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"VALUATION ISSUES RELATING TO SHARES OF PRIVATE CORPORATIONS"

presented by

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INTRODUCTION

> “The capital stock of a corporation, its net assets and its shares of stock are entirely different things ... the value of one bears no fixed or necessary relation to the value of the other”.
>
> United States Supreme Court
> *Ray Consolidated Copper Co*. v. *United States*
> 45 S.Ct. 526 (1925), at 528.

The subject matter of this paper is valuation issues relating to shares of private corporations. While this is not intended to be an exhaustive review of the myriad issues, the paper addresses some of the more common and practical issues that arise in determining fair market value for income tax purposes. As can be imagined, as valuation is an art and not an exact science,[1] there is literally no end to the differences of opinion concerning the development of fair market value opinions.[2]

Differences of opinion between the taxpayer’s business valuator and the CRA’s business valuator with respect to the fair market value of shares of private corporations arise most often with respect to one or more of the following issues:

- <u>At the entity level:</u>
  - The valuation approach adopted;
  - The premise of value (going concern vs. liquidation);
  - The valuation methodology and techniques applied under the approach;
  - Adjustments made to “normalize” the reported results (with respect to non-recurring items, non-arm’s length transactions, transfer pricing, discretionary expenses, non-economic expenses, management/shareholder remuneration, the use of mathematical weights applied in averaging a number of years’ earnings, etc.);

- The capitalization rate (price/earnings multiple) to apply to the maintainable earnings of the subject business in valuing the corporation;
- If the "discounted cash flow method"[3] is applied, the reasonableness of the projections used and the principal underlying assumptions on which they were based, the calculation of the residual value, the discount rate used in present-valuing the projected cash flows, etc.;
- Where the "guideline company" method[4] is used, the appropriateness and similarity of the market comparables used;[5]
- Identification and valuation of "redundant" assets (excess assets and non-operating assets) in the corporation;
- Effect of cyclicality and/or seasonality, if any, on the annual maintainable earnings used in the valuation analysis;
- Effect on maintainability of earnings of the business when there is a high degree of dependency on a key person;
- Treatment of off-balance sheet items (e.g., contingent assets, contingent liabilities, litigious claims, valuable intangibles, etc.);
- In the case of an investment holding company, treatment of the embedded or "trapped-in" income taxes on accrued capital gains (as discussed in some detail in my paper presented at the 1998 Annual Conference of the Canadian Tax Foundation)[6] as well as refundable dividend tax on hand ("RDTOH")[7] considerations;
- In the case of a real estate investment company, portfolio discounts in respect of large and diverse holdings of properties as well as recapture of capital cost allowance or loss-of-tax-shield considerations;
- In the case of a start-up operation, the quality and reliability of projections;
- Special-purchaser considerations; etc.

- <u>At the shareholder level:</u>
  - Valuation methodology (e.g., whether to value the minority shares using a "top-down" approach, "bottom-up" approach, or a market-based approach);[8]
  - The discount for lack of control (minority discounts) in a family-controlled business;
  - The discount for lack of marketability or illiquidity (marketability discounts);
  - The discount for fractional co-ownership interests in real estate;

- In the case of an investment holding company, whether an asset-based approach can be used if the shareholder cannot cause the liquidation of the corporation under the provisions of the relevant company law statute (e.g., a minority shareholder or a shareholder owning less than 66-2/3% of the voting shares);[9]
- Blockage discounts;
- Special-purchaser considerations; etc.

As valuation is more of an art than an exact science[10] and opinions may differ, the foregoing areas, among others, are often open to challenge by officials of the Canada Revenue Agency ("CRA"). In determining the fair market value of the shares of a private corporation for income tax and estate planning purposes, the application and quantification of the following valuation discounts are accordingly the most contentious areas:[11]

- <u>At the entity level:</u>
  - Discounts with respect to embedded capital gains tax liabilities of investment holding companies;
  - Other tax discounts in respect of depreciable property;
  - Key-person discounts with respect to operating companies; and
  - Portfolio discounts with respect to investment holding companies.
- <u>At the shareholder level:</u>
  - Minority discounts on shares of family-controlled corporations;
  - Marketability discounts on such shares;
  - Blockage discounts; and.
  - Personal income taxes, where RDTOH is included in the fair market value of the corporation.

In considering these factors, it is essential to keep in mind that "fair market value" (the term employed in the Act) is based on the "willing-buyer/willing-seller" standard; it contemplates uncompelled, arm's length, informed parties, acting in their respective self-interests and with equity to both. "Value to owner", on the other hand, is a separate and distinct valuation standard,[12] but as will be discussed, it can have a bearing on fair market value for income tax purposes. "Fair value", yet another standard of value, has a different meaning when it is employed (a) in the CBCA[13] or (b) under generally-accepted accounting principles for purposes of intangible asset allocation in business combinations,[14] goodwill impairment[15] and fresh-start reporting.[16]

Recognizing the potential disagreements that can arise, price-adjustment clauses are usually included in the purchase and sale agreement. In many cases, the taxpayer will commission an independent valuation to support the fair market values used in the transaction, particularly if possibly-contentious areas involve material amounts. An independent professional valuation would have a two-fold effect:

(a) help support the values for price-adjustment clause[17] purposes; and

(b) help avoid exposure to third-party civil penalties by the CRA (discussed below).[18]

Reference will be made throughout this paper to a number of important valuation-related decisions of the United States Tax Court as well as United States Courts of Appeals. Valuation is a subject that has invited the Canadian courts during the past twenty-five years to seek some guidance from the U.S. courts particularly in connection with shareholder dissent remedies under the appraisal provisions of the company law statutes[19] and, more recently, in income tax matters.

In *Re Domglas Inc.*,[20] a minority shareholder dissent remedy case, Mr. Justice Greenberg of the Quebec Superior Court noted:

> "The concept of an appraisal remedy in favour of dissenting shareholders is American in origin. It was first granted in the early part of this century [20th century] by Maryland and Delaware. Today, the company law of every state of the American Union provides such a remedy, excepting only West Virginia. Thus, it goes without saying that *the American jurisprudence on the matter is also relevant and helpful* in the determination of the present case." (Emphasis added.)

Justice Greenberg then spent several pages of his decision reviewing a number of the early "classic" U.S. valuation cases relating to the appraisal remedy.[21] He also commented extensively on Columbia University Professor Bonbright's 1937 two-volume treatise, *Valuation of Property*[22] as well as to Graham, Dodd and Cottle's celebrated U.S. finance textbook, *Security Analysis.*[23]

In one of the early "classic" Canadian valuation cases, *Re Wall and Redekop Corp.*,[24] the British Columbia Supreme Court stated that it was guided in part by the *American General*[25] decision. Also, Justice Estey (then of the Court of Queen's Bench of Saskatchewan), in deciding the *Montgomery* v. *Shell Canada*[26] case, had considered the U.S. decision in *Endicott Johnson Corp.* v. *Bade*[27].

In *Maple Leaf Foods Inc.* v. *Schneider Corporation,*[28] a shareholder oppression remedy case, the Ontario Court reviewed Delaware case law, stating that "[a]lthough the … decisions of the courts in Delaware … are not the law of Ontario, they can, however, offer some guidance". The Ontario court had reviewed the U.S. decisions in *Revlon*, *Paramount* and *Barkan* in addressing the alleged oppression.

More recently, Associate Chief Justice Bowman of the Tax Court of Canada made the following comments with respect to U.S. case law in relation to valuation issues.

In Aikman v. The Queen:[29]

> "The United States authorities ... , while not binding, are entitled to respect and are illustrative of the way in which U.S. courts, operating under a different statutory regime, have sought to cope with the valuation of unique and in some cases unmarketable properties. One must, however, treat foreign authorities with caution."

In *Aikman*, counsel for the Minister of National Revenue had referred to a number of U.S. valuation cases, some of which were dealt with by Bowman ACJ — subject to the reservation that they may not necessarily be appropriate in Canada.[30]

In *Klotz* v. *The Queen*,[31] Associate Chief Justice Bowman stated:

> "Considerable argument was devoted to a number of United States Tax Court decisions. That court has had to deal with very similar arrangements. ... one must treat foreign authorities with caution, but they are entitled to respect and they can be instructive where they deal with essentially the same problem."

Bowman, ACJ also referred to various U.S. Tax Court cases.[32] In particular, he considered the decision in *Samuel E. Hunter* v. *Commissioner*[33] as "another instructive authority in the United States Tax Court".

MINORITY DISCOUNTS AND FAMILY CONTROL

> "A number of years of experience has demonstrated that it is extremely difficult to find any market for minority interests … , despite efforts to do so … . On the relatively rare occasions when an offer is made to buy a minority interest, it is almost always for an amount far less than the fiduciary and the beneficiary expect to get."[34]

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

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

- The size of the shareholding;
- The relationship of the shareholder to the other shareholders;
- Whether group control exists;
- The dispersion of the other shareholdings;
- Whether or not there are "special purchasers"[35] in the marketplace;
- Dividend history and policy;
- The terms of the shareholders' buy/sell agreement,[36] if any; and
- Degree of influence on management policy.

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

- Appoint management (and directors, in the case of a corporation);
- Block corporate or partnership actions;
- Change the articles of incorporation, by-laws, or terms of a co-partnership agreement;
- Declare and pay dividends or make distributions;

- Determine management compensation and perquisites;
- Dissolve, liquidate, sell or recapitalize, in the case of a corporation;
- Make acquisitions;
- Liquidate assets;
- Register the shares for a public offering, in the case of a corporation;
- Select people with whom to do business or award contracts;
- Sell or acquire treasury shares, in the case of a corporation;
- Formulate policy and change the course of business.

The CRA has no stated policy regarding the size of a minority discount, if such discount would be applicable. The Department will, however, recognize the applicability of minority discounts — applying them on a fact-specific basis — in situations where family and group control does not exist.

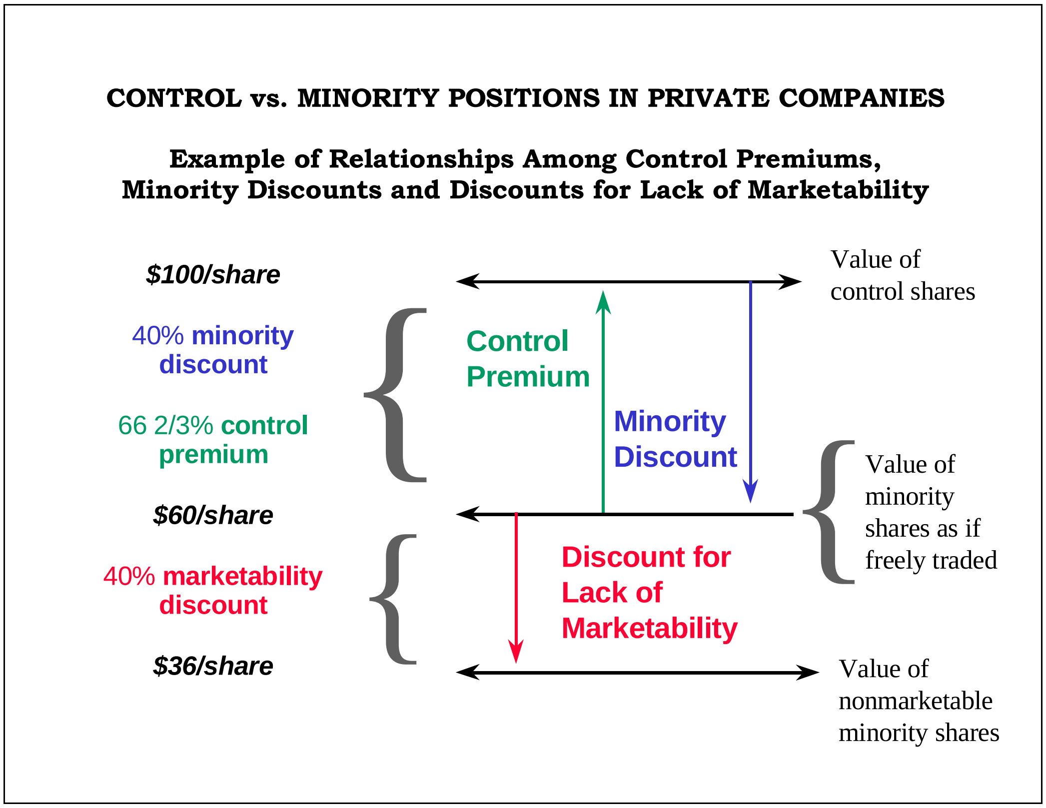
The Canadian courts have considered the applicability and quantum of minority discounts in a host of valuation-related cases, particularly income tax and corporate. At this juncture, it is important that a distinction be drawn between a "minority discount" and a "marketability discount".

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

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

> The concept of *minority interest* deals with the relationship between the interest being valued and the total enterprise … . The primary factor bearing on the value of the minority interest in relation to the value of the total entity is the degree of control the minority interest does or does not have over the particular entity. The concept of *marketability* deals with the liquidity of the interest, that is, how quickly and certainly it can be converted to cash at the owner's discretion.[37]

The following graph visually depicts the difference between a minority discount and a marketability discount. It distinguishes among control value, marketable minority interest value and non-marketable minority interest value, being the three possible levels of value (other than "strategic control value").[38]



Some of the following cases may help shed light on the courts' thinking in this regard.

In *Taylor Estate* v. *MNR*[39], the assets of an estate included minority shareholdings of 33%, 30% and 33% in three private companies. With respect to the latter two, the remaining shares were held by relatives, being either the deceased's three sons or her half-brother. Despite these familial relationships, her investments were nonetheless considered to represent minority interests. The Tax Appeal Board stated:

> "In view of the fact that only one of the shareholders was not related to the deceased, but was a corporation, I think that 10%, *instead of the more usual 20%*, would be an appropriate allowance to make for the minority interest held … .

> "In my view, and having regard to a family situation that could prove awkward for a stranger purchasing the deceased's shares, an allowance should be made by the respondent for the fact that the deceased's interest was definitely a minority one. I can see no reason why this factor was not taken into account and consider that an allowance of not less than 10% should again be made for the minority interest held.[40] (Emphasis added.)

Moynihan v. *MNR*[41] related to the valuation of a holding of 150 shares out of a total of 600 issued and outstanding shares in a small incorporated insurance agency. The Tax Appeal Board valued the shares at $5 each, implying a 95% discount from *pro rata* value. The Board stated that only the whole enterprise could be sold as no one would acquire a partial interest. Presumably, the implied discount recognized both the lack of control and lack of marketability aspects.

In *H.P. Connor* v. *The Queen*[42] the issue before the Federal Court (Trial Division) was the fair market value on valuation day of ten shares of a private company, representing 10% of the company's outstanding shares. Discounts were considered for both the illiquid and minority aspects of the investment. Based upon the expert evidence, the court applied discounts of 20% for illiquidity and 10% for lack of control, or a composite discount of 30%.

In *Andrew Yager* v. *The Queen,*[43] the Federal Court (Trial Division) held that a minority discount of only 10% was appropriate for a 48% shareholding, considering the long-standing and good working relationship and the respective salaries of Mr. Yager and the arm's length 52% shareholder.

In *Mayson* v. *MNR*[44] the Tax Court of Canada had to decide whether two different classes of shares held by the same shareholder should be valued separately or together.[45] A secondary issue dealt with the applicability of a minority discount. The appellant was a 50% shareholder. The Court stated:

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

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

While there are no empirical data for purposes of quantifying a discount that would apply to a 50% shareholding, 10% to 15% discounts have been applied to the 50% pro-rata value of the equity interests. This assumes that there is no shareholders' agreement in place or possible other factors that may impact value. As far back as 1980, some CRA officials were contending that, in the absence of a shareholders' agreement, a discount of approximately 15% should be assumed.[46]

As discussed below, the CRA generally does not recognize minority discounts if the shareholders are related to one another.

Voting Rights in Two-Class Share Structures

Often, with two-class share structures, there may be three separate and distinct common shareholdings to be valued:

(a) common shares that have the majority of the voting rights/votes;

(b) common shares that are voting, but have minority voting rights; and

(c) common shares that are non-voting.

A question that often arises is whether a premium should be placed on minority-held *voting* shares over *non-voting* (minority) shares, neither shares influencing the operations or policies of the corporation. An example would be the position of a minority shareholder who owns *voting* shares in a public company versus a minority shareholder who holds *non-voting* shares of that same public company (both shares having identical rights, except that one class is voting *vis-à-vis* the corporation's business operations and the other class is not). In some cases, the non-voting shares of the public company might trade at a higher price than the voting shares (which, but for the voting rights, are identical to the non-voting shares). The reason is that, in such a case, the non-voting shares are more liquid (the publicly-traded float being substantially larger).

Generally, the "premium" attached to *minority* voting shares is in the range of 3% to 5% over *minority* non-voting shares of the corporation.

There may be a difference between valuing family minority shares (a) in the hands of a family member who also owns the controlling shares and (b) in the hands of a family member who, alone, does not also hold the controlling shares. In the latter scenario, based on the case authorities cited below, a presumption must be made that the family shareholders would act in concert and simultaneously sell all of the issued shares *en bloc*, with the result that the minority shares would be valued rateably with all of the issued shares.

The cases address the proposition that both the voting shares and the non-voting shares would be sold by a shareholder, together as one block, in order to realize the best possible price for the non-voting shares. See, for example, *Estate of Curry* v. *U.S.*[47], *Attorney-General of Ceylon* v. *Mackie*[48] and *Ahmanson Foundation* v. *U.S.*[49]

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

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

> "The sole reason for assigning a lesser value to the non-voting shares in this case is their lack of voting rights which would, the estate argues, make them less attractive to a prospective purchaser. But that defect disappears where, as here, the non-voting stock is an integral part of the larger estate which retains a controlling equity interest. Here, when viewed in the hands of the estate, the non-voting stock would simply not be subject to the disadvantages of an isolated non-voting interest.
>
> "Like this Court, the Ninth Circuit in *Ahmanson* rejected the argument, made by the estate here, that non-voting shares could be assigned a lesser value than controlling voting shares even where both comprised a single bloc, noting, '[t]he record simply does not contain support for the proposition that non-voting shares are sold at a discount when sold together in a package with sufficient voting shares to give control.' In short, when viewed as part of the estate's integrated stock holdings, as they must be, the non-voting shares simply do not suffer any strategic disadvantage."[50]

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

Therefore, to the extent that a controlling shareholder has non-voting shares in the family corporation, the foregoing cases establish there should be no discount applied and they should be valued as if they were voting, because they would be sold as part of a unit that would consist of them and the control shares.

In *Marina Quebec* v. *Minister of National Revenue,*[51] Chief Justice Tremblay of the Tax Court of Canada stated:

> "*Considering the principle that control which makes it possible ultimately to redeem the preferred shares is the primary element in valuing such shares, I believe that the value of these preferred shares is equal to their redemption value, where the person who may decide, directly or indirectly, to redeem the preferred shares is the same person who controls the common shares*. It is clear that this approach cannot apply unless the company is solvent.
>
> "I could not find the above principle in the Canadian cases, or in the American cases *Ahmanson Foundation* v. *U.S. ...* and *Curry Estate* v. *U.S.* ... or the English case *Ceylon* v. *Mackie* ... . In those cases the deceased owned both the preferred shares and the common shares (American cases) or both of two distinct classes of voting shares (English case). However, I am of the view that in these cases, as in the case at bar, the fundamental issue is still control such as to permit the shares in issue to be redeemed. Whether such control is direct, that is, it arises from the fact that the owner of one class of shares is also the owner of the second class of shares, or is indirect, that is, it arises from the fact that another person who owns a class or classes of shares other than those in issue can decide to redeem, the basic principle is the same: control makes it possible to redeem the shares."

In *Diligenti* v. *RWMD Operations Kelowna Ltd. (No. 2)*,[52] Mr. Justice Fulton noted that the minority shares held by Mr. Diligenti were being acquired by the controlling shareholders and that such shares were being added to, and consolidated with, the control shares at the time. In particular, Justice Fulton stated:

> " ... the situation here is quite different from that of a minority shareholder offering his shares on the open market. In such a situation ... the purchaser would end up as the new minority shareholder, subject to all the disadvantages of the position of the original shareholder: obviously a minority discount would be applicable. But here,

> where the purchase will be by virtue of an order that existing shareholders, or the company, make the purchase, the result will be that existing shareholders will simply consolidate their position."

In *Mann* v. *Minister of Finance of B.C.,*[53] the share capital of an investment holding company was divided into 990 Class A common shares and 10 Class B common shares of $1. The Class A and Class B ranked *pari passu* in all respects, except only that the Class B shares were voting. At the time of Mr. Mann's death, the Class A shares were owned equally by his two children and the Class B shares were owned by Mr. Mann. The net worth of the company was approximately $150,000. The court determined that the 10 Class B voting common shares had a fair market value of approximately $1,500, being its pro-rata (1%) fair market value of the *en bloc* value of the company.

The CRA's Policy

The CRA's *IC 89-3*[54] sets out the Department's position on family and group control as it relates to fair market value.

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

The CRA generally does not recognize a minority discount where either a related group or an unrelated group of shareholders who control a corporation owned, among themselves, at least 50% plus 1 of the issued and outstanding voting shares of the corporation at the same time and if they have historically acted in concert as a group. *IC 89-3* states that it is "a rebuttable presumption that a family group has acted in concert to control a corporation."[55]

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

- Shareholders' and directors' minutes may be examined to determine the extent of consultation among the group.
- A review of remuneration may be made to ensure that all members of the group were treated fairly.

- Interviews with members of the group may be held to determine the role played by each member.
- Details of actual purchases and/or sales made by the claimants may be examined.

Where the CRA is satisfied that the documentation provided indicates a consistent pattern of group control, it will value each family member's shares on a pro-rata basis, and not allow a minority discount.

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

Each case is dealt with on its own merits.

Since the formulation in 1989 of the policy, there have been a large number of creative "custom-made" classes of Special Shares devised for income tax planning and/or estate planning purposes[56] which had not been previously been envisioned by the Department when it originally issued *IC 89-3*. The CRA's position in this regard is that each class of "special shares" must be valued taking into account specific rights, conditions and other attributes attaching to the shares of the class.

Paragraph 32 of *IC 89-3* states:

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

The U.S. Internal Revenue Service's Policy

For a number of years, the IRS shared the same views as the CRA, *viz.*, that no minority discount should be allowed in valuing minority interests held by family members in private companies. Minority shares should, for valuation purposes, aggregated with all family-held shares of the same corporation.[57]

Until the IRS released *Revenue Ruling 93-12*[58] concerning minority discounts in family-controlled companies, the IRS and the CRA shared the same views, i.e., minority discounts were not recognized. The IRS now takes the position that there will be no regard to the family relationship of the parties in valuing minority interests for gift tax purposes (and that the Service will follow *Propstra*, *Bright* and *Andrews* decisions (infra) of the U.S. Tax Court).

In *Propstra* v. *United States*[59] the taxpayer and his wife owned, in community of property, an undivided one-half interest in several parcels of real estate. The District Court decided that the estate was entitled to a 15% discount on the undivided one-half interest. The decision was appealed by the government, which argued that since the one-half interest held by the estate would ultimately be sold along with the other undivided interest, the market value of the whole would be realized by each one-half interest owner. The trial court decision was affirmed by the Court of Appeals.

In *Estate of Bright* v. *U.S.*[60] the Fifth Circuit held that the minority interest had no control value, even though the family unit had control of the corporation. This decision was based on (a) established case law, which did not support any type of "family attribution" where the control of a corporation was attributed to family members and (b) the concept of the hypothetical willing buyer/willing seller. The Court interpreted the expression "willing seller" (within the context of the fair market value definition) as a hypothetical seller rather than the particular estate, concluding that the actual identities of the parties receiving the shares should be disregarded (an "objective standard").

In *Estate of Andrews*[61], the *objective* standard (hypothetical willing buyer/seller) was emphasized because of its advantage over a subjective inquiry into the feelings, attitudes and anticipated behaviour of heirs and legatees which might well be boundless.

After further consideration of its position taken in *Revenue Ruling 81-253*, and in light of the above-noted cases that the IRS lost on this point, the Service concluded that, in the case of a corporation with a single class of stock, notwithstanding the family relationship of the donor, the donee, and other shareholders, the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest. Therefore, if a donor transfers shares of a corporation to each of his or her children, the factor of corporate control in the family is not considered in valuing each transferred interest for estate and gift tax valuation purposes. The IRS will not assume that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest:

> "Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest. This would be the case whether the donor held 100 percent or some lesser percentage of the stock immediately before the gift".[62]

EFFECT OF SPECIAL PURCHASERS ON VALUE

Fair market value in a notional-market context (i.e., in an income tax setting) must consider the possible existence of special interest purchasers, or strategic buyers, in the marketplace who might be prepared to pay a premium over and above the stand-alone, intrinsic value of the business, i.e., a price that is absent consideration of a price reflecting perceived post-acquisition synergies and/or strategic advantages by potential arm's length purchasers.

In Canada, special interest purchasers must be considered in determining fair market value and, if they can be identified, an assessment made as to whether they would have the interest and financial ability to transact. An attempt must also be made to quantify/estimate the purchaser-perceived post-acquisition net economic value-added and the degree to which such purchaser can be negotiated into paying for it.

In *The Market Approach to Valuing Businesses*[63], Dr. Shannon P. Pratt states:

> " ... *acquisition value* in the context of synergistic mergers and acquisitions .... would be something over and above control value, reflecting an *acquisition premium* or *synergistic premium* consisting of the value of perceived synergies included in the transaction price, over and above the control value of the acquiree on a stand-alone basis."

In Canada, the existence in the marketplace of a special interest purchaser will have the effect of increasing the stand-alone fair market value in the *notional market* to the "price" that might be paid in the *open market* ("acquisition value"). In this context, "fair market value" for Canadian purposes can be equated with "acquisition value" for U.S. purposes: both would include applicable special purchaser/strategic buyer considerations.

Fair market value in Canada recognizes that if the market includes a group of special interest purchasers, it would become a "special purchaser market" from which "ordinary purchasers" would be excluded.

As open-market (real-world) negotiations between the buyer and seller will likely not have occurred proximate to the effective valuation date, it may be difficult, if not impossible, to identify potential special interest purchasers for the business — and even assuming they can be identified, whether such buyers would be prepared and be financially able to transact. However, assuming that such a purchaser can be identified, it may be difficult at best to identify, let alone quantify, the perceived post-acquisition net economic value-added and other benefits resulting from the transaction. As value is in the eye of the beholder, there can be as many possible prices for a business or business ownership interest as there are potential purchasers, as each purchaser will view post-acquisition net economic value-added differently. If a willing and able special purchaser/strategic buyer can be clearly identified, and the perceived net economic value-added (achieved as a result of post-acquisition synergies and/or strategic advantages by combining the target's business and that of the purchaser) can be reasonably quantified, a special-purchaser premium will be added to the acquiree's intrinsic, stand-alone value in a *notional-market* context to arrive at fair market value. The premium is the *open-market* price (acquisition value) that a special interest purchaser may pay over and above that which "ordinary" purchasers (financial buyers) would pay. A valuator may attempt to estimate the type of premium that might be reasonably negotiated, as a special purchaser will not knowingly pay dollar-for-dollar for the perceived post-acquisition net economic value-added, i.e., one does not pay $1 to receive $1 in return. The buyer's risk increases as the price for the perceived post-acquisition synergies and strategic advantages increases.

However, unless the market has been tested or the valuator has conducted serious negotiations with possible purchasers, it would be difficult, if not impossible, to know whether the "highest price" (in the definition of fair market value) has been arrived at in a notional-market context. In this regard, the Federal Court of Canada, in *Dominion Metal & Refining Works Ltd.* v. *The Queen*,[64] held that "[t]he special purchaser theory ... requires some evidentiary base before it may be applied". This had been the case in *Re Lynall*,[65] a decision of the British House of Lords, in which the existence of a special purchaser influenced value only where it was established by cogent evidence that, at the valuation date, the special purchaser was in fact:

- offering to purchase the shares;
- financially able to buy the shares at the enhanced price; and
- this fact was known to the public.

An important issue that was raised by the Federal Court in *Dominion Metal* was whether, at the relevant valuation date, the buyer, Ogilvie Mills, was a special purchaser even though its presence in the notional market "wasn't even known to itself". That is, at the time Ogilvie acquired the property from Dominion Metal in 1974, it was a special purchaser; however, as of the relevant valuation date in 1971, there was no evidence led supporting the proposition that it was a special purchaser on the valuation date:

> "The special purchaser theory, as all theories, requires some evidentiary base before it may be applied. As I have observed before, 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."

Accordingly, it seems clear that the existence of a special purchaser must be established beyond a reasonable double.

The English courts also require evidence of this situation before the effect of a special purchaser on fair market value is given any weight. In *Clay* (*infra*), the special fact enhancing the price of the property was assumed to be a matter of local knowledge. This will be referred to later.

Canadian jurisprudence relating to certain situations involving special purchasers is summarized below.

The principle that the use of property by the purchaser must be a determinant of value has also been applied by the Supreme Court of Canada in *Fraser* v. *The Queen*,[66] an expropriation case, where the property involved 110 acres of rocky ground. Its "bare ground" value was $50 per acre. However, it was strategically situated on the Canso gut between the Mainland and Cape

Breton Island where the public authorities had decided to build a causeway linking the two. The purpose of the expropriation was to make a quarry site for the 9,000,000 tonnes of rock required for the causeway. Canadian Supreme Court Justice Cartwright, in addressing the valuation issue, observed:

> "We must deal with the realities of the situation. What was compulsorily taken from the appellant was intended to be used not as land but as a source of building material for which there was an ascertainable market price." (At page 458.)

Justice Ritchie, in adopting the reasoning of the House of Lords in *Raja Vyricherla Narayana Gajapatiraju* v. *Revenue Divisional Officer, Vizagapatam,*[67] stated:

> "The exclusion from the Court's consideration of 'increase in value consequent on the execution of the undertaking' to build a causeway and of any value based on the Crown acting under compulsion as a necessitous purchaser does not mean that the value of the special adaptability to the owner at the date of expropriation is to be disregarded." (At page 474.)

The special-value approach had also been adopted by the Federal Court of Canada in *Cyprus Anvil Mining Corp.* v. *Dickson et al*[68] and *Laycock* v. *The Queen*[69].

In *Cyprus Anvil*, a case involving a takeover bid followed by the compulsory acquisition of dissenting minority stockholders' shares and the fixing of "fair value", the British Columbia Supreme Court stated that "it is a fundamental principle of valuation that the subject property [a mine located close to the purchaser's mining and milling operations] will be valued at its highest and best use", and held that the value that the single special purchaser placed on the property must accordingly be considered the fair value of the property.

Chief Justice McEachern, stated:

> "It is a fundamental principle of valuation that the subject property will be valued at its highest and best use. Anything else is unreal. Thus when a buyer and seller discuss the price of a property — not an *objet d'art* or something having personal or sentimental value — they assume its highest and best use. For example, if a prudent farmer is selling his farm to a developer, he will not accept a price based upon agricultural use, and the developer would not expect him to do so. Problems of zoning may affect the potential of the property but that is just a factor which is taken into account in assessing the potential of the property."

In *Laycock* (*supra*), an income tax case dealing with "fair market value", the court recognized a value 50% higher than its value as "ordinary farm land".

In *Lakeshore Enterprises Ltd. et al* v. *Minister of National Revenue*,[70] the Tax Review Board held that, for fair market value purposes, a special value existed for the land, and that "the Royal Bank of Canada was a special purchaser".

In *931 Holdings Ltd.* v. *Minister of National Revenue*,[71] the City of Toronto was willing to pay a premium of 40% over and above the normal fair market value because the owner of the lands involved enjoyed a non-conforming use that the city authorities wished to eliminate. The Court held in deciding on the issue of fair market value for income tax purposes:

> "It is clear from the evidence that on December 31, 1971, the City of Toronto was in the market to purchase the property to rid it of an obnoxious non-conforming use." (At page 395).

Recognizing the "open-market" component of the "fair market value" definition, Canadian courts generally recognize that all possible purchasers should be considered. In *The Queen* v. *Edmund Littler, Sr.*[72], the Federal Court of Appeal upheld the decision of the lower court with respect to the valuation of shares of a Canadian publicly-traded company acquired by the U.S. conglomerate, Standard Brands Limited. Mr. Justice Decary of the Federal Court — Trial Division stated:

> "Furthermore, the shares of Lowney were worth far more to Standard because Standard wished to acquire not only the voting control of Lowney, not only a passive holding, but a going concern to be integrated in their own business as the business of Lowney, the making of candy, was akin to the one of Standard, the food business. The evidence of ... the Chairman of the Board of Standard leaves no doubt that the control of Lowney is worth, per share, many times more than the Exchange Value. Standard wanted a wholly-owned subsidiary. As to the value, in such an instance, the evidence of [the] President of Kraft Foods (Canada) Ltd. is to the same effect."

The Canadian family law courts have also accepted the effect of special purchasers on value.[73]

The stand-alone value of a target business in the *notional market* might not *necessarily* be increased by a special-purchaser premium in arriving at fair market value (even assuming that such premium it could be reasonably quantified) because:

(a) If there is only one special purchaser, the purchase price may be only nominally higher than what "ordinary purchasers" would pay in order to ensure a successful bid for the target; and

(b) If there are two or more special purchasers, the market would become a special-purchaser market (where there may be competitive bidding) and ordinary purchasers would therefore be excluded. These special purchasers would bid up the price for the business to an amount that would represent its value to them. In this regard, a special purchaser is not considered to be an exceptional purchaser, but rather the more typical kind of buyer present in the open market. If a number of notional purchasers are willing to pay a "premium" over the price offered by other purchasers, it would not be considered a "premium", but simply fair market value.

A good example of competitive bidding was given by Wolfe D. Goodman, QC, in his presentation at the 1976 Biennial Conference of The Canadian Institute of Chartered Business Valuators:

> "... where there is no single majority shareholder but, rather, there are several minority shareholders, to each of whom the shares of another minority shareholder have a special value, fair market value may be affected by their position as special purchasers.
>
> "Assume, for example, that there are three equal shareholders in a company, A, B and C, that the value of 100% of the shares of the company in the hands of a single shareholder would be $300,000, but outside investors would be prepared to pay only $60,000 for a one-third interest in the company. In valuing C's shares, it is not unreasonable to assume that there would be competitive bidding between A and B to acquire these shares, which, together with the purchaser's original holding, would constitute a majority shareholder. If A or B could realize only $60,000 each by selling their shares to investors but, by acquiring C's shares and obtaining majority control of the company, they could ensure that their total shareholdings were worth their full rateable value of $200,000, A or B might be prepared to pay up to $140,000 for C's one-third interest in the company. C's minority interest might, in these circumstances, be worth substantially more than its rateable value of $100,000.
>
> "This is hardly surprising: In an extreme case, where there are two equal shareholders, each with 49% of the shares, a stranger with only 2% of the shares might be able to realize vastly more than the rateable value of his shareholding, if there were competitive bidding for his shares by the other shareholders."[74]

In *Inland Revenue Commissioners* v. *Clay and Buchanan*[75], for example, an early English decision, Lord Justice Swinfen Eady of the Court of Appeal, referring to the presence of a special purchaser in the marketplace, noted:

> "It was then urged by the Solicitor-General that if the probability of this special buyer purchasing, above the price, which but for his needs would have been the market price, could be taken into consideration at all, then only one further point or bid could be allowed, and it must be assumed that this special buyer would have become the purchaser upon making this one extra bid. Such an assumption would ordinarily be quite erroneous. The knowledge of the special need would affect the market price, and others would join in competing for the property with a view to obtaining it at a price less than that at which the opinion would be formed that it would be worth the while of the special buyer to purchase." (At page 476.)

Other cases in which the British House of Lords and/or Privy Council addressed the issue of special purchasers include *Robinson Brothers (Brewers) Limited* v. *Durham County Assessment Committee*[76] and *Raja Vyricherla Narayana Gajapatiraju* v. *Revenue Divisional Officer, Vizagapatam*[77].

The issue in *Robinson Brothers* was a notional-market valuation in a context involving a number of special purchasers. Lord Macmillan stated:

> "I can see no justification for including [the special purchasers] among the competitors but excluding [the amount] which they would offer. The motives which actuate buyers in a market may be of all kinds, but it is not their motives but their bids that matter."

In *Raja Vyricherla Narayana Gajapatiraju* (*supra*), an Indian case, the U.K. Privy Council was required to determine whether the value of potentialities (or unusual features) of certain land as a building site should be included for valuation purposes:

> "[F]or it has been established by numerous authorities that the land is not to be valued merely by reference to the use to which it is being put at the time at which its value has to be determined ... , but also by reference to the uses to which it reasonably capable of being put in the future. No authority, indeed, is required for this proposition. It is a self-evident one. No one can suppose, in the case of land which is certain or even likely, to be used in the immediate or reasonably near future for building purposes, but which at the valuation date is waste land, or is being used for agricultural purposes, that the owner, however willing a vendor, will be content to sell the land for its value as waste or agricultural land, as the case may be. It is plain that

> in ascertaining its value the possibility of its being used for building purposes would have to be taken into account. ... "
>
> "The same consideration will apply to cases where the owner is not the only person, but merely one of the persons, able to turn the potentiality to account. The value to him of the potentiality will not be less than the profit that would accrue to him by making use of it had he retained it in his own possession. Take the case, however, where the owner is himself unable to turn the potentiality to account, whether by promotion of a company or otherwise. In such a case there may be several other persons who would be able to do so, or there may be only one. If there are more than one, it is recognized by all the authorities that have been cited to their Lordships, and seems to be consistent with common sense, that the owner is entitled to be paid the value to him of the potentiality, though the ascertainment of its value may in many cases be a matter of considerable difficulty."

The English courts appear to have adopted the following "rules" from an historical perspective, based in particular on *IRC* v. *Clay*[78] and *IRC* v. *Crossman*[79]:

- Where the attraction to the special purchaser <u>is inherent in the property itself</u>, e.g., the adjoining house in *Clay*, and there is an identifiable purchaser in the market as well as evidence as to the price at which a seller could negotiate a sale to the purchaser, the value is that price. This is similar to the issues respectively addressed by the tax courts in Canada (*Dominion Metal* v. *The Queen*[80]) and in the U.S. (*Serdar* v. *Commissioner*[81]).
- Where the attraction <u>arises from the particular position of the purchaser</u>, e.g., a trust company being insulated from the restrictions triggered by the death of a shareholder (as in *Crossman*), the price is not whatever price the purchaser could afford to pay; it would instead be the price at which an assumed sale could take place, *viz*., the special-purchaser price. There may be situations in which a purchaser could pay an "irrational" price because of his or her particular position. In such case, the price could hardly be viewed as a "special purchaser" price; rather, regard would be had to basic economics.

<u>Speculators</u>

The possible existence of speculators, who might purchase the property simply in order to "flip" it at a profit to a special purchaser must also be considered. The English decision in *IRC* v. *Clay and Buchanan*[82] concerned the value of a house. The house was valued by the assessor at approximately £750. However, it adjoined a nursing home that was considering adding an extension. The trustees of the nursing home purchased the house for £1,000. The Court of

Appeal considered that £1,000 to be the appropriate commercial value to the purchaser and not a "fancy price", commenting that anyone knowing beforehand that the nursing home was willing to purchase would be entitled to anticipate a price of approximately £1,000 and not £750. Lord Cozens-Hardy M.R. stated:

> "I can see no ground for excluding from consideration the fact that the property is so situate that to one or more persons it presents greater attractions than to anybody else ... . To say that a small farm in the middle of a wealthy landowner's estate is to be valued without reference to the fact that he will probably be willing to pay a large price but solely with reference to its ordinary agricultural value, seems to me absurd. If the landowner does not at the moment buy, land brokers or speculators will give more than its agricultural value with a view to reselling it at a profit to the landowner."

The appellate court appeared to suggest that if there were one special purchaser and if it was general knowledge in the marketplace that the subject property had special value to this purchaser, then in addition to ordinary purchasers, the market would be assumed to contain speculators who would be prepared to pay more than ordinary purchasers in the hope that they could resell at a profit to the special purchaser. Lord Justice Swinfen Eady stated:

> "A value, ascertained by reference to the amount obtainable in an open market, shows an intention to every possible purchaser ... . Not only is the probable buyer a competitor in the market, but other persons, such as property brokers, compete in the market for what they know another person wants, with a view to a resale to him at an enhanced price, so as to realize a profit.
>
> ...
>
> "The justification for the second approach which envisages a resale of the controlling shares is that a market is to be assumed from which no buyer is to be excluded and this market is deemed to include persons who buy with a view to resale at an enhance price to others whose wants are known to the market."

In *Glass* v. *IRC*[83], a Scottish case, there was only one special purchaser. The court, citing two English cases, *Gough* v. *Aspatria Silloth District Joint Water Board*[84] and *Lucas* v. *Chesterfield Gas and Water Board*[85], valued the subject land at substantially more than the price ordinary purchasers would have been willing to pay, and not at a value just "one point higher" than might otherwise be the case when there is no competitive bidding, because of the probability of potential speculators in the marketplace:

> "I think it highly probable that, in these circumstances, more than one speculator would have come forward with offers substantially in excess of the agricultural value, in the reasonable expectation that they would sooner or later find a purchaser in the Water Commissioners, at a figure that would yield them a profit on the transaction."

The court suggested that if there is a single special purchaser, and if the fact that the property in question had a special value to that purchaser was a matter of general knowledge in the marketplace, it must be assumed that, in addition to ordinary purchasers, the market would also contain speculators who would be prepared to pay more than an ordinary purchaser in the hope that they could later resell the property at a gain to the special purchaser.

Generally, the position of the Canadian courts is that a special purchaser market will affect the determination of fair market value if (a) it can be established that, at the valuation date, such purchaser was present in the market and was financially able to transact, and (b) the market was aware of the special purchaser's presence.

Where there is only <u>one special purchaser</u> in the marketplace:

(a) the special purchaser would need to pay only "one point up" over the price paid by ordinary purchasers;

(b) where the market is aware of a special purchaser, speculators would enter the market to drive the price up that which they believe a special purchaser would be prepared to pay; and

(c) the potentiality or special nature of the property that is especially desirable to a potential purchaser would bring a higher price for the property than its ordinary use.

Again, where there is <u>more than one special purchaser</u>, there will be competitive bidding, which will drive up the price; in this scenario, ordinary purchasers will be excluded and the market will become a special purchaser market.

VALUE TO OWNER

The standard of value under the Act is generally "fair market value", defined as:

> "The highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market, between informed and prudent parties, dealing at arm's length, neither party being under any compulsion to transact."

Nonetheless, value to owner cannot be ignored. Value to the owner is defined as "the value to a particular investor based on individual investment requirements and expectations".[86]

As the court found in *Raja Vyricherla,*[87] what the owner would accept is an important factor in the determination of fair market value.

In this regard, the following comments were made at a professional conference of The Canadian Institute of Chartered Business Valuators:

> "One may question whether the expression 'fair market value' might be said to be synonymous with the expression 'value to the owner' when dealing with shares of a privately-held company. Even if one can accept that fair market value of a block of shares in a privately-held company can be determined by reference to the value to the owner, the next question which arises is whether, in determining the value to the owner of a minority interest, the valuator is entitled or required to take into account such matters as the relationship between the minority shareholder and all of the other shareholders in the corporation and facts as to whether the particular shareholder actually participates in the management and control of the business of the corporation and therefore, in fact, forms part of the control group. There is little, if any, jurisprudence on this subject which would assist in advancing or rejecting this contention.[[*]] Much of the jurisprudence in dealing with the valuation of minority interests has been developed under the estate tax legislation of the United Kingdom which specifically provides that the value, for estate tax purposes, is to be the estimated price which the property would fetch if sold in the open market at the time of death — somewhat negating an argument to support the value to the owner concept. Notwithstanding these express provisions that value is to be determined by reference to a price received on an open market sale, the U.K. courts have come very close to establishing that the value for estate tax purposes of a share interest in a company must be the value to the owner of the shares as they have presumed that the transfer to the proposed purchaser is consented to and that the proposed purchaser takes the shares on terms where, in future circumstances (e.g. his own death), a first right of refusal may become operative against him. Therefore, the English cases seem to have adopted a value to the owner technique to establish a hypothetical open market price by putting the purchaser into the same shoes as the taxpayer.[[**]]
>
> "It may therefore be suggested that where the value of a block of shares to the particular owner who participates with other shareholders in control may be higher than the value of the block to a total outsider who might not be admitted to the controlling group, it might be supposed that the outsider is to buy on condition that he be admitted to the controlling group and stand in the same shoes as the taxpayer in his relationship to the other shareholders. If this is an appropriate basis for valuation,

> mere arithmetical minorities would not be heavily discounted if they actually formed part of the controlling group.[88]

The courts consider that value to owner — albeit an entirely separate and distinct standard of value — is nonetheless a relevant consideration in determining fair market value. The "fair market value" standard, which is an *objective* standard, requires a willing seller and a willing buyer. Yet, there are situations in which value to owner (a subjective standard) may affect fair market value.

In *Marina Quebec* v. *Minister of National Revenue*,[89] the Tax Court of Canada concluded, with respect to the redemption of preferred shares of the company, that:

> "I therefore find that it was possible to redeem the shares, and so that the value to the owner (in the broad sense, that is, the person who ultimately controls redemption) is equal to the redemption value. The fair market value is equal to that value ... ."

In *Lauder* v. *MNR*[90] the Tax Review Board dealt with the December 31, 1971 ("valuation day") value of a 24% interest in a company. The Board held that despite the taxpayer's unique experience and background in the industry, his influence on the value of his holdings was limited because he was a minority shareholder. From the taxpayer's perspective, however, because of his background with the company as well as his position on the Board of Directors and his industry expertise, his shares had a unique value ("value to owner" concept). In his submission to the Tax Review Board, counsel for the CRA raised the following important point:

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

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

MARKETABILITY DISCOUNTS

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

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

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

> "[i]n the absence of an effective exit vehicle, private placements normally sell at a significant discount — often 30% — 60% or even more — from freely traded securities".[91]

Because a minority discount reflects a value decrement due to lack of control, the value base from which the minority discount is subtracted is its proportionate share of the value of the total entity (or at least the common equity) taken as a whole, including all rights of control. As a discount for lack of marketability reflects a value decrement due to lack of liquidity, the value base from which the discount is subtracted is the value of an entity or interest that is otherwise comparable but enjoys higher liquidity (i.e., can more readily be sold and converted to cash).[92]

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

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

> "A minority interest in a privately-held firm should contain an even greater discount for lack of marketability than a control share. We see from these studies in Pratt that there is a pure discount for lack of marketability even when there is no question as to the ability to convert to cash on a specified date (again the amount is uncertain, but the ability to convert to cash hence time at which it can occur are both certain). When we compare a minority letter stockholder to a private company minority stockholder,

> the latter is obviously much less marketable. It may take 30 years to sell the private stock, and it may never sell. The majority owner can even cash out, selling his shares only without the firm as a whole, leaving the minority shareholder still sucking wind, waiting for a knight in shining armor. In the meantime, private firms rarely ever pay dividends, while letter stockholders may well be receiving them."[93]

In a U.S. article published some thirty years ago, the author noted:

> "Obviously the courts in the past have overvalued minority interests in closely-held companies for federal tax purposes. But most (probably all) of those decisions were handed down without benefit of the facts of life recently made available for all to see."
>
> "Some appraisers have, for years, had a strong gut feeling that they should use far greater discounts for non-marketability than the courts had allowed. From now on those appraisers need not stop at 35 percent merely because it's perhaps the largest discount clearly approved in a court decision. Appraisers can now sight a number of known arm's length transactions in which the discount ranged up to 90 percent."[94]

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

> "Based on the various studies relating to the question of marketability only, it would be hard to dispute as a minimum an average 35 percent discount. I believe greater discounts could be argued based on the fact that closely-held companies in general would be smaller in size than the average publicly-traded company and thus justify a higher discount. This theory seems to be supported by the data in the SEC Institutional Investor Study. Thus, a 35 percent marketability discount applied to a closely held company could, I believe, only be viewed as conservative.
>
> "Combining the 30 percent adjustment from market to minority with the non-marketability discount of 35 percent, we arrive at an average total minority discount of approximately 65 percent, as established in the public marketplace. As suggested earlier, the average discount may be somewhat conservative, as I believe that the general circumstances surrounding the shares used to derive the two segments led to lesser discounts than would be appropriate for 'true' minority shares of a typical closely held corporation.
>
> "Applying the logic of the public market to the closely held corporation, it would appear that, on average and absent particular benefits to enhance marketability, a top down discount of, say 65 percent would not be unrealistic or unwarranted. Based on my reading, it would appear that the courts have allowed minority discounts in excess of 50 percent several times, but on the whole the courts still seem to be more

comfortable with discounts in the 20 to 40 percent range. With the odd exception, it would appear that U.S. courts have been reluctant to recognize a composite discount. In some situations, the status of the buyer has been used by the courts to justify a lower discount (controlling shareholder buying minority shares – value to purchaser or family group, etc.), rather than fair market value.

EXHIBIT 3
Reconciliation

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

"This reconciliation is supported by a number of the authors previously cited who have suggested total discounts of 75 percent or more. As noted earlier, John S. Harper, Jr. and Peter Lindquist, in an article in *The Appraisal Journal*, April 1983, entitled 'Quantitative Support for Large Minority Discounts for Non-Yielding Interests in Closely Held Corporations', demonstrated the applicability of total minority discounts of up to 75 percent using a top down approach."[95]

The U.S. Tax Court has considered three different approaches that were intended to support discounts for lack of marketability:

1. *The pre-IPO approach*, which involves comparing the market prices of shares of a public company following an initial public offering ("IPO") to private transaction prices of the same company's shares prior to the IPO;
2. *The restricted share approach*, which involves comparing private placements of restricted shares of public companies with their freely-traded counterpart, i.e., shares having attributes identical to those of the restricted shares, except that they are freely-traded; and
3. *The quantitative approach*, which uses quantitative models to support the discount for lack of marketability.

With respect to the pre-IPO data gleaned from empirical studies of trading prices of restricted shares and pre-IPO transactions, the observation has been made that the two most important factors in determining the magnitude of the discount were (a) the dividends paid and (b) the particular holding period. A lower marketability discount would apply if dividends were paid during the perceived holding period, and the longer the perceived holding period, the greater the discount.

Another factor impacting the size of the discount for lack of marketability is the size of the company: The larger the company, the lower the perceived risk and hence the lower the marketability discount.

Based on pre-IPO transactions analyzed, discounts averaged in the range of 45% to 47%. In a U.S. gift tax case, *Okerlund* v. *United States*[96], the court noted that both the taxpayer's expert and the IRS' expert relied on pre-IPO data as well as publicly-traded restricted shares data, concluding that:

> "... unlike the [IRS' expert's] Report, the [taxpayer's expert's] Report considered the pre-IPO studies more relevant for the purpose of determining the appropriate discount for lack of marketability. According to [the taxpayer's expert], the discounts observed in restricted stock studies reflect the existence of a public market for the stock once the temporary restrictions lapse. For a variety of reasons, ... purchasers of restricted stock 'generally expect to be able to resell the stock in the public market in the foreseeable future'. Pre-IPO discounts, on the other hand, are based on purely private transactions before a company enters the public market, a situation more comparable to closely-held companies such as [the subject company] ... ".

Pre-IPO data have been favourably considered by the U.S. Tax Court and other courts in *Estate of Gallo* v. *Commissioner*[97], *Mandelbaum* v. *Commissioner*[98] and *Davis* v. *Commissioner.*[99]

In another case, however, the U.S. Tax Court appeared to prefer the restricted share approach to the pre-IPO approach.[100]

While the pre-IPO studies may be more relevant for purposes of quantifying the discount for lack of marketability in a particular situation, the restricted share data should also be considered. Data are available from a number of studies, including the following:

When using data from U.S. "restricted stock studies", it is noted that marketability discounts for public company restricted shares have decreased mainly due to changes in U.S. Securities and Exchange Commission ("SEC") regulations relating to restricted share trading, in particular the reduced minimum holding period required for restricted shares from two years to one year, effective 1997. Currently, U.S. data show that the average marketability discount for minority shareholdings in private companies compared with that for restricted shares of public companies is approximately 20 percentage points. The SEC rules include a "dribble out" rule for restricted shares, providing that, after the minimum one-year holding period expires, the shareholder may sell shares on the market each quarter, equal to the greater of 1% of the outstanding shares and 1% of the average monthly trading volume. This suggests that a larger shareholding would take longer to liquidate in the open market.

The following observations have been made with respect to restricted share transactions:

(a) the larger the shareholding in relation to the total issued and outstanding shares, the fewer potential purchasers for the shares;

(b) the longer the perceived holding period, the larger the marketability discount; and

(c) in quantifying a marketability discount using data from restricted stock studies, (i) regard should be had to the comparability of the companies used in the database transactional data and the private company the shares of which are being valued and (ii) to the implied restricted share discount in (i) above, an additional amount will be added in respect of the illiquidity attaching to private-company shares as opposed publicly-traded shares.

In effect, the marketability discount could be calculated as the aggregate of (a) the discount that would apply if the shares were restricted shares of a public company and (b) and increment[101] to recognize that the company is private.

Notwithstanding the use of pre-IPO and restricted share data in estimating discounts for lack of marketability of private company minority interests, there is much debate among business valuators and financial analysts with respect to the observations made as well as the interpretations and inferences drawn from the various studies.[102]

The quantitative approach uses criteria that are generally considered by market participants:

- dividend yield;
- required holding period;
- capital appreciation; and
- prospects for liquidity.

The major criticism of this approach is that it relies on assumptions relating to the foregoing criteria as opposed to open-market transactional data. The quantitative approach, which is theoretically sound, is often corroborated by data based on observations from either the pre-IPO or restricted share studies.

In at least one instance, the CRA has, in addition to using one particular restricted stock study (because it included U.S. shares having a one-year SEC restriction), applied an alternative method, the Black-Scholes Option Pricing Model, to calculate the restricted share discount for publicly-traded shares transacted by a taxpayer. Using this model, five variables are typically considered: share price, exercise price, risk-free rate, time to expiration and volatility (each on an annualized basis).

Empirical Studies

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

Empirical Study		Period	Transactions	Average Discount
SEC, Overall Average	(a)	1966-1969	398	25.8%
SEC, Nonreporting OTC Companies	(a)	1966-1969		32.6%
Gelman	(b)	1968-1970	89	33.0%
Trout	(c)	1968-1972	60	33.5%
Moroney	(d)	1968-1972	148	35.6%
Maher	(e)	1969-1973	33	35.4%
Standard Research Consultants	(f)	1978-1982	28	45.0% (median)
Willamette Management Associates, Inc.	(f)	1981-1984		31.2% (median)
Silber	(h)	1981-1988	69	33.8%
Management Planning, Inc.	(i)	1980-1996	53	27.1%
FMV Opinions, Inc.	(j)	1979-1997	253	23.0%
Bruce Johnson	(k)	1991-1995	70	20.0%
Columbia Financial Advisors	(l)	1996-1997	23	21.0%
Columbia Financial Advisors	(m)	1997-1998	15	13.0%

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

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

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

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

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

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

(g) Willamette Management Associates study (unpublished).

(h) William L. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices", *Financial Analysts' Journal*, July-August 1991, pp. 60-64.

(i) R.P. Oliver and R.H. Meyers, "Discounts Seen in Private Placements of Restricted Stock: The Management Planning, Inc., Long-Term Study (1980-1996)" (Chapter 5) in R.F. Reilly and R.P. Schweihs, Eds., *The Handbook of Advanced Business Valuation*, McGraw Hill (New York: 2000).

(j) Lance S. Hall and Timothy C. Polacek, "Strategies for Obtaining the Largest Valuation Discounts", *Estate Planning*, January/February 1994, pp. 38-44.

(k) *Shannon Pratt's™ Business Valuation Update*.

(l) *Shannon Pratt's™ Business Valuation Update*.

(m) *Shannon Pratt's™ Business Valuation Update*.

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

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

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

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

Of the 173 transactions in the 6 studies, 32 were actual sales, 7 of which were in the 1993 study. The remaining transactions were mostly options granted at fair market value. In general, actual sales transactions in the 6 studies were 49% and the median was 52.5%. In most cases, the transactions were stated to have been at fair market value. All ultimately would have had to been able to withstand SEC, IRS or judicial review, particularly in light of the subsequent public offering. The transactions primarily took one of two forms, (a) the granting of stock options at the then fair market value of the shares or (b) the direct sale of shares.[103]

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

DISCOUNTS FOR MINORITY POSITION AND NON-MARKETABILITY

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

Bolten concluded:

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

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

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

> non-marketability discount considerably higher than the suggested fifty percent base."[104]

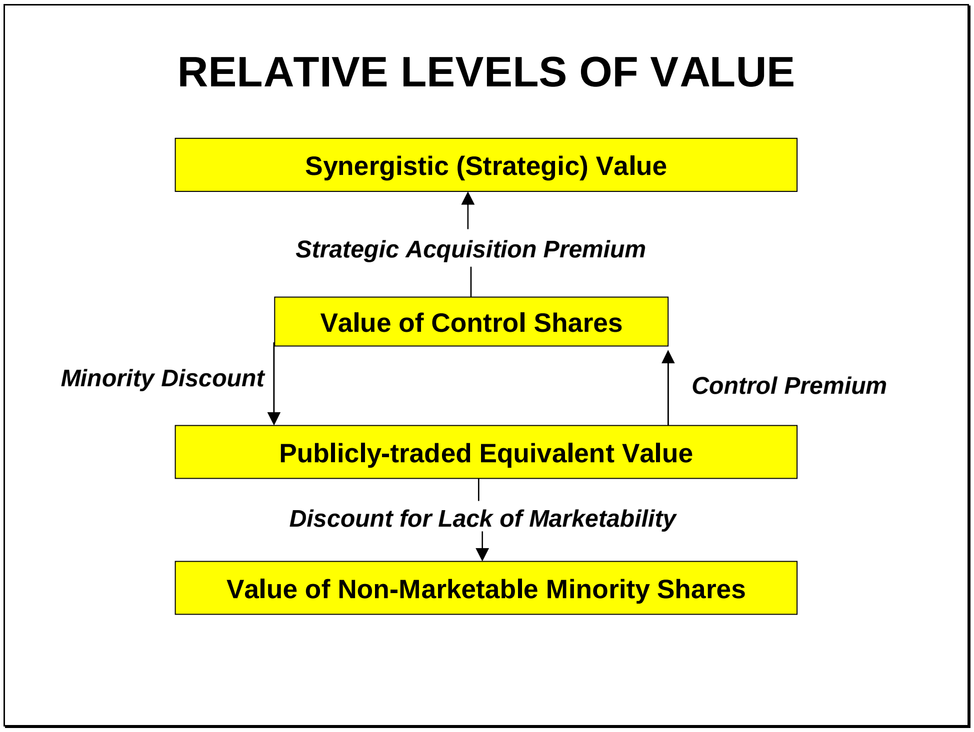
In U.S. *Revenue Ruling 77-287*[105], relating to the valuation of securities restricted from immediate resale for federal tax purposes, reference is made to an analysis by the SEC, pursuant to Congressional direction, as to the purchases, sales, and holding of securities by financial institutions, in order to determine the effect of institutional activity upon the securities market.[106] The study provides an analysis of restricted securities and deals with, *inter alia*, marketability discounts on different trading markets. It is of interest that the IRS noted that the market in which publicly-held securities are traded also reflected variances in the amount of discount that is applied to restricted securities purchases. According to the institutional Investor Study of the SEC, discount rates were greatest on restricted stocks with unrestricted counterparts traded over-the-counter, followed by those with unrestricted counterparts listed on the American Stock Exchange, while the discount rates for those shares with unrestricted counterparts listed on the New York Stock Exchange were the smallest.[107]

In *Black v. Black*[108], an Ontario matrimonial case, Walsh J., after hearing the expert valuation evidence given by this author (called by G. Montagu Black III), stated:

> " … I found the following facts to be the most determinative of the value of the husband's business interest [a 50% interest in a holding company in which the shareholder's brother, Conrad Black, owned the other 50%]: the *highly-illiquid* nature of those interests and the substantial third party debt to which they were subject; that a purchaser of them would not be buying control or a route to control of their underlying public companies … ."[109] (Emphasis added.)

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

The following graph visually depicts the difference between a minority discount and a marketability discount. It distinguishes among strategic control value, financial control value, marketable minority interest value and non-marketable minority interest value, being the four possible levels of value.[110]



There are numerous analyses and studies relating to discounts for lack of marketability of private-company shares in business valuation textbooks, valuation journals, conference presentations and various articles.[111]

Controlling interests in private companies may also suffer a discount for lack of marketability. However, in such cases, there are no empirical data that might serve as a benchmark. As the U.S. Tax Court noted in *Estate of Andrews* v. *Commissioner:*[112]

> "Even controlling shares in a non-public corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock".

The U.S. Tax Court also recognized a marketability discount on controlling interests in *Estate of Dunn* v. *Commissioner,*[113] *Estate of Jameson* v. *Commissioner*[114] and *Estate of Dougherty* v. *Commissioner.*[115]

In *Estate of Borgatello* v. *Commissioner,*[116] the court recognized a marketability discount aggregating 33%, determined as follows:

Potential tax on capital gains	25%
Restrictions on share transfer	3%
Transaction and other costs	6%
Total marketability discount	33%

PORTFOLIO AND BLOCKAGE DISCOUNTS

Portfolio Discounts

In determining the fair market value of the shares of an entity that holds a large number of individual, non-homogeneous real estate properties, securities or other investments, it may be appropriate for a "portfolio discount" to be applied (at the entity level) to the aggregate of the respective values of each of the items comprised in the portfolio. This reflects the fact that while the value of each property may represent, on an individual basis, the "highest price obtainable" (as contemplated by the term "fair market value"), the mix and quantity of the properties may result in the bundle *en bloc* being less attractive to a notional purchaser than each one viewed individually. While the notional purchaser is presumed to be attracted to the majority of the properties (acquiring the entity's shares so as to gain control and ownership of the underlying properties), the purchaser may likely wish to (imminently) dispose those considered to be the least desirable. As there may be difficulties, delays, risks and costs associated with any disposition, a notional purchaser acquiring a large portfolio of properties (comprised in the issued shares of the target corporation) should be able to negotiate a better price from the vendor. Coupled with the foregoing factors would be the concept of the "quantity discount" (because of effectively buying "wholesale").

Consideration of the portfolio discount is particularly important in the valuation of minority shares because a minority shareholder would not have the ability to cause the corporation to liquidate or redeploy the assets of the company. In such a case, the discount is applied to the aggregate value of the individual properties comprising the non-homogeneous portfolio.

In *LoCicero* v. *B.A.C.M. Industries Ltd.,*[117] the Manitoba Court of Queen's Bench (reversed by the Manitoba Court of Appeal[118] but restored by the Supreme Court of Canada),[119] held that the appraised values of individual parcels of land must be discounted for the following reasons:

- Appraisals of individual properties are unreliable indicators of fair market values of shares of large real estate companies;
- The specific nature of each property, the assumptions on the economy, local markets or financing and, most particularly, the size of a holding can vitiate the usefulness of any

valuation technique used by real estate appraisers (replacement cost, comparable sales or economic value);

- Appraisals do not reflect the varying capital structures of different companies; and
- Appraised values are in effect very spasmodic and ephemeral, and can be drastically reduced in only a few months.

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

Discounts in excess of 30% had not been unusual in the industry during the recession of the early 1980s, as market conditions were weak and in favour of the buyer. The size of the discount will depend upon market conditions, the economy, the attraction of the particular type of real estate (e.g., residential, commercial, industrial, etc.), the position of the cycle in the industry, the location of the real estate, etc.

There is abundant empirical evidence gleaned from the public markets, which supports portfolio discounts — particularly with respect to minority shareholdings. This may be categorized as follows:

- 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.[120]

An example of this last category is the break-up of Canadian Pacific Limited ("CP"). The trading price at the date of the analysts' report was $36½ and the estimated minority price in the public market if the CP shares were traded separately was estimated at $43, representing a portfolio discount of 15% (in February 2001).

Portfolio discounts have been recognized by the U.S. Tax Court in *Estate of Maxcy* v. *Commissioner*[121] and *Estate of Piper* v. *Commissioner.*[122]

A "portfolio discount" is separate and distinct from a "blockage" discount. The blockage principle stems from fundamental economics: where supply exceeds demand, the price will be lower. Hence, the price obtained in the sale of a large block of a company's shares may be less than what would be realized in smaller sales because selling pressure on the market depresses price. This recognizes the fact that market prices are based on sales in small quantities. For this reason, the holder of a large block of shares would likely sell in small amounts over a period of time rather than selling the shares *en bloc*, in which case a discount may be warranted.

Currently, portfolio discounts are substantially lower, and might be well below 10%.[123]

Blockage Discounts

A blockage discount is "an amount or percentage deducted from the current market price of publicly-traded security to reflect the decrease in the per-share value of a block of those securities that is of a size that could not be sold in reasonable period of time given normal trading volume".[124]

In *Untermyer Estate* v. *Attorney-General for British Columbia*,[125] Mr. Justice Mignault of the Supreme Court of Canada stated, in rejecting a large blockage discount:

> "All the witnesses recognized that it would have been impracticable to attempt to sell at once this large block of shares. Such a course would have broken the market where, of course, to a large extent, price is regulated by the economic law of supply and demand, and it fluctuates accordingly as one or the other of these element predominates ... I would not deduct anything from the market value of these shares on the assumption that the whole of them would be placed on the market at one and the same time, for I do not think that any prudent stockholder would pursue a like course. To make such a deduction in a case like the one at bar, would be to render the 'sacrifice value' or 'dumping value' of the shares' measure of value".

In *Corkings* v. *Collins*,[126] the Supreme of Court of Canada allowed an approximate 20% "blockage" discount from stock market price. The court held that although the price at the which the shares in question were selling on the stock exchange might be regarded as *prima facie* evidence of value, the lower courts were "quite right in declining to accept that as conclusive ... ".

Recently, the Federal Court of Appeal, in *The Queen* v. *Charles Malette*,[127] reversed the Tax Court, noting that:

> "It is undisputed that blockage discounts are an accepted principle of proper valuation methodology. The two experts who testified, the three major accrediting bodies for the [art] appraisal profession, The Appraisal Foundation and all the testimony regarding generally accepted valuation techniques are consistent on this one point — that blockage discount is an appropriate valuation methodology."

The Appeal Court concluded that "a blockage discount is not precluded by the Act, and that the Tax Court Judge erred in law in holding otherwise". The Federal Court of Appeal did not consider the Supreme Court's comments in *Untermyer*, *supra*. (A blockage discount had been denied by the Exchequer of Canada in *Dobieco Limited* v. *MNR*[128]).

In the U.S., the concept of blockage had been rejected by the IRS for many years until the courts first adopted it in the late 1930s. In 1937, the Board of Tax Appeals decided that "blockage is not a law of economics, a principle of law or a rule of evidence,"[129] but is based on the facts and circumstances of each case. The concept of blockage was finally recognized by the IRS in 1958, with the issuance of Federal Tax Regulations under Sections 2031 and 2512. Even though the IRS HAS issued regulations,[130] they are not conclusive as to objective guidance on how to actually identify and quantify a blockage discount.

A blockage discount is much less than the marketability discounts arrived at through the restricted stock studies.[131] Blockage discounts typically do not exceed to 15%, and most often are well below that. Each case is based on its specific facts and circumstances.

An analysis of U.S. court decisions and relevant valuation literature reveals a pattern of factors to be considered in order to support the determination of a blockage discount applicable to shares, if applicable:[132]

1. The percentage of shares represented by the subject block of shares relative to the number of shares outstanding of the company.
2. The share size of the subject block relative to the daily, weekly, quarterly and annual volume of shares traded in the subject stock.
3. The volatility of the price of the subject shares and the actual price changes in the stock under recent and preceding market conditions.
4. The size of trading "float" of the stock, relative to the number of shares outstanding.
5. How much daily volume could be increased without affecting price and how long it would take to "dribble out" the shares into the market.
6. Whether the shares trade on a recognized national stock exchange, over the counter, or on a regional exchange.

7. The trend of the price and financial performance of the subject shares relative to the general equity markets for the periods preceding the valuation date.
8. The dividend yield of the subject company as compared with industry and general market equity yields.
9. The current economic outlook for the business of the company, its industry and the national and regional economy.
10. The existence of recent large block trades or major secondary offering of the subject shares or the guideline companies.
11. The existence of significant news or articles on the company or industry that may have affected stock price behaviour.
12. The total number of shareholders in the company and how many are institutional investors and their proportion of ownership.
13. Any special features or attributes of the shares — voting/non-voting, different classes and so forth.
14. How many analysts follow the shares and whether there have been any recent changes in their recommendations.
15. How many market makers there are and who they are.

NON-COMPETITION AGREEMENTS

A non-competition covenant is typically executed as part of a transaction in order to protect the purchaser's investment.

New subsection 56.4(2) of the Act relates to such a covenant, as referred to in Finance's Explanatory Notes (February 27, 2004) to the Legislative Proposals and Draft Regulations Relating to Income Tax of October 7, 2003:[133]

> "Where ...
>
> A Is the amount that would be the fair market value of all the taxpayer's eligible interest[134] that is disposed of — if all of the restrictive covenants that may reasonably be considered to relate to the disposition of an interest in the business by any taxpayer were provided for no consideration, and

B Is the amount that would be the fair market value of the taxpayer's eligible interest that is disposed of if no covenant were granted by any taxpayer that held an interest in the business."

Subsection 56.4(3) provides exceptions to the income inclusion rule in subsection 56.4(2), which would otherwise require that amounts received in respect of a non-competition agreement are to be included in the vendor's income.

The allocation of the total sales proceeds between the non-competition agreement and the shares of the subject company can be subjective and judgmental, similar to situations requiring an allocation of sales proceeds among various assets of a business. The two major areas that would involve subjectivity and judgment are:

1. In identifying the proceeds allocable to the covenant, consideration is given to:

- Whether the compensation allocated to the non-competition covenant is severable from the price paid for acquired goodwill. The covenant cannot merely be protective of the goodwill acquired; it should be established that the seller could compete against the buyer if not legally restrained in this regard by the covenant. It must be demonstrated that the vendor had a probable and viable means to compete. The real and likely threat of competition from the vendor (because of the vendor's product knowledge, technical skills, employee loyalty, customer loyalty, capital resources, expertise, managerial skills, relationships, etc.) would generally be required to meet this first test. It may be necessary to demonstrate that the vendor, absent the non-competition agreement, might be inclined to compete with the purchaser, considering the former's age, ability, health, financial condition, customer and employee loyalty;
- Whether either party to the contract is repudiating an amount which is knowingly fixed by both the purchaser and the vendor as allocable to the non-competition covenant;
- The degree of evidence that both the purchaser and the vendor actually intended (when they executed the purchase agreement) that a certain portion of the price be assigned to the non-competition covenant; and
- Whether the non-competition agreement is economically real and meaningful.

2. In quantifying the value of the covenant, various methods can be used.

The most common method is the "comparative business valuation method", pursuant to which the indicated future earnings of the business are determined under one scenario having the non-competition agreement in place and another without a non-competition agreement. Under the latter scenario, the most likely level of competition must be assumed, which would not only reflect the business' lost sales revenue resulting from such competition but also the incremental expenses that would be incurred in order to fend off the effects of the competition. The fair market value of the subject business is calculated under each scenario, having regard to the risk-profile of the business in each case during the relevant period. The difference in the two values would represent the value of the agreement.

The valuator first determines what the most likely method of competition by the vendor would be and the effect thereof on the acquiree's operating results during the term of the covenant. Accordingly, two principal factors must be considered:

(a) The effect of the competing vendor attracting clients or customers from the acquiree firm,

(b) The effect of the competing vendor also attracting potential new clients or customers who might otherwise have patronized the acquiree firm.

Having created such an economic "model" of the affected business of the acquiree firm, a comparison is made between the projected results with the vendor competing with the business and those without such competition. The projected annual loss of operating cash flow is discounted back to the effective valuation date at an appropriate rate of return.

In summary, the valuation of the covenant not to compete involves the comparison of the acquiree firm's equity value *with* competition by the vendor and *without* competition, and is equal to the profits that would be lost by the subject business if the vendor were free to compete with the firm he or she sold. The judgmental factors in the quantification process include:

- The assumptions underlying the projected earnings of the subject business under each of the two scenarios (without competition and with competition);
- The financial projection period used;
- The quality of the projections;

- The estimate of lost sales absent a non-competition covenant;
- The projected sales with a non-competition covenant in place;
- The costs of implementing appropriate countermeasures (such as increased advertising, price reductions, etc.) absent the covenant;
- The capitalization multiples to apply to the net earnings of the business under each scenario, considering the different risk profiles that would prevail.

The difference in the earnings projections under each scenario, i.e., the resulting lost profits measurement, is similar to that when quantifying economic damages.[135]

The U.S. Tax Courts apply an "economic reality" test. The covenant not to compete must have some independent basis or an arguable correlation to business reality, in that reasonable persons might bargain or contract for such an agreement. The following factors have been considered by the U.S. courts:

- The seller's (i.e., covenanter's) having the business expertise to compete;
- The seller's intent to compete;
- The seller's economic resources;
- The potential damage to the buyer posed by the seller's competition;
- The seller's contacts and relationships with customers, suppliers and others in the business;
- The seller's intention to remain in the same geographic area;
- The buyer's interest in eliminating competition;
- The duration and geographic scope of the covenant;
- Enforceability of covenant not to compete under state law;
- The age and health of the seller;
- Whether payments for the covenant not to compete are pro-rata to the seller's share ownership in the company being sold;
- Whether the payments under the covenant not to compete cease upon breach of the covenant or upon the death of the seller; and
- The existence of active negotiation over the terms and value of the covenant not to compete.

In situations where there is also an employment agreement, the CRA might argue that this would prevent the possibility of competition for the term of the agreement and only after the termination thereof would the non-competition agreement take effect.

In *Thompson* v. *Commissioner*[136], the U.S. Tax Court decided that because (a) the possibility existed that the employment relationship could be terminated by either side, in which case, absent a non-competition agreement, the vendors could engage in competition, and (b) the non-competition agreement would (as was required by the bank, in this case) be part and parcel of a share-sale transaction, an employment agreement does not preclude the necessity of a non-competition agreement during the term of the former.

REASONABLE COMPENSATION — GUIDANCE FROM U.S. COURTS

One of the most typical normalization adjustments made by the business valuator (or the purchaser) in arriving at the normalized, representative net earnings of a closely-held business for valuation/pricing purposes relates to shareholder/employee (owner/manager) compensation. The compensation booked for accounting purposes and reflected on the financial statements for "owner/manager" remuneration is not often at market value; nor is it required to be. This may be for a number of reasons, including tax planning (salary/bonus/dividend mix), income splitting with other family members, etc. 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 that would subsequently be assumed by a notional replacement. It can be difficult to define the comparable services, experience and educational background, unique talents, enthusiasm/working habits, etc., that would be replaced. The essential point is that a normalized, economic, arm's length remuneration package must be imputed for purposes of normalizing profits (to which a capitalization multiple will be applied for valuation purposes). Such imputed remuneration would be substituted for that 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 an issue that arises not only in income tax issues[137] from a "reasonableness" point of view,[138] but also 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 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 for the services that are being performed by the owner-manager of the business (irrespective of what was actually being paid by the business to such individual)?

The following example may help illustrate the importance of this issue. Assume that, except for “owner/manager” remuneration, the normalized representative net after-tax maintainable profits of a business are $600,000, and that the owner/manager compensation that had been booked for accounting purposes was $400,000. If a reasonable level of compensation for the services was only $100,000, a pre-tax adjustment of $300,000 would be required for valuation purposes. Assuming a 40% income tax rate, the after-tax adjustment (add-back) to normalize earnings would be $180,000 ($300,000 – $120,000). If the appropriate capitalization multiple[139] 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 $1,440,000 (8 × $180,000), a material amount relative to the value of the company, $6,240,000 [8 × ($600,000 + 180,000)].

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 different circuits.

One of the early U.S. cases that provided comprehensive criteria to evaluate compensation levels was *Mayson Mfg. Co.* v. *Commissioner,*[140] 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:

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*[141], 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.
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*,[142] 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*[143], 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, 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).[144]
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 Court of Appeals 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.

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,[145] 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;[146] and (d) comparative (guideline) market rates of return to be used as benchmarks.[147]

In *Owensby & Kritikos Inc.*,[148] 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 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".[149]

If the shareholder/employee is a key person, further considerations may be required for purposes of arriving at the fair market value of the business. This is discussed in the following section of this paper.

KEY-PERSON EFFECT ON VALUE

In valuing the shares of a corporation, consideration is given to the possibility that the loss of a key executive[150] may have a negative effect on the business and, hence, the value of its issued shares, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. The extent of the loss may also relate to the timing of the key manager's departure.

However, there may be situations in which the nature of the business and its assets may be such that there will be no impairment due to the loss of the key person's services; the loss may be adequately covered by life insurance, or competent replacement management might be employed at the same consideration paid for the key person's services. These, and other offsetting factors, if found to exist, are carefully weighed against the loss of the key person's services in valuing the shares of the enterprise.[151]

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

In *Les Placements A&N Robitaille Inc.* v. *MNR*[152], Mr. Justice Archambault of the Tax Court of Canada recognized that Mr. Robitaille, who played a key role in his company's business (a small-scale operation which reconditioned defective boats imported from the United States) was the key man in the operation of the company's business and had substantial personal goodwill:

> "In order to take account of Mr. Robitaille's personal goodwill, I believe that it is essential to recognize a key-man discount, as Mr. Wise did in his report. The evidence clearly established that Mr. Robitaille plays a preponderant role in the operation of this business. I am satisfied that if Mr. Robitaille were to leave the business, Marina Quebec would suffer a substantial reduction in its earnings. In the circumstances, I believe that it is reasonable to use a discount rate of 35%."

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

Justice Archambault noted that the personal goodwill that Mr. Robitaille had did not mean that no commercial goodwill could coexist in the corporation.

Key-person discounts have been recognized in the United States courts for over seventy years,[153] in circumstances under which existing or prospective management could not properly take over the duties of the deceased.

In a U.S. Tax Court decision, *Estate of Milton Feldmar* v. *Commissioner*[154], Judge Fay noted:

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

The court also stated:

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

> comparable to those of the decedent, we shall reduce the key employee discount to be applied from 35% to 25% to account for such potentiality".

In *Estate of Rodriguez et al* v. *Commissioner*[155], Judge Williams reduced the company's future earnings (instead of applying a discount to the share value otherwise determined) in recognizing the loss of the key man:

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

Key-person valuation discounts may be applied by way of:

- A reduction of normalized earnings to arrive at a maintainable level of earnings absent the key person;
- A reduction of the capitalization multiple that would otherwise be applied to the unaffected earnings;
- A reduction of estimated future cash flows or earnings to be discounted[156];
- A reduction, as a separate discount, from the fair market value of the business otherwise arrived at.

The factors considered in estimating the size of the key-person discount include:

- The amount of key-person life insurance proceeds payable to the business;
- The availability of competent new management who can be hired at the salary and benefits formerly paid to the key person;
- The existence of a current employee or management team that has been groomed to take over the key person's responsibilities; and
- The extent of the key person's day-to-day involvement in the business.

Moreover, a so-called "cost to cure" method can be used when it is possible to (a) identify the risk of losing the services of the key person and (b) estimate the expense that might be incurred by the business to remedy its financial exposure. To estimate the key-person discount, an estimate of the salary and other related costs to hire a potential replacement of the key person if he or she were to leave. Such additional compensation would be capitalized at the business' rate of return.

THIRD-PARTY CIVIL PENALTIES

The third-party civil penalties under section 163.2 of the Act also apply to (a) business valuators who provide an opinion in connection with a proposed scheme/shelter that could be used by unidentified investors (such as a limited partnership tax shelter to be marketed by a promoter) and (b) business valuators who provide an opinion for a specific taxpayer (or for a number of persons who can be identified), such as in tax or estate plan.

The penalties were originally aimed at promoters who developed schemes for providing taxpayers with large capital cost allowance claims on inflated asset values (e.g., computer software, seismic data, etc.) or income and estate tax planning where fair market value was "misstated". The tax-shelter promotions were typically accompanied by business valuation opinions. The Canadian Act employs the term, "fair market value", as does the U.S. income and estate tax law.[157]

The CRA states 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.[158]

Business valuators have expressed their concern to the CRA that a simple "valuation review" might no longer be sufficient for tax-related valuations and, accordingly, valuators performing tax-purpose business valuations will have to protect themselves from these penalties by preparing full opinions pursuant to the Standards promulgated by the CICBV. The effect of this might mean that income tax reorganizations, estate freezing, etc., as well as valuations for deceased taxpayers may end up being too costly for small-business taxpayers. The CRA does not anticipate invoking civil penalties against reasonable good-faith valuations prepared for such purposes. Also, it should be noted that the CICBV recently adopted additional standards that address fair market value "estimates"[159] and fair market value "calculations"[160] (as opposed to full, comprehensive "opinions").

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

The exculpatory provisions 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. The penalty against business valuators can be severe. The CRA will not invoke the penalty provisions if the valuator's fair market value opinion falls outside of the "prescribed range" provided that it 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. This reference to "assumptions" is directly 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. These valuations are 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" the "hockey-stick" projections prepared by the promoters, the penalty will be invoked. To avoid the penalty, the assumptions used (or accepted) by the valuator must be:

- supported;
- reasonable; and
- not purely hypothetical.[161]

Depending on the ultimate *purpose* and *use* of a tax-related valuation opinion, the third-party civil penalty would be as follows:

"Planner Penalty"

> A business valuator who renders a valuation opinion for a proposed tax shelter (e.g., in connection with an offering of units in a limited partnership), which could be used by a number of *unidentified* investors, could, if his or her opinion is considered to be a "false statement" under a prescribed formula (not yet determined by Finance and Revenue), face a penalty of (a) $1,000, or (b) an amount equal to the valuator's total professional fees for the valuation, whichever is greater.

"Preparer Penalty"

> A business valuator who is found to have made, or participated in, or assented to, or acquiesced in the making of, a false statement (which would include a valuation opinion misstatement) that could be used for purposes of tax planning for a specific taxpayer or a number of persons *who can be identified*, will be subject to a penalty[162], equal to the greater of:

(a) $1,000, and

(b) the lesser of:

(i) the penalty to which the taxpayer (generally the valuator's client) was subject because the taxpayer filed a tax return knowing that the valuation opinion was misleading; and

(ii) $100,000 plus the valuator's gross compensation for the misleading valuation opinion.

The "preparer penalty" therefore also applies to "an appraiser or valuator preparing a report for a specific taxpayer or a number of persons who can be identified".[163]

Valuations for purposes of purchase price allocations and transfer-pricing valuations can also expose the business valuator to this penalty.

IRS VALUATIONS

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

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

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

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

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

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

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

As noted earlier, while the CRA does not address the issue of marketability in *IC 89-3*, or any of the above-noted Interpretation Bulletins, the IRS addresses the marketability issue in *Revenue Rulings 59-60, 77-287 and 83-120.*

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

The IRS had established an Appraisal Policy Working Group and has developed Business Valuation Guidelines for its "Valuation Engineers, Appraisers, Valuation Specialists, and others engaged in valuation practice".[164] These relate to the development, resolution and reporting of issues involving business valuations, stating that, "valuators must be able to reasonably justify any departure from these guidelines", noting that the Guidelines incorporate, by reference, the Code of Conduct applicable to all IRS employees and all provisions of *Internal Revenue Manual 4.3.16*. Appended to the Guidelines are the International Glossary of Business Valuation Terms ("Exhibit BVG-1"), adopted by The Canadian Institute of Chartered Business Valuators, The American Institute of Certified Public Accountants, American Society of Appraisers, National Association of Certified Valuation Analysts and The Institute of Business Appraisers and Exhibit BVG-2, Valuation Report Checklist, used to assist IRS valuators. It provides authoritative references to *The Principles of Appraisal Practice and Code of Ethics* of the American Society of Appraisers, the *Uniform Standards of Professional Appraisal Practice* of the Appraisal Standards Board of The Appraisal Foundation, and the Standards of the Institute of Business Appraisers.

In Canada, the CRA has stated that its business valuators comply with the Practice Standards[165] promulgated by the Canadian Institute of Chartered Business Valuators.[166]

The CRA has established business valuation programs.[167] The CRA's valuation group is responsible for advising as to the fair market value of closely-held and publicly-traded securities, partnerships, proprietorships, copyrights, royalties, patents, goodwill, financial instruments and other business equities for income tax purposes. It also provides expert opinions on technical valuation and related issues, which are prepared in conformity with the CICBV Standards and Ethics.

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

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 Business Valuation Guidelines published by the IRS. The CRA purposely keeps its national valuation policies to a minimum — essentially the policies contained in *IC 89-3*.

The Department's reasoning is as follows:

> " … a significant body of policies would compromise the independence of departmental valuators by requiring them to employ valuation methodology dictated by their employer rather than their own professional judgment. This is not an insignificant issue. Departmental valuators have been criticized in court by lawyers attempting to undermine their credibility by claiming that their values were based on government policy rather than their independent opinion.
>
> "National valuation consistency and independent valuation opinions are mutually exclusive goals; any move towards one of these adversely affects the other. Since independence is necessary for us to provide sustainable opinions the amount of comfort we can give taxpayers through formal valuation policies is limited. As a result our national policies are kept to a minimum.[168]

The U.S. Tax Court, in *Estate of Thomas A. Fleming* v. *Commissioner*[169], added a footnote in its decision, attempting to encourage taxpayers and the IRS to settle, rather than litigate, disputes regarding fair market value:

> " … we take this opportunity, as we did before and after the trial of this case, to remind the parties that questions of fair market value, like the one that is presented here, are

> generally more properly resolved through the give and take of settlement negotiations by the parties, rather than adjudication by the Court.
>
> "This pressure to settle is becoming increasingly prevalent in many courts. Most courts are not anxious to hear valuation cases."

CONCLUSION

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

Courts often favour "real world" solutions based on actual similar transactions or on valuation methods commonly applied in pricing a particular type of business for an actual transaction — rather than more theoretical indications of value — unless there is strong evidence that those methods are not appropriate in the specific case. The Tax Court of Canada may be inclined to side completely with the party whose valuation is more complete, realistic, thorough and better presented.

Considering the subjective and judgmental nature of the valuation process, if the Practice Standards promulgated by The Canadian Institute of Chartered Valuators will be adhered to by both the taxpayer's valuator and the CRA's valuator, this may help narrow the often wide gaps in the respective fair market value ranges arrived at in the valuation of a corporation's shares.

ENDNOTES TO
<u>"VALUATION ISSUES RELATING TO SHARES OF PRIVATE CORPORATIONS"</u>

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

(2) See, for example, M.G. Miles, *The Business Appraiser and Litigation Support*, John Wiley & Sons Inc. (New York: 2001); Richard M. Wise, *Financial Litigation — Quantifying Business Damages and Values*, Canadian Institute of Chartered Accountants (Toronto: loose-leaf service); and John A. Bogdanski, *Federal Tax Valuation*, Warren, Gorham & Lamont (Valhalla, NY), loose-leaf service.

(3) For a discussion of the valuation methodology, see, Richard M. Wise, Jay E. Fishman and Shannon P. Pratt, *Guide to Canadian Business Valuations*, Carswell (3 Volumes: loose-leaf service), Chapter 5, Vol. 1.

(4) *Ibid.*, Chapter 6, Vol. 2.

(5) See *Information Circular* 89-3, "Policy Statement on Business Equity Valuations", dated August 25, 1989, Paragraph 5(i) ("*IC 89-3*").

(6) Richard M. Wise, "Valuations and Price-Adjustment Clauses", *Report of the Proceedings of the Fiftieth Tax Conference*, Canadian Tax Foundation (Toronto: October 25-28, 1998), pp. 33:1-33:50.

(7) Subsection 129(1) of the *Income Tax Act*, RSC 1985 c.1 (5th Supp.), as amended (the "Act").

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

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

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

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

See S.P. Pratt, R.F. Reilly and R.P. Schweihs, *Valuing a Business*, Fourth Edition, McGraw-Hill (New York: 2000), pp. 376-379.

(9) For example, subsection 2(1) of the *Canada Business Corporations Act*, RSC, 1985, c. C-44, as amended (the "CBCA") requires a two-thirds vote to pass a special resolution.

(10) *Supra*, Note 1.

(11) *Supra*, Note 3.

(12) *Supra*, Note 3.

(13) Section 190, addressing the shareholder dissent remedy.

(14) Canadian Institute of Chartered Accountants *Handbook* ("Handbook"), Section 1581.

(15) Handbook, Section 3062.

(16) Handbook, Section 1625.

(17) See Richard M. Wise, "Valuations and Price-Adjustment Clauses", *Report of the Proceedings of the Fiftieth Tax Conference*, Canadian Tax Foundation (Toronto: October 25-28, 1998), pp. 33:1-33:50.

(18) Section 163.2 of the Act.

(19) For example, section 190 of the CBCA.

(20) *Re Domglas Inc.*, (1980) 13 BLR 135; 1980 CS 925 (Que. S.C.); aff'd (1982) 138 DLR (3d) 521 (QCA).

(21) *American General Corp.* v. *Camp* (1937), 190 A. 225; *Roessler* v. *Security Savings & Loan Co.* (1947), 72 N.E. 2d 259; *Phelps* v. *Wattson-Stillman Co.* (1956), 293 S.W. 2d 429; *Warren* v. *Baltimore Transit Co.* (1959), 154 A. 2d 796; *Woodward* v. *Quigley*, 133 N.W. 2d 38; *Felder* v. *Anderson Clayton & Co.*, 159 A.2d 278; *Southdown Inc.* v. *McGinnis*, (1973), 510 P. 2d 636; *Re Libby, McNeill & Libby*, 406 A. 2d 54; *Tri-Continental Corporation* v. *Battye*, 74 A.2d 71; *First National Bank in Cedar Falls* v. *Clay*, 2 NW 2d 85; *Levin and Lynch* v. *Midland-Ross Corp.*, 194 A.2d 853.

(22) James C. Bonbright, McGraw-Hill Publishing Company (New York: 1937), 2 Volumes.

(23) B. Graham, D.L. Dodd and S. Cottle, *Security Analysis*, Fourth Edition, McGraw Hill Book Company (New York: 1962).

(24) [1975] 1 WWR 621 (3d) 733 (BCSC), 50 DLR (3d) 733.

(25) *Supra*, Note 21.

(26) [1980] 5 WWR 543 (Sask. Q.B.).

(27) (1975), 376 NY 2d 103.

(28) (1998), 42 OR (3d) 177 (CA).

(29) [2000] 2 CTC 2211; aff'd [2002] DTC 6874 (FCA).

(30) *Johnson* v. *CIR*, 85 TC 469; *Trip* v. *CIR*, 337 F.2d 432 (CA); *Publicker* v. CIR, 206 F.2d 250 (CA); *Guggenheim* v. *Rasquin*, (1941), 312 US 254 (USSC); and *Adams* v. *CIR*, 50 TCM (CCH) 48.

(31) 2004 TCC 147 (under appeal as of September 7, 2004).

(32) *Lio* v. *Commissioner*, 85 TC 56; *Goldstein* v. *Commissioner*, 89 TC 38; *Hunter* v. *Commissioner*, TC Memo 1986-308, 51 TCM (CCH) 1537; *Chiu* v. *Commissioner*, 84 TC 722.

(33) 51 TCM (CCH) 1533.

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

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

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

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

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

(39) 65 DTC 405 (TAB).

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

(41) 62 DTC 64.

(42) (1978) CTC 669 (FCTC); aff'd (1979) CTC 365 (FCA).

(43) 85 DTC 5494.

(44) 85 DTC 341.

(45) This issue has been addressed by the American courts in *Ahmanson Foundation* v. *U.S.*, 674 F. 2d 761 (9th Cir. 1981), *Curry Estate* v. *U.S.*, 706 F. 2d 1424 (USCA 7th Cir. 1983) and *Citizens Bank and Trust Co.* v. *Commissioner*, 839 F. 2d 1249 (7th Cir. 1988). *Estate of Curry* v. *U.S.*, 83-1 USTC, paragraph 13,518; 51 AFTR 2d 83-1232 (7th Cir. 1983), is commented on below.

(46) See, for example, W.D. Goodman, QC, "Valuation of a Fifty Per Cent Shareholding", *The Journal of Business Valuation*, The Canadian Institute of Chartered Business Valuators (Proceedings of the Fifth Biennial Conference), October 1980, p. 24. See also S.P. Pratt, *Business Valuation Discounts and Premiums*, John Wiley & Sons Inc. (New York: 2001), p. 28.

(47) *Supra*, Note 45.

(48) [1952] 2 All ER 775 (PC).

(49) 81-2 USTC, paragraph 13,438; 674 F. 2d 761 (9th Cir. 1981).

(50) 83-1 USTC, paragraph 13,518; 51 AFTR 2d 83-1232 (7th Cir. 1983), at 87,289.

(51) 91 DTC 1392 (TCC).

(52) (1977), 4 BCLR 134 (BCSC).

(53) [1972] 5 WWR 23; aff'd [1973] CTC 562 (BCCA); aff'd [1974] CTC 222 (SCC).

(54) Paragraphs 32 to 37.

(55) Paragraph 32.

(56) For example, "exclusionary dividend shares" and "special rights preferred shares" ("special shares").

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

(58) 26 CFR 25.2512-1, Valuation of property; in general.

(59) 680 F. 2d 1248 (1981).

(60) 658 F. 2d 999 (1981).

(61) 79 TC 938 (1982).

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

(63) John Wiley & Sons Inc. (New York: 2001), page 142.

(64) 86 DTC 6311 (Trial Division).

(65) [1971] 3 All ER 914, (1971) 3 WLR 759 (HL).

(66) [1963] SCR 455.

(67) [1939] AC 302, [1939] 2 All ER 317 (P.C.).

(68) (1982), 20 BLR 21 (BCSC).

(69) (1978), 78 DTC 6349, at 6356.

(70) 83 DTC 388 (Tax Review Board).

(71) 85 DTC 388 (Tax Review Board).

(72) [1976] CTC 379, 76 DTC 6210 (FCTD); aff'd, [1978] CTC 235, 78 DTC 6179 (FCA).

(73) See, for example, *Verdun* v. *Verdun* (1994), 9 RFL (4th) 54 (Ontario Court of Justice — General Division); and *Simms* v. *Simms* (1996), 20 RFL (4th) 147 (New Brunswick Court of Queen's Bench).

(74) W.D. Goodman, QC, "Valuation of Shares: Some Areas of Controversy", *The Journal of Business Valuation*, Vol. 3, December, 1976 (Proceedings of the Third Biennial Valuation Conference), page 43.

(75) [1914] 1 KB 339, [1914] 3 KB 466, a case under subsection 25(1) of the U.K. *Finance Act*, 1910.

(76) [1938] AC 321.

(77) *Supra*, Note 67.

(78) *Supra*, Note 75.

(79) *Inland Revenue Commissioners* v. *Crossman* [1937] AC 26 (HL), rev'g [1935] 1 KB 26.

(80) *Supra*, Note 64.

(81) T.C. Memo No. 86-504.

(82) *Supra*, Note 75.

(83) [1915], 52 Sc LR 414 (Valuation Appeal Court).

(84) [1904] 1 KB 417.

(85) [1909] 1 KB 16.

(86) *International Glossary of Business Valuation Terms.*

(87) *Supra*, Note 67.

* "An interesting article recently published in the United States makes a strong case that this should be done. See Alan L. Feld, "The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares", 1974 University of Pennsylvania Law Review, 934. In *Holt* v. *IRC,* [1953] 2 All E.R. 1499, Danckwerts, J. dealt with the problem of valuing a minority interest held by a member of a family in a corporation controlled by the family. He felt bound by the *Crossman Estate* case, *supra* to ignore the fact that the family would be certain to purchase the shares (which they had the right to do under the articles) and felt bound to assume that an outside purchaser (who would not participate in control) would acquire them. *Quaere:* To what extent would this be followed in Canada?"

** "In the Australian case, *Cattanach* v. *Water Conservation* & *Irrigation Commission*, [1963] N.S.W.R. 304, it was indicated that 'fair market value' does not connote anything different from 'value to the owner'."

(88) D.A. Ward, QC, "Fair Market Value and the Income Tax Act", *The Journal of Business Valuation*, Vol. 2, No. 1, November, 1974 (Conference Proceedings of the Canadian Association of Business Valuators, Toronto), pp. 24-26.

(89) 91 DTC 1392 (TCC)"

(90) 79 DTC 764.

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

(92) S.P. Pratt, R.F. Reilly and R.P. Schweihs, *Valuing a Business* (Third Edition), Irwin Professional Publishing (Chicago: 1996), p. 46. See also, S.P. Pratt, R.F. Reilly and R.P. Schweihs, "Distinction between Discount for Lack of Control and Discount for Lack of Marketability", Chapter 3, *Valuing a Business* (Fourth Edition), McGraw-Hill (Chicago: 1990), pp. 50 ff.

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

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

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

(96) 53 Fed. Cl. 341, 2002 U.S. Claims LEXIS 221.

(97) TC Memo 1985-363, 1985 Tax Ct. Memo LEXIS 273 (July 22, 1985)

(98) TC Memo 1995-255, 1995 Tax Ct Memo LEXIS 256 (June 12, 1995).

(99) 110 TC 530, 110 TC No. 35 (June 30, 1998).

(100) *Estate of True*, TCM 2001-167.

(101) The increment is computed as the difference between (a) the total discount on large shareholdings relative to the total issued and outstanding shares and (b) the average discount for shares that have attributes similar to the private-company shares being valued.

(102) See, for example, J. Hatch, "Discount for Lack of Marketability: Do IPO Studies Tell Us Everything?", *Business Valuation Review*, American Society of Appraisers, Vol. 23, No. 1, March 2004, pp. 10-13; M. Hertzel and R.L. Smith, "Market Discounts and Shareholder Gains For Placing Equity Privately", *Journal of Finance*, Vol. XLVIII, No. 2, June 1993, pp. 459-485; W. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices", *Financial Analysts' Journal*, July/August 1991, pp. 60-64; S.P. Pratt, *Business Valuation Discounts and Premiums*, John Wiley & Sons Inc. (New York: 2001), pp. 152-163; M.A. Lerch and L. Kumar, "The Graphic Measurement of Marketability Discounts from IPOs on Common Stocks — June 1997 Through March 2000", *Business Valuation Review*, American Society of Appraisers, Vol. 22, No. 2, June 2003; A.B. Abbott, "Discount for Lack of Marketability: An Empirical Analysis", *Business Valuation Review,* American Society of Appraisers, Vol. 22, No. 4, December 2003, pp. 172-179.

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

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

(105) 1977-2, C.B. 319, amplifying *Revenue Ruling* 59-60 (C.B. 1959-1,237), as modified by *Revenue Ruling* 65-193.

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

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

(108) (1988), 18 RFL (3d) 303 (Ontario HC).

(109) At 313.

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

(111) See, for example, *Business Valuation Review*, Quarterly Publication of the Business Valuation Committee of the American Society of Appraisers; S.P. Pratt, *Business Valuation Discounts and Premiums*, John Wiley & Sons Inc. (New York: 2001), pp. 152-163; Z.C. Mercer, *Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests*, Peabody Publishing, LP (Memphis, Tenn.: 1997); various conference proceedings of the American Society of Appraisers and of The Institute of Business Appraisers; Richard M. Wise, "Valuations and Price-Adjustment Clauses", *Report of the Proceedings of the Fiftieth Tax Conference*, Canadian Tax Foundation (Toronto: October 25-28, 1998), pp. 33:1-33:50.

(112) 79 TC 938 (1982).

(113) TC Memo 2000-12, 79 TCM (CCH) 1337.

(114) TC Memo 1999-43, 77 TCM (CCH) 1383.

(115) TC Memo 1990-274, 59 TCM (CCH) 772.

(116) TC Memo 2000-264, 80 TCM (CCH) 260.

(117) 31 Man. R. (2d) 208.

(118) [1986], 25 DLR (4th) 269; (1986), 38 Man. R. (2d) 134; [1986] WWR 152.

(119) [1988] SCR 399 (SCC).

(120) 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.

(121) TC Memo 1969-158, 28 TCM (CCH) 783 (1969).

(122) 72 TC 1062 (1979).

(123) For a discussion concerning blockage discounts, see Wolfe D. Goodman, QC, "Some Current Valuation Problems Raised by Recent Cases", *The Journal of Business Valuation*, Proceedings of the Seventh Biennial Conference of The Canadian Association of Business Valuators (Toronto: November 5 and 6, 1984), pp. 93-95; and Richard M. Wise, "Discounts in Arriving at Share Values of Closely-Held Corporations", *The Journal of Business Valuation*, Proceedings of the Second Joint Business Valuation Conference of The Canadian Institute of Chartered Business Valuators and the American Society of Appraisers (Vancouver: October 11 and 12, 1990), pp. 145-148.

(124) *International Glossary of Business Valuation Terms*.

(125) [1929] SCR 84; [1929] DLR 315.

(126) [1936] SCR 37.

(127) 2004 FCA 187.

(128) 63 DTC 1063.

(129) *Safe Deposit & Trust Co. of Baltimore* v. *Commissioner*, 35 BTA 259 (1937), 127 F.2d 214 (29 AFTR 209).

(130) Federal Tax Regulations 20.2031-2(e) and 25.2512-2(e).

(131) See, for example, Milton Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely Held Company," *Journal of Taxation*, June 1972, pp. 353-354; Robert R. Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities", *Taxes*, June 1977, pp. 381-385; Robert E. Moroney, "Most Courts Overvalue Closely Held Stocks", *Taxes*, March 1973, pp. 144-154; and Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, "Discount for Lack of Marketability" (Chapter 25) in *Valuing Small Businesses and Professional Practices*, Third Edition, McGraw-Hill (New York: 1998), pp. 445-475.

(132) Philip W. Moore, "Blockage Redux", *Trusts and Estates*, February 1992; J. Michael Julius, "Blockage Discounts and Restricted Stocks", *Mercer Capital Value Added*, Vol. 6, No. 3, 1994.

(133) Finance Canada Release 2003-049.

(134) New subsection 56.4(1) defines "eligible interest" of a taxpayer to be capital property of the taxpayer that is (a) a partnership interest in a partnership that carries on a business, or (b) a share of the capital stock of a corporation that carries on a business. For purposes thereof, "taxpayer" includes a partnership.

(135) See Richard M. Wise, "Quantification of Economic Loss", *The Civil Law of Damages*, McGill University Faculty of Law (Montreal, 1996); and Richard M. Wise, "Quantification of Economic Damages", *The Journal of Business Valuation*, Proceedings of the 1998 Joint Advanced Business Valuation Conference, The Canadian Institute of Chartered Business Valuators and the American Society of Appraisers, Carswell Thomson Professional Publishing (Montreal, 1998), pp. 361-412.

(136) T.C. Memo, 1997-287.

(137) 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.*

(138) 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.

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

(140) 178 F.2d 115 (6th Cir. 1949).

(141) 716 F.2d 1241, 1245-46 (9th Cir. 1983).

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

(143) 196 F.3d 833 (7th Cir. 1999).

(144) *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.

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

(146) 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.

(147) The benchmark rate of return on equity should be that which would apply to the subject business. For an example of how the rate of return (capitalization rate or discount rate) is developed 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.

(148) 819 F.2d 1315, 60 AFTR 2d 87-5224 (CA-5, 1987).

(149) 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).

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

(151) See IRS *Revenue Ruling 59-60*, section 4.02(b). See, also, Richard M. Wise, "Discounts in Arriving at Share Values of Closely-Held Corporations", *The Journal of Business Valuation*, Proceedings of The Second Joint Conference of The Canadian Institute of Chartered Business Valuators and American Society of Appraisers (Vancouver, 1990), pp. 127 ff.

(152) 96 DTC 1062 (TCC).

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

(154) 56 TCM 118 (1988).

(155) 56 TCM 1033 (1989), at 1039.

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

(157) For certain differences between the "fair market value" standards in the U.S. and Canada, 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, pp. 122-127.

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

(159) The Estimate Valuation Report "contains a conclusion as to the value of shares, assets or an interest in a business that is based on limited review, analysis and corroboration of relevant information, and generally set out in less detailed Valuation Report. (CICBV Standard 110.)

(160) The Calculation Valuation Report "contains a conclusion as to the value of shares, assets or an interest in a business that is based on minimal review and analysis and little or no corroboration of relevant information, and generally set out in a brief Valuation Report. (CICBV Standard 110.)

(161) See, for example, Standard 9-2(g) of the *Uniform Standards of Professional Appraisal Practice* in the United States, where use of hypothetical conditions must result in a credible analysis.

(162) Subsection 163.2(5) of the *Act*.

(163) Subsection 163.2(4) of the *Act*.

(164) The Guidelines are available on the Web at http://www.bvresources.com/FreeDownloads/irs-guidelines.pdf.

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

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

(167) Business Equity Valuation Program.

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

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