“VALUATION — RECENT DEVELOPMENTS”

by

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1. INTRODUCTION

There have been many developments in the last year or two regarding tax-purpose valuations of businesses, business equity ownership interests, securities and intangible assets. In addition, there are important developing areas that relate to tax-purpose valuations. This paper reviews both subjects. Attention is paid to developments in the United States as well, because of the very similar valuation-related issues that are addressed in that country and the significant pronouncements, laws and fair market value guidance emanating therefrom.

2. VIEWS OF CANADA REVENUE AGENCY VALUATORS

The Canada Revenue Agency ("CRA") has stated[1] that its business valuators comply with the Practice Standards[2] promulgated by The Canadian Institute of Chartered Business Valuators ("CICBV").

Under the CRA's established business equity valuation programs, its valuation group is responsible for advising on the fair market value of closely-held and publicly-traded securities, partnerships, proprietorships, copyrights, royalties, patents, goodwill, financial instruments and

(1) CRA *Information Circular 01*-1, Third-Party Civil Penalties, September 18, 2001 ("*IC 01-1*"), paragraph 46.

(2) The CICBV Standards are continually updated and expanded, and can be found on the Web at http://www.cicbv.ca/aboutus/standards.asp.

other business equities for income tax purposes. The valuation group also provides expert opinions on technical valuation and related issues.[3]

The CRA continues to receive criticism that its Business Equity Valuation group practices are not consistent among regional Tax Services Offices or, indeed, within the same Tax Services Office. The Department has received complaints that the uncertainty regarding how a specific Office or valuator will review a transaction places the taxpayer at excessive risk in organizing his or her financial affairs.

The CRA 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 comprehensive Business Valuation Guidelines recently published by the Internal Revenue Service ("IRS"), which are addressed later in this paper. The CRA states that it purposely keeps its national valuation policies to a minimum, which essentially are those contained in *Information Circular 89-3, Policy Statement on Business Equity Valuations* ("*IC 89-3*").

The Department's reasoning has been 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

(3) *IC 01-1*, paragraph 46.

> comfort we can give taxpayers through formal valuation policies is limited. As a result our national policies are kept to a minimum.[4]

The CRA has also identified some of the following "more frequent issues" in matters relating to fair market value:

2.1 Price-Adjustment Clauses

The CRA continues to review price-adjustment clauses in non-arm's length transactions. If a price-adjustment clause is to be considered, there must be a "fair and reasonable" valuation method applied in arriving at the fair market value of the transferred property, as such term is employed in *Interpretation Bulletin IT-169, Price-Adjustment Clauses*.[5]

In this regard, the CRA recommends that an independent valuation be commissioned to ensure that (a) the review is sufficient in scope and (b) the methodology is appropriate in the specific circumstances.

2.2 Stock Market Prices

CRA may question adjustments to the stock market price of publicly-traded shares for purposes of determining whether they are reasonable under one or more of the following circumstances:

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(4) Dennis Turnbull, Canada Revenue Agency, "Tax Valuation Update", paper presented at the 1998 Joint Business Valuation Conference of the CICBV and the American Society of Appraisers, Montreal, September 24-25, 1998.

(5) August 6, 1974. See paragraph 1(a).

- there are blockage[6] considerations;
- the shares are restricted from trading (e.g., escrowed shares); and
- there are control issues.

The CRA notes that when there are adjustments to the stock market price in respect of minority discounts or control premiums, they are often not well supported.

With respect to trading restrictions, one senior member of the CRA Business Equity Valuation Group has stated that reliance on restricted stock studies[7] "is typically a poor basis for establishing marketability discounts for employee stock option plans, escrowed shares and pre-IPO shares", suggesting that any discounts for trading restrictions should be based on the specific attributes of those securities and of the issuing company.

Concerning the use of stock market trading prices in valuing publicly-traded shares, a Canadian tax case (in which this conference presenter was the Crown's valuation expert) is *National System of Baking of Alberta Limited* v. *The Queen*,[8] in which Mr. Justice Mahoney of the Federal Court — Trial Division provided, in his reasons for judgment, a detailed analysis of the relevance of the market and share trading prices.

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(6) Defined as "an amount or percentage deducted from the current market price of a publicly-traded stock to reflect the decrease in the per-share value of a block of stock that is of a size that could not be sold in a reasonable period of time given normal trading volume. *International Glossary of Business Valuation Terms*, June 2001, developed jointly by the American Institute of Certified Public Accountants, American Society of Appraisers, The Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and the Institute of Business Appraisers. (The principle has also applied to assets that are not publicly-traded shares.)

(7) See Richard M. Wise, "Valuation Issues Relating to Shares of Private Corporations", *Report of Proceedings of the Fifty-Sixth Tax Conference*, 2004 Conference Report, Canadian Tax Foundation (Toronto: 2005).

(8) [1978] CTC 30; 78 DTC 6018.

2.3 Blockage Principle

In addressing the issue of blockage, the CRA believes that a trading imbalance is assumed in many secondary exchanges, frequently characterized by low volume and high volatility, stating that fair market value requires a "carefully planned program" in order to maximize the return. A discount might well be appropriate for holding-period risk and the time-value of money.

The issue of blockage was considered by the Federal Court of Appeal in *Malette*:[9]

> "The need to apply such a discount is a function of supply and demand. When, for any reason, a large number of personal property items comes on the market at the same time, a depressive effect on the value of the individual items can occur due to the fact that the number of items offered for sale exceeds the number of willing buyers."

This appears to be a departure from the 1929 decision of the Supreme Court of Canada in *Untermyer Estate* v. *AG of British Columbia.*[10] In *Untermyer*, shares of public companies were deemed to be disposed of at the date of death. The taxes on the gain were a function of their fair market values. The taxpayer had applied a blockage discount, but the Supreme Court held that an orderly disposal of the shares, rather than an immediate sale thereof, was appropriate and denied the application of the discount. In *Malette*, the Federal Court of Appeal allowed, in effect, a marketability discount, which generally applies when there is no formal market (e.g., private-company shares, art, etc.). The art cases, *Nash* and *Klotz*, addressed the "market" for property.

(9) [2004] 4 CTC 24; (2004) 58 DTC 6415.

(10) [1929] SCR 84.

2.4 Use of Hindsight

There are situations in which CRA valuators use hindsight. They state, however, that in doing so, they will consider:

- the proximity of the subsequent event(s) to the valuation date;
- whether or not the post-valuation date events that have taken place were foreseeable at the valuation date; or
- whether there a fundamental change in the entity.

It is well established that value is determined as of a specific point in time (or at a specific date) and is a function of facts that existed and events anticipated (or forecasts made) as of that point in time. Because factual evidence from subsequent events that occurred would not have been available to a willing buyer and willing seller at the effective valuation date, it is only what would or would have reasonably been anticipated *vis-à-vis* the future, which is presumed by the parties at the time. That is, as hindsight is not available to a buyer and seller in an *open market* (real-world) transaction, it should not be admissible in reaching a valuation conclusion in *notional market*[11] transactions, e.g., in fair market value determinations for income tax purposes.

The use of hindsight and the degree to which it is admissible for valuation purposes has been considered by the courts in a number of valuation cases. The issues have arisen mainly in three broad areas: (1) taxation, (2) expropriation and (3) shareholder appraisal rights.

(11) For a discussion of the notional market, see Richard M. Wise, "Canada-U.S. Mobility of Residence and Immobility of Fair Market Value", *Business Valuation Review*, Vol. 19, No. 3, September 2000; and R.M. Wise, "The Effect of Special Interest Purchasers on Fair Market Value in Canada", *Business Valuation Review*, Vol. 22, No. 4, December 2003.

While retrospective evidence is inadmissible in reaching valuation conclusions in the *notional* (hypothetical or imaginary) market, it has been allowed by the courts to test (or confirm) the reasonableness of assumptions or projections made in arriving at value as of the effective valuation date. As the United States Supreme Court stated, in *Ithaca Trust Co.* v. *U.S*:.[12]

> "[T]he value of property at a given time, like all values, as the word is used by the law, depends largely on more or less certain prophecies of the future; and the value is no less real at that time if later the prophecy turns out to be false than when it comes out true."

Facts subsequent to a 1971 valuation date were admitted by the Federal Court — Trial Division in *J.A. Carruthers* v. *The Queen*[13] in order to test an assumption:

> "The validity of this conclusion, which would be reasonable to make as of [the valuation date], can be verified by the fact that [Mr. Carruthers] did in fact leave the company in 1976 following the sale of his shares ... in 1975 ... ."

The court found no apparent reason why an assumption which could be made concerning the 1971 valuation date, i.e., that Mr. Carruthers would not remain long in the employ of the company should he and his wife have chosen to dispose of their shares, cannot find some support in the fact that this is what eventually took place:

> "The price paid ... to the Carruthers for their shares is of course in no way relevant to the valuation as at [the valuation date], for [the purchaser] was obtaining full control of the company and moreover *during the intervening years between 1971 and 1975 the company continued to prosper and the shares increased in value*." (Emphasis added.)

(12) 7 AFTR 8856 (49 S.Ct. 291).

(13) [1982] CTC 5; 82 DTC 6009.

Because the extent to which hindsight is admissible can be a key issue in valuation litigation, comments made by the courts in this regard may be of interest.

The admissibility of hindsight has been considered in a number of Canadian cases. In *National System of Baking of Alberta Ltd.*,[14] a case which involved the takeover of a public company ten months after the valuation date, Mahoney J. of the Federal Court of Canada — Trial Division stated: "I expressly rejected the validity of hindsight as probative of fair market value at a given date and took nothing that occurred after [the valuation date] into account."[15]

Shortly thereafter, in *Connor* v. *The Queen*[16], Justice Mahoney again considered the admissibility of subsequent events in determining value as of the valuation date, stating: "The reasonableness of *projected* earnings may be measured against the yardstick of *actual* results without arriving at those projections by application of hindsight." (Emphasis added.)

The Federal Court of Appeal in *Edmund Littler, Sr.* v. *The Queen*[17] addressed the valuation of shares for Canadian federal gift-tax purposes (when gifts used to be taxable under the provisions of the pre-1972 *Income Tax Act*[18]). Two of the three Appeal Court justices held that the fair market value of the shares of Walter M. Lowney Company Ltd. (a Canadian public company) was the eventual $68 takeover price by Standard Brands of the U.S. and not the $24 stock market price on the valuation date. Such view was taken without the benefit of hindsight and was based, instead, on *facts actually existing* at the valuation date. Affirming the decision of the Trial Division, the appellate court stated:

> "The Minister [of National Revenue] had every reason to attribute to the value of a share in Lowney's a figure of $68.22 quite apart from what eventually took place in May 1968 ... . As far as the Minister's decision is concerned, *it was not ... a case of*

(14) *Supra*, footnote 8.

(15) *Ibid.*, at 6024.

(16) [1978] CTC 669; 78 DTC.

(17) [1978] CTC 235; 78 DTC 6179.

(18) RSC 1952, c. 148, as amended.

> *hindsight at all. It was based on substantial facts existing prior to the transaction challenged herein*." (Emphasis added.)

The court in *Littler* contrasted (a) the use of retrospective evidence with (b) the availability of facts "actually existing" at the valuation date.

In *Dominion Metal & Refining Works Ltd.* v. *The Queen*,[19] an important issue that was raised by the Trial Division of the Federal Court was whether, at the relevant valuation date, the buyer, Ogilvie Mills, had been a "special purchaser" in the notional market.[20] That is, while at the time Ogilvie acquired the subject property from Dominion Metal in 1974, it was a special purchaser, as of the relevant valuation date in 1971, Joyal J. found that there was no evidence supporting the proposition that Ogilvie Mills was a special purchaser at that earlier date:

> "The special purchaser theory, as all theories, requires some evidentiary base before it may be applied. ... Ogilvie Mills had been a neighbour of the subject lands for generations, without any covert or overt, or presumed intentions to acquire more property. There is no evidence of Ogilvie Mills exerting any acquisitive clout or giving the mere impression of it to alert the notional buyer that at [*the valuation date*] the subject lands might have a considerably enhanced value over other locations simply because they were located next door to it. There is no evidence of notional movement by Ogilvie Mills in any direction. Even if one might establish the presence of Ogilvie Mills as a special purchaser [*18 months subsequent to the valuation date], I cannot readily see where as at [the valuation date*], Ogilvie Mills can fit into the special purchaser category.
>
> ...
>
> "... In the cases cited by the plaintiff and to which lengthy reference was made, there were facts which gave credence to the presence of special purchasers not only at the date of acquisition but at the relevant valuation date as well. In the case before me, I fail to find that kind of foundation upon which the presence of a special purchaser in the notional market [*at the valuation date*] may be reasonably established. I can only ascribe the excellent price paid for the subject property in 1974 to a fortuitous combination of a self-compelled buyer on the one hand and an astute and obviously knowledgeable seller on the other." (Emphasis added.)

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(19) 86 DTC 6311 (FCTD).

(20) For a detailed discussion regarding special purchasers and their effect on fair market value, see, R.M. Wise, "The Effect of Special Interest Purchasers on Fair Market Value in Canada", *Business Valuation Review*, Vol. 22, No. 4, December 2003.

Other cases that found hindsight to be inadmissible include *Brunelle* v. *MNR*,[21] in which case Chairman Cardin of the Tax Review Board stated:

> "In evaluating shares at a specific prior time there can be no doubt that it is a proper evaluation procedure to consider the company's actual earnings for the past three to five years. It is also proper to project the future earnings of the company on the basis of its past performance and that is done as accurately as possible by means of the weighted averages and the use of a realistic multiplier. However, in my opinion, which is supported by other members of this Board, *it is not proper in evaluating shares as of a prior date to use the company's actual record of surplus or extra earnings which occurred subsequent to [the valuation date] and which are not known or expected on [the valuation date]. In my view, this hindsight evaluation, whether it increase or decreases the value of the shares, cannot and does not establish the fair market value of the shares as at [the valuation date] and should not be employed in an evaluator's calculation ...* . (Emphasis added.)
>
> ...
>
> "On the basis of the evidence presented to the Board in the appeals, there are no special facts or circumstances that existed on [the valuation date] which might permit anyone to expect or to foresee at that time any marked increase in the company's earnings in subsequent years."

To highlight the importance and relevance of timing, the provisions of the *Income Tax Act*,[22] which contains deemed-disposition rules that apply on the death of a taxpayer, stipulate five individual and precise points in time for fair market value determination in such circumstances, depending on the type or quality of income deemed to be triggered:

(21) [1977] CTC 2506; 77 DTC 326.

(22) RSC 1985, c.1 (5th Supp.), as amended (herein the "ITA").

Description	***ITA Section***	***Timing of Deemed Disposition for FMV Purposes***
Accrued periodic amounts (interest, rent, etc.)	70(1)	*Day* of death
"Rights or things" (receivables, etc.)	70(2)	*Time* of death
Capital property (investments, personal property)	70(5)	Immediately *before* death
Transfer (rollover) to spousal trust	70(7)	Immediately *after* death
Disposition by spousal trust	104(4)	At the *end of the day* on which the spouse dies

Hence, a business valuator may be engaged on behalf of an estate, in which there might be different specific points in time as of which fair market value must be determined.

Because four of those different points in time are used in the very same section of the ITA (section 70), the legislators appear to have had every intention of distinguishing among them when requiring value determinations for a decedent's final tax return.[23]

Hindsight might be used where the retrospective data provide evidence, or further evidence, of conditions that actually existed or could have been reasonably anticipated, at the valuation date (as in *Carruthers*, *supra*, footnote 13).

For income tax purposes, it may be advisable to commission an independent valuation proximate to the valuation date (transaction date) when there is a non-arm's length transfer of a business or other economic interest. This should not only help to avoid a possible third-party civil penalty under section 163.2, but also help avoid being considered as "self-serving" (as, for example, a valuation that is commissioned after a reassessment has been received).

The CRA suggests that if a non-arm's length transaction has taken place, information and documents that were in existence at the valuation date should be made available at the

(23) See, for example, *The Queen* v. *Mastronardi Estate*, [1977] CTC 355; 77 DTC 5217 (FCA); aff'g [1976] CTC 572; 76 DTC 6306 (FCTD). See, also, CRA *Interpretation Bulletin IT-416R3*, dated July 10, 1987, "Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder".

assessment phase, so that any disputed items may be resolved in order to reduce the likelihood of litigation before the Tax Court: "CRA valuators will show more flexibility in negotiation when they are ... [provided] with an initial credible valuation submission".

2.5 Fractional Interests in Real Property

There are situations in which the CRA has been valuing a taxpayer's undivided co-ownership interest ("fractional interest") in real property on a pro-rata basis. For example, if the subject real estate had a fair market value of $1,000,000 and the taxpayer owned a 22% undivided co-ownership interest therein, the CRA has frequently taken the position that the fair market value of that fractional, or fragmented, interest was the pro-rata amount of $220,000. Often, it is CRA's real estate appraisal group, rather than the business equity valuation group, opining on the issue.

The taxpayer must advance the following in connection with the CRA's review.

An undivided interest is an interest or right in property owned by tenants in common, or joint tenants. Each tenant has an equal right to make use of and enjoy the entire property. The owner of an undivided interest (which comprises a bundle of rights) holds his or her percentage of the entire property and not an identifiable, separable or legally described section, acre, floor, room, entrance, easement,[24] or anything else that can be readily separated and sold. An undivided interest derives from "unity of possession" and is to be distinguished from interests that have been partitioned, i.e., divided and distributed to the different owners for their use in severalty. It may be of only a fractional share, in which case the holder is entitled to his or her percentage participation in all profits and sale proceeds, but has a right to possession of the whole.[25]

(24) A concurrent interest whereby an owner of real property permits another party to use or enjoy the property.

(25) J.A. Yogis, QC, LL.M, *Canadian Law Dictionary*, Barron's Educational Series, Inc. (Toronto: 1983), pp. 217 and 218.

First, it is suggested that the Business Equity Valuation group be involved — the same way that those professionals would be involved in valuing the shares of a real estate investment holding company

Tenancy in common is a form of tenancy that "arises when owners have community of possession but distinct and several titles to their shares which need not necessarily be equal: and there is no right of survivorship between owners in common".[26]

A property interest in the real estate entity constitutes a *whole property interest* and the undivided interest of each of the tenants-in-common is also a *whole property interest*. Both joint tenancy and tenancy in common are forms of co-ownership.[27]

In summary, if a real estate property (primary property interest) is held in co-ownership:

- The benefits are prorated in proportion to the co-owners' shares;
- The primary property interest is undivided;
- The undivided primary property interest is a *whole property interest*;
- Each co-owners' interest is an undivided interest in the primary property interest and is a *whole property interest*; and
- Any of the co-owners' interests can be held in sole ownership or co-ownership.[28]

For valuation purposes, it is important to determine whether there is a co-ownership agreement among the taxpayers and, if so, the terms thereof, and whether the taxpayer's interest is marketable (e.g., existence of put rights that may attach to the co-ownership).

(26) *Ibid.*

(27) H.A. Babcock, *Appraisal Principles and Procedures*, American Society of Appraisers (October 1980), p. 32.

(28) *Ibid.*, p. 32.

The disadvantages of lack of control for a fractional interest in real property 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 therefrom. Importantly, however, unlike a corporate shareholding, which may not always be liquidated but does have protection under the company law statutes with respect to reasonable expectations, etc., pursuant to the oppression-remedy[29] provisions or dissent-remedy[30] provisions, the owner of a fractional interest in real property has the ability to seek partition and therefore has a degree of control over this proportionate share of ownership. Nonetheless, discounts from pro-rata value are typically appropriate in view of the cost, uncertainties and delays attendant upon partition proceedings before the interest can be converted to cash.

The two major factors in determining the costs of the 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 disagreements exist among the co-owners, and where lengthy negotiations and the use of additional professionals are required, the time and costs would of course be greater.

In estimating the fair market value of co-ownership interests, it is therefore appropriate to apply discounts to the *pro-rata* share of the respective underlying net asset values of the property. That is, the taxpayer's *pro-rata* share of the property would be discounted to reflect (a) lack of control (compared to a 100% dominion-and-control position)[31] and/or (b) lack of marketability (compared to a 100% dominion-and-control position). The owner of 100% of an unencumbered real property could simply place an ad in the newspaper or list the property with an agent or broker.

(29) For example, section 241 of the *Canada Business Corporations Act*, RS 1985, c-44 ("CBCA").

(30) Section 190 of the CBCA.

(31) The undivided co-ownership interest discount does not result from the potential imposition of the majority's will over that of the minority, absent an agreement to the contrary. In the U.S., some states provide the owner of a minimum specified percentage undivided interest in certain types of real property certain elements of control. Unlike a minority shareholder of a corporation, a co-owner (co-tenant) is legally entitled to possess and use the subject asset if not otherwise subject to an agreement.

Valuing a Business[32], one of the leading business valuation authorities in the United States, comments as follows in this regard:

> "**Discounts for Direct Undivided Ownership Interests in Real Estate**
>
> "Empirical market data on sales of fractional ownership interests in real estate are scarce. However, the available data do support the concept that fractional ownership interests in real estate, when they are sold, generally are priced at less than a pro rata portion of the market value of the total real estate parcel.
>
> "One study covered 54 undivided interests, with the undivided ownership interest price discounts ranging from zero to 82 percent, with a median price discount of 35 percent.[33] Another study covered 21 undivided ownership interests, with the undivided ownership interest price discounts ranging from 5 percent to 94 percent, with a median price discount of 30 percent.[34]
>
> "Real estate undivided ownership interest discounts tend to be considerably smaller than lack of control discounts for stocks of partnership interests. This probably is explained in large part by differences in the respective rights of the ownership interests. An owner of an individual ownership interest in real estate may sue for partition — that is, to have the property divided and to give each owner his or her pro rata share. If the court finds that the property is not divisible, then it may order the property to be sold. Owners of noncontrolling stock and partnership ownership interests have no such rights.
>
> "It is interesting to note that the U.S. Tax Court has distinguished between (1) lack of control (i.e., minority interest) and (2) lack of marketability discounts for an undivided interest in real estate. The court stated:
>
>> 'A minority interest discount for an interest in real property may be allowed on account of the lack of control which accompanies co-ownership." The minority interest discount should consider "the cost, uncertainty, and delays attendant upon partition proceedings… The marketability discount, by contrast, measures the diminution in value attributable to the lack of a ready market for the property." This two-

(32) S.P. Pratt, R.F. Reilly and R.P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, Fourth Edition, McGraw-Hill (New York: 2000), p. 383.

(33) Peter J. Patchin, "Market Discounts for Undivided Minority Interests in Real Estate," *Real Estate Issues*, Fall/Winter 1988, pp. 14-16.

(34) Don L. Harris, Philip A. McCormick, and W.D. Davis Sr., "The Valuation of Partial Interests in Real Estate," *ASA Valuation*, December 1983, pp. 62-73.

> step process is similar to prior Tax Court decisions regarding corporate and partnership interests.'"[35]

One author makes the following comments in respect of an owner of an undivided minority interest in real estate, i.e., a fractional direct interest, seeking partition of the subject property,

> "The following partition assumptions were based on discussions with attorneys experienced in partition actions in the subject property's county [in the U.S.], and details included in the real estate appraisers report:
>
> - It will take 90 to 120 days and a minimum of $5,000 to get the first hearing and interlocutory judgment.
> - It will take a minimum of two years and $5,000 to $10,000 per year per party to complete the sale and divide the proceeds.
> - The court generally appoints a referee (who may also be a broker) who is paid either hourly or by commission (generally 6%).
> - There is usually a 10% to 20% discount from the otherwise fair market value of the property.
> - There is property appreciation of 3% annually during the partition period, based on the real estate appraiser's report on the fee simple interest.
> - Operation of the property will continue through the partition period. Rental revenue and operating expenses are based on those used by the real estate appraiser in an income approach.
> - An environmental remediation costing $25,000 is required before sale.
> - A discount rate is estimated as follows:

Capitalization rate utilized by real estate appraiser	7.0%
Expected long-term growth rate	3.0
Incremental risk and uncertainty	1.0
Discount rate	11.0%"

...

(35) *Samuel J. LeFrak* v. *Commissioner*, 66 T.C.M. 1297 (1993).

> " ... the discounts associated with the partition process are 29.0% for an uncontested partition and 31.6% for a contested partition. In reaching a conclusion, these results would be considered in relation to the analysis of comparable transactions. Selection of one method over the other, or whether to combine the two methods, should be based on the facts and circumstances relevant to the case."[36]

The New York transfer-tax regulations as far back as 1937 prescribe the following:

> "The valuation of a fractional interest in property is not necessarily the same fractional part of a value of the entire property. For example, if the evidence should establish that a one-third interest is worth less than one-third of the entire value, the lesser valuation should be adopted."[37]

In summary, the basic premise supporting a discount for a fractional interest includes the "forced" sharing of control. If there are disagreements between or among the parties concerning the use or management of the property, there are two alternatives:

1. partition, which involves dividing the property into separate properties, each of which is held as a fee interest by only one of the parties (former co-tenant); or

2. selling the property and dividing the proceeds of disposition.[38]

As the U.S. Tax Court stated in *Estate of Stevens* v. *Commissioner*:[39]

(36) Ted Israel, "Discounts on Undivided Interests in Real Estate", *Valuation Strategies*, Warren Gorham & Lamont, May/June 2003, p. 47.

(37) Article 35.

(38) Sometimes referred to as partition by "licitation".

(39) TC Memo 2000-53, 79 TCM 1525, citing *Estate of William* v. *Commissioner*, TC Memo 1998-59.

> "The importance of partitioning costs is dependent on the circumstances of each case. Partition is a more viable approach where real property is improved. Where significant income-producing improvements are involved, partition is a less plausible approach. [The IRS's] use of partitioned cost alone does not give adequate weight to other reasons for discounting a fractional interest in this case such as the significance of the control factor and the historic difficulty of selling an undivided fractional interest in improved real property." (Page 302.)

2.6 Intellectual Property Valuations

A contentious issue is the valuation and transfer pricing of in-process research and development, early-stage technology and other intangible assets having significant future potential and high value. Certain taxpayers transfer these intellectual property ("IP") rights at an early point in time to an offshore affiliate at very low prices, so that, in future, the commercial exploitation is enjoyed in a tax-free or low-tax jurisdiction.

At issue is the methodology in valuing the IP, considering the variables, judgment and risk/reward factors that must be evaluated.[40]

2.6.1 Reasonable Royalties Method

The value of intellectual property is often established through a reasonable royalty. This approach is based on the estimated future royalty stream, generally expressed as a percentage of revenue, which could be generated by (a) licensing the right to use the trademark or brand name or (b) the royalties one would be required to pay if he or she did not own the trademark or brand, but merely manufactured under licence from the plaintiff.

(40) For a discussion on the valuation considerations regarding IP, see Richard M. Wise, "Valuation and Damage Quantification Issues Relating to Intellectual Property", *Meredith Lectures, Making Sense of Intellectual Property*, McGill Faulty of Law (Montreal: 1996), pp. 197-239.

More specifically, royalty and licensing terms entered into in exchange for the ability of another party (licensee) to commercially exploit the intellectual property are established to provide the owner of the asset with a fair rate of return on investment. The rate of return must also be acceptable to the potential licensee and should consider the rates of return available on alternative forms of investment, which compare, in terms of risk, (a) the value of the intellectual property, (b) required complementary assets used to commercialize such property and (c) the relative risk, such as potential obsolescence, competing technology, industry changes and government regulations.

Royalties must relate directly to profits. A reasonable royalty is generally calculated based on one of the following:

(i) An established royalty.

(ii) A notionally (hypothetically) negotiated royalty.

(iii) Adopting an analytical approach (which determines the reasonable royalty for the intellectual property as the excess of the anticipated profits on sales over a normalized industry profit margin).

For example, with respect to the notionally (hypothetically) negotiated royalty in IP infringement cases, U.S. courts have applied a "willing licensor-willing licensee rule":

> "In fixing damages on a royalty basis against an infringer, the sum allowed should be reasonable and that which would be accepted by a prudent licensee who wishes to obtain a license but was not so compelled and prudent patentee, who wished to grant a license but was not so compelled. In other words, the sum allowed should be that

> amount which a personal desiring to use a patented machine and sell its product at a reasonable profit would be willing to pay."[41]

There are a host of factors to consider for purposes of determining what is a reasonable royalty in a specific case. In the United States, the leading case which provides guidance is *Georgia-Pacific Corp.* v. *United States Plywood Corp.*[42] This decision sets out fifteen factors to be considered in attempting to estimate a reasonable royalty, i.e., a notional royalty rate that would have been negotiated in the open market between a willing patentee and a willing infringer at the commencement of the infringement:

1. Royalties received by the patentee for the licensing of the infringed patent, proving (or tending to prove) an established royalty.

2. Rates paid by the licensee for the use of comparable patents.

3. The nature and scope of the licence, as exclusive or non-exclusive, or as restricted or non-restricted territorially or with respect to whom the manufactured product may be sold.

4. The licensor's established policy and marketing program to maintain its patent monopoly by not licensing others to use the invention or by granting licences under special conditions designed to preserve the monopoly.

5. The commercial relationship between the licensor and licensee, such as whether they are competitors or whether they are inventor and promoter.

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(41) *Horvath* v. *McCord Radiator & Manufacturing Co.*, 100 F.2d 326, 335; 40 USPQ. 394, 402-03 (6th Cir. 1938).

(42) 318 F. Supp. 116 (SDNY 1970), modified and aff'd., 496 F.2d 295 (2d Cir. 1971).

6. The effect of selling the patented specialty in promoting sales of other products of the licensee, the existing value of the invention to the licensor as a generator of sales its non-patented items and the extent of such tag-along/accessory/convoyed sales.

7. The duration of the patent and the term of the licence.

8. The established profitability of the patented product, its commercial success and its current popularity.[43]

9. The utility and advantages of the patented property over the old modes or devices, if any, which had been used for working out similar results.

10. The nature of the patented invention, the character of the commercial embodiment of it as owned and produced by the licensor and the benefits to those who use the invention.[44]

11. The extent to which the infringer has used the invention and any evidence probative of the value of such use.[45]

12. The portion of the profit or selling price customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions.

13. The portion of the realizable profit that should be credited to the invention as distinguished from other factors (non-patented elements, the manufacturing process, business risks or significant features or improvements added by the infringer).[46]

14. The opinion testimony of qualified experts.

(43) What matters is the profitability of the patentee and not the infringer.

(44) U.S. courts may invoke the Entire Market Value Rule (*supra*).

(45) *Id.*

(46) Footnote 44, *supra*.

15. The amount which a prudent licensor (such as the patentee) and a prudent licensee (such as the infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and willingly trying to reach an agreement; i.e., the amount which a prudent licensee — who desired, as a business proposition, to obtain a licence to manufacture and sell a particular article embodying the patented invention — would have been willing to pay as a royalty and yet be able to make a reasonable profit and which amount would have been acceptable by a prudent patentee.[47]

In *Georgia-Pacific*, the U.S. Second Circuit Court placed heavy reliance upon the "willing buyer/willing seller" approach, which defines the estimated royalty rate as the amount a willing licensee would have paid as well as the amount a willing licensor would have accepted, if such rate had been negotiated (at the time the patent infringement had begun).

In *Honeywell* v. *Minolta Camera Co.,*[48] the Court added three others:

1. The extent to which the infringement prevented Honeywell from using or selling the invention;

2. The relative bargaining positions of Honeywell and Minolta.

3. The market to be tapped.

Consideration of subsequent events and facts was explicitly permitted. As can be seen, valuation experts must determine the royalty that the relevant parties would have been expected to negotiate at the time of entering into the agreement and support such analysis.

(47) Footnote 40, *supra*.

(48) 1990 WL 66182.

In effect, and subject to a few modifications, the calculated royalty rate is a notional rate which might reasonably have been negotiated arm's length between the patent owner and the licensee immediately prior to the infringement.[49]

2.6.2 The Analytical Approach

Adopting the analytical approach, a reasonable royalty is determined by calculating the excess of the anticipated profits from infringing sales over a "normal profit" level for the industry, such excess yielding the royalty rate on infringing sales. Emphasis is placed on the anticipated profit from exploiting the property at the time of infringement. Because there are two principal variables in this calculation, a high degree of judgment and analytical support is required to satisfy the court.

In some cases, a plaintiff may have regard to the operations of a comparable firm by which to measure the damages had it not been for defendant's infringing behaviour. This typically involves finding a business having substantially similar investment characteristics to that of plaintiff.[50]

Applying the analytical approach to establish a reasonable royalty in the calculation of infringement damages requires the application of finance, investment analysis and business valuation theory. Typically, a business enterprise is financed by a combination of debt and equity. The investor must receive a reasonable rate of return on his or her investment in the company on the weighted average cost of capital ("WACC"). The WACC considers the cost of debt weighed by the percentage amount of debt in the company's capital structure as well as the cost of equity and

(49) It should be noted that although the court likened the process to a "willing buyer-willing seller" (or notional) negotiation, it realized that such approach is really a fiction of law, noting that the "rule is more a statement of approach than a tool of analysis".

(50) In a U.S. decision, *TWM Mfg. Co. Inc.* v. *Dura Corp.*, 789 F.2d 895 (Fed. Cir. 1986), the royalty was based on an analysis of the infringer's internal business plan prepared immediately prior to the infringement.

its percentage of total capital. The cost of equity is used to discount earnings or cash flow accruing to the equity investment.[51] (It should be noted, however, that in the calculation of damages for lost profits and reasonable royalties, financial expenses are excluded.)

As outlined earlier, the business enterprise typically has the following asset categories, or components:

- *Working Capital*: Current assets less current liabilities.[52]
- *Other Tangible Assets*: Machinery and equipment, plant, land and buildings, office furniture and equipment, vehicles, leasehold improvements, etc.
- *Intangible Assets*: Goodwill and intellectual property.

For example, from a financial reporting perspective, the *Handbook* of the Canadian Institute of Chartered Accountants ("CICA")[53] requires the following with respect to intangible assets, pursuant to generally-accepted accounting principles:

(51) Free cash flow (also referred to as "discretionary cash flow") is cash flow from operations minus sustaining capital reinvestment minus changes in non-cash working capital. It represents the cash available to be paid as dividends to shareholders after the retention of capital expenditures necessary to sustain operations at existing levels and is used to discount the cash flow before interest charges, as it considers both the cost and magnitude of debt and equity. If there are anticipated changes to the company's capital structure in the future, a blended WACC will consider how the cost of each component (debt and equity) will vary over time. Accordingly, a blended WACC takes such changes into consideration and calculates one discount rate which, when applied to the cash flows from each time period, yields a present value equal to the present value determined by discounting each discretionary cash flow by its own specific discount rate and then aggregating the present values so calculated.

(52) Cash, accounts receivable, inventories, marketable securities and pre-paid expenses minus current liabilities (trade accounts payable, income taxes and withholding taxes payable, accrued liabilities, current portion of long-term debt, etc.).

(53) Section 1581.

.48 "An intangible asset should be recognized apart from goodwill when:

(a) the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or

(b) the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).

Otherwise it should be included in the amount recognized as goodwill".

.49 "An intangible asset that cannot be sold, transferred, licensed, rented or exchanged individually meets the criterion in paragraph 1581.48(b) when it can be sold, transferred, licensed, rented or exchanged in combination with a related contract, asset or liability. An assembled workforce is not recognized as an intangible asset apart from goodwill. The Appendix provides additional guidance relating to the recognition of acquired intangible assets apart from goodwill, including examples of intangible assets that meet the recognition criteria in paragraph 1581.48."

The criteria set out in Paragraphs 1581.48 (a) and (b) of the CICA *Handbook* are generally referred to as the "contractual-legal criterion" and the "separability criterion", respectively.

Appendix A to Section 1581 of the CICA *Handbook* provides illustrative examples of specific intangible assets to be recognized apart from goodwill, classified into five general categories:

(i) Marketing-related;

(ii) Customer-related;

(iii) Artistic-related;

(iv) Contract-based; and

(v) Technology-based.

Appendices A1 to A8 to Section 1581 of the CICA *Handbook* establish a hierarchy for fair value measurements, comprising three "levels":

> A2 Quoted market prices in active markets, if available, are the best evidence of fair value and are, therefore, used as the basis for fair value measurement, when available.
>
> ...
>
> A5 When quoted market prices are not available or are not representative of fair value, estimates of fair value are based on the best information available, including prices for similar items and the results of other valuation techniques. Valuation techniques used would be consistent with the objective of measuring fair value.
>
> ...
>
> A7 A valuation technique based on multiples of earnings, revenue or a similar performance measure may be used if that technique is consistent with the objective of measuring fair value. Use of multiples of earnings or revenues in determining the fair value of a business unit may be appropriate, for example, when the fair value of an enterprise with comparable operations and economic characteristics is observable and the relevant multiples of the comparable enterprise are known. Conversely, use of multiples is not appropriate in situations when the operations or activities of an enterprise for which the multiples are known are not of a comparable nature, scope or size as the business unit for which fair value is being estimated.
>
> A8 A present value technique is often the best available technique with which to estimate the fair value of a group of items (such as a group of assets in a reporting unit) and generally includes the following elements:
>
> (a) an estimate of the series of future cash flows at different times;
>
> (b) expectations about possible variations in the amount or timing of those cash flows;
>
> (c) the time value of money, represented by the risk-free rate of interest; and
>
> (d) the price for bearing the uncertainty inherent in the asset or liability.
>
> Other factors, if identifiable, include illiquidity and market imperfections.
>
> ...

A10 If a present value technique is used to measure fair value, estimates of future cash flows are to be consistent with the objective of measuring fair value. These cash flow estimates incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. Otherwise, an enterprise may use its own assumptions.

A11 An enterprise's best estimate of the present value of cash flows will not necessarily equal the fair value of those uncertain cash flows. There are several reasons why an enterprise might expect to realize or pay cash flows that differ from those expected by others in the marketplace. Those include:

(a) The enterprise's managers might intend different use or settlement than that anticipated by others. For example, they might intend to operate a property as a bowling alley, even though others in the marketplace consider its highest and best use to be a parking lot.

(b) The enterprise's managers may prefer to accept risk of a liability (like a product warranty) and manage it internally, rather than transferring that liability to another enterprise.

(c) The enterprise might hold special preferences, like tax or zoning variances, not available to others.

(d) The enterprise might hold information, trade secrets, or processes that allow it to realize (or avoid paying) cash flows that differ from others' expectations.

(e) The enterprise might be able to realize or pay amounts through use of internal resources. For example, an enterprise that manufactures materials used in particular processes acquires those materials at cost, rather than the market price charged to others. An enterprise that chooses to satisfy a liability with internal resources may avoid the markup or anticipated profit charged by outside contractors.

A12 Cash flow estimates are based on reasonable and supportable assumptions and consider all available evidence. The weight given to the evidence is commensurate with the extent to which the evidence can be verified objectively.

A13 An enterprise incorporates expectations about possible variations in cash flows into either the projected cash flows or the discount rate or some combination of the two.

Appendices A9 through A13 of Section 1581 of the CICA *Handbook* elaborate on certain general principles governing the application of present-value techniques in measuring assets or liabilities.

The CICA and the Financial Accounting Standards Board ("FASB") in the U.S. are continuously reviewing these standards through various committees and joint task forces.[54]

The required rate of return may be different for each of the foregoing categories of assets. The excess of such total earning power over the normal commercial return on the tangibles equals "super profits" or "excess earnings" attributable to the intangibles, essentially goodwill and intellectual property for the most part.

In "formula" terms, the "economic value added" by intangible assets is, for a specific time period, calculated as follows:

$$\mathbf{EVA_t = earnings_t - \mathit{r}\,(capital_{t-1})}$$

Where:

- EVA = Economic value added.
- r = Cost of capital employed
- $capital_{t-1}$ = Net capital employed at the commencement of period t.
- $earnings_t$ = Actual earnings on the capital during period t.

Considering the firm's basic categories of assets, WACC (which itself is apportioned between the debt and equity in the firm's capital structure) can be allocated among the asset categories within the business, having regard to the respective degree of risk which each category represents.

In addition to attempting to establish a normal commercial return or normal industry profit margin, the analytical approach does not always consider appropriately the relationship between relative profit margins and the investment which is required in other, complementary assets. The standard "industry profit margin" calculation must also take into account the complementary assets required to commercially exploit the property. The more unique the intellectual property,

(54) See, for example, FASB *Project Updates* at www.fasb.org and various Exposures Drafts. See, also, FASB Statement on Financial Accounting Standard 157, dated September 2006.

the higher investment might be required in tangible capital assets (such as manufacturing facilities) than the industry average, or vice versa.

An analysis must also be performed comparing a "commodity product" with an "enhanced product", the latter generating super profits from the intellectual property and the former providing a benchmark which can help provide the standard or normal industry product for purposes of measuring the contribution of the enhanced product.[55] In effect, the royalty rate is derived by calculating the excess of the profit margin on the enhanced product over the profit margin on the commodity product (where the commodity product is in the same industry and requires a similar level of investment in complementary assets).

The foregoing is but an introduction to the types of potential issues or controversies that can arise in a valuation "debate".

2.7 Stock Options

A taxable benefit arises under paragraph 7(1)(a) when an employee stock option is exercised, unless the employer is a Canadian-controlled private corporation dealing at arm's length with the employee, in which case the benefit will be recognized at the time the shares are disposed of.[56] The benefit equals the amount, if any, by which the value of the securities (say, shares of the employer-company) at the time the employee acquired them exceeds the amount paid, or to be paid, by the employee plus any amount that he or she paid to acquire the right to purchase the securities.

Some of the CRA's Tax Services Offices are looking more closely at stock-based compensation and other stock-based payments, particularly the value of the private-company or publicly-traded

(55) These benchmark profits should ideally consider similar investments in complementary assets required in the commercial exploitation of the intellectual property.

(56) Subsection 7(1.1).

shares subject to the options that were granted by the employer-company. This is because of situations in which various restrictions or conditions are placed on the shares, such as trading restrictions for a specified period, vesting requirements, performance thresholds, etc. In cases where there are conditions, prerequisites, contingencies and/or restrictions,[57] the shares subject to the stock options would have a lower value than their freely-traded counterparts on the exchange and, hence, the taxable benefit would be reduced.

From the employer-corporation's perspective, there is a smaller accounting charge against the employer's earnings. The recognition and measurement of the cost to the employer-corporation of the employee's services is addressed in the CICA *Handbook*, which promulgates Canadian generally-accepted accounting principles.[58] For example, paragraphs 3870.30-.33 state:

> ".30 The objective of the measurement process is to estimate the fair value, based on the stock price at the grant date, of stock options or other equity instruments to which employees become entitled when they have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise stock options or to sell shares of stock). ...
>
> ".31 Restrictions that continue in effect after employees have earned the rights to benefit from their instruments, such as the inability to transfer[59] vested employee stock options to third parties, affect the value of the instruments actually issued and therefore are reflected in estimating their fair value. Restrictions that stem directly from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a non-vested option or to sell non-vested stock, do not affect the value of the instruments issued at the vesting date, and their effect therefore is not included in that value. Instead, no value is attributed in instruments that employee forfeit because they fail to satisfy specified service- or performance-related conditions.

(57) See Richard M. Wise, *supra*, footnote 7.

(58) Section 3870, "Stock-Based Compensation and Other Stock-Based Payments".

(59) Footnote omitted.

“.32 *The fair value of a share of non-vested stock*[60] *awarded to an employee should be measured at the market price (or estimated market price, if the stock is not publicly-traded) of a share of the same stock as if it were vested and issued on the grant date. The fair value of a share of restricted stock awarded to an employee, that is, a share that will restricted after the employee has a vested right to it, should be measured at its fair value, which is the same amount as a share of similarly restricted stock granted to non-employees.*

“.33 The fair value of a stock option (... [granted by a public company or a company controlled by a public company]) is estimated using an option pricing model (for example, the Black Scholes or a binomial model) that takes into account as of the grant date:

(a) the exercise price;

(b) the expected life of the option;[61]

(c) the current price of the underlying stock;

(d) its expected volatility;

(e) expected dividends on the stock;[62] and

(f) the risk-free interest rate for the expected term of the option.”[63]

In the U.S., FASB has issued Statement on Financial Accounting Standards No. 123R, *Share-Based Payment*[64]. This standard relates to both public and private companies. Additional guidance on stock-option valuation is provided by the Public Company Accounting Oversight

(60) Non-vested stock granted to employees is usually referred to as restricted stock, but Section 3870 of the *Handbook* reserves that term for shares the sale of which is contractually or governmentally restricted after the shares are vested and fully outstanding.

(61) To reflect the effect of holders’ inability to sell their vested options, Section 3870 of the *Handbook* requires that the value of a holder’s stock option be based on its expected life rather than its maximum term. In the absence of reliable evidence on a stock option’s expected life, its contractual life is used for accounting purposes.

(62) The fair value of an award of stock options on which dividend equivalents are paid to employees or are applied to reduce the exercise price pursuant to anti-dilution provisions is estimated based on a dividend payment of zero.

(63) For options that an enterprise grants on its own stock, the risk-free interest rate used is the rate currently available on zero coupon Canada government bonds with a remaining term equal to the expected life of the options.

(64) Dated December 2004.

Board in Washington ("PCAOB") in a document entitled *Staff Questions and Answers — Auditing the Fair Value of Share Options Granted to Employees*.[65] Also, the U.S. Securities and Exchange Commission ("SEC") staff has provided its views on the valuation of share-based payment arrangements for public companies in its Staff Accounting Bulletin 107.[66]

The U.S. *Internal Revenue Code* ("*Code*") requires options granted by companies to be valued at their fair market values on the date of their granting. Under Section 409A, if the IRS determines that the option exercise price is less than fair market value, the onus is on the company to prove that its share valuation is reasonable. Under these provisions, the penalty could include 20% additional tax being levied on the optionee, income taxes, employment taxes as well as possible interest charges. The IRS will not permit deferred compensation to be granted at a discount.

Pursuant to Section 409A of the *Code*, there are three ways to obtain the "presumption of reasonableness" for stock option valuations:

1. Independent appraisal conducted by a qualified appraiser who applies accepted valuation methods and meets the basic requirements applicable to appraisals for employee stock ownership plans, if performed within twelve months (and updated if subsequent events so warrant).

2. Valuation based on a binding formula contained in a shareholders' agreement, provided that the shares are valued in the same manner for any other transfer of shares of the same or substantially similar share class.

3. Illiquid start-up valuation made "reasonably and in good faith", subject to specific requirements enumerated in Section 409A of the *Code*.

(65) Office of the Chief Auditor, Washington, D.C., October 17, 2006. The questions and answers are applicable to audits of financial statements in circumstances in which a company has granted share options to employees that must be accounted for as compensation costs in conformity with SFAS No. 123R.

(66) Dated March 29, 2005

3. REASONABLE COMPENSATION — GUIDANCE FROM U.S. COURTS

One of the most typical adjustments made by a business valuator (or the purchaser) in arriving at the normalized, representative net earnings (earning power) of a closely-held business for valuation purposes relates to shareholder/employee (owner/manager) compensation. The compensation booked for accounting purposes and reported on the financial statements in respect of owner/manager remuneration is rarely at market levels; nor is it required to be. This is because tax planning strategies (salary/bonus/dividend mix) and income-splitting with other family members. In such circumstances, the business valuator will impute a normalized, economic level of remuneration (being the cost of replacement "labour"), considering the specific role, functions and tasks performed by the present shareholder/employee of the business and which would subsequently be assumed by a notional replacement by the hypothetical purchaser. It can be difficult to define the comparable services, experience and educational background, unique talents, enthusiasm/working habits, etc., that would be replaced. A normalized, economic, arm's length remuneration package must be imputed (to replace the notional seller's discretionary level of compensation) for purposes of normalizing profits (to which a capitalization multiple will be applied) for valuation purposes. In summary, such imputed arm's length level of remuneration is substituted for what was booked for accounting purposes and reflected on the financial statements of the subject business.

Compensation paid to a shareholder/employee who is part of the controlling group is a subject that arises not only in income tax matters[67] from a "reasonableness" point of view,[68] but also arises in business valuation where the fair market value of the business is at issue. Reasonable compensation to a controlling shareholder/employee is typically one of the most common, and often material, adjustments that a business valuator will make in "normalizing" the reported accounting profits of the privately-owned business for valuation purposes. The question that is

(67) The CRA has commented on compensation from an income tax perspective on various occasions, including the Canadian Tax Foundation's 2001 Annual Conference, various Advance Income Tax Ruling requests and, more recently, in *Income Tax Technical News.*

(68) For example, Section 67 of the Act. See "CCRA Round Table", *2003 Conference Report*, Report of Proceedings of the Fifty-Fifth Tax Conference of the Canadian Tax Foundation, September 21-23, 2003 pp. 8A:12-8A:14.

therefore typically considered is “what is a reasonable level of compensation to be imputed for the services of the executive operating the family-controlled corporation?”. Stated differently, what would an arm’s length purchaser consider to be reasonable compensation that had been for the services that are being performed by the owner-manager of the business, irrespective of what was actual being paid to him or her?

The following example may help illustrate the importance of this issue. Assume that the normalized net after-tax maintainable earnings of a business are $600,000, and that the owner/manager compensation that had been booked for accounting purposes was $400,000. However, if a reasonable market level of compensation for the services was only $100,000, a pre-tax adjustment (increase) to earnings of $300,000 would be required for valuation purposes. Assuming a 35% income tax rate, the after-tax adjustment would be $195,000 ($300,000 – $105,000). If the appropriate capitalization multiple[69] for the subject business were, say, 8 times earnings, the net effect of this adjustment on the fair market value of the business would be $1,560,000 (8 × $195,000), which can be a material amount relative to the value of the company.

The general factors to consider in determining reasonable compensation for the services provided by an entity’s top executive(s) have been enumerated in several decisions of the U.S. Tax Court and the Courts of Appeals of various circuits.

One of the early U.S. cases that provided comprehensive criteria to evaluate compensation levels was *Mayson Mfg. Co.* v. *Commissioner,*[70] in which the U.S. Court of Appeals for the Ninth Circuit sets out nine factors to be considered in the determination of the reasonableness of employee/shareholder compensation:

(69) The required rate of return (usually expressed as a percentage) that is used to convert net income into value. The multiple is the inverse of the rate of return.

(70) 178 F.2d 115 (6th Cir. 1949).

1. Employee's qualifications.

2. Nature, extent, and scope of the employee's work.

3. Size and complexity of the business.

4. Comparison of salaries paid with gross income and net income.

5. Prevailing general economic conditions.

6. Comparison of salaries with distributions to stockholders.

7. Prevailing rates of compensation for comparable positions in comparable companies.

8. Salary policy of the taxpayer as to all employees.

9. Compensation paid in prior years.

Over the years, the courts had consistently made reference to many of these criteria when analyzing compensation issues — expanding, modifying, or eliminating some. In *Elliotts, Inc.* v. *Commissioner*[71], the Court of Appeals for the Seventh Circuit presented an in-depth analysis of the following five criteria ("Elliott's Factors") it considered most relevant in the evaluation of the owner/manager compensation:

1. Employee's role in the company.

2. External comparison of the employee's direct compensation with compensation paid by similar companies for similar services.

3. Character and condition of the company.

(71) 716 F.2d 1241, 1245-46 (9th Cir. 1983).

4. Conflict of interest between the company and the employee.

5. Internal consistency in the company's treatment of payments employees.

When a shareholder/employee works in his or her own privately-owned business, the relevant economic returns comprise (a) a return on labour and (b) a return on invested equity capital. However, using a multi-factor approach such as that outlined above, only the return on labour (reasonable compensation) is determined absent consideration of the return on equity to the shareholder.

In addition to considering Elliott's Factors, some courts have found it relevant to assess the reasonableness of executive compensation from the perspective of a detached, independent investor ("Independent Investor Test"). Applying this test, the amount of compensation paid to the corporate management group (or to an individual executive) is considered reasonable if a hypothetical independent (arm's length) investor would be satisfied with the corporation's return on investment.

For purposes of the Independent Investor Test, return on investment is often measured as return on shareholders' equity. This return is calculated after the subject executive compensation is deducted as an operating expense in arriving at the business enterprise's net profit.

In *Dexsil*,[72] the Second Circuit stated that, " ... in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed. See *Rapco*, 85 F.3d at 954-55 ... ".

The Independent Investor Test has sometimes been the only benchmark used. In *Exacto Spring Corp.* v. *Commissioner*[73], the IRS claimed that *Exacto* had over-compensated its president in 1993 and 1994. The Tax Court agreed with the IRS on the basis of a *multifactor* test. However,

(72) *Dexsil Corporation* v. *Commissioner*, 147 F.3d 96, 81 AFTR2d 98-2312 (CA-2, 1998).

(73) 196 F.3d 833 (7th Cir. 1999).

on appeal by Exacto, the Tax Court was reversed because the Seventh Circuit concluded that the multifactor test was "redundant, incomplete, and unclear", giving the following five reasons why this test should not be used with regard to Exacto:

1. The factors are nondirective.
2. The factors do not relate to each other or to the primary purpose of Section 162(a)(1).[74]
3. Judges are not qualified to determine employee salaries.
4. The factors invite the making of arbitrary decisions.
5. Their use makes the Tax Court's reaction to compensation unpredictable.

The appellate court based its decision entirely on the Independent Investor Test and concluded that a high rate of return to corporate shareholders meant that a higher salary could be paid to the corporate executives. It stated that "[t]he new test [Independent Investor Test] dissolves the old [multifactor approach] and returns the inquiry to basics".

This therefore has the effect of changing the method of determining shareholder/employee reasonable compensation from the multi-factor approach (used for determining an appropriate return on labour *directly*) to a single-factor approach (used to determine an appropriate return on labour *indirectly*). That is, if the shareholder/employee's return on *equity* during a relevant period is considered to be reasonable, then it might be concluded that the costs incurred by the business to realize such return are reasonable as well; and this would include the compensation to the shareholder/employee.

(74) *Internal Revenue Code* Section 162(a)(1) allows a corporation to deduct salaries as a business expense. However, the amount deducted for salaries must constitute "reasonable allowance" for the services actually rendered.

However, different considerations may apply when the Independent Investor Test is used. In *Exacto Spring*, the court addressed the shareholder/employee reasonable compensation from an *income tax* — rather than a *valuation* perspective. The Independent Investor Test in *Exacto Spring* simplifies the shareholder/employee reasonable compensation issue, because it eliminates contradictory, overlapping and non-determinative factors (above), by considering both (a) normalized shareholder/employee compensation expense (cost of replacement labour for the tasks, functions and duties that were performed by the shareholder/employee) and (b) a reasonable rate of return on the shareholders' equity. Applying the Independent Investor Test requires that the increase in fair market value of the business during the relevant period,[75] i.e., its growth be calculated, in order that a return on investment can be computed. Such increase in fair market value would, of course, necessarily take into account a reasonable shareholder/employee compensation for labour (remuneration). A business valuator applying the Independent Investor Test to determine the reasonableness of shareholder/employee compensation must therefore consider (a) whether the shareholder/employee is a controlling or minority shareholder; (b) the relevant period during which the respective labour and equity investment returns are being calculated; (c) the requirement for valuations at both the commencement and end of the period;[76] and (d) comparative (guideline) market rates of return to be used as benchmarks.[77]

In *Owensby & Kritikos Inc.*,[78] the Fifth Circuit refused to accept the taxpayer's argument that if a business is generating an adequate return for an independent investor, after remunerating the

(75) The period during which the reasonableness of the shareholder/employee compensation is being considered.

(76) The U.S. Tax Court has applied the Independent Investor Test without requiring the fair market value of the equity in the business to be calculated; rather, it allowed "book value" as a proxy for fair market value (which can be misleading and meaningless). However, see, Richard M. Wise, "Valuation Aspects of Shareholders' Buy-Sell Agreements", *Proceedings of the Thirty-Sixth Tax Conference*, Canadian Tax Foundation, (November 1984), pp. 1013 ff, which identifies the many problems and distortions that the use of "book value" can present.

(77) The benchmark rate of return on equity should be that which would apply to the subject business. For an example of developing the rate of return (capitalization rate or discount rate) is found in Richard M. Wise, Jay E. Fishman and Shannon P. Pratt, *Guide to Canadian Business Valuations* (Vol. 1, pp. 5-5-5-27), Carswell, loose-leaf service.

(78) 819 F.2d 1315, 60 AFTR 2d 87-5224 (CA-5, 1987).

shareholder/employee, a substantial presumption should be made that the shareholder/employee compensation is reasonable, stating that "[t]he so-called Independent Investor Test is simply one of the factors a court should consider, and in certain cases, it may be a substantial factor".[79]

In *B&D Foundations, Inc.* v. *Commissioner*,[80] the U.S. Tax Court applied a multi-factor test adopted by the Tenth Circuit in *Pepsi-Cola Bottling Co. of Salina, Inc.* v. *Commissioner*,[81] to determine reasonable compensation for a private company.[82] With respect to the "independent investor test and taxpayer's financial performance", the Court held that regardless of the approach used in calculating the taxpayer's return on shareholders' equity, the company incurred a negative return on equity even before consideration of its "deferred compensation" obligation to its only officers, directors and shareholders (*viz*., Mr. and Mrs. Myers). The Court therefore concluded that an independent investor would not be satisfied with the company's financial performance in that year, particularly when the total officer compensation paid to the shareholders for the year was almost three times that of the investors' year-end equity in the company. The IRS prevailed.

In a more recent case before the U.S. Tax Court, *Miller & Sons Drywall, Inc.* v. *Commissioner*,[83] the Court adopted a similar approach. Other U.S. cases in which the Tax Court has addressed the issue of reasonable compensation include *Beiner, Inc.*,[84] *LabelGraphics* v. *Commissioner*,[85] *E.J. Harrison and Sons, Inc.* v. *Commissioner*.[86]

(79) The Tenth Circuit similarly rejected the taxpayer's requests that the court replace the multi-factor approach with the Independent Investor Test. *Eberl's Claim Service, Inc.*, 249 F.3d 994, 87 AFTR 2d 2001-2075 (CA-10, 2001).

(80) TC Memo 2001-262, 82 TCM (CCH) 692 (October 3, 2001).

(81) 528 F.2d 176 (1975).

(82) The Court had listed nine factors in *Pepsi-Cola*, and in this case the Court reviewed ten factors.

(83) TC Memo 2005-114 (May 19, 2005).

(84) TC Memo 2004-219.

(85) TC Memo 1998-343; aff'd 221 F.3d 1091 (9th Cir. 2000).

(86) TC Memo 2003-239.

4. TAX-RELATED DEVELOPMENTS IN THE U.S.

The following business valuation-related standards, guidelines and/or amendments were respectively issued during 2006 by the Internal Revenue Service ("IRS"), the American Institute of Certified Public Accountants ("AICPA"), The Appraisal Foundation/Appraisal Standards Board ("TAF/ASB") and the American Society of Appraisers ("ASA"):

IRS	Valuation Guidelines (July 2006)
AICPA	Exposure drafts on proposed Statements on Standards for Valuation Services, "Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset" (2006)
TAF/ASB	Uniform Standards of Professional Appraisal Practice (July 2006 amendments)
ASA	Exposure Draft on Valuation of Intangible Assets (2006) and Procedural Guidelines on Fair Value Measurement of Intangible Assets (2006)

Significant developments have occurred in the United States relating to tax-purpose valuations. As in Canada, the U.S. adopts a "fair market value" standard in connection with various types of transactions/events identified in the *Code*. Fair market value determinations are also necessary for gift tax and estate tax purposes.[87]

Significant developments in the U.S. have occurred on five fronts:

- Internal Revenue Service Valuation Guidelines;
- Treasury Department Regulations;
- *Internal Revenue Code*;

(87) Fair market value is also the standard of value required by the U.S. Department of Labor in connection with employee stock option plans under the *Employee Retirement Income Security Act* ("ERISA").

- Business valuation professional standards; and
- U.S. Tax Court and Circuit Courts of Appeals decisions.

4.1 Internal Revenue Service Valuation Engineering Program

4.1.1 Business Valuation Guidelines

In July 2006, the Valuation Policy Council of the U.S. Internal Revenue Service released Business Valuation Guidelines ("Guidelines") to be followed by all IRS business valuators. The Guidelines apply to the development, resolution and reporting of issues involving business and similar valuation issues. Any departure from the Guidelines must be reasonably justified by the IRS valuator. The Guidelines state that the successful completion of an IRS valuation assignment must include planning, identifying critical factors, documenting specific information and analyzing the relevant information — all relevant valuation activities having to be documented in the working papers.

The Guidelines promulgate three types of practice standards: (1) development, (2) resolution and (3) reporting. They also provide guidance on the IRS valuator's review of a taxpayer's valuation.

IRS *Development Guidelines* include planning, identifying, analyzing, preparation of working papers and reviewing. The types of relevant information considered necessary to accomplish the assignment include those enumerated in IRS *Revenue Ruling 59-60*,[88] which has long been the "guidepost" for U.S. tax-purpose valuations. (*IC 89-3*, which provides the CRA's views on certain business valuation issues, includes some items taken from the *Revenue Ruling*, which was issued in 1959.)

(88) 1959-1 C.B. 237.

The IRS Guidelines also provide that a review by an IRS valuator of a taxpayer's valuation will include determining the completeness of that report, the apparent adequacy and relevance of the data, the propriety of any adjustments thereto, the appropriateness of the valuation method and techniques used and, if there is any disagreement, providing the reasons. They also state that the IRS valuator should also determine whether the analyses, opinions and conclusions in the taxpayer's report are appropriate and reasonable, and develop the reasons for any disagreement. If there is disagreement as to the report's factual representations, underlying assumptions, methodology or conclusions, the IRS valuator should conduct additional fact-finding, research and/or analyses necessary to arrive at an appropriate value for the business or business interest.

The *Resolution Guidelines* require IRS valuators to make efforts to arrive at a resolution of the matter after fully considering all relevant facts and as early in the examination as possible. "Credible and compelling work by the valuator will facilitate resolution of issues without litigation ... . The valuator will work in concert with the internal customer and taxpayer to attempt to resolve all outstanding issues".

The *Reporting Guidelines* include the specific information to be included or addressed in an IRS valuation report, which are to provide convincing and compelling support for the conclusions reached. The IRS valuation report should contain all of the information necessary to allow a clear understanding of the valuation analyses and to explain how the conclusions were reached. The Guidelines also specify what should be included in the contents of the valuation report.

It is interesting to note that the types of Guidelines released by the IRS are similar to, but not quite as detailed or comprehensive as, the Practice Standards promulgated by the CICBV or the ASA in the U.S. The CRA's stated policy is that its Business Valuation Equity Program, which has the responsibility of advising the Department's Audit groups (general, specialized and international) and Appeals section, and providing expert opinions on technical valuation and related issues with respect to fair market value determinations of private and public securities, partnerships, proprietorships, intangible assets and other business equities for tax purposes, follows the Standards and Ethics promulgated by the CICBV.

In addition to recently issuing the Guidelines, the IRS has now issued three more sets of valuation guidelines for IRS personnel engaged in valuation practice. These new Guidelines relate to the development, reporting and resolution of issues involving intangible property, tangible personal property and real property. IRS valuators must be able to reasonably justify any departure from these Guidelines, which, by reference, incorporate the ethical and conduct provisions contained in the Office of Government Ethics Standards of Ethical Conduct, applicable to all IRS employees.

4.1.2 Intangible Property Guidelines

The new Intangible Property Valuation Guidelines relate to:

- computer software;
- patents, inventions, formulae, processes, designs, patterns, trade secrets or know-how;
- copyrights and literary, musical or artistic compositions;
- trademarks, trade names or brand names;
- franchises, licenses or contracts;
- methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data, etc.

The Guidelines note that valuations of assets owned and/or transferred by or between "controlled taxpayers" (within the meaning of the U.S. Treasury Regulations) may present substantive issues that are not addressed in the Guidelines.

Intangible property valuation guidelines include development guidelines, planning, identifying, documenting and analyzing. There are also working paper requirements. In addition, these Guidelines include rules for the IRS valuator who reviews a taxpayer's intangible property valuation and reports the results of that review.

As with the Business Valuation Guidelines, IRS valuators must make efforts to obtain a resolution of the case after fully considering all relevant facts, the objective being to resolve the issue as early in the examination as possible. "Credible and compelling work by the [IRS] valuator will facilitate resolution of issues without litigation. ... The valuator will work in concert with the internal customer and taxpayer to attempt to resolve all outstanding issues". The IRS Guidelines also state that "valuators will employ independent and objective judgment in reaching conclusions and will decide all matters on their merits, free from bias, advocacy and conflicts of interests". Once the IRS valuator has arrived at his or her findings, a report will be prepared, which must provide "convincing and compelling" support for the conclusions reached. Reports relating to a review of a taxpayer's valuation must contain, at a minimum, information on those items in the identification, documentation and analysis that are necessary to support the IRS valuator's assumptions, analyses and/or conclusions.

The new Tangible Personal Property and Real Property Guidelines require IRS valuators to follow similar rules.

4.2 Treasury Department Regulations

4.2.1 Circular 230

Circular 230 was revised in June 2005 by the U.S. Treasury Department as an important guiding publication entitled, *Regulations Governing the Practice of Attorneys, Certified Public Accountants ["CPAs"], Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal*

Revenue Service[89]. Subpart A of Part 10 contains rules relating to the "authorization" to practice before the IRS; Subpart B prescribes the duties and restrictions relating to such practice; Subpart C prescribes the sanctions for violating the regulations; Subpart D contains the rules applicable to disciplinary proceedings and Subpart E contains general provisions including those relating to the availability of official records.

Circular 230 applies to anyone who practices before the IRS. The Circular had been amended by the IRS in 1985, to conform to legislative changes requiring the disqualification of a valuator who is assessed a penalty under Section 6701 of the *Code*, i.e., for aiding and abetting the understatement of a tax liability. Section 6701 penalties are outlined above. The provisions of Circular 230 have been applied almost exclusively to attorneys, CPAs and enrolled agents.[90] There have been no valuators barred from practice before the IRS under Circular 230.[91]

Pursuant to Circular 230, after due notice and opportunity for hearing, a valuator may be disqualified by the Treasury Secretary where a penalty has been assessed under Section 6701(a) of the *Code*.[92] If a valuator is disqualified, he or she is barred from presenting evidence or testimony in any administrative proceeding before the Department of the Treasury or the IRS, unless and until authorized to do so by the Director of Practice.[93] Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the IRS.[94] Section 10.51 describes types of conduct considered "incompetent and disreputable". Injunction from further engaging in "specified conduct" is governed by Section 7408 of the *Code*.

(89) Department of the Treasury, Internal Revenue Service, Title 31 Code of Federal Regulations, Subtitle A, Part 10, revised as of June 20, 2005. Part 10 contains rules governing the recognition of attorneys, CPAs, enrolled agents and other persons representing taxpayers before the IRS.

(90) See Michael J. O'Keefe, "The Evolving Nature of Tax Practice", *Report of the Proceedings of the Fifty-Seventh Tax Conference*, Canadian Tax Foundation (Vancouver: 2006), p. 2:12.

(91) There are rare instances of any penalties against valuators.

(92) Section 10.50(b).

(93) Section 10.50(b)(1).

(94) Sectin 10.50(b)(2).

Specified conduct includes any action, or failure to take action, that would be subject to a penalty under Section 6700 or Section 6701.[95] Upon approval by Area Counsel, a referral is made to the Department of Justice to proceed with civil action.

(Sections 6700 and 6701 of the *Code* respectively provide for penalties against valuators for promoter activities and aiding and abetting activities. To date, the assertion of a penalty under Section 6701 has occurred fewer than five times.[96])

The IRS has the burden of proof in establishing three elements of Section 6701. The burden is satisfied with a preponderance of evidence. There is no statute of limitations on assessing such penalty. An Internal Legal Memorandum issued by special counsel for administrative provisions and judicial practice contains a complete description of each required element:

1. A showing that the appraiser assisted in tax return or document preparation;
2. The appraiser knew, or had reason to believe, that the document would be used in any material matter; and
3. The appraiser "knew" that, if so used, the document would result in an understatement of the tax liability of another person.

In applying these "standards" of knowledge, the requisite standard that the IRS uses is "actual knowledge". The Internal Legal Memorandum makes a comparison to a lower standard of "wilful blindness", a standard that would not support a penalty under United States law. In Canada, the standard is also "actual knowledge". The exception, however, that is not found

(95) An assessment of a penalty under *Code* Section 6701 results in a fine of U.S. $1,000 for a document relating to an individual tax return or U.S. $10,000 for a document relating to a corporate tax return. While these penalty provisions were legislated in 1982, there are rare instances of any penalties against valuators.

(96) As of the date of preparing this paper, there were approximately 25 open and active investigations.

under U.S. law is that, absent actual knowledge, "culpable" knowledge is sufficient to levy a penalty. For example, CRA *IC 01-1*[97] states that:

> "'Culpable conduct' must be present in the absence of actual knowledge of a false statement, in order for the third-party civil penalties to be considered. Culpable conduct refers to conduct that is not simply an honest error of judgement or failure to exercise reasonable care (i.e., ordinary negligence). As stated in the *Revised Explanatory Notes Relating to Income Tax*, issued in December 1999 by the Department of Finance, the concept 'culpable conduct' is defined with reference to the types of conduct to which the courts have considered applying a civil penalty under the tax law (i.e., criteria considered for subsection 163(2) gross negligence penalty in the case of *Lucien Venne v. Her Majesty the Queen*, 84 DTC 6247 (FCTD)). 'Culpable conduct' refers to conduct (an act or a failure to act) that is tantamount to intentional conduct, shows an indifference as to whether the ITA/ETA is complied with, or shows a wilful, a reckless or a wanton disregard of the law."

With respect to questionable appraiser conduct in the U.S., the IRS enumerates examples of the types of appraiser conduct resulting in approved investigations:

- Assuming facts that do exist;
- Purposely excluding a valuation approach that produces credible results;
- Ignoring strong market evidence;
- Presenting false information;
- Including assumptions as to future events that are implausible;
- Assuming forms of ownership that do not exist;
- Developing complex transactions that are intended to disguise the true nature of the transaction;

(97) *Supra*, footnote 1.

- Intentional disregard of professional standards of appraisal practice;
- Any participation by an appraiser that results in a value determination intended to reduce tax without objective and credible evidence to support the appraisal.

4.3 Notice 2006-96 and Code Section 170

The IRS's Engineering Program is a specialty program within the Large- and Mid-Size Business operating unit. The Program Manager for Engineers and Appraisers directs the Valuation Policy Council and has established the Appraisal Issues Professional Responsibility Committee. The two working groups have established internal valuation standards. Issues involving appraiser professional responsibility heavily affect the Engineering Program, to which significant commitments of human resources are required.

In August 2006, President Bush signed the *Pension Protection Act of 2006* ("PPA") into law.[98] With the enactment of this legislation, the U.S. Congress has strengthened the tools available to the IRS to ensure appraiser professional responsibility. The IRS Engineering Program will play an important role in the guidance and enforcement that will result from the new law.

Section 1219 of the PPA affects valuators. This new law changes the definitions of "Qualified Appraisal"[99] and "Qualified Appraiser"[100] in Section 170(f)(ii) of the *Code*, which relates to charitable donations. The definition of "Qualified Appraisal" now refers to a valuation that an

(98) 109 P.L. 280; 120 Stat. 780; 2006 Enacted H.R. 4; 109 Enacted H.R. 4.

(99) "Qualified Appraisal" is defined as "an appraisal that is (1) treated as a Qualified Appraisal under regulations or other guidance prescribed by the Secretary and (2) conducted by a Qualified Appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary".

(100) "Qualified Appraiser" is defined as "an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (2) regularly performs appraisals for which the individual receives compensation, and (3) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance".

individual conducts in accordance with "generally accepted appraisal standards". The new definition of "Qualified Appraiser" refers to an individual who has earned an "appraisal designation from a recognized professional appraiser organization" or meets other criteria that the U.S. Secretary of the Treasury may specify. This appears to be the first reference to "generally accepted appraisal standards" and "appraisal designation" to be employed in the *Code*.

Another provision in the PPA gives the IRS more power to sanction valuators for a substantial error in any tax-purpose valuation. It effectively puts valuators on the same footing as accountants and lawyers who practise before the IRS, as described in Treasury Circular 230 (above). Prior thereto, the appraisal discipline was subject to the standards set forth in Section 6701(a) of the *Code* (above). The PPA also changes the criteria that determine when a valuation error is substantial enough to trigger a penalty. The IRS's increased ability to sanction valuators now creates additional professional exposure for valuators performing tax-purpose valuations.

Moreover, Notice 2006-96 also provides transitional guidance on the new definitions of "Qualified Appraisal" and "Qualified Appraiser" in Section 170(f)(11), and new Section 6695A of the *Code* regarding substantial or gross valuation misstatements, as added by Section 1219 of the PPA[101] (above). As noted earlier, under Section 170(f)(11), U.S. taxpayers are required to obtain a qualified appraisal for purposes of substantiating deductions for certain charitable contributions of property. The PPA provides statutory provisions of a Qualified Appraisal and Qualified Appraiser for tax returns filed after August 17, 2006. It also adds a penalty provision for appraisals that result in a substantial or gross valuation misstatement under Section 6662 of the *Code*. An appraisal that meets the requirements of Notice 2006-96 will be considered a

(101) *Pension Protection Act of 2006*, Pub. L. No. 109-280, 120 Stat. 780 (2006). The IRS and the Treasury Department are expected to issue regulations under Section 170(f)(11).

Qualified Appraisal for purposes of Section 170(f)(11). A Qualified Appraiser must meet the requirements under the Notice as of the date that the appraisal is made.[102]

The IRS has requested comments on the definitions of the following terms:

(a) "generally accepted appraisal standards" in Section 170(f)(11)(E)(i)(II);

(b) "appraisal designation from a recognized professional appraisal organization" in Section 170(f)(11)(E)(ii)(I);

(c) "minimum education and experience requirements" in Section 170(f)(11)(E)(ii)(I); and

(d) "verifiable education and experience in valuing the type of property subject to the appraisal" in Section 170(f)(11)(E)(iii)(I).[103]

Section 170(f)(11)(E)(iii) provides that an individual will not be treated as a Qualified Appraiser unless that individual (1) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal and (2) has not been prohibited from practicing before the Internal Revenue Service by the Secretary under Section 330(c) of Title 31 of the United States *Code* at any time during the 3-year period ending on the date of the appraisal.

Section 1219 of the PPA also adds a new penalty provision. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under Section 6662 of the *Code*, a penalty is imposed by new Section 6695A on any person who prepared the

(102) The IRS and the Treasury Department have invited comments containing suggestions for future guidance under Section 170(f)(11), including regulations.

(103) The IRS has also requested comments on the potential impact any guidance under Section 170(f)(11) may have on small businesses. Comments are to be submitted by January 17, 2006 to the U.S. Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044, ATTENTION: CC:PA:LPD:PR, Room 5203 or electronically to Notice.Comments@irscounsel.treas.gov.

appraisal and who knew, or reasonably should have known, that the appraisal would be used in connection with a return or claim for refund.

SECTION 3. TRANSITIONAL GUIDANCE

.01 *In general*

The Service and the Treasury Department expect to issue regulations under § 170(f)(11), as amended by the PPA. The terms in section 3 of this notice apply to contributions of property (other than readily valued property within the meaning of § 170(f)(11)(A)(ii)(I)) by individuals, partnerships, or corporations for which a deduction of more than $5,000 is claimed on returns filed after August 17, 2006, and before the effective date of the regulations that the Service and the Treasury Department expect to issue. Until regulations are effective under § 170(f)(11), as amended by the PPA, an appraisal that meets the requirements of this notice shall be treated as a qualified appraisal for purposes of § 170(f)(11). The determination of whether an appraiser is qualified under section 3.03 of this notice must be based on the appraiser's qualifications as of the date the appraisal is made.

.02 *Transitional terms-qualified appraisal*

(1) *Qualified appraisal.* An appraisal will be treated as a qualified appraisal within the meaning of § 170(f)(11)(E) if the appraisal complies with all of the requirements of § 1.170A-13(c) of the existing regulations (except to the extent the regulations are inconsistent with § 170(f)(11)), and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards. See sections 3.02(2) and 3.03 of this notice.

(2) *Generally accepted appraisal standards.* An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of § 170(f)(11)(E)(i)(II) if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation. Additional information is available at http://www.appraisalfoundation.org.

.03 *Transitional terms – qualified appraiser*

(1) *Appraisal designation.* An appraiser will be treated as having earned an appraisal designation from a recognized professional appraiser organization within the meaning of § 170(f)(11)(E)(ii)(I) if the appraisal designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed.

(2) *Education and experience in valuing the type of property*. An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal within the meaning of § 170(f)(11)(E)(iii)(I) if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the

appraiser is qualified to make appraisals of the type of property being valued. See also § 1.170A-13(c)(5).

(3) *Minimum education and experience.* An appraiser will be treated as having met minimum education and experience requirements within the meaning of § 170(f)(11)(E)(ii)(I) if –

(a) *For real property*

(i) For returns filed on or before October 19, 2006, the appraiser is qualified as a "qualified appraiser" within the meaning of § 1.170A-13(c)(5) to make appraisals of the type of property being valued.

(ii) For returns filed after October 19, 2006, the appraiser is licensed or certified for the type of property being appraised in the state in which the appraised real property is located.

(b) *For property other than real property –*

(i) For returns filed on or before February 16, 2007, the appraiser is qualified as a "qualified appraiser" within the meaning of § 1.170A-13(c)(5) to make appraisals of the type of property being valued.

(ii) For returns filed after February 16, 2007, the appraiser has (A) successfully completed college or professional-level coursework that is relevant to the property being valued, (B) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and (C) fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued.

.04 *Applicability of reporting and substantiation regulations*

(1) *In general*

The requirements of § 1.170A-13(c) of the existing regulations concerning qualified appraisals and qualified appraisers continue to apply to all taxpayers, including those to whom the transitional guidance in this section may apply, except to the extent the regulations are inconsistent with the provisions of § 170(f)(11). In particular, all taxpayers are required to comply with §§ 1.170A-13(c)(3), (c)(5), (c)(6) and (c)(7).

(2) *Revision to appraiser declaration*

For returns filed after February 16, 2007, the declaration required under § 1.170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under § 6695A. See also § 1.170A-13(c)(3)(iii).[104]

Prior to the enactment of the PPA, the IRS's remedy for appraisers who failed to exercise due professional responsibility was a penalty under Section 6700 or 6701 of the *Code* as well as injunctions from practice before the IRS.[105] The increasing abuse in the area of over- and under-valuation and the high visibility placed on ethical standards for tax professionals by the Commissioner of Internal Revenue has brought focus to these issues by the IRS's Engineering Program (referred to earlier).[106]

4.4 Proposed Rules To Deny Valuation Discounts in the U.S.

On January 27, 2005, at the request of United States Senate Finance Committee Chairman Charles Grassley and Ranking Member Max Baucus, the Joint Committee on Taxation staff issued a report entitled, *Options to Improve Tax Compliance and Reform Tax Expenditures*, which included a recommendation to deny certain "valuation discounts" in determining fair market value for U.S. federal estate and gift tax purposes, namely, (1) minority (lack of control) discounts,[107] (2) marketability (illiquidity) discounts,[108] (3) fragmentation (fractional interest) discounts (discussed above) and (4) investment company discounts.[109] These types of discounts

(104) "Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions", Notice 2006-96.

(105) *Code*, Section 7408.

(106) The Appraisal Issues Professional Responsibility Committee addressed these *Code* Sections in late 2004. The Committee has members representing the IRS operating units in order to ensure that the penalties and sanctions are administered fairly and consistently.

(107) A discount for lack of control applicable to an ownership interest of less than 50% of the voting interest in a business enterprise.

(108) An amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.

(109) Prepared by the staff of the Joint Committee on Taxation, January 27, 2005, addressing the fair market value of property being transferred on the date of transfer pursuant to *Code* Sections 2031 (Estate Tax), 2512 (Gift Tax) and 2624 (Generation-skipping Transfer Tax). Report No. JCS-02-05.

are discussed in my paper presented at the Canadian Tax Foundation's Fifty-Sixth Annual Conference in September 2004.

The Joint Committee document notes that the U.S. courts and the IRS have recognized that, for various reasons, interests in an entity (e.g., shares of a corporation or partnership interest) may be worth less than the owner's proportionate share of the value of the entity's assets.[110] It also notes that in many cases, courts apply more than one discount.

Minority (lack of control) discounts: Numerous courts as well as the IRS have recognized that shares or other ownership interests in a closely-held business entity, which represent a minority interest, are usually worth less than a pro-rata share of the value of the assets of the entity.[111] Minority discounts often result in reductions of between 15% and 40% of the pro-rata value of transferred property.

Marketability (illiquidity) discounts: The Joint Committee document notes that the marketability discount can apply in valuing either a controlling interest or a minority interest. It recognizes that, for example, controlling shares of a private corporation, with respect to which there would be no minority (lack of control) discount, may nonetheless be subject to a marketability discount because there is no ready private placement market and because transaction costs must be incurred if the corporation were to make a public offering. It notes that generally the size of the marketability discount is reduced as the donor's or deceased's control of the corporation (or partnership) increases. Such discount has been applied to a 100% ownership interest in a private corporation. For minority interests, marketability discounts often result in reductions in the value of transferred property of 20% to 30% from the minority discounted, as-if-freely traded

(110) See, Richard M. Wise, "Valuation Issues Relating to Shares of Private Corporations", *Proceedings of the Fifty-Sixth Annual Tax Conference*, Canadian Tax Foundation (Toronto, 2004); and **"**Valuations and Price-Adjustment Clauses**"**, *Proceedings of the Fiftieth Annual Tax Conference*, Canadian Tax Foundation (Toronto, 1998).

(111) See IRS *Revenue Ruling 93-12*, 1993-2 C.B. 202. See also *Propstra* v. *United States*, 680 F.2d 1248 (9th Cir. 1982); *Ward* v. *Commissioner*, 87 TC 78 (1986); *Estate of Leyman* v. *Commissioner*, 40 TC 100 (1963); and *Estate of Bright* v. *United States*, 658 F.2d 999 (5th Cir. 1981).

value.[112] The U.S. Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. The Court has ruled that the minority discount is applied first and then the marketability discount is applied to the minority-discounted figure.[113]

Another type of discount noted by the Joint Committee staff is the "fragmentation" (or fractional interest) discount discussed elsewhere in this paper, which arises from the lack of control inherent in joint ownership or co-ownership of an asset (e.g., an undivided co-ownership interest in real estate). Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount reflects the cost of partition and the value of the interest secured thereby.[114] Finally, an investment company discount is being reviewed by the Joint Committee staff. This discount arises because the market values of closed-end mutual funds and investment companies are often less than the net asset values of those entities' net assets. Such discounts may overlap with the marketability discount. The Joint Committee document provides an example of a U.S. Tax Court decision in *Estate of Folks* v. *Commissioner*[115] in which the taxpayer was able to claim a 50% investment-company discount and an additional 50% marketability discount, resulting in a total discount of 75%.

There is empirical evidence gleaned from the public markets supporting portfolio discounts — which may be categorized as follows:

(112) See levels of value chart above.

(113) *Estate of Bailey* v. *Commissioner*, TC Memo 2002-152.

(114) See earlier discussion in this paper regarding fractional interest in real estate.

(115) TC Memo 1982-43.

- increases in aggregate market value when a conglomerate company announces (or completes) a break-up or a spin-off of its assets;
- observed differences in discounts from the net asset value of real estate investment companies holding homogeneous assets as opposed to non-homogeneous real estate holdings; and
- estimates made with by financial analysts as to the break-up values of conglomerates compared to their respective stock market trading prices.[116]

An example of this last category is the break-up in 2001 of CP Ltd. ("CP"). The trading price at the date of the analysts' report was $36.50 and the estimated minority price in the public market if the CP shares were traded separately was estimated at $43.00, representing a holding company discount or conglomerate discount of 15% (in February 2001).

Date of Analyst Report	**Conglomerate**	**(A) Stock Price at Date of Report ($)**	**(B) Analyst's Break-Up Value ($)**	**(B)-(A)/(B) Portfolio Discount**
31/10/99	Monsanto	38.50	55.00	30%
25/01/00	B&H	27.00	37.00	27%
28/01/00	Pac. Dunlop	1.98	3.48	43%
25/10/00	IBM	112.00	150.00	25%
30/10/00	British Telecom	117.00	165.00	29%
24/11/00	Optus	4.37	4.55	39%
13/02/01	CP Ltd.	36.52	43.00	15%
			Mean	**21%**

(116) See S.P. Pratt, *Business Valuation Discounts and Premiums*, John Wiley & Sons, Inc. (New York: 2001), p. 261. See also, J. Mikami, "AT&T Break Up is Empirical Evidence of 'Portfolio Discount' Theory", *Shannon Pratt's™ Business Valuation Update* (November 1995), p. 8.

The U.S. Joint Committee staff proposal would limit the application of such discounts in valuing *inter vivos* and testamentary gifts of shares, partnership interests and other closely-held business ownership interests. It contains "Aggregation Rules" and "Look-Through Rules", which would apply to *inter vivos* and testamentary transactions as well generation-skipping events for transfer-tax purposes. Any interest in an asset owned by the spouse of a transferor or transferee would be considered to be respectively owned by that transferor or transferee. Step-transaction principles would be applied to determine whether two are more transfers are treated as a single transfer.

Under the "basic aggregation rule", the value of an asset is generally the transferor's pro-rata share of the total fair market value of the asset immediately before the transfer. The "transferee aggregation rule" would apply if a donor, or a deceased's estate, does not own a controlling interest in an asset immediately before it is transferred to the recipient (in whose hands the transferred asset will form part of a controlling interest). In such case, the estate, gift or generation-skipping transfer tax value would be the pro-rata share of the *en bloc* (100%) fair market value of the interest in the asset that will be owned by the donee or beneficiary — not by the transferor. The basic aggregation rule would determine the existence of a minority discount by taking into account the entire interest held by the transferor immediately before the transfer. The transferee aggregation rule, although inconsistent with this theory, would prevent the strategic sequencing of multiple gifts to the same donee.

The "look-through rule" provides that if at least one-third of an entity's (Holdco's) assets (by value) comprises marketable assets, the fair market value of the transferred interest in Holdco is the aggregate of (a) the net value of the Holdco's *marketable* assets (e.g., cash, marketable securities, precious metals, etc.) allocable to that transferred interest, and (b) the value of the transferor's interest in Holdco attributable to *non-marketable* assets. The effect of this rule is to deny a marketability discount on Holdco's issued shares to the extent that Holdco owns assets that are marketable. When this rule applies, a minority discount will also be denied because a condition of the look-through rule is that the transferred interest must be part of a *controlling* interest either before or after the transfer.

Hence, a marketability discount applied to the issued shares of Holdco would result in the under-valuation of a shareholding if the shareholder owns a controlling interest and therefore has easy access to Holdco's marketable assets. The proposal would not eliminate minority and marketability discounts if the facts generally support those discounts. In summary, the proposed aggregation and look-through rules are intended to restrict the taxpayer's ability to claim minority and marketability discounts in situations where such discounts do not accurately reflect the value of the ownership interest transferred.

The Joint Committee staff believes that the focus of the estate and gift tax should be on the amount a property transfer will deplete the value of the transferor's holdings. Thus, a minority discount should not apply if the transferor owns a controlling interest in the property immediately before the transfer.

The Joint Committee staff also noted that the U.S. courts have recognized (a) blockage discounts, (b) key-person discounts and (c) discounts for taxes on accrued capital gains of a holding company.

The proposal would apply to transfers made and estates created on or after the date of enactment.

Of course, with a Democratic House and Senate, it is unclear whether this proposal will survive.

4.5 U.S. Valuation-Related Penalties

For background information, Section 6662 of the *Code* (which is not a new provision) provides for accuracy-related penalties applied to the portion of any underpayment of tax that is attributable to one or more of the following five situations:

1. Negligence;

2. Substantial understatement of income tax;

3. Substantial valuation overstatement;

4. Substantial estate or gift tax valuation understatement; and

5. Substantial overstatement of pension liabilities.

The substantial valuation overstatement penalty and the substantial estate or gift tax valuation understatement penalty specifically relate to valuation issues. However, a negligence penalty[117] can be levied in regard to a valuation issue if the facts support taxpayer negligence.[118] The negligence penalty may be assessed on valuation-related tax disputes if the taxpayer had acted in a manner that was careless or reckless. Moreover, a penalty can be imposed on the tax-return preparer if there is wilful understatement of tax liability associated with a valuation that is not supportable.[119]

The accuracy-related penalty can apply to income tax, gift tax and estate tax-related valuation issues including transfer pricing.[120]

4.6 U.S. Court Decisions

In a recent case before the U.S. Tax Court, *Kohler* v. *Commissioner*,[121] the court carefully considered the respective qualifications of the business valuators retained by the taxpayer and the

(117) *Code*, Section 6662(b)(12).

(118) The negligence penalty does not have a minimum threshold of a U.S. $5,000 tax understatement, as does each of the penalties related exclusively to valuation.

(119) *Code*, Section 6694(b).

(120) *Code*, Section 482.

(121) TC Memo 2006-152.

IRS. As the following comments of the U.S. Tax Court demonstrate, professional standards promulgated by recognized appraisal or valuation bodies are critical:

> "We shall ... consider the conclusions of respondent's expert witness, Dr. Scott Hakala [who] concluded that the fair market value of the estate's stock ... was $156 million.
>
> **"1. Dr. Hakala's Background and Certifications**
>
> "Although Dr. Hakala has a doctorate from the University of Minnesota and is a chartered financial analyst, he is not a member of the American Society of Appraisers ... or the Appraisal Foundation. Dr. Hakala's report also was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP). Dr. Hakala did not provide the customary USPAP certification, which assures readers that the appraiser has no bias regarding the parties, no other persons, besides those listed provided professional assistance, and that the conclusions in the report were developed in conformity with USPAP."
>
> **"3. Analysis**
>
> "We have several significant concerns about the reliability of Dr. Hakala's report. These concerns lead us to place no weight on Dr. Hakala's report as evidence of the value of the Kohler stock the estate held. We have previously discussed the lack of customary certification of Dr. Hakala's report and that ***his report was not prepared in accordance with all USPAP standards***." (Emphasis added.)
>
> " ... Dr. Hakala did not understand Kohler's business. He spent only 2-1/2 hours meeting with management. ... He did not discuss his fabricated expense structure with management to test whether it was realistic. Dr. Hakala also decided to weight the operations plan model 80 percent and the management plan model only 20 percent ... despite the admonitions of management ... ."
>
> "After carefully reviewing and considering all of the evidence, we continue to find Dr. Hakala's conclusions to be incredible. We therefore give no weight to [IRS'] expert's conclusions. ... "
>
> **"D. <u>Petitioners' Experts</u>**
>
> "We now briefly describe the reports and valuation conclusions of petitioners' experts, Mr. Schweihs and Mr. Grabowski, each of whom we find thoughtful and credible. We give significant weight to their reports ... ."

> **"1. Mr. Schweihs' Valuation**
>
> " ... Mr. Schweihs had periodically performed valuations of Kohler stock in the several years before the valuation date and is very familiar with the company. For this assignment in particular, he was required to review significant information regarding the company and interview Kohler management."
>
> **"2. Mr. Grabowski's Valuation**
>
> " ... Mr. Grabowski spent 3-1/2 days at the company and interviewed 12 employees, spending considerable time with 6 of them, including [President and Chairman of the Board and the General Counsel]. [He] also reviewed numerous documents and considered general economic conditions and the industries in which Kohler operates."

This seems to tie in with the earlier commentary in this paper regarding "qualified appraiser" and "qualified appraisal".

5. CANADIAN VALUATION-RELATED PENALTIES

Third-party civil penalties relating to income tax matters are levied pursuant to the provisions Section 163.2 of the ITA. The CRA issued *IC 01-1* in September 2001 with respect to such penalties.[122] In May 2006, the CRA's Internal Audit and Program Evaluation Branch reported that there had been 19 referrals to the Headquarters Third-Party Penalty Review Committee.[123]

The CRA has stated that it has no intention of punishing good-faith valuation opinion differences if the Practice Standards and Code of Ethics of the CICBV have been adhered to and where normal due diligence has been exercised.[124] However, if the valuator's opinion of fair market value falls outside of a prescribed range, and the opinion was not considered to have been arrived

(122) September 18, 2001.

(123) CRA, Use of Legislated Enforcement Provisions, May 2006. The review period for this report was 2002 to 2003 and 2004 to 2005 results, being the first five years of the third-party civil penalty provisions.

(124) Dennis Turnbull, Canada Revenue Agency, "Current Tax Valuation Issues", CICBV Western Regional Conference, September 20 and 21, 2001, Calgary, Alberta.

at in good faith and/or with reasonable cause, the penalty provisions would apply because the opinion will be deemed to be a “false statement”.

There are exculpatory provisions that provide that if the fair market value was determined in *good faith* and there was *reasonable cause* for the over- or understatement of value (“false statement”), the CRA would not apply the penalty. Such would be the case in which a valuator’s fair market value opinion falling outside of the “prescribed range” was:

1. reasonable in the circumstances;
2. made in good faith; and
3. not based on unreasonable or misleading assumptions.

The last item, “... unreasonable or misleading assumptions”, continues to be very much open to debate. The reference to “assumptions” is directed primarily at inflated, discounted cash flow-based valuations of tax shelter offerings that provide investors with a high CCA deduction through, say, a limited partnership. Such valuations have been based on projections that rely on assumptions that are aggressive, unrealistic and likely unachievable. In such cases, if a valuator blindly relies on such assumptions to support “hockey-stick” projections prepared by the promoter, the penalty is likely to be invoked. To avoid the penalty, the assumptions used (or accepted) by the valuator must be:

- supported;
- reasonable; and
- not purely hypothetical.[125]

Depending on the ultimate *purpose* and *use* of a tax-related valuation opinion, the third-party civil penalty could be severe.

5.1 CRA Valuations

CRA has publicly stated that its "well-established" Business Equity Valuation program provides expert opinions on technical valuation and related issues, which are "prepared in accordance with current professional standards and ethics, as set out by the Canadian Institute of Chartered Business Valuators".

Standard No. 110 of the CICBV defines a Valuation Report (which includes an Estimate Valuation Report) as "**any written communication on letterhead and/or where the author(s) is identified, containing a conclusion as to the value of shares, assets or an interest in a business, prepared by a Valuator acting independently and that is not clearly marked as being in draft form.**"

However, a report in *draft* form is *not* subject to the Standards. In fact, some reports emanating from the CRA are marked "without prejudice".

(125) See, for example, Standard 9-2(g) of the U.S. *Uniform Standards of Professional Appraisal Practice* of The Appraisal Foundation in Washington, where use of hypothetical conditions must result in a credible analysis.

6. CONCLUSION

The foregoing comments and observations merely summarize a number of recent developments as well as developing areas regarding tax-purpose valuations. At the time this paper was being prepared, there were major issues being considered not only by various Tax Services Offices of the CRA, but also by the Tax Court of Canada.