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TORONTO, ONTARIO

"VALUATIONS AND PRICE-ADJUSTMENT CLAUSES"

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1. THE PRICE-ADJUSTMENT CLAUSE

A price-adjustment clause is generally incorporated into a purchase and sale agreement in non-arm's length transactions to provide for an adjustment to the transaction price in the event that a third party, such as Revenue Canada or a court, determines that the transaction price (i.e., "fair market value"[1] ultimately determined) of the property is other than that agreed to by the transacting parties (the fair market value declared).

The price-adjustment clause is generally used in order to avoid adverse tax consequences, such as those noted below, should the Department dispute the declared fair market value of the asset(s) transferred to the corporation.

To the extent that a non-arm's length transaction takes place at other than fair market value, the transaction may be subject to the provisions of section 69 of the *Income Tax Act*[2]. The effect of an assessment by Revenue Canada under section 69 may be double-taxation, in that one side of the transaction will be adjusted,[3] without a corresponding adjustment to the other side. If, however, there has been *bona fide* attempt to determine the fair market value of the transacted property and to transfer it at that price, the one-sided adjustment resulting from the operation of section 69 will not be applied by Revenue Canada.

Where property is transferred by a taxpayer to a corporation pursuant to the provisions of section 85 of the Act, the transferor will usually receive from the transferee corporation non-share consideration ("boot") and share consideration, the aggregate amounting to the fair market value of the property transferred. If the aggregate consideration (share and non-share) received by the transferor has a higher value than the property transferred, the transferor will be deemed to have received from the corporation a shareholder benefit under subsection 15(1). If the aggregate consideration has a lower value, the provisions of section 69 will not apply (i.e., deem the transferor to have received proceeds equal to the fair market value) if an election has been made under section 85, since the rollover provisions of section 85 override the general provisions of section 69. However, paragraph 85(1)(e.2) provides that if it is reasonable to consider any portion of the excess of the fair market value of the transferred property over the fair market value of the consideration received as a benefit which the transferor desired to confer on a related person, the transferor must include such excess in the proceeds of disposition. The transferor will be taxed on the capital gain thus triggered; while there will be an increase in the cost of the property to the corporation, neither the adjusted cost base ("ACB") of the shares taken back by the transferor nor that of the shareholder(s) who benefited will increase.

Hence, when there are non-arm's length transactions, including those subject to the rollover provisions of the Act (e.g., section 85 or 86 holding company or recapitalization freezes, respectively), the adverse tax consequences under section 69, paragraph 85(1)(e.2) or subsection 86(2) of the Act may apply if the Department disagrees with the value of the consideration transacted between the parties.

Accordingly, the transferor and the transferee corporation will include a price-adjustment clause in the purchase and sale agreement.

1.1 The *Guilder News* Decision

Prior to the decision in *Guilder News Co. (1963) Ltd. et al* v. *MNR*[4], taxpayers included price-adjustment clauses in their purchase and sale agreement so that in the event the Minister of National Revenue might subsequently make a final determination that the fair market value of the assets purchased and sold was less or greater than the price stipulated in the agreement, the price stipulated therein would simply be adjusted, automatically, to the fair market value finally determined.

In *Guilder News*, Revenue Canada assessed based on the assumption that the sale of property by the corporation to the individual at a price less than fair market value was a device adopted for the purpose of conferring a shareholder benefit under the provisions of subsection 15(1)[5]. The shareholder was assessed on a taxable benefit equal to the excess of the fair market value of the shares acquired over the price the shareholder paid to the company.

The purchase and sale agreement contained the following clause:

> "4. It being the intention of the Vendor and the Purchaser that the prices herein stipulated should represent the fair market value of the shares being purchased and sold herein, the parties hereto agree that in the event that the Minister of National Revenue should at any time hereafter make a final determination that the fair market value of the said shares as of the date of the Agreement is less than or greater than the prices herein stipulated, the prices herein stipulated shall be automatically adjusted *nunc pro tunc* to conform with such fair market value as finally determined and all necessary adjustments shall be made, including adjustment of the above-mentioned promissory note."

The Department assessed under subsection 15(1) (formerly subsection 8(1)). Refusing to recognize the price-adjustment clause, because the parties had not reasonably, and in good faith, attempted to transact at fair market value, Jackett, C.J. stated (at pp. 5051 and 5052 (DTC)):

> "If, in fact, a company simply sold property to its sole shareholder on expressed terms that the price payable was an amount equal to fair market value and provided a fair manner to determine such value, I would agree with the contention on behalf of the appellants that there could not, as a matter of law, be a benefit arising out of the sale.
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> "In my view, however, the 1964 sale was not such a sale.
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> "In the first place, it is common ground that 'the purchase price in each transaction was *obviously* less than the fair market value of the shares being sold … ' (the italics are mine) as appears from the Memorandum of Fact and Law filed in this Court on behalf of the appellants at paragraph 7. It follows that, at least with regard to the sale price set out in the contract, the statement in the opening words of clause 4 that it was 'the intention of the Vendor and Purchaser that the prices herein stipulated should represent the fair market value … ' is a departure from the truth and can have no effect (unless it be as evidence that the clause was in fact a 'sham')."
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> …
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> "This agreement is radically different from a sale that is expressly made for a consideration equal to value. This is an agreement for a sale at a price obviously less than value, which price is to be the only amount payable until such time, if any, as the Minister of National Revenue determines the value of the shares that happen to be the subject matter of this sale. While it can be said, as a matter of law, that a simple sale for value, with no other provisions, cannot result in a benefit, it cannot be said, as a matter of law that the 1964 sale is such a sale merely because it is an agreement containing clause 4. That sale is at a substantial undervaluation and, except in a certain event, it will continue indefinitely to be so. Even if that event should arise at some subsequent time, the individual will have had the benefit of not having had to pay the amount in excess of the 'price' until that subsequent time and this, in days of high interest, can be substantial benefit."

The effect of *Guilder News* decision is that taxpayers cannot take the chance that, if Revenue Canada should ultimately challenge the price, such artificially low price (in the eyes of Revenue Canada) can be automatically or otherwise adjusted so that there would be no adverse tax consequences under subsections 15(1), 86(2) or paragraphs 85(1)(e.2) and 53(1)(c).

1.2 Revenue Canada's Policy

The *Guilder News* judgment of the Federal Court of Appeal was received from the court on January 5, 1973. Revenue Canada issued its *Interpretation Bulletin* IT-169, "Price Adjustment Clauses" ("IT-169"), on August 6, 1974, approximately one and one-half years later.

Revenue Canada's policy regarding price-adjustment clauses is set out the *Interpretation Bulletin*. It states that the Department will recognize the intended effect of a price-adjustment clause provided that each of the following conditions is met:

1. The agreement provides a *bona fide* intention of the parties to transfer the property at fair market value and the value was arrived at by a fair and reasonable method;

2. Each of the parties to the agreement notifies the Department in his tax return for the year indicating that he is prepared to have the price reviewed by the Department, that he will take the necessary steps to settle any resulting excess or shortfall and that a copy of the agreement will be filed with the Department if and when demanded; and

3. The excess or shortfall is actually refunded or paid or the legal liability therefor is adjusted.

Since issuing IT-169, the Department has commented further in this regard, in order to make its policy more clear to taxpayers and tax practitioners.

As to its experience as to the willingness of taxpayers to give such notification, the Department's policy is:

> "When a corporation acquires property from a shareholder as part of an estate planning transaction and the corporation issues shares to the transferor that are subject to a price adjustment clause, we have no policy concerns regarding the nominal value of the shares issued should there be a subsequent change in the determined value of the property transferred. Our concern is to ensure that the price adjustment clause provides for a change in the redemption amount of such shares equal to any change in the fair market value of the property as subsequently determined."
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> …
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> "We are unable to comment on the experience of the willingness of taxpayers to give notification of the existence of price adjustment clauses. It is the choice of the taxpayers whether or not they agree to the operation of a price adjustment clause. In order for the price adjustment clause to be operative, the Department must be notified by a letter attached to a taxpayer's return for the year in which the property was transferred. This policy is reflected in *Interpretation Bulletin* IT-169 and, where the taxpayers have not done so, they should inform the Department immediately if they wish to have the clause considered.
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> "In an advanced ruling application, a taxpayer may simply state that the transaction is subject to a price adjustment clause. For it to be operative, however, all the terms and conditions of IT-169 must be satisfied."[6]

With respect to the second condition, which has virtually been ignored in practice, at the 1990 Conference "Revenue Canada Round Table", the Department stated that, "[i]f the parties fail to notify the Department in their returns, this failure, in and by itself, will not preclude the application of [the Department's position in IT-169] if the other conditions are met".[7]

In *Information Circular* IC 76-19R3,[8] Revenue Canada's expanded on its position with respect to price-adjustment clauses:

> "IT-169, Price Adjustment Clauses, states the conditions under which the Department will recognize a price adjustment clause for property transferred in a non-arm's length transaction. However, a price adjustment clause does not automatically amend a section 85 election. In order to give effect to a price adjustment clause, you have to file an amended election under subsection 85(7.1). An acceptable price adjustment clause has to adjust the price of the property transferred and the consideration received, not the quantity of the property transferred. The terms 'amount' and 'fair market value' in section 85 must be interpreted as fixed and specific dollar figures at the date of transfer, not formulas that can determine or adjust an amount later. A price adjustment clause cannot change these figures retroactively."

Interpretation Bulletin IT-448, "Dispositions — Changes in Terms of Securities"[9], states that "a change in a defined entitlement (e.g., a change in par value) to share in the assets of a corporation upon dissolution (preferred shares only) … is normally considered to be of sufficient substance to be regarded as a disposition".

Furthermore, Rulings Division had stated, in Advance Income Tax Ruling ATR-36[10] that, since the implementation of a price-adjustment clause is not a "proposed transaction", but rather a hypothetical event, the Department will not give an advance ruling to the effect that if an adjustment is made under such a clause, subsection 15(1) would not be applied to consider the transferor as having received a shareholder benefit. The Advance Ruling nonetheless did contain Revenue Canada's (non-binding) opinion that the price-adjustment clause would be effective if all of the criteria of IT-169 were met.[11]

With respect to V-Day (December 31, 1971) valuations, *Information Circular* 76-19R2, dated June 15, 1990, replaced IC 76-19R. Paragraph 14 of former IC 76-19R provided that " … where the taxpayer makes a reasonable effort to determine the V-Day value … the Department will adjust the agreed amount … ". IC 76-19R2 discontinued this relief by removing this paragraph, requiring an amended election and payment of the applicable penalty if there is a V-Day value disagreement. The only circumstance in which an adjustment to the elected amount can be made was set forth in paragraph 14 of IC 76-19R. The agreed amount expressed in dollars would be adjusted where: (a) the taxpayer had indicated on the election form that the amount was the estimated ACB; (b) the ACB was based on V-Day value; and (c) a reasonable attempt was made to determine V-Day value correctly. The adjustment to the agreed amount would be to reflect the change in the V-Day value only. (Other errors and omissions would not be considered in calculating the ACB.)

Should the agreed-upon amount be adjusted downward without a corresponding reduction in the non-share consideration, paragraph 85(1)(b) would automatically adjust the elected amount to an amount equal to the non-share consideration which would give rise to the capital gain. In such circumstances, it may be necessary to effect a "boot adjustment clause" in the agreement, in order to adjust the non-share consideration received by the transferor to an amount which would not exceed the V-Day value of the transferred property.

Also important in structuring the estate plan is the effect of a shareholders' buy-sell agreement on fair market value. This matter was elaborated on at the 1984 Annual Conference. (See Richard M. Wise, "Valuation Aspects of Shareholders' Buy-Sell Agreements", *1984 Conference Report*.)

2. CONTENTIOUS VALUATION ISSUES

With the foregoing general background, for a price-adjustment clause to be effective, a *bona fide* attempt must be shown to have been made to transact at a fair market value, arrived at by adopting a fair and reasonable valuation approach and employing appropriate valuation techniques. Presumably, this would require adherence to generally-accepted business valuation principles, practices and standards[12], in the determination of fair market value. Also, the taxpayer should be aware of the Department's own position as set out in *Information Circular 83-3*, "Policy Statement on Business Equity Valuations", dated August 25, 1989 ("IC 89-3").

However, as diligent, objective and thorough the valuation process might be, there nonetheless will continue to be the "classic" issues which may be contested by Revenue Canada when a non-arm's length transfer occurs.

These issues relate to, among other things, (a) special shares (mainly "exclusionary dividend common shares" and "special rights preferred shares"), (b) the valuation process applied in valuing the enterprise as a whole ("above-the-line" issues) and (c) the valuation of specific shareholdings in family-controlled corporations ("below-the-line" issues). It is not unusual, in fact, for disagreements to occur with respect to both the valuation of the enterprise as a whole (whether an operating company or a holding company) and the specific shareholdings therein (minority positions).

As the United States Supreme Court observed:

> "The capital stock of a corporation, its net assets, and its shares of stock are entirely different things … . The value of one bears no fixed or necessary relation to the value of the other.[13]

2.1 Special Shares

Special Shares created specifically for income tax and estate planning purposes are valued as a function of the rights, conditions and other attributes of the shares. These shares must be valued having regard to the relevant provisions of the company law (e.g., *Canada Business Corporations Act*[14] or its provincial counterpart) as well as the case law.

Revenue Canada notes a major difference in the approach used by its valuators and that used by valuators retained by taxpayers in allocating the overall enterprise value to the corporation's various issued shares, in tax and estate planning. This difference arises from the so-called "customized" share classes, e.g., "exclusionary dividend shares" and "special rights preferred shares", such Special Shares not generally being issued by a corporation in arm's length situations.[15]

2.1.1 Exclusionary Dividend Common Shares

There continues to be differences between the Department and the taxpayer with respect to the valuation of exclusionary dividend common shares. These types of shares are generally issued by a closely-held family corporation having various classes of common shares, each shareholder owning shares of one specific class. While all share classes have the right to receive dividends, there is no absolute dividend right.[16] Generally, only one share class will have voting rights, or, if there is more than one class of voting shares, one shareholder may have the voting control and, hence, control over the declaration and allocation of dividends. The shares are generally issued for income-splitting purposes, with dividends being sprinkled among family members (often the spouse and/or children of the controlling shareholder) who are taxed at lower marginal rates. The shares would be issued for a nominal amount.[17]

Both the Department and taxpayer had valued exclusionary dividend shares at nominal value because an uncompelled arm's length purchaser could be excluded from dividend distribution and other benefits. However, subsequently, when it came to crystallizing capital gains, taxpayers began to value these shares based on full rateable value, i.e., on a controlling basis (along with the voting shares which carried control), based on either (a) a "value to owner" concept or (b) an assumed *en bloc* sale of all the corporation's issued shares in order to maximize value. While Revenue Canada continues to maintain its position that the exclusionary dividend common shares must be valued on a stand-alone basis, there is some question as to whether such position is supportable[18]. As discussed further hereinbelow (see **"Below-the-Line Discounts, Minority Discounts and Family Control"**), there may be a difference between considering, for valuation purposes, family minority shares or non-voting shares (a) in the hands of a family member who also owns the controlling shares and (b) in the hands of a family member who, by himself or herself, does not also hold the controlling shares. In the latter scenario, a material presumption must be made that the family shareholders will act in concert and simultaneously sell all of the issued shares *en bloc*, with the result that the taxpayer's minority shares will be valued pro-rata to all of the issued shares. In the former scenario, where one individual shareholder holds two classes of shares, the result may be quite different, in that the individual shareholder has personal control over his or her commercial transactions. This latter scenario has been addressed in the following cases.

These cases address the proposition that both the voting shares and the non-voting shares would be sold by a shareholder, together as one block, in order to realize the best possible price for the non-voting shares. This view appears to be supported in particular by the decisions of *Estate of Curry* v. *U.S.*[19] and *Attorney-General of Ceylon* v. *Mackie*.[20]

In *Estate of Curry*, the U.S. Court of Appeals reversed the decision of the District Court, which had found that the non-voting shares of the company had a lower per share value than the voting shares. The Appeal Court held that the deceased's shares, both voting and non-voting, were to be valued as one interest and, because he controlled the corporation, his non-voting shares were worth as much as his voting shares. In this case, the estate argued that the deceased's shareholdings should be divided into separate voting and non-voting blocks for valuation purposes and that the non-voting shares could have had a lower value even if viewed as part of a single unit that included the voting shares. The taxation authorities, on the other hand, argued that for estate tax purposes, the property transferred must be valued as the deceased held it, not in the form it could conceivable take in a subsequent transfer, and that, in the hands of the estate, the absence of voting control appurtenant to some of the shares would not diminish their value because voting control still resided in the deceased's power.

The Appeal Court held that both the law and common sense compel the conclusion that the fair market value of the non-voting shares in the hands of an estate, with sufficient voting shares to ensure the estate's control of a corporation, cannot be less than the value of the estate's voting shares. In rejecting the government's instruction, the Court therefore concluded that the District Court erred as a matter of law to the substantial prejudice of the rights of the government. Justice Wood stated:

> "The sole reason for assigning a lesser value to the non-voting shares in this case is their lack of voting rights which would, the estate argues, make them less attractive to a prospective purchaser. But that defect disappears where, as here, the non-voting stock is an integral part of the larger estate which retains a controlling equity interest. Here, when viewed in the hands of the estate, the non-voting stock would simply not be subject to the disadvantages of an isolated non-voting interest.
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> "Like this Court, the Ninth Circuit in *Ahmanson*[21] rejected the argument, made by the estate here, that non-voting shares could be assigned a lesser value than controlling voting shares even where both comprised a single bloc, noting, '[t]he record simply does not contain support for the proposition that non-voting shares are sold at a discount when sold together in a package with sufficient voting shares to give control.' In

> short, when viewed as part of the estate's integrated stock holdings, as they must be, the non-voting shares simply do not suffer any strategic disadvantage."[22]

In *Mackie*, an estate duty case, the deceased held two classes of voting shares. The shares of neither class afforded him voting control of the company, but in the aggregate, they constituted control. The Privy Council upheld the valuation of the deceased's shares for estate duty purposes on the basis that it must be presumed that shares of both classes would be sold together in order for the holder to obtain the highest price for them.

Therefore, to the extent that a controlling shareholder has non-voting shares in the family corporation, there should be no discount applied and they should be valued as if they were voting, because they would be sold as part of a unit that would consist of them and the control shares. However, if these non-voting shares are held by a family member who, by himself or herself, does not have control, the "family and group control" policy of Revenue Canada may be open to challenge. While there will be revisions to Revenue Canada's IC 89-3, the Department may continue to value each class of shares on a stand-alone basis. Taxpayers will still not have heard the end of these ongoing issues. The Department must consider its position in IC 89-3 in light of the following two decisions.

In *McClurg*[23], the Supreme Court of Canada confirmed that exclusionary dividend clauses were legal and that the payment of such dividends did not derogate from corporate or common law principles. The discretionary dividend clause was a "valid exercise of contractual rights between the company and its shareholders in accordance with the common law and statute. The court also noted that the shareholders must be presumed to be "fully aware of their entitlements and privileges to the extent that the presumption of equality is rendered inapplicable".

In *The Queen* v. *Neuman*[24], the court confirmed that discretionary dividend rights were legally valid, stating that:

> "The law as it stands as a result of *McClurg* (*supra*) is that discretionary dividend clauses in Articles of incorporation are valid (presumably unless precluded by statute) and rebut the common law presumption of equality of treatment among shareholder classes."

The impact of *McClurg* and *Neuman* on the valuation of exclusionary dividend shares is that a holder of such shares cannot claim full pro-rata value for a minority interest based on having legitimate expectations of dividends (notwithstanding the specific exclusionary payment rights in the company's articles) because of being in a position to apply to the court under the oppression remedy provisions of the *Canada Business Corporations Act*[25] or similar provisions of a provincial statute.

The Supreme Court in *Neuman* had noted that the taxpayer was assessed prior to the enactment of the GAAR legislation, leaving open the possibility that GAAR might apply to exclusionary dividend payments. The Department has not stated whether or not it will attempt to apply to GAAR to transactions which are similar to those in *McClurg* and *Neuman*.

Mr. Justice Iacobucci stated, with respect to the relationship of a shareholder's contribution to a corporation and dividends received from that corporation:

> " … I assume, of course, that proper consideration was given for the shares when issued. I am not aware of any principle of corporate law that requires in addition that a so-called 'legitimate contribution' be made by a shareholder to entitle him or her to dividend income and it is well accepted that tax law embraces corporate law principles unless such principles are specifically set aside by the taxing statute.
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> "Furthermore, there is no principled basis upon which this distinction can be drawn; the fact that a company is closely-held or that no contribution is made to the company by a shareholder benefiting from a dividend in no way changes the underlying nature of a dividend. Neither the fact that the transaction is non-arm's length nor the fact that the shareholder has not contributed to the corporation serves to overcome the conclusion that dividend income cannot satisfy the fourth pre-condition to attribution under s. 56(2)."[26]

The Department insists that each class of Special Shares be valued having regard to its rights, conditions and other attributes.

In order to make its position *vis-à-vis* its policy with respect to valuation and family control very clear, the Department proposes to revise the wording of paragraph 32 of IC 89-3, specifically because tax practitioners often interpret the second paragraph to mean that where family control of a company is demonstrated, IC 89-3 will apply to all classes of the company's shares held by all family members regardless of the rights and conditions of the individual classes of shares. More specifically, the Department faces claims from tax professionals that "exclusionary dividend shares" must be given full pro-rata value pursuant to its policy in IC 89-3. Revenue Canada's response is that its policy was intended to cover only minority shares which essentially had equal rights to the controlling shares; extension of its policy to allow pro-rata value for all family-held shares irrespective of their rights and conditions is not acceptable.

2.1.2 Retractable Preferred Shares

Retractable preferred shares are issued generally in the context of a holding company freeze under section 85 or a recapitalization freeze under section 86.

As noted earlier, the holding company freeze and the recapitalization freeze are potentially subject to adverse tax consequences under paragraph 85(1)(e.2) or subsection 86(2) of the Act, respectively.[27] Revenue Canada has stated that for private-company retractable preferred shares, taken back in either a holding company freeze or a recapitalization freeze, to hold their value (be equal to their redemption amount) they should at least have the following attributes:

(a) be redeemable[28] at the option of the holder (i.e., retractable) for an amount equal to the retraction amount;

(b) have priority in the event of a wind up, liquidation or redemption;

(c) the issuer must not be permitted to pay dividends on the other shares in an amount that would reduce the fair market value of the subject preferred shares below their redemption amount;

(d) the shares should have voting rights at least on any matter involving a change to the preference, rights, conditions or limitations attaching to them.

With respect to the future ability of the corporation to redeem the shares at the retraction amount, the company must, at least at the valuation date (and viewed prospectively at that time), have sufficient liquidity (liquidation preference) to pay such amount to the shareholder upon a retraction demand.

Where retractable preferred shares have been issued by a holding company (Holdco) for purposes of freezing the growth of an operating company (Opco) having substantial goodwill, the valuation of the preferred shares should take into account, among other factors:

- The tax liability to Holdco on the ultimate sale of the Opco shares to fund payment of the retraction amount;[29]
- That a redemption by Holdco of the preferred shares may subject the shareholder to personal income tax; and
- Whether Holdco is a newly-incorporated shell, essentially having no assets other than the Opco shares.

Accordingly, the valuation of retractable preferred shares used in tax and estate planning will consider the following factors as of the freeze date (for section 85 and 86 purposes) and as of a subsequent date of transfer:

- Dividends — whether they should be fixed, based on a percentage of stated value or an adjustable-rate feature;
- Frequency of dividend payments — whether they should be annual, semi-annual, quarterly or monthly;
- Whether dividends are cumulative and, if so, the rights, if any, that would accrue to the holder because of missed dividends;
- Whether the shares are voting under all circumstances;
- Whether the shares are exchangeable;
- The financial ability of the issuer to redeem the shares upon the shareholder's retraction demand;
- The issuer's financial viability, capital structure and "staying power" under adverse conditions or in cyclical downturns; and
- The level of senior ranking charges against issuer's operating cash flow.

As regards the dividend yield on the preferred shares taken back by the transferor, as a higher "quality" preferred share will sell at a higher price, the dividend yield can be lower (because there would be less risk of non-payment of dividends than for a preferred share of inferior quality). Therefore, the higher (a) the anticipated ratio of earnings and cash flow to preferred dividend requirements and (b) the ratio of net current assets (or shareholders' equity) to the retraction value of the preferred shares, the better the quality of the shares and, hence, the lower the dividend-yield required on the shares.

The appropriate rate of return (yield) for the retractable preferreds will have regard to the indicated yields of the most applicable rating category of "guideline" preferred shares which might be used as a benchmark.

While the Department generally accepts retractable preferred shares as having a fair market value equal to their stated retraction amount (provided the company has the assets and is in a sufficiently liquid position to pay the retraction amount to the shareholder), its policy does not establish value for subsequent transactions involving the preferred shares. That is, "retraction amount" will equal fair market value at the time of transfer under subsection 85(1) or recapitalization under section 86; the shares must be valued again at the time of a subsequent transfer based on their attributes at that subsequent time. The Department's experience has been that retractable preferred shares, deemed to have been disposed of by a taxpayer immediately before death pursuant to paragraph 70(5)(a), have been valued by the taxpayer's representatives at significantly lower amounts than the original retraction amounts.

In reviewing these values, the Department examines, on a case-by-case basis, the economic effect of a notional retraction of the shares by the individual shareholder, considering the after-tax proceeds on redemption at the retraction amount. It also considers whether tax planning may be available (such as a rollover of the retractable preferred shares into a corporation prior to the retraction demand, in order to have any deemed dividend afforded section 112 treatment).

To the extent that the shares meet the investment criteria outlined above, they may retain their stated retraction amount. Again, the Department considers each case on its own merits.[30]

2.2 "Above-the-Line" Issues

With respect to the fair market value of an enterprise as a whole, differences of opinion between the "opposing" valuators may typically relate to the following, among others:

- The valuation approach adopted;
- The valuation techniques applied under this approach;
- Adjustments to "normalize" the reported results (with respect to non-recurring items, non-arm's length transactions, transfer pricing, discretionary expenses, non-economic expenses, management/shareholder remuneration, the use of mathematical weights applied in averaging a number of years' earnings, etc.);
- The income tax factor used in calculating the level of after-tax maintainable earnings to be capitalized;
- Selection of the capitalization rate (price/earnings multiple) to apply to the maintainable earnings;
- If, alternatively, a "discounted cash flow approach"[31] is adopted, the reasonableness of the projections used and the underlying assumptions on which they were based, the calculation of residual ("terminal") value, the discount rate used in present-valuing the projected cash flows, etc.;
- Where the "guideline company" (market comparable) method[32] is used, the appropriateness of the "comparatives" used, i.e., the degree of similarity between the market transactional data to those of the business being valued[33];

- Identification and valuation of “redundant” assets (excess assets and non-operating assets);
- Effect of cyclicality and/or seasonality, if any, on the annual earnings level used in averaging past results;
- Effect on maintainability of earnings of the business when there is a high degree of dependency on a key person;
- Treatment of “off-balance sheet” items (e.g., contingent assets, contingent liabilities, litigious claims, valuable intangibles, etc.);
- In the case of an investment holding company, recognition of the “trapped-in” income taxes on accrued capital gains;
- In the case of real estate investment companies, portfolio discounts in respect of large pools of properties;
- In the case of a start-up operation, the quality and reliability of projections;
- Special-purchaser considerations; etc.

2.3 “Below-the-Line” Issues

In addition to the foregoing “above-the-line” (i.e., total-enterprise level) valuation issues, the following areas of dispute occur with respect to “below-the-line” levels of value (i.e., with respect to the specific shareholdings, or business ownership interests, themselves):

- Valuation methodology (e.g., whether to value the minority shares using a “top down” approach, “bottom up” approach, or possibly a market-based approach);[34]
- Discounts for lack of control (minority discounts);
- Discounts for lack of marketability or liquidity (marketability discounts);
- Discounts for fractional interests in real estate (for unmarketable, undivided co-ownership interests);
- In the case of a holding company, whether an asset-based approach can be adopted if the shareholder cannot cause the liquidation of the corporation under the provisions of the relevant company law statute;
- Blockage discounts;
- Special-purchaser considerations; etc.

2.4 Should Discounts Be Discounted?

As valuation is more of an art than a exact science[35], the foregoing areas — and many more — are open to challenge by Revenue Canada (or actually any others who may possibly have an opposing view, such as the respective parties in mergers and acquisitions, shareholder disputes, matrimonial matters, going-private transactions, etc.[36]). This paper will focus on the following discounts, often being the most contentious areas:[37]

- Above-the-line:
  - Discounts with respect to built-in capital gains tax liabilities of investment holding companies;
  - Key-person discounts with respect to operating companies; and
  - Portfolio discounts with respect to investment holding companies.
- Below-the-line:
  - Minority discounts on shares of family-controlled corporations;
  - Marketability discounts on these shares; and
  - Discounts for fractional interests in non-family-controlled real estate investments.

This paper will also outline Revenue Canada's policy regarding "special shares" and "retractable preferred shares" used in tax and estate planning.

In considering the factors which will be discussed herein, it is essential to keep in mind that "fair market value" (which is the term employed in the Act) is the "willing-buyer/willing-seller" standard; it necessarily contemplates uncompelled, arm's length, reasonably informed parties, acting in their respective self-interests and with equity to both. "Value to owner" is a totally and fundamentally separate valuation standard.[38]

Recognizing the potential disagreements which might arise, considering that the non-arm's length share transfer in the course of the estate plan may well be subject to scrutiny by the Department's business valuators, a price-adjustment clause should be included in the purchase and sale agreement. In many cases, it may be desirable — indeed prudent — for the taxpayer to commission an independent valuation to support the fair market values used in the transaction, particularly if the foregoing areas involve material amounts and/or extremely contentious issues.

2.5 Above-the-Line Discounts

2.5.1 Built-In Capital Gains Tax Liability Discounts

Assume that a corporation has only one asset — a parcel of vacant land having a value of $1,000,000 on the valuation date and an ACB of $200,000. There are no liabilities. Much debate has occurred as to whether, for purposes of valuing the corporation's issued shares, a discount should apply in respect of the taxes on the accrued capital gain of $800,000 if there is no intention to sell the asset or liquidate the corporation. Would a purchaser pay $1,000,000 for the shares, even if there is no intention to sell? What if the ACB of the land was $1,000,000 instead of $200,000?

The issue of the trapped-in capital gains tax arises most often in the valuation of investment holding companies, particularly those which do not generate significant income or cash flow. These types of companies may hold a portfolio of marketable securities which do not generate substantial dividends, or might own undeveloped real estate which may have dramatically increased in value. As a consequence, they are valued in relation to their underlying portfolio of assets (applying an asset-based approach) rather than as an operating company (applying an income-based approach).

When a company is valued using an income-based approach, the corporate level of tax on the income generated by the company is considered in deriving value. Conversely, if the company is valued using the net asset or liquidation method, consideration must be given to any corporate level tax that would be generated upon sale or liquidation, since this method assumes that the company's shares are no more valuable than the underlying net assets.[39]

Because the term "fair market value" is defined as the highest price at which property would change hands between a willing buyer and a willing seller, dealing at arm's length, neither being under any compulsion to transact and both having reasonable knowledge of all relevant facts, some discount should be appropriate because a built-in capital gains tax on the accrued, or unrealized, gain would reduce the price which a knowledgeable buyer would be willing to pay. An informed, uncompelled buyer would not consider the unavoidable future taxes on a private corporation's appreciated assets in determining the fair market value of the issued shares.

For many years, in the U.S., a discount for the built-in capital gains tax liability had not normally been recognized by the U.S. tax courts, because the gain could often be avoided or minimized in a liquidation. Similarly, income taxes and liquidation costs were not generally permitted for purposes of determining the fair market value of a corporation's shares when the prospect of liquidation was speculative. This is generally the same position as in Canada.

In its *Technical Advice Memorandum* (TAM) 9150001, the Internal Revenue Service ("IRS") stated that an estate was not entitled to discount the net asset value of a corporation's shares for estate tax purposes to reflect the potential capital gains taxes that would be incurred if the corporation were liquidated where no liquidation was, in fact, contemplated. The position in this Letter Ruling contradicts the language in IRS *Revenue Ruling 59-60*[40], which is the basic policy of the IRS with respect to the valuation of closely-held businesses. The *Revenue Ruling* states that "if the business consists of a closely-held investment or real estate holding company, whether or not family owned, the cost of liquidating it, if any, merits consideration".[41]

There is also an apparent contradiction between the Letter Ruling in TAM 9150001 and the position of the IRS in its *Valuation Guide for Income, Estate and Gift Taxes*[42].

This private Letter Ruling, however, fails to distinguish among the markets or marketplaces in which a transaction may occur, *viz.*, the leveraged buyout market, the real estate finance market, the market for restricted shares, etc.

In one case, however, the U.S. Tax Court permitted a 15% discount for lack of marketability, stating:

> "A discount for lack of marketability was not warranted; yet, we feel it necessary to reduce the net asset value of the corporation by the transaction costs that would be incurred in obtaining that direct ownership. The corporate form cannot simply be ignored."[43]

The cases which were decided prior to the enactment of the U.S. *Tax Reform Act of 1986* ("TRA") and the repeal of the *General Utilities*[44] doctrine were decided on the basis that an acquiring corporation could re-value the acquiree's assets to current fair market values without paying a capital gains tax on the increase in the cost basis of the acquiree's assets (although the acquiree was subject to tax on recapture of depreciation) under the *General Utilities* doctrine.

The position of the U.S. Tax Court in the pre-1986 cases is summarized in *Estate of William T. Piper*[45]*:*

> "We consider such a discount unwarranted under the net asset valuation technique employed herein, where there is no evidence that a liquidation of the investment company was planned or that it could not have been accomplished without incurring a capital gains tax at the corporate level. If the purchaser had been an individual, the use of §337 would have afforded the opportunity to avoid the capital gains tax at the corporate level, and any gain at the shareholder level would have reflected only the increase in value of the assets subsequent to the purchase. If the purchaser [was] a corporation, the same opportunity with similar consequences would have been afforded under §332 and §334(b)(2)."

Recently, the foregoing long-standing policy of the U.S. Tax Court has changed, as the result of two important judicial decisions.

In *Estate of Artemus D. Davis* v. *Commissioner*[46], the issue was the fair market value of each of two 25-share blocks (out of a total of 97 outstanding shares) of a holding company, ADDI & C ("Holdco"), the principal asset of which comprised in excess of 1 million shares of Winn-Dixie Stores, having a value in excess of U.S. $70 million on the valuation date (November 1992). The cost base of the shares was only U.S. $338,000. The greater portion of a potential capital gains tax liability of U.S. $2.7 million was attributable to the Winn-Dixie shares held by Holdco. Each of the two 25-share blocks of Holdco was valued at US. $6.9 million by the taxpayer and U.S. $13.5 million by the IRS. The IRS imposed a gift tax deficiency[47] against the Estate of Artemus Davis.[48] The major part of the difference in value related to the treatment of built-in capital gains taxes.

Judge Chiechi stated:

> "We reject respondent's position that, as a matter of law, no discount or adjustment attributable to [Holdco's] built-in capital gains tax is allowable in the instant case."

The IRS relied on a line of jurisprudence which, as noted above, holds that built-in capital gains taxes should not be taken into account in determining fair market value where liquidation is speculative. It also argued that Holdco could have converted to an S-corporation and have avoided capital gains taxes on the sale of Holdco's assets after a ten-year holding period.[49] The Court added:

> " … we agree that as of the valuation date it was unlikely that [Holdco] would have converted to an S-corporation. Based on the record before us, we reject respondent's unwarranted assumptions that [Holdco] could have avoided all of [its] built-in capital gains tax by having it elect S-corporation status and by not permitting it to sell any of its assets for ten years thereafter, and the record does not establish that there was any other way as of the valuation date by which [Holdco] could have avoided all of such tax.
>
> "We are convinced …, and we find that, even though no liquidation of [Holdco] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [Holdco's] built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [Holdco's] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no … built-in capital gains taxes of that date."

Interestingly, not only did the taxpayer's valuation expert apply a discount, but even the IRS valuation expert applied a discount (15%) in respect of built-in capital gains taxes. These discounts were included in the marketability discounts applied to each block of shares, *viz.*, 50% and 38%, respectively.

In Judge Chiechi's view, a deduction with respect to the full amount of taxes in calculating Holdco's net asset value was not appropriate unless a liquidation or asset sale was occurring. Accordingly, the respective valuation approaches of the valuators for each side, i.e., the inclusion of a discount for built-in capital gains tax as part of the marketability discount, were appropriate:

> " … we find that on the valuation date there was less of a ready market for each of those two blocks because of [Holdco's] built-in capital gains tax than there would have been for each such block without such a tax."

The most recent decision on point is that of the U.S. 2nd Circuit Court of Appeals in *Eisenberg* v. *Commissioner of Internal Revenue*[50], reversing the decision of the U.S. Tax Court[51] which had denied the taxpayer the ability to reduce the fair market value of shares gifted[52] to her relatives by the capital gains tax[53] which her real estate holding company would have incurred if it liquidated, sold or distributed its only real estate asset. The lower court had held that well-established precedent dictated that no reduction in the value of private-company shares may be taken into account to reflect the built-in capital gains tax liability where evidence fails to establish the likelihood of a liquidation or sale of the corporation or its assets, because the tax liability is purely speculative. In addition, the Tax Court found no indication that a hypothetical purchaser would acquire the corporation with a view of either liquidating it or disposing of its real estate, such that the built-in tax liability would be considered a material or significant concern. That is, if, as of the valuation date, there was no contemplation of such liquidation or sale, should the determination of fair market value of the issued shares take into account the built-in capital gains tax liability?

As noted in *Piper* (*supra*), the U.S. Tax Court had, in the past, generally held that, in valuing private-company shares using the asset-based approach (net asset value method), a special reduction of the value of the shares with respect to built-in capital gains tax liabilities at the corporate level was unwarranted where there was no evidence that a tax-triggering event, such as a liquidation or sale of the corporation's assets, was likely to occur.[54] The denial of a reduction for built-in capital gains tax liability was based, in part, on the possibility that the taxes could be avoided by liquidating the corporation.[55]

The question before the 2nd Circuit in the *Eisenberg* appeal was whether it agreed with the reasoning of the Tax Court that the capital gains tax liability was too speculative to be valued as of the date of the gift where no liquidation, sale or distribution of the taxpayer's corporation was planned.

The Court referred to *Estate of Davis* (*supra*), which "reject[ed] respondent's position that, as a matter of law, no discount or adjustment attributable to [the corporation's] built-in capital gains tax is allowable". The Tax Court, in *Estate of Davis*, found that even the respondent acknowledged that irrespective of whether a liquidation of the corporation or a sale of its assets was contemplated on the valuation date, "some reduction in value would be appropriate if, in fact, avoidance of a corporate level gains tax was not available". The Court in *Davis* stated:

> "We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [the corporation's] built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [the corporation's] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no … built-in capital gains tax as of that date … . We have found nothing in the … cases on which respondent relies that requires us, as a matter of law, to alter our view … ".

The court allowed a discount for the built-in capital gains tax because "that is what a hypothetical willing seller and a hypothetical willing buyer would have done".

In reversing the decision of the Tax Court in *Eisenberg*, which had held that "the primary reason for disallowing a discount for capital gains taxes in this situation is that the tax liability itself is deemed to be speculative",[56] the 2nd Circuit Court of Appeals stated:

> " … We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C-corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock. We therefore remand this matter to the Tax Court to ascertain the gift tax to be paid by the taxpayer consistent with this opinion."

It is important to recognize that the built-in capital gains tax is not deducted from what would otherwise be the fair market value of the corporation's real estate (or other appreciated investments); rather, it impacts the fair market value of the corporation's issued shares.

It is also important to keep in mind that in the valuation of a minority interest in an investment holding company, the minority shareholder cannot pass a special resolution to liquidate the company. Hence, unless liquidation is contemplated in any event, an asset-based valuation approach may be totalling inappropriate.

2.5.2 Key-Person Discounts

In business valuation, consideration is given to the possibility that the loss of a key executive[57] may have a negative effect on the business and the value of its issued shares, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the shares of such a business, the effect of the loss of the manager on the future expectancy of the business, and the absence of management succession potentialities, are accordingly pertinent factors. The extent of organizational damage may also be related to the suddenness of the key manager's departure.

On the other hand, the nature of the business and of its assets may be such that they will not be impaired by the loss of the key person's services. In certain cases, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the key person's services. These, or other offsetting factors, if found to exist, are carefully weighed against the loss of such services in valuing the shares of the enterprise.[58]

The valuation discount to reflect the loss of a key individual depends on several factors, one of the most important typically being the extent of the key person's actual duties, responsibilities and contributions to the business. The key person's primary contribution is often in the form of long-standing customer and/or supplier relationships and general industry know-how. Other important factors impacting the valuation discount include the ability of the other executives and employees of the company to assume the duties of the "vacant" position, the compensation necessary to replace such individual, the reaction of customers, competitors and — depending on the nature of the business — suppliers, upon learning of the loss, as well as the amount of any insurance proceeds on the life of the key person (if death is the reason for the loss).

In *Les Placements A&N Robitaille Inc.* v. *MNR*[59], Mr. Justice Archambault of the Tax Court of Canada recognized that Mr. Robitaille, who played a key role in his company's business (a small-scale operation which reconditioned defective boats imported from the United States) was a key man in the operation of the company's business and, therefore, had substantial personal goodwill. Justice Archambault commented that the personal goodwill that Mr. Robitaille had did not mean that no commercial goodwill could coexist in the corporation. In recognizing a key-man discount, His Lordship stated:

> "In order to take account of Mr. Robitaille's personal goodwill, I believe that it is essential to recognize a key-man discount, as Mr. Wise did in his report. The evidence clearly established that Mr. Robitaille plays a preponderant role in the operation of this

> business. I am satisfied that if Mr. Robitaille were to leave the business, Marina Quebec would suffer a substantial reduction in its earnings. In the circumstances, I believe that it is reasonable to use a discount rate of 35%."

The court allowed a 35% key-man discount to be deducted from the company's after-tax maintainable earnings, prior to capitalizing such earnings, to arrive at the value of the business as a going concern.

Key-person discounts have been recognized in the United States for over a half-century[60] when existing or prospective management could not properly take over the duties of the deceased.

In a U.S. Tax Court decision, *Estate of Milton Feldmar* v. *Commissioner*[61], Judge Fay noted:

> "We further recognize, however, that where a corporation is substantially dependent upon the services of one person, and where that person is not longer able to perform services for the corporation by reason of death or incapacitation, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee (key employee discount). … we find that Milton Feldmar was an innovative driving force upon which UEC was substantially dependent for the implementation of new marketing strategies and acquisition policies. Therefore, we find that a key employee discount is appropriate … ".

The judge also stated:

> " … we find that an investor would be willing to pay a 15% premium for a controlling block of shares in UEC, but the same investor would expect a 35% discount for the loss of a key employee. … a key man discount of 35% is appropriate in this case because UEC suffered a serious loss when decedent took to his grave his considerable expertise in finding and exploiting innovative insurance products and services. Such 35% discount should be reduced, however, to account for UEC's potential for finding a new leader, from outside of its existing management, to replace decedent. Although we find it to be a very remote possibility that UEC might find a new helmsman with knowledge, experience, innovative skills, and resources comparable to those of the decedent, we shall reduce the key employee discount to be applied from 35% to 25% to account for such potentiality".

In *Estate of Rodriguez et al* v. *Commissioner*[62], Judge Williams reduced the company's future earnings (instead of applying a discount to the share value otherwise determined) in recognizing the loss of the key man:

> "The evidence shows that decedent was the dominant force behind Los Amigos. He worked long hours supervising every aspect of the business. At the time of his death, Los Amigos' customers and suppliers were genuinely and understandably concerned about the future of the business without decedent. In fact, Los Amigos soon lost one of its largest accounts due to an inability to maintain quality. The failure was due to decedent's absence from operations. Profits fell dramatically without decedent to run the business. No one was trained to take decedent's place.
>
> "Capitalizing earnings is a sound valuation method requiring no adjustment only in a case where the earning power of the business can reasonably be projected to continue as in the past. Where, as in this case, a traumatic event shakes the business so that its earning power is demonstrably diminished, earnings should properly be adjusted … . An adjustment to earnings before capitalizing them to determine the company's value rather than a discount at the end of the computation is appropriate to reflect the diminished earnings capacity of the business. We adopt petitioners' expert's adjustments to earnings for the loss of the key man." (at 1039.)

Key-person discounts may be given effect in the valuation by:

- A reduction of normalized earnings to arrive at a maintainable level of earnings absent the key person;
- A reduction of the multiple which would otherwise be applied to the unaffected earnings;
- Reduction of estimated future cash flows or earnings to be discounted[63]; etc.
- Reduction, as a separate discount, from the fair market value of the business otherwise arrived at.

2.5.3 Portfolio Discounts

In valuing a company owning a large number of individual real estate properties, securities or other investments, it may be appropriate to apply a "portfolio discount" to the aggregate of the respective values of each of the items comprised in the portfolio. This reflects the fact that while the value of each property may represent, on an individual basis, the "highest price obtainable" (as contemplated in the term "fair market value"), the mix and quantity of the properties may result in the bundle *en bloc* being less attractive to a notional purchaser than each one viewed individually. While the notional purchaser is presumed to be attracted to the majority of the properties (as he or she is acquiring the issued shares in order to obtain control and ownership of the properties), the purchaser may likely wish to (imminently) dispose of the ones considered to be the least desirable. As there are risks and costs associated with any disposition, if the purchaser has paid fair market value (on the basis of the properties viewed individually) and subsequently realizes such amount on sale, there would be no economic return (ignoring the time value of money), i.e., a purchaser would not pay $1 to receive $1 in exchange. A notional purchaser acquiring a large portfolio of properties (comprised in the issued shares of the target corporation) should be able to negotiate a better price from the vendor by being granted a "quantity discount" (because of buying "wholesale") as well as a further discount to recognize the risks relating to the more undesirable properties in the portfolio.

The discount is applied to the aggregate value of the individual properties. This would recognize that, through a share transaction, the notional purchaser is acquiring the properties *en bloc*.

In *LoCicero* v. *B.A.C.M. Industries Ltd.*[64] a decision of the Manitoba Court of Queen's Bench, reversed by the Manitoba Court of Appeal[65], the Supreme Court of Canada restored the decision of the trial court[66], which had accepted that appraised values of individual parcels of land must be discounted for the following reasons:

- Appraisals of individual properties are unreliable indicators of fair market values of shares of large real estate companies;
- The specific nature of each property, the assumptions on the economy, local markets or financing and, most particularly, the size of a holding can vitiate the usefulness of any valuation technique used by real estate appraisers (replacement cost, comparable sales or economic value);
- Appraisals do not reflect the varying capital structures of different companies; and
- Appraised values are in effect very spasmodic and ephemeral, and can be drastically reduced in only a few months.

A discount of 47% was applied to the appraised values of B.A.C.M. Industries Ltd.'s real estate to represent the "realities of the market" and the financial world, which discount would have reflected how the market viewed the appraised value of a substantial land bank during the 1970s.

Portfolio discounts are generally applied in arriving at share values because of the necessity to inherit, through a share purchase, the entire real estate portfolio of the acquired corporation. Discounts in excess of 30% had not been unusual in the industry during the recession of the early 1980s, as market conditions were weak and in favour of the buyer. The size of the discount will depend, *inter alia*, upon market conditions, the economy, the attraction of the particular type of real estate (e.g., residential, commercial, industrial, etc.), the position of the cycle in the industry, the location of the real estate, etc.

Currently, portfolio discounts are substantially lower.

2.6 Below-the-Line Discounts

2.6.1 Minority Discounts And Family Control

> "A number of years of experience has demonstrated that it is extremely difficult to find any market for minority interests … , despite efforts to do so … . On the relatively rare occasions when an offer is made to buy a minority interest, it is almost always for an amount far less than the fiduciary and the beneficiary expect to get."[67]

A minority interest is a shareholding that does not carry *de jure* control, i.e., the shareholding represents less than 50% + 1 of the voting shares; stated differently, it represents 50% or less of the voting shares.

The size of the discount to be applied to a minority shareholding will typically depend on the facts and circumstances in each case, which include, *inter alia*:

- The size of the shareholding;
- The relationship of the shareholder to the other shareholders;
- Whether group control exists;
- The dispersion of the other shareholdings;
- Whether or not there are "special purchasers"[68] in the marketplace;
- Dividend history and policy;
- The terms of the shareholders' buy/sell agreement, if any;
- Restrictions as to transferability; and
- Degree of influence on management policy[69].

Certain "degree of control" factors may or may not exist in any specific ownership interest. For example, among the factors which typically influence the value of a minority position include the degree to which the shareholder or partner has the ability to:

- Appoint management (and directors, in the case of a corporation);
- Block corporate or partnership actions;
- Change the articles of incorporation, by-laws, or terms of a co-partnership agreement;
- Declare and pay dividends or make distributions;
- Determine management compensation and perquisites;
- Dissolve, liquidate, sell or recapitalize, in the case of a corporation;
- Make acquisitions;
- Liquidate assets;
- Register the shares for a public offering, in the case of a corporation;
- Select people with whom to do business or award contracts;
- Sell or acquire treasury shares, in the case of a corporation;
- Formulate policy and change the course of business.

Revenue Canada has no policy regarding discount ranges for minority discounts, if they should be applicable. The Department does, however, recognize the applicability of minority discounts — applying them on a specific-fact basis — in situations where family and group control does not exist.

2.6.1.1 Canadian Tax Cases

The Canadian courts have considered the applicability and quantum of a minority discount in a host of valuation-related cases, particularly income tax and corporate. At the outset, it is important to keep in mind that there is a distinction between a "minority discount" and a "marketability discount", as will be noted below.

Canadian tax courts have considered the minority-discount issue for many years.

In *Taylor Estate* v. *MNR*[70], the assets of an estate included minority shareholdings of 33%, 30% and 33% in three private companies. With respect to the latter two, the remaining shares were held by relatives, being either the deceased's three sons or her half-brother. Despite these familial relationships, her investments were nonetheless considered to represent minority interests. The Board commented as follows:

> "In view of the fact that only one of the shareholders was not related to the deceased, but was a corporation, I think that 10%, *instead of the more usual 20%*, would be an appropriate allowance to make for the minority interest held … .
>
> "In my view, and having regard to a family situation that could prove awkward for a stranger purchasing the deceased's shares, an allowance should be made by the respondent for the fact that the deceased's interest was definitely a minority one. I can see no reason why this factor was not taken into account and consider that an allowance of not less than 10% should again be made for the minority interest held.[71] (Emphasis added.)

In *Mayson* v. *MNR*[72] the Tax Court of Canada had to decide whether two different classes of shares held by the same shareholder should be valued separately or together.[73] A secondary issue dealt with the applicability of a minority discount. The appellant was a 50% shareholder. The Court stated:

> "Where each of two shareholders owns 50% they are, in effect, both minorities and in their respective positions can do nothing, except in unison, to change the share structure of the company and thereby prejudice the non-voting shares, which in this case, apart from the voting privilege, were in all other respects equal."

Hence, no minority discount was applied. The value of the shares was determined by reference to actual negotiated transactions that took place between the parties involved.

Moynihan v. *MNR*[74] related to the valuation of a holding of 150 shares out of a total of 600 issued and outstanding shares in a small incorporated insurance agency. The Tax Appeal Board valued the shares at $5 each, implying a 95% discount from *pro rata* value. The court stated that only the whole enterprise could be sold as no one would acquire a partial interest.

In *Lauder* v. *MNR*[75] the Tax Review Board dealt with the December 31, 1971 ("valuation day") value of a 24% interest in a company. The Board held that despite the taxpayer's unique experience and background in the industry, his influence on the value of his holdings was limited because he was a minority shareholder. From the taxpayer's perspective, however, because of his background with the company as well as his position on the Board of Directors and his industry expertise, his shares had a unique value ("value to owner" concept). In his submission to the Tax Review Board, counsel for Revenue Canada raised the following important point:

> "Mr. Lauder had a combination of his experience, his history with the company, his ability, his position on the Board of Directors; he had all of those things. That is not what a purchaser is buying. A purchaser is only buying the shares. A new purchaser does not get with the shares what Mr. Lauder had with the shares. Here is the difference."

While there is no mention of the specific quantum of discount applied by the Board, it determined the value to be 63.5% lower than that originally claimed by the taxpayer. A significant portion of this reduction can be attributed to the application by the Tax Review Board of a minority discount.

In *H.P. Connor* v. *The Queen*[76] the issue before the Federal Court (Trial Division) was the fair market value on valuation day of ten shares of a private company, representing 10% of the company's outstanding shares. Discounts were considered for both the illiquid and minority aspects of the investment. Based upon the expert evidence, the court applied discounts of 20% for illiquidity and 10% for lack of control, or a composite discount of 30%.

In *Carruthers* v. *MNR*[77] the Federal Court (Trial Division) held that a minority shareholding, even of 48%, must be discounted from *pro rata* value. The Tax Review Board had not agreed with the *en bloc* value submitted, and its findings produced an 82% discount from the appellant's *en bloc* value[78]. While the Federal Court increased the value of the shareholding, a minority discount of 67% was still implied.

In *Trynor and Boyd* v. *MNR*[79] Madam Justice Kempo of the Tax Court had to decide upon the fair market value, on "valuation day", of certain minority positions. Her Ladyship stated:

> "Further I concur with the position of counsel for the Appellant, Ms. Boyd, that because of her minority shareholding some discount may be appropriate but that given her long-term and amicable business relationship with Mr. Trynor and the probability that a reasonably prudent purchaser would have wanted to acquire all of the issued shares and that they would have been readily-forthcoming, only a nominal discount should be employed. In this respect I would assess the discount to be 5% … ."

In *Yager* v. *The Queen*[80] Mr. Justice Pinard of the Federal Court (Trial Division) held that a minority discount of only 10% was appropriate for a 48% shareholding, considering the long-standing and good working relationship and the respective salaries of Mr. Yager and the 52% shareholder.

As discussed below, Revenue Canada generally does not recognize minority discounts where the shareholders are related to one another.[81]

2.6.1.2 U.S. Tax Cases

Until the Internal Revenue Service issued *Revenue Ruling 93-12*[82] just a few years ago, it did not recognize a minority discount on private-company shares if the minority shareholder was related to the control group. However, certain cases litigated in the U.S. Tax Court, the taxpayer prevailed.

In *Propstra* v. *United States*[83] the taxpayer and his wife owned, in community of property, an undivided one-half interest in several parcels of real estate. The District Court decided that the estate was entitled to a 15% discount on the undivided one-half interest. The decision was appealed by the government, which argued that since the one-half interest held by the estate would ultimately be sold along with the other undivided interest, the market value of the whole would be realized by each one-half interest owner. The trial court decision was affirmed by the Court of Appeal.

In *Estate of Bright* v. *U.S.*[84] the 5th Circuit Court held that the minority interest had no control value, even though the family unit had control of the corporation. This decision was based on (a) established case law, which did not support any type of "family attribution" where the control of a corporation was attributed to family members and (b) the concept of the hypothetical willing buyer/willing seller. The Court interpreted the expression "willing seller" (within the context of the fair market value definition) as a hypothetical seller rather than the particular estate, concluding that the actual identities of the parties receiving the shares should be disregarded (an "objective standard").

In *Estate of Andrews*[85], the *objective* standard (hypothetical willing buyer/seller) was emphasized because of its advantage over a subjective inquiry into the feelings, attitudes and anticipated behaviour of heirs and legatees which might well be boundless.[86]

As will be noted below, the U.S. Internal Revenue Service changed its policy as a result of these decisions and now permits minority discounts on family-held minority shares in gift and estate tax transfers (*Revenue Ruling 93-12)*.

2.6.1.3 Revenue Canada's Policy

Revenue Canada's IC 89-3, sets out the Department's position on family and group control as it relates to the determination of fair market value.

The Department states that its policy is essentially the same for family control and unrelated group control; however, the criteria for accepting the existence of an arm's length control group is more stringent that the requirements for family control.

As noted above, Revenue Canada will not recognize a minority discount where either a related group or an unrelated group of shareholders who control a corporation owned, among themselves, at least 50% plus 1 of the issued and outstanding voting shares of the corporation at the same time and if they have historically acted in concert as a group. IC 89-3 states that it is "a rebuttable presumption that a family group has acted in concert to control a corporation."[87]

The Department's position *vis-à-vis* the application of minority discounts on family-held minority shares is as follows:

> "In a situation where the existence of family control is recognized, the Department will employ a *rateable valuation* for each family group member's shares." (Emphasis added.)

IC 89-3 states that, in order to determine whether a certain pattern of conduct is indicative of collusive action in all matters relating to control, Revenue Canada may undertake the following actions individually or in any combination:

- Shareholders' and directors' minutes may be examined to determine the extent of consultation among the group.
- A review of remuneration may be made to ensure that all members of the group were treated fairly.
- Interviews with members of the group may be held to determine the role played by each member.
- Details of actual purchases and/or sales made by the claimants may be examined.

Where the Department is satisfied that the documentation provided indicates a consistent pattern of group control, it will apply a rateable valuation for each member's shares, and not allow a minority discount.

The Department also recognizes that *de facto*, or effective, control can exist in a public corporation where an individual or group has a large block of shares, where through unconditional proxies, a majority of votes at any shareholders' meeting controls management and where the remaining shares are widely dispersed. In these cases, satisfactory evidence of control must be provided.

Each case is dealt with by Revenue Canada on its own merits.

Paragraphs 32 to 37 of IC 89-3 sets out the Department's policy. Since the formulation in 1989 of the policy, there have been a large number of creative "custom-made" classes of Special Shares devised for income tax planning and/or estate planning purposes[88] which had not been previously been envisioned by the Department when it originally issued IC 89-3.

Revenue Canada's position is that each class of Special Shares must be valued having regard to its specific rights, conditions and other attributes.

Paragraph 32 of IC 89-3 reads:

> "Family and Group Control
>
> "32. The Department recognizes that in certain situations either a related group or an related group of shareholders may control a corporation if they owned amongst themselves at 50% plus 1 of the issued and outstanding voting shares of the corporation at the same time and if they have historically acted in concert as a group. It is a rebuttable presumption that a family group has acted in concert to control a corporation.
>
> "An assertion by a minority shareholder that he/she is part of a family control group must be considered in light of all relevant factors, including the rights and restrictions attributable to his/her particular shares.
>
> "In a situation where the existence of family control is recognized, the Department will employ a rateable valuation for each family group member's shares."

Accordingly, Revenue Canada proposes to insert, between the first and last paragraphs of Paragraph 32 of IC 89-3, the following paragraph:

> "Where there is more than one class of shares, the en bloc value of the corporation should be apportioned between the various classes of shares. The fair market value of each class must then be determined on its own merits according to the individual rights and restrictions of that class."

In addition, the following sentence will be added to the last paragraph of Paragraph 32:

> "For greater certainty, any reference to rateable value means rateable value within each class."

The Department does not believe that the revised wording would change its position on family control, in that its policy was never intended to provide an overall "umbrella" protection for all family-owned shares under all conceivable share structures. Under the revised wording, each class of shares must be valued separately before considering family control. If specific classes (such as exclusionary dividend shares) are determined to have no value, they will not be given an artificial value through the application of the Department's family-control policy.[89] Revenue Canada's family-control policy was not intended to be an option offered by the Department, as IC 89-3 does not expressly or implicitly provide a discretionary application right. The Department's position is that the policy applies where families have shown a history of acting in concert as a group in the best interests of the family members.[90]

2.6.1.4 Internal Revenue Service's Policy

Until the IRS released *Revenue Ruling 93-12* concerning minority discounts in family-controlled companies, the IRS and Revenue Canada shared the same views, i.e., minority discounts were not recognized. The IRS now takes the position that there will be no regard to the family relationship of the parties in valuing minority interests for gift tax purposes (and that the Service will follow the *Bright, Propstra* and *Andrews* decisions (*supra*) of the U.S. Tax Court): "A minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest".

For a number of years, the IRS shared the same views as Revenue Canada that no minority discount should be allowed in valuing minority interests held by family members in private companies. Minority should, for valuation purposes, aggregated with all family-held shares of the same corporation.[91]

Revenue Ruling 93-12 revoked *Revenue Ruling 81-253*[92] which held that, ordinarily, no minority shareholder discount was allowed with respect to transfers of shares between family members if, based upon a composite of the family members' interests at time of the transfer, controlled (either majority voting control or *de facto* control through family relationships) of the corporation existed in the family unit. The Ruling also stated that the IRS would not follow the decision of the 5th Circuit in *Estate of Bright* v. *United States*.[93]

After further consideration of its position taken in *Revenue Ruling 81-253*, and in light of a series of cases that the IRS lost on this point[94], the Service concluded that, in the case of a corporation with a single class of stock, notwithstanding the family relationship of the donor, the donee, and other shareholders, the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest.

The position taken by the IRS in *Ruling Revenue 93-12* is that family relationship will not be the sole reason to challenge minority-interest transfers when a family has control of a corporation. More specifically, if a donor transfer shares of a corporation to each of his or her children, the factor of corporate control in the family is not considered in valuing each transferred interest for estate and gift tax valuation purposes. The IRS will not assume that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest:

> "Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest. This would be the case whether the donor held 100 percent or some lesser percentage of the stock immediately before the gift".[95]

It would not appear that, considering the proposed revisions to IC 89-3 with respect to family control, Revenue Canada would at this juncture be leaning toward the policy of its U.S. counterpart.

2.6.2 Marketability Discounts

Marketability is defined as the ability to convert a property to cash quickly, with minimum transaction and administrative costs in so doing, and with a high degree of certainty of realizing the expected amount of net proceeds.

In *Corporate Cashflow Magazine*, the author observes that:

> "[i]n the absence of an effective exit vehicle, private placements normally sell at a significant discount — often 30% — 60% or even more — from freely traded securities".[96]

To an investor, the lack of marketability makes an investment less attractive and therefore the investor would require a higher rate of return than on an alternative investment having all of the same investment and risk characteristics, except marketability. As ready marketability adds value to a security, the market pays a premium for liquidity. Conversely, the market applies a discount when there is lack of marketability or liquidity.

The *marketability discount* is separate and distinct from the *minority discount* and is applied to a different valuation base (see example). The distinction between these may be outlined as follows:

A *minority discount* reflects a decrease in value due to lack of control (as noted above), and such decrease (discount) is subtracted from the rateable (proportionate) share of the *en bloc* value of the total common equity, or partner's equity, including control. As a *marketability discount* reflects the decrease in value due to the illiquid nature of the investment, the objective value-base with respect to which the decrease (discount) is referenced is a security having the same investment attributes except that it can more readily be liquidated.

> The concept of *minority interest* deals with the relationship between the interest being valued and the total enterprise … . The primary factor bearing on the value of the minority interest in relation to the value of the total entity is the degree of control the minority interest does or does not have over the particular entity. The concept of *marketability* deals with the liquidity of the interest, that is, how quickly and certainly it can be converted to cash at the owner's discretion.[97]

Because a minority interest discount reflects a value decrement due to lack of control, the value base from which the minority interest discount is subtracted is its proportionate share of the value of the total entity (or at least the common equity) taken as a whole, including all rights of control. As a discount for lack of marketability reflects a value decrement due to lack of liquidity, the value base from which the discount is subtracted is the value of an entity or interest that is otherwise comparable but enjoys higher liquidity (i.e., can more readily be sold and converted to cash).[98]

For example, if a minority interest in a privately-held corporation, or partnership, is valued by reference to trading prices of publicly-held shares, or real estate investment trust units, privately-held non-marketable minority interests are being compared with liquid, publicly-traded minority interests. The private-company shares or partnership interests (as the may be) are accordingly discounted for the lack of marketability *vis-à-vis* the publicly-traded securities, but not in respect of the minority-interest aspect, as the publicly-traded security is also a minority interest and, accordingly, already reflects a minority discount.

An article in *Business Valuation Review*, makes the following observation:

> "A minority interest in a privately-held firm should contain an even greater discount for lack of marketability than a control share. We see from these studies in Pratt that there is a pure discount for lack of marketability even when there is no question as to the ability to convert to cash on a specified date (again the amount is uncertain, but the ability to convert to cash hence time at which it can occur are both certain). When we compare a minority letter stockholder to a private company minority stockholder, the latter is obviously much less marketable. It may take 30 years to sell the private stock, and it may never sell. The majority owner can even cash out, selling his shares only without the firm as a whole, leaving the minority shareholder still sucking wind, waiting for a knight in shining armor. In the meantime, private firms rarely ever pay dividends, while letter stockholders may well be receiving them."[99]

In another U.S. article, published some 25 years ago, the author noted:

> "Obviously the courts in the past have overvalued minority interests in closely-held companies for federal tax purposes. But most (probably all) of those decisions were handed down without benefit of the facts of life recently made available for all to see."
>
> "Some appraisers have, for years, had a strong gut feeling that they should use far greater discounts for non-marketability than the courts had allowed. From now on those appraisers need not stop at 35 percent merely because it's perhaps the largest discount clearly approved in a court decision. Appraisers can now sight a number of known arm's length transactions in which the discount ranged up to 90 percent."[100]

A. Joel Adelstein, former President of The Canadian Institute of Chartered Business Valuators, reviewed the various U.S. studies performed between 1970 and 1990 and concluded as follows:

> "Based on the various studies relating to the question of marketability only, it would be hard to dispute as a minimum an average 35 percent discount. I believe greater discounts could be argued based on the fact that closely-held companies in general would be smaller in size than the average publicly-traded company and thus justify a higher discount. This theory seems to be supported by the data in the SEC Institutional Investor Study. Thus, a 35 percent marketability discount applied to a closely held company could, I believe, only be viewed as conservative.
>
> "Combining the 30 percent adjustment from market to minority with the non-marketability discount of 35 percent, we arrive at an average total minority discount of approximately 65 percent, as established in the public marketplace. As suggested earlier, the average discount may be somewhat conservative, as I believe that the general circumstances surrounding the shares used to derive the two segments led to lesser discounts than would be appropriate for 'true' minority shares of a typical closely held corporation.

"Applying the logic of the public market to the closely held corporation, it would appear that, on average and absent particular benefits to enhance marketability, a top down discount of, say 65 percent would not be unrealistic or unwarranted. Based on my reading, it would appear that the courts have allowed minority discounts in excess of 50 percent several times, but on the whole the courts still seem to be more comfortable with discounts in the 20 to 40 percent range. With the odd exception, it would appear that U.S. courts have been reluctant to recognize a composite discount. In some situations, the status of the buyer has been used by the courts to justify a lower discount (controlling shareholder buying minority shares – value to purchaser or family group, etc.), rather than fair market value.

EXHIBIT 3
Reconciliation

	Percentage
Value of entity	100
Minority market discount, say	30
Hypothetical minority trading price	70
Marketability discount	35
Residual closely held minority interest, maximum	35

"This reconciliation is supported by a number of the authors previously cited who have suggested total discounts of 75 percent or more. As noted earlier, John S. Harper, Jr. and Peter Lindquist, in an article in *The Appraisal Journal*, April 1983, entitled 'Quantitative Support for Large Minority Discounts for Non-Yielding Interests in Closely Held Corporations', demonstrated the applicability of total minority discounts of up to 75 percent using a top down approach."[101]

2.6.2.1 Empirical Studies

The following summarizes restricted stock studies conducted during the past number of years:

Study	Years Covered in Study	Average Discount
SEC, Overall Average[a]	1966-1969	25.8
SEC, Nonreporting OTC Companies[b]	1966-1969	32.6
Gelman[b]	1968-1970	33.0
Trout[c]	1968-1972	33.5[i]
Moroney[d]	[h]	35.6
Maher[e]	1969-1973	35.4
Standard Research Consultants[f]	1978-1982	45.0[i]
Willamette Management Associates, Inc.[g]	1981-1984	31.2[i]

a. From "Discounts Involved in Purchasers of Common Stock (1966-1969)", *Institutional Investor Study Report of the Securities and Exchange Commission,* H.R. Doc. No. 64, Part 5, 92nd Cong., 1st Sess. 1971, pp. 2444-2456.

b. From Milton Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely Held Company", *Journal of Taxation,* June 1972, pp. 353-354.

c. From Robert R. Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities", *Taxes*, June 1977, pp. 381-385.

d. From Robert E. Moroney, "Most Courts Overvalue Closely Held Stocks", *Taxes*, March 1973, pp. 144-154.

e. From J. Michael Maher, "Discounts for Lack of Marketability for Closely-Held Business Interests", *Taxes,* September 1976, pp. 562-571.

f. From "Revenue Ruling 770287 Revisited" *SCR Quarterly Reports,* Spring 1983, pp. 1-3.

g. From Willamette Management Associates study (unpublished).

h. Although the years covered in this study are likely to be 1969-1972, no years were given in the published account.

i. Median discounts.

In studies of the price relationship between private, closely-held share transactions and subsequent initial public offerings ("IPOs") of the same shares, the following results were obtained:

Study	# of IPO Prospectuses Reviewed	# of Qualifying Transactions	Discount	
			Mean	Median
1992-1993	443	54	45%	44%
1990-1992[1]	226	35	42%	40%
1989-1990[2]	157	23	45%	40%
1987-1989[3]	98	27	45%	45%
1985-1986[4]	130	21	43%	43%
1980-1981[5]	97	13	60%	66%
		173	47%	46%

1. Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock", *Business Valuation Review,* December 1992, pp. 208-212.
2. December 1990, pp. 114-116
3. June 1989, pp. 55-57.
4. December 1986, pp. 12-14.
5. September 1985, pp. 21-24.

The foregoing six studies were made over a period of thirteen and one-half years in eighteen-month segments. They were all performed on the same basis. The information for these studies came exclusively from IPO prospectuses. Each prospectus identified securities transactions between principals and insiders which took place since the beginning of the registrant's last fiscal year prior to the offering.

Of the 173 transactions in the 6 studies, 32 were actual sales, 7 of which were in the 1993 study. The remaining transactions were mostly options granted at fair market value. In general, actual sales transactions in the 6 studies were 49% and the median was 52.5%. In most cases, the transactions were stated to have been at fair market value. All ultimately would have had to been able to withstand Securities and Exchange Commission ("SEC"), IRS or judicial review, particularly in light of the subsequent public offering. The transactions primarily took one of two forms, (a) the granting of stock options at the then fair market value of the shares or (b) the direct sale of shares.[102]

In his article, Emory provides an example of the value of marketability with respect to a 42% economic interest in a company making an IPO:

> "As an example of the value of marketability, on July 21, 1993, Robert W. Baird & Co. Incorporated, my employer, was the managing underwriter in an initial public offering of 2,150,000 shares of Starcraft Automotive Corporation at a price of $10.00 per

> share. On March 29, 1993, about four months before the IPO and with full knowledge of the IPO, in a disclosed and arms' length negotiated transaction, a principal holding 50% of the voting stock which represented 42% of the economic interest of Starcraft, negotiated a sale of 738,400 shares of his Starcraft stock to Starcraft for a price of $5.42 per share, a discount of 46% from the offering price. This same individual also sold another 486,000 shares less than four months later in the IPO at $10.00 per share and then he retired."

Emory concludes:

> "In keeping with these guidelines and prior studies, I eliminated from consideration development stage companies, companies with a history of real operating losses and companies whose IPO price was less than $5. In all of these situations the companies were promising in nature, and their securities had good potential for becoming readily marketable. Why else would investors have bought the unregistered stock and why would a *bona fide* investment banker pursue a firm underwriting commitment?
>
> "The final question to be answered is that if these kinds of discounts are appropriate for promising situations where marketability is probable, but not a certainty, how much greater should discounts be for the more typical company's stock that has no marketability, little if any chance of ever becoming marketable, and is in a neutral to unpromising situation?
>
> "In summary, size of the discount for lack of marketability depends on the individual situation. While there is not one discount for lack of marketability applicable at all times and to all situations, it is apparent that the lack of marketability is one of the most important components of value, and the public marketplace emphasizes this point."

Bolten presents a summary of discounts for minority position and non-marketability, noting that although the studies took place over a ten-year period, each discovered an average discount of approximately the same amount. Bolten states that "thus, we may safely assume that the non-marketability discount not only is appropriately applied because of its historically observed presence but also because of its relative stability".

DISCOUNTS FOR MINORITY POSITION AND NON-MARKETABILITY						
		Minority Position			Non-Marketability	
		Range	Average	Suggested	Range	Average
		(%)	(%)	(%)	(%)	(%)
1	Arneson	15-55	34.0	>55	–	–
2	Coolidge	>20-78	36.1	–	–	–
3	Dant	15-55	34.0	42	–	–
4	Feld	–	–	–	–	–
5	Friedlob	–	–	–	–	–
6	Gelman	–	–	–	<15->40	33.0
7	Lyons/Whitman	–	cited 16.0	–	cited 20-30	–
8	Maher (76)	–	–	–	14.75	35.0
9	Maher (79)	–	16.1	–	–	–
10	Moroney (73)	–	–	–	14.90	36.3
11	Moroney (77)	–	–	–	25-100	50.0
12	*Revenue Ruling 77-287*	–	–	–	–	–
13	Business Owner	30-50	40.0	–	–	–
14	Standard Research Consultants	–	–	–	7.91	45.0
		15-78	29.37	48.5	7-100	39.66
	Average minority position discount			**29.37%**		
	Average non-marketability discount			**39.86%**		
	Total discounts			**69.23%**		

Bolten concludes:

> "The IRS and other parties to whom minority position and non-marketability discounts are not totally accepted, however, tend to recognize them only reluctantly and agree with considerably lower specific levels than those observed. However, as research into the subject continues to reveal consistent and increasingly frequent evidence in support of larger discounts, a recognition of the realty that relatively large discounts exist should be forthcoming".

After considering substantial empirical data relating to the marketing of common shares, another U.S. valuators concludes as follows:

> "Considering all of the factors which a stock issuance would involve indicates that a base for a non-marketability discount should be closer to fifty percent. Other factors could increase this considerably, or in a few instances might cause a reduction. Risk and timing, to the extent they have not been included in the basic valuation appraisal study or are peculiar only to evaluating a particular stock issuance, could result in a

> non-marketability discount considerably higher than the suggested fifty percent base."[103]

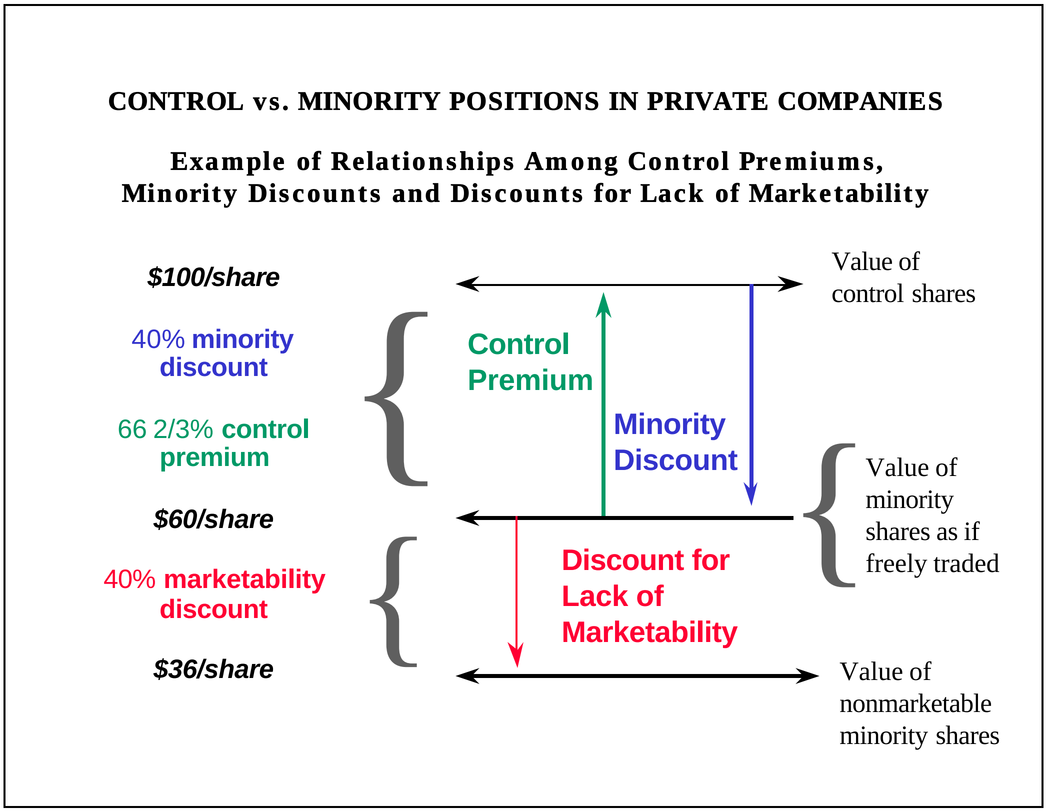
In U.S. *Revenue Ruling 77-287*[104], relating to the valuation of securities restricted from immediate resale for federal tax purposes, reference is made to an analysis by the SEC, pursuant to Congressional direction, as to the purchases, sales, and holding of securities by financial institutions, in order to determine the effect of institutional activity upon the securities market.[105] The study provides an analysis of restricted securities and deals with, *inter alia*, marketability discounts on different trading markets. It is of interest that the IRS notes that the market in which publicly-held securities are traded also reflects variances in the amount of discount that is applied to restricted securities purchases. According to the institutional Investor Study of the SEC, discount rates were greatest on restricted stocks with unrestricted counterparts traded over-the-counter, followed by those with unrestricted counterparts listed on the American Stock Exchange, while the discount rates for those shares with unrestricted counterparts listed on the New York Stock Exchange were the smallest.[106]

In *Black v. Black*[107], an Ontario matrimonial case, Walsh J., although not addressing the issue specifically, stated:

> " … I found the following facts to be the most determinative of the value of the husband's business interest [a 50% interest in a holding company in which the shareholder's brother, Conrad Black, owned the other 50%]: the *highly-illiquid* nature of those interests and the substantial third party debt to which they were subject; that a purchaser of them would not be buying control or a route to control of their underlying public companies … ."[108] (Emphasis added.)

Revenue Canada does not address the issue of marketability in *Information Circular* 89-3 or any of the *Interpretation Bulletins*. The IRS, on the other hand, addresses marketability in *Revenue Rulings 59-60*[109], *77-287 and 83-120*[110].

The following graph visually depicts the difference between a minority discount and a marketability discount. It distinguishes among control value, marketable minority interest value and non-marketable minority interest value, being the three possible levels of value.[111]



2.6.3 Discounts on Fractional Interests In Real Estate

Generally, pro-rata net asset values of undivided real property are discounted to reflect (a) lack of control and (b) lack of marketability, For a partial or fractional interest in real property, the disadvantages of lack of control are similar to those found in a corporation or a partnership, *viz*., impediments to the unfettered ability to control the use of the assets or the cash flows from the assets. The marketability discount reflects the time and the cost to convert the interest to cash. However, unlike a corporate shareholding, the owner of a fractional interest in real property has the ability to seek partition, and therefore, control, of his or her proportionate share of ownership. A discount is often appropriate in view of the cost, uncertainty and delays attendant upon partition proceedings.

The U.S. Internal Revenue Service had issued a *Technical Advice Memorandum* 9336002 relating to the discount on a 50% undivided interest in a property, stating that "the amount of any discount should be limited to the petitioner's share of the estimated cost of a partition[112] of the property".[113] The IRS also states, in its *Valuation Guide for Income, Estate and Gift Taxes*[114], that " … the smaller the [fractional] interest, the larger the discount … [and] the fewer owners, the smaller the discount … ".

Overall discounts from net asset value can range from 10% to 20% for even the simplest partition suit and from 30% to 35% or more on larger, more complex suits and/or larger properties … ".

An article in *Business Valuation Review*[115], the official publication of the Business Valuation Committee of the American Society of Appraisers, Washington, D.C., comments:

> "Historical Tax Court decisions often have allowed some discounts from pro rata shares of net asset value for undivided real property interests. IRS's TAM 9336002 [above] suggests that the amount of discount should be the cost to partition. Careful examination of the partitioning process, and particularly the time required, demands substantial discounts from net asset value, as the cost to partition is often under-estimated. The hypothetical willing buyer of an undivided interest must consider the substantial time and costs that could be required to gain control of the cash flow and to make the interest marketable".

Key factors in determining the discount include:

(a) The size of the fractional interest;

(b) Comparable sales of undivided interests, if available;

(c) The number of other co-owners of the property;

(d) The time required to realize an income from the property or to achieve return on the investment;

(e) The size of the tract, in the case of land;

(f) The time and cost to partition;

(g) Lack of management;

(h) Lack of liquidity.

3. VALUATION GUIDANCE FROM THE U.S.

Because of the significant degree of guidance from the United States experience in valuation maters, the fact that there is so much similarity from a valuation perspective (as regards principles, concepts, practices, procedures and jurisprudence), reference was made throughout this paper to the relevant U.S. case law as well as pronouncements of the IRS.

In addition to the extensive body of case law in the U.S., the IRS has issued the following *Revenue Rulings* relating to the valuation of businesses and business ownership interests:

Revenue Ruling No.	Subject Matter
59-60	Valuing closely-held businesses
65-192	Extension of Revenue Ruling 59-60 to all types of business interests and to income taxes, gift taxes and estate taxes
65-193	Modifies Revenue Ruling 59-60 by recognizing the possibility of valuing the tangible and intangible assts of a business separately
68-609	"Formula Method" (Excess Earnings Approach)
77-287	Use of restricted stock studies in quantifying discounts for lack of marketability
80-213	Further modifies Revenue Ruling 59-60; valuation of subsidiary corporation's shares in transactions
83-120	Valuation of preferred shares; recapitalization
93-12	Minority discounts in valuing minority interests of family members in family-controlled private companies for gift tax purposes

The IRS also issues other types of opinions in the form of Technical Advice Memoranda (TAMs), private Letter Rulings, Revenue Procedures and General Counsel Memoranda. These relate to specific-fact situations with respect to which a taxpayer has sought advice from the IRS (much like Advance Rulings from Revenue Canada).

The IRS *Revenue Rulings* and *Valuation Guide* (see below) also address certain other matters not covered in any of the Revenue Canada pronouncements, such as holding company issues, intangible assets, management remuneration, excess earnings and preferred share valuation.

The IRS issues a training guide to its Appeals Officers, *IRS Valuation Guide for Income, Estate and Gift Taxes*, published in January 1994. This publication includes the full text of the *Valuation Training for Appeals Officers* coursebook, which is an aid provided by the IRS in its Appeals Officer Training Program. Written primarily by appeals officers, the coursebook is geared towards trainees with little or no experience in resolving valuation issues. The concept of "fair market value" is discussed as it applies the to valuation of closely-held corporations, real estate and *objets d'art*. Problems of comparability, evaluation of expert testimony and appraisal reports are included. Also covered is the determination of intangible value of goodwill and patents. In summary, the *Guide* provides taxpayers and tax advisors with insight into the major valuation problem areas and the IRS's views as to the accepted methods and approaches in considering valuation matters.

Perhaps the most significant difference between the pronouncements of Revenue Canada and those of the IRS relate to minority discounts in family-controlled corporations. The position of Revenue Canada is as outlined above, namely, that the Department will not allow a minority discount where either a related group or an unrelated group of shareholders controlling a corporation own, among themselves, at least 50% plus 1 of the issued voting shares of the corporation at the same time and have historically acted in concert as group. The IRS, on the other hand, will permit a minority discount, although the size of the discount is not indicated.

Furthermore, while Revenue Canada does not address the issue of marketability in IC 89-3, or any of the above-noted Interpretation Bulletins, the IRS addresses the marketability issue in *Revenue Rulings 59-60*[116]*, 77-287 and 83-120*[117].

As the context in which the respective pronouncements of Revenue Canada and the IRS specifically relate to "fair market value", it is important to bear in mind the definitions of fair market value on each of the border. In the U.S., fair market value is defined as "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts as of the applicable valuation date". Except for "as of the applicable valuation date", the definition contained in IRS *Ruling Revenue 59-60* comports with that contained in the *IRS Guide*.

With increasing cross-border transactions and cross-border valuations, practitioners will be facing many additional challenges and will be required to keep abreast of the business valuation standards and revenue-department pronouncements on both sides of the border, let alone the numerous valuation-related court decisions emanating from south of the border.

Consider the following example. In Canada, the fair market value of a business interest includes a "premium" over and above its intrinsic value, or stand-alone notional fair market value, to the extent there is a "special purchaser"[118] who can be negotiated into paying for anticipated synergies or strategic advantages.[119] In the U.S., fair market value as used in the *Internal Revenue Code* does not include such additional value. If the price is affected by special purchasers or strategic buyers in the marketplace, the value for U.S. tax purposes is "transaction value" rather than "fair market value".

Will cross-border problems arise in valuing businesses or business ownership interests, say, for non-arm's length transfer pricing or the Canadian departure tax, because "fair market value" for purposes of Section 482 of the U.S. *Internal Revenue Code* differs from "fair market value" for purposes of Section 69 of the Act? Will it be necessary, in transfer pricing situations, for the Contracting States to consult together, as contemplated in Article XXVI of the *Canada-U.S. Income Tax Convention (1980)*, because there may be different fair market values (or differences in the fair market value standard) under each country's respective interpretations (e.g., inclusion vs. exclusion of special purchasers)?

Also, the IRS will not recognize a price-adjustment clause to which the shares of a U.S. taxpayer may be subject. As noted earlier, Revenue Canada does not generally permit a minority discount in valuing shares held by family members (IC 89-3); the IRS does (*Revenue Ruling 93-12*).

Say a Canadian moves to the U.S. The fair market value of his or her private-company shares must be determined in the notional market for purposes of the Canadian "departure tax"[120], as there is no actual, economic realization based on a third-party transaction. At the same time, the cost basis of the shares in the U.S. will be based on original cost. The problem is that the émigré will pay tax in Canada on a deemed gain (based on the higher, special-purchaser price in the notional market) — a price which had not been actually realized. When there is an ultimate sale, there will be double taxation on the spread between original cost and the value on departure.

If the original cost of the shares was $500,000, the intrinsic (stand-alone) value was $1,200,000, but the fair market value (considering a special purchaser in the marketplace) was $1,800,000, for Canadian departure-tax purposes, there would be a deemed disposition of the shares at $1,800,000. Upon entering the U.S. — ignoring foreign exchange considerations — the shares would be valued for U.S. tax purposes at $500,000. If, shortly thereafter, the special purchaser exited the marketplace and the shares were sold at arm's length for $1,200,000, Canada would have taxed a $1,300,000 gain ($1,800,000 – $500,000) and the U.S. will tax $700,000 ($1,200,000 – $500,000) — as long as the present disconcordances remain in the respective tax laws (and in the interpretations of "fair market value").

Given that a price-adjustment clause must reflect a *bona fide* intention of the parties to transact at fair market value and that the value be arrived at by a fair and reasonable method, the taxpayer's valuation — to the extent it does not specifically conform to Revenue Canada's policies in IC 89-3 and the general position taken by its Business Equity Valuation group (with respect to built-in capital gains tax, marketability discounts, key-person discounts, etc.) — the contentious areas should be fully supported (by relevant authorities, arm's length transactions in the marketplace, judicial decisions, generally-accepted investment theory, empirical evidence or a combination thereof).

As an example of empirical evidence, in August 1997 the U.S. balanced budget was tabled containing a bipartisan measure to reduce capital gains tax significantly. Immediately, the indicated percentage discount from net asset values of closed-end investment companies listed on U.S. stock exchanges decreased as the likelihood of the proposal's enactment increased. This reaction appeared to confirm the view of many valuation practitioners and investors that taxes on accrued capital gains are a factor in valuing the shares of a corporation owning appreciated investments.

Case law may provide are useful guidelines by which to assess the methodologies favoured by the courts and Revenue Canada and to understand the approach they are likely to take with respect to the valuation logic, evidence and analysis.

Courts often favour "real world" solutions based on actual similar transactions or on valuation methods commonly applied in pricing a particular type of business for an actual transaction —

rather than more theoretical indications of value — unless there is strong evidence that those methods are not appropriate in the specific case. The Tax Court of Canada may be inclined to side completely with the party whose valuation is more complete, realistic, thorough and better presented.

Returning to the experience in the U.S., notwithstanding the extensive guidance to be obtained from the IRS's *Revenue Rulings*, TAMs, Letter Rulings, Revenue Procedures and General Counsel Memoranda, which represent administrative (rather than legislative) tax authority, there nonetheless remain significant practical and administrative problems in the application of IRS valuation policies.

The American Society of Appraisers, Washington, issued a press release[121] commenting on a study it completed in early 1997. The study concluded that the IRS may be losing billions of dollars of tax revenues because of deficient appraisal policies. It stated, among other things:

> "There is 'convincing evidence' that billions of dollars in tax revenues are being lost each year because IRS policies governing how tax payers estimate the fair market value of real estate, personal property and ownership interests in businesses 'lack clarity and consistency and violate generally accepted appraisal standards.' This is the central finding of a nine-month study released by the American Society of Appraisers (ASA), one of the nation's largest professional appraisal societies. The study is being sent to the IRS Commissioner, to Congress and to the Treasury Department's office of Tax Policy for their consideration."
>
> …
>
> " … [The president of ASA] … said, 'weaknesses in Service valuation requirements lead to unreliable and uneven taxpayer estimates of fair market value, result in confusion to taxpayers and tax practitioners, and actually foster needless disputes and litigation between taxpayers and the IRS. Since taxpayers and IRS district office managers are reading from different pages when determining how property and business interest are to be valued and reported … it is little wonder that appraisal issues generate major controversies, which IRS appeals officers and the Tax Court are constantly called upon to resolve.'
>
> "Major weaknesses in IRS appraisal policies cited in ASA's study include:
>
> …
>
> - "IRS Does Not Require Use of a Uniform Methodology to Estimate Fair Market Value: IRS does not require that calculations of fair market value be based on generally accepted valuation methodology, such as the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by The Appraisal Foundation. This means that taxpayers are able to adopt significantly different approaches to valuing comparable property or business interests, leading to

unacceptably wide variances in the dollar values assigned to such comparable items.

- "For Most Tax Purposes, IRS Does Not Require the Use of Appraisers, Even to Value Complex and High-Dollar-Value Properties: IRS permits taxpayers, for most tax purposes, to perform their own valuations even of complex and high-dollar-value property and business interests, sometimes without any requirement that they describe the method used to estimate fair market value. This policy helps produce what appears to be a large number of market value estimates that are inaccurate and often understate the tax liability of the filer.

…

"The study recommends a number of major changes in IRS appraisal requirements and notes that many of its recommendations track federally related valuation reforms enacted by Congress, including reforms relating to charitable gift contributions and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. ASA's central proposals are:

- "IRS should adopt a single set of valuation requirements, based on generally accepted principles of professional appraisal practice for all taxpayer-claimed values above an established dollar threshold.
- "IRS should require all taxpayers and IRS District Offices to adhere to a uniform valuation methodology, such as the Uniform Standards of Professional Practice, which is recognized by professional appraisers, by most government agencies and by most private sector users of appraisal services.
- "Taxpayer-furnished estimates of fair market value of complex or expensive properties and business interests should be performed by professional appraisers with meaningful skills and training."

The IRS has recently established an Appraisal Policy Working Group in response to the ASA's report on deficiencies in IRS valuation practices and a recommendation regarding the proposed reforms is expected in December, 1998.

Revenue Canada has also continually faced the criticism that its Business Equity Valuation group practices are not consistent among regional offices or, indeed, within the same District Taxation Office. The Department has received complaints that the uncertainty regarding how a specific District Office or valuator will review a transaction places the taxpayer at excessive risk in the arrangement of the person's affairs.

Revenue Canada recognizes that the "consistency" problem can be addressed through the establishment of formal, published valuation policies followed nationally by all department staff. Presumably, this would be similar to the guidelines published by the U.S. Internal Revenue Service.

Revenue Canada purposely keeps its national valuation policies to a minimum, *viz.*, the policies contained in IC 89-3.

The Department's reasoning is as follows:

> " … a significant body of policies would compromise the independence of departmental valuators by requiring them to employ valuation methodology dictated by their employer rather than their own professional judgment. This is not an insignificant issue. Departmental valuators have been criticized in court by lawyers attempting to undermine their credibility by claiming that their values were based on government policy rather than their independent opinion.
>
> "National valuation consistency and independent valuation opinions are mutually exclusive goals; any move towards one of these adversely affects the other. Since independence is necessary for us to provide sustainable opinions the amount of comfort we can give taxpayers through formal valuation policies is limited. As a result our national policies are kept to a minimum.[122]

Again, referring to the United States, the Tax Court, in *Estate of Thomas A. Fleming* v. *Commissioner*[123], added a footnote encouraging taxpayers and the IRS to settle, rather than litigate, disputes regarding fair market value:

> " … we take this opportunity, as we did before and after the trial of this case, to remind the parties that questions of fair market value, like the one that is presented here, are generally more properly resolved through the give and take of settlement negotiations by the parties, rather than adjudication by the Court.
>
> "This pressure to settle is becoming increasingly prevalent in many courts. Most courts are not anxious to hear valuation cases."

ENDNOTES:

(1) Defined as "the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market, between informed parties dealing at arm's length, neither party being under any compulsion to transact".

(2) RSC 1985, c.1 (5th Supp.), as amended (the "Act").

(3) For example, under paragraph 69(1)(b), the fair market value will be deemed to have been received by the transferor, but there is no provision in the Act for a corresponding upward adjustment to the consideration paid by the purchaser.

(4) 73 DTC 5048 (FCA), aff'g 72 DTC 6146 (FCTD).

(5) Formerly subsection 8(1).

(6) "Revenue Canada Round Table", *1980 Conference Report*, Q. 14, p. 604.

(7) *1990 Conference Report*, Canadian Tax *Foundation*, at 53:14 (Q. 58). Some practitioners have suggested that, provided the parties have made a *bona fide* attempt to transact at fair market value, a price-adjustment clause would prevail and not be subject to the type of attack along the lines of *Guilder News*. See, for example, D. Ewens, "Use of Adjustment Clauses in Non-Arm's Length Reorganizations", 1981 *Canadian Tax Journal*, 718 (at 723).

(8) Paragraph 26.

(9) June 6, 1998.

(10) November 4, 1988.

(11) Advance Tax Ruling ATR-36 approved the transaction with respect to which the redemption amount appeared to be defined as the fair market value of a promissory note.

(12) See, for example, Richard M. Wise, Jay E. Fishman and Shannon P. Pratt, *Guide to Canadian Business Valuations* (Volume 1), Carswell (loose-leaf service).

(13) *Ray Consolidated Copper Co.* v. *United States*, 45 S.Ct. 526 (125), at 528.

(14) RSC 185, c. C-44, as amended.

(15) The Department does not state its position *vis-à-vis* these types of Special Shares in IC 89-3 because they do not constitute Revenue Canada policy; they are a consensus on the method of valuing these shares.

(16) For example, the corporation's Articles may contain the following Clause: "In the event that the Directors declare a dividend pursuant to these Articles, the Directors may, in their absolute discretion, declare a dividend to any class of shares or a combination thereof to the exclusion of any other class of shares or combination thereof".

(17) Revenue Canada has considered income splitting through the payment of exclusionary dividends as tax avoidance. The Department initially attempted to assess these transactions by attributing value to the shares when they were issued to the family members. However, the Department's own business valuators agree that the shares would have nominal value, in that an informed, uncompelled, arm's length purchaser would recognize that a non-family member may be excluded from dividend payments as well as other benefits enjoyed by family members, such as employment in the company, company-supplied automobile, entertainment expenses, etc. which could not be assumed to be transferable to a "stranger".

(18) See, for example, *Marina Quebec Inc*. v. *MNR*, 92 DTC 1392 (TCC). Interestingly, even though it lost in the Tax Court of Canada, Revenue Canada chose not to appeal the decision, which had taken into account control by the same person or group of persons in setting a value for, in this case, non-retractable preferred shares.

(19) 83-1 USTC, paragraph 13,518; 51 AFTR 2d 83-1232 (7th Cir. 1983).

(20) [1952] 2 All ER 775 (PC).

(21) *Ahmanson Foundation* v. *U.S.*, 81-2 USTC, paragraph 13,438; 674 F 2d 761 (9th Cir. 1981).

(22) *Supra*, note 19, at 87,289.

(23) 91 DTC 5001.

(24) 92 DTC 1652 (TCC); aff'd 94 DTC 6094 (FCTD); rev'd 96 DTC 6464 (FCA); and rev'd 98 DTC 6297 (SCC).

(25) Section 241.

(26) The fourth pre-condition to attribution under subsection 56(2) is that it was not argued by the Minister of National Revenue that the appellant was involved in a sham or another artificial transaction.

(27) For a detailed discussion of the types of consideration to be given the various attributes of preferred shares, see Richard M. Wise, "The Valuation of Preferred Shares Issued on a Section 85 Rollover", *Canadian Tax Journal*, March-April 1984, pp. 239 ff.

(28) Paragraph 2(1)(b) of the CBCA defines "redeemable share" as a share issued by a corporation that the corporation is required, by the articles, to purchase or redeem either at a specified time or upon the demand of a shareholder.

(29) That the share value of the common shares of Opco likely reflects substantial intangible value (goodwill) and, therefore, there may be a large amount of contingent taxes on the accrued gain at the time of the estate freeze.

(30) For a detailed examination of retractable preferred shares issued in connection with a section 85 holding company freeze, see Richard M. Wise, "The Valuation of Preferred Shares Issued on a Section 85 Rollover", *Canadian Tax Journal*, March-April 1984, pp. 239ff.

(31) Note 12, *ibid.*, Chapter 5.

(32) Note 12, *ibid.*, Chapter 6.

(33) See *Information Circular* 89-3, "Policy Statement on Business Equity Valuations", Paragraph 5(i).

(34) The three broad approaches to the valuation of minority interests are:

(1) determining the value of the total enterprise on a control basis, and deduct any discounts appropriate for minority interests and/or lack of marketability; or

(2) valuing the interest by direct comparison with other minority interest transactions. (As most available data on minority share transactions deal with publicly-traded stocks, this approach usually requires the further step of deducting a marketability discount with no further deduction for the minority interest.); or

(3) valuing the interest with a "bottom-up" approach based on the discounted future returns the shareholder may expect to realize through dividends and/or liquidation of the interest at some future date.

See S.P. Pratt, *Valuing a Business*, 2nd Edition, Dow Jones-Irwin (Homewood, Illinois: 1989), pp. 389-390.

(35) Viscount Simon, *Gold Coast Selection Trust Ltd.* v. *Humphrey* (1948) 2 All ER 379.

(36) See, for example, Richard M. Wise, *Financial Litigation — Quantifying Business Damages and Values*, Canadian Institute of Chartered Accountants, Toronto (loose-leaf service).

(37) Note 12, *supra*.

(38) Note 12, *supra*.

(39) Roger W. Lusby, III, "Recognizing Built-in Capital Gains for Valuation Purposes", *AICPA National Conference on Business Valuation*, November 17, 1997, p. 7.

(40) 1959-1 CB 237.

(41) Section 5(b).

(42) January 1994, pages 9-15 and 9-16.

(43) *Estate of Charles Russell Bennett* v. *Commissioner*, TC Memo 1993-34 (1993).

(44) *General Utilities and Operating Co.* v. *Helvering*, 296 U.S. 200 (1935).

(45) 72 TC 1062 (1979), at 1087.

(46) 110 TC 35 (June 30, 1998).

(47) *Internal Revenue Code*, Section 6662.

(48) Mr. Davis died in June 1995.

(49) Section 136(b)(1)(B) and (C) of the U.S. *Internal Revenue Code* provides that if a C-corporation converts to an S-corporation and retains its assets for ten years thereafter, capital gains tax could be avoided. All decisions which rejected the capital gains factor since enactment of the *Tax Reform Act of 1986* repealed the General Utilities Doctrine had special circumstances, such as S-corporation status, which avoided capital gains taxes at the entity level.

(50) August 18, 1998.

(51) October 27, 1997.

(52) Section 2501 of the *Internal Revenue Code* imposes a gift tax "on the transfer of property by gift during [the] calendar year by any individual".

(53) The capital gains tax consisted of the aggregated Federal Income Tax, New York State Franchise Tax on Business Corporations and New York City General Corporation Tax.

(54) See, for example, *Ward* v. *Commissioner*, 87 TC 78, 103-04 (1986); *Estate of Piper* v. *Commissioner*, 72 TC 1062, 1087 (1979); and *Estate of Cruikshank* v. *Commissioner*, 9 TC 162, 165 (1947).

(55) The law in this area, embodied in the *Internal Revenue Code* of 1954, was loosely-based on the U.S. Supreme Court decision in *General Utilities & Operating Co.* v. *Helvering*, 296 US 200 (1935), which held that a corporation did not recognize gain on a dividend distribution of appreciated property by employing the *General Utilities* doctrine, a corporation could liquidate and distribute appreciated or depreciated property to its shareholders without recognizing built-in gain or loss, and thus could circumvent double-taxation. Such tax favourable options ended

with the enactment of the U.S. *Tax Reform Act of 1986* ("TRA"), which abrogated the *General Utilities* doctrine for liquidations after 1986 and rejected tax principles that were more than half a century old. The TRA removed a corporation's ability to avoid recognition of a gain on the distribution of appreciated property to its shareholders, irrespective of whether the gain occurred in a liquidating or non-liquidating context.

(56) 74 TCM (CCH) at 1048.

(57) Defined as an individual whose contribution to a business is so significant that there is certainty that present earning levels will be adversely affected by the loss of the individual.

(58) See IRS *Revenue Ruling 59-60*, section 4.02(b).

(59) 96 DTC 1062 (TCC).

(60) See, for example, *Newell* v. *Commissioner*, 66 F. 2d 102 (1933); *Fourth National Bank* v. *U.S.*, 15 AFTR 1011 (1934); *Patton et al* v. *Wisconsin Tax Commissioner*, 278 NW 866 (1938).

(61) 56 TCM 118 (1988).

(62) 56 TCM 1033 (1989), at 1039.

(63) If a discounted cash flow method or discounted future earnings method is employed by the valuator.

(64) 31 Man. R. (2d) 208.

(65) [1986], 25 DLR (4th) 269; (1986), 38 Man. R. (2d) 134; [1986] WWR 152.

(66) [1988] SCR 399 (SCC).

(67) H. Calvin Coolidge, "Survey Shows Trend Toward Larger Minority Discounts", *Estate Planning*, September 1983, p. 282. This comment of H. Calvin Coolidge in his study as a bank trust officer who was handling trusts and estates holding interests in closely-held corporations was the first of two. In his second study, in 1983, he noted a trend toward higher discounts (from book value).

(68) Defined as purchasers who are prepared to pay a premium over the price ordinary purchasers would pay, because of the ability to realize synergies and/or strategic advantage.

(69) See Richard M. Wise, "Some Valuation Concerns in Buy-Sell Agreements", *CA Magazine*, February 1985, and Richard M. Wise, "Valuation Aspects of Shareholders' Buy-Sell Agreements", *1984 Conference Report* (Report of the Proceedings of the Thirty-Sixth Tax Conference), Canadian Tax Foundation, Toronto, p. 1013.

(70) 65 DTC 405 (TAB).

(71) The U.S. Federal District Court in *Bertram* v. *Graham*, 157 F.Supp. 757 (D. Conn. 1957) was of the view that a purchaser of the deceased's shares could likely be found among the members of his family.

(72) 85 DTC 341.

(73) This issue has been addressed by the American courts in *Ahmanson Foundation* v. *U.S.*, 674 F. 2d 761 (9th Cir. 1981), *Curry Estate* v. *U.S.*, 706 F. 2d 1424 (USCA 7th Cir. 1983) and *Citizens Bank and Trust Co.* v. *Commissioner*, 839 F. 2d 1249 (7th Cir. 1988).

(74) 62 DTC 64.

(75) 79 DTC 764.

(76) (1978) CTC 669 (FCTC); aff'd (1979) CTC 365 (FCA).

(77) 82 DTC 6010 (FCTD).

(78) 79 DTC 906.

(79) 88 DTC 1294 (TCC).

(80) 85 DTC 5494.

(81) See, for example, the *obiter dicta* of the justices of the Federal Court of Appeal in *The Queen* v. *Littler,* 78 DTC 6179, aff'g 76 DTC 6210 (FCTD).

(82) 26 CFR 25.2512-1, Valuation of Property, in General.

(83) 680 F. 2d 1248 (1981).

(84) 658 F. 2d 999 (1981).

(85) 79 TC 938 (1982).

(86) Other decisions and valuation issues are referred to in a paper presented by L. Racette at the 1995 Conference: "Valuation Issues in Owner-Manager Businesses", *Conference Report*, pp. 22:1 ff.

(87) Paragraph 32.

(88) For example, "exclusionary dividend shares" and "special rights preferred shares" ("Special Shares").

(89) The Department notes, as an additional source of conflict in the application of the family and group control policy, the increasingly common interpretation that the policy can be evoked or disregarded at the taxpayer's discretion. The Department's experience is that taxpayer's representatives have applied the policy in specific transactions when it is to their advantage to adopt it, and have argued that the policy should not be applied to the same shares in other transactions. Such submissions have claimed that the Department is required to accept these conflicting positions if requested by the taxpayer.

(90) As of the time of drafting this paper, there is no case law either supporting or rejecting any of the various interpretations of the family-control policy.

(91) This position was called the "family attribution doctrine", stated in *Revenue Ruling 81-253*, which was revoked by *Revenue Ruling 93-12*.

(92) 1981-1C.B. 187.

(93) 658 F.2d 999 (5th Cir. 1981).

(94) *Propstra* v. *U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Andrews* v. *Commissioner*, 79 TC 938 (1982); and *Estate of Lee* v. *Commissioner*, 69 TC 860 (1978), nonacq., 1980-2 C.B. 2.

(95) The *Revenue Ruling* related the to transfer by a donor, who owned all of the single outstanding class of shares of a corporation, by making simultaneous gifts of 20% of the shares to each of the donor's five children.

(96) Daniel W. Bielinsky, "The Comparable-Company Approach, Measuring the True Value of Privately-held Firms", *Corporate Cashflow Magazine*, October 1990, p. 68.

(97) S.P. Pratt, *Valuing a Business*(Second Edition), Dow Jones-Irwin (Homewood, Illinois: 1988) p. 59.

(98) S.P. Pratt, R.F. Reilly and R.P. Schweihs, *Valuing a Business* (Third Edition), Irwin Professional Publishing (Chicago: 1996), p. 46.

(99) Jay B. Abrams, "Discount for Lack of Marketability, A Theoretical Model", *Business Valuation Review*, September 1994, Vol. 13, No. 3, American Society of Appraisers, p. 136.

(100) Robert E. Moroney, "Most Courts Overvalue Closely-Held Stocks", *Taxes*, March 1973, p. 154.

(101) A.J. Adelstein, "Minority Discounts Revisited", *Journal of Business Valuation*, Proceedings of the Eleventh Business Valuation Conference of The Canadian Institute of Chartered Business Valuators, June 4 and 5, 1992, pp. 425-426.

(102) John D. Emory, "The Value of Marketability As Illustrated in Initial Public Offerings of Common Stock — February 1992 Through July 1993", *Business Valuation Review*, March 1994, Vol. 13, No. 1, American Society of Appraisers, p. 3.

(103) George S. Arneson, "Nonmarketability Discount Should Exceed Fifty Percent", *Taxes*, January 1981, p. 31.

(104) 1977-2, C.B. 319, amplifying *Revenue Ruling* 59-60 (C.B. 1959-1,237), as modified by *Revenue Ruling* 65-193.

(105) The study report was published in eight volumes in March 1971: "Discounts Involved in Purchases of Common Stock" in U.S. 92nd Congress, First Session, House Institutional Investor *Study Report of the Securities and Exchange Commission*, Washington, D.C.: U.S. Government Printing Office (March 10, 1971, 5: 2444-2465, Document No. 92-64, part 5).

(106) *Revenue Ruling 77-287*, Section 4.02(c).

(107) (1988), 18 RFL (3d) 303 (Ontario HC).

(108) At 313.

(109) Section 4.02(g).

(110) Section 4.06.

(111) For a comprehensive and authoritative analysis with respect to developing and supporting marketability discounts in valuing closely-held business interests, see Z.C. Mercer, *Quantifying Marketability Discounts*, Peabody Publishing, LP (Memphis, Tennessee: 1997).

(112) The two major factors in determining the cost to partition are (a) the time required for each element of the process (not simply the court time) and (b) the legal and other expenses involved during that time. Where significant disagreement exist among the parties and where lengthy negotiations and the use of additional professionals are required, the costs and time could be much greater.

(113) Technical Advice Memorandum 9336002.

(114) CCH, 1994, p. 9-23.

(115) Ronald M. Seaman, "Valuation of Undivided Interest in Real Property", *Business Valuation Review*, March 1997, American Society of Appraisers (Vol. 16, No. 1), p. 32.

(116) Section 4.02(g).

(117) Section 4.06.

(118) A purchaser who, for one or more reasons, such as perceived post-acquisition benefits such as economies of scale, other synergies and/or strategic advantages, would be willing to pay a higher price for a business and/or its issued shares than other (ordinary) purchasers.

(119) See, for example, *Edmund Littler Sr.* v. *MNR* [1976] CTC 379; aff'd [1978] CTC 235.

(120) Subsection 48(1) of the Act.

(121) April 14, 1997.

(122) Dennis Turnbull, Revenue Canada, "Tax Valuation Update", paper presented at the 1998 Joint Business Valuation Conference of The Canadian Institute of Chartered Business Valuators and the American Society of Appraisers, Montreal, September 24-25, 1998.

(123) U.S. Tax Court, October 27, 1997.