning, deferred the recognition of a capital gain on the disposition of some property for 25 years after the disposition. The CRA concluded that this deferral was not allowable under subsection 87(4) of the Income Tax Act.

The background and technical issues involved in the transactions and assessment were explained in the prior review. Put very simplistically it was the CRA's contention that assets held by Mohawk Lubricants Ltd., having a fair market value of $15,500,000,

were transferred for no value through the receipt of worthless preferred shares as consideration. Mohawk Canada Limited was reassessed under the anti-gifting rule in subsection 87(4) of the Income Tax Act on the basis that it conferred a benefit in the amount of $15,500,000 on a company formed by Balaclava enterprises Ltd. and Husky. Balaclava Enterprises Ltd. had been a significant shareholder of Mohawk prior to the subject transactions. At trial the Tax Court had accepted the Minister's valuation assumptions because the taxpayer had not presented evidence rebutting the assumptions and had called no expert witness to provide an opinion on the value of the assets or preferred shares. The Tax Court concluded that subsection 87(4) applied to the transaction and Husky could not utilize the tax-deferred rollover provisions in the Income Tax Act. This decision was appealed to the Federal Court of Appeal (FCA).

The taxpayer did not raise the valuation issue on appeal but instead argued that the anti-gifting rule in subsection 87(4) did not apply to the transactions under review. After an analysis the FCA agreed with this position, allowed the appeal, and set aside the judgment of the Tax Court. Given the basis of the FCA decision the fair market values of the various assets under consideration were irrelevant, however the FCA chose to comment on the Tax Court's valuation analysis and indicated that, had the FCA been required to review the valuation issue, it may not have agreed with the Tax Court's conclusions. The FCA stated:

> *[49] When the terms of that sale were agreed to, the parties to the proposed sale transaction*
>
> *.....dealt with each other at arm's length. That normally justifies a presumption that the fair market value of the property being sold is equal to the fair market value of the agreed consideration, unless there is some evidence to the contrary. As I understand the evidence, the parties in fact had agreed at the outset that the price to be paid for the Lubricants shares would be $15.5 million payable in 2023 which is consideration that necessarily is valued at less than $15.5 million. That would suggest that the fair market value of the Lubricants shares was not $15.5 million but some lesser amount, namely, the value in 1998 of $15.5 million payable in 2023 without interest.*
>
> *[50] However, the judge adopted a different interpretation of the evidence, which has not been challenged. Therefore, I would not determine this appeal on the basis that the judge made a palpable and overriding factual error in accepting as fact the Minister's assumption that the pre-amalgamation fair market value of the Lubricants shares was $15.5 million.*

Glaxosmithkline Inc. v. The Queen

2010 FCA 201

The previous edition of this publication included a review of *Glaxosmithkline Inc. v. The Queen,* a case heard in the Tax Court of Canada in respect to reassessments made for the 1990 through 1993 taxation years. The background and technical issues involved in the transactions leading to the assessment were explained in detail in the prior review.

The issue was the price that Glaxosmithkline Inc. ("Glaxos") paid a non-resident corporation for the pharmaceutical ingredient ranitidine, a component of Zantac, a drug manufactured and sold by Glaxos in Canada. Subsection 69(2) of the Income Tax

Act stated that where a taxpayer had paid a price for the use of any property to a non-arm's length non-resident which was greater than a reasonable price that would have been paid to an arm's length party, the taxpayer's income was to be calculated on the basis that the taxpayer had paid the "reasonable" amount. The CRA had concluded that Glaxos was paying a price for ranitidine well in excess of the amount it would have paid an arm's length party and Glaxos was reassessed based on the amount that the CRA considered to be a reasonable price.

At Tax Court the Crown's position was that the best comparison, for transfer pricing purposes, was the price charged for generic ranitidine substitutes legally available in Canada and which were chemically equivalent to the ranitidine under patent by Glaxos. One issue addressed by the Tax Court was the value, if any, to be assigned to two contracts attached to the ranitidine purchase right, the Supply Agreement and the License Agreement. The Supply Agreement related to the purchase of ranitidine. This included the annually adjusted price, a foreign exchange guarantee for the Appellant, indemnity insurance, and the provision of intellectual property. The License Agreement contained the following provisions:

- The right to manufacture, use and sell products;
- The right to the use of the trademarks owned by Glaxo Group, including Zantac;
- The right to receive technical assistance for its secondary manufacturing requirements;
- The use of the registration materials prepared by Glaxo Group;
- Access to new products, including line extensions;
- Access to improvement in drugs;
- The right to have a Glaxo World company sell to the Appellant any raw materials;
- Marketing support; and
- Indemnification against damages arising from patent infringement actions.

The Tax Court Judge considered the Supply Agreement relevant to his analysis. However he was of the opinion that the License Agreement should not form part of his consideration in determining the amount "that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length" since the items in the License Agreement were not directly linked to the purchase of ranitidine.

After rejecting the use of the License Agreement as a factor in the determination of value, the Tax Court agreed with the Crown's position and used the Canadian generic ranitidine prices subject to a minor adjustment.

The taxpayer appealed this decision to the Federal Court of Appeal (FCA). On appeal the Appellant argued that the Tax Court erred in its interpretation of subsection 69(2) by not inquiring into whether a reasonable person, in the Appellant's business circumstances and dealing at arm's length, would have paid the amounts that the Appellant paid to Adechsa. The Appellant pointed out that the Tax Court instead determined that the amounts paid by the Appellant to Adechsa were unreasonable because they exceeded the "fair market value" of ranitidine.

The Appellant also took issue with the Tax Court's decision to disregard the License Agreement, claiming that an arm's length party could not have sold Zantac-branded

products without the rights in the License Agreement because the Glaxo Group owned the Zantac trademark. More particularly, the Appellant said that the License Agreement required that it purchase ranitidine from a company in the Glaxos group and, if the License Agreement were terminated, it would have found itself without any product to sell. The Appellant argued that by not considering the License Agreement the Tax Court had ignored a crucial business circumstance.

The Crown submitted that the proper comparables were only those transactions in which only ranitidine was sold. If it was proper to consider both the License Agreement and the Supply Agreement together to determine if the transfer price was reasonable, the applicant had failed to present credible evidence of what an unrelated party would have paid in circumstances similar to those of the Appellant. This included the functions it performed, the risks it undertook and the market in which it operated. The Crown also argued that the "reasonable in the circumstances" standard incorporated the standard of "arm's length" and "reasonable business judgment".

The FCA concluded that the Tax Court had erred in deciding that the License Agreement was an irrelevant consideration. The FCA believed the Tax Court misunderstood the test in subsection 69(2) being: if the Appellant had been dealing with Adechsa at arm's length, would the price paid by the Appellant for its ranitidine have been "reasonable in the circumstances"? In order to make that determination, the Tax Court had to consider all relevant circumstances which an arm's length purchaser would have had to consider. The FCA quoted a statement of the Exchequer Court in *Gabco Limited v. Minister of National Revenue* (1968), 68 DTC 5210 (Ex. Cr.):

It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business considerations of the Appellant in mind. [Emphasis added in original]

The FCA concluded that the proper test required an inquiry into the circumstances which an arm's length purchaser, standing in the shoes of the Appellant, would consider relevant in deciding whether it should pay the price paid by the Appellant for its ranitidine. However this was not what the Tax Court had done. Instead the Tax Court had determined the "fair market value" of ranitidine based on the Canadian price for generic versions of the drug. The FCA concluded that the Tax Court's approach was mistaken because the correct question was whether an arm's length purchaser would be able to sell the ranitidine under the Zantac trademark. As a result of the approach which it took, the Tax Court failed to consider the business reality which an arm's length purchaser was bound to consider if he intended to sell Zantac.

The License Agreement was central to the Appellant's business reality as it would be to a party dealing at arm's length with the Glaxo Group. This was "a circumstance" which had to be taken into account by the Tax Court. The FCA stated that the Tax Court, by failing to consider the License Agreement, had made its determination in a fictitious business world where a purchaser was able to buy ranitidine at a price which did not take into account the ability of the purchaser to make and sell Zantac. As a result, the Tax Court ignored the key business circumstances of Glaxo's purchase of ranitidine, and assumed a set of circumstances that would not exist in an arm's length transaction.

In the FCA's view there were a number of "circumstances" which confirmed that the License Agreement was a crucial consideration in determining "the amount that would have been reasonable in the circumstances" if the Appellant and Adechsa had been dealing at arm's length:

1. Glaxo Group owned the Zantac trademark and Zantac commanded a premium over generic ranitidine drugs.
2. Glaxo Group owned the ranitidine patent.
3. Without the License Agreement, the Appellant would not have been in a position to use the Zantac trademark and the ranitidine patent. Consequently, in those circumstances, the only possibility open to the Appellant would have been to enter the generic market and the cost of entry into that market would likely have been high.
4. Without the License Agreement, the Appellant would not have had access to the portfolio of other patented and trademarked products to which it had access under the License Agreement.

The FCA concluded that these circumstances did not arise from the non-arm's length relationship between the Appellant and the Glaxo Group. These circumstances "arose from the market power attaching to Glaxo Group's ownership of the intellectual property associated with ranitidine, the Zantac trademark and the other products covered by its License Agreement with Glaxo Canada".

As a result of these findings the FCA allowed the appeal on the basis that the Tax Court erred in law in failing to apply the proper test in determining "the amount that would have been reasonable in the circumstances" if the parties had been dealing at arm's length. Counsel for the Appellant had argued that in the event that the FCA agreed with the Appellant's position it should determine "the reasonable amount". The FCA instead decided that the trial judge, after more than forty days of hearing evidence, was in a better position than the FCA to make a determination on the issue. The FCA therefore set aside the Tax Court's decision and returned the matter to the original trial judge for rehearing and reconsideration based on the FCA's reasons.

On March 24, 2011, the Supreme Court of Canada provided leave to allow the Crown's appeal, and allow the taxpayer's cross-appeal, of the Federal Court of Appeal's *GlaxoSmithKline* decision.