Valuation by Compromise in the Tax Courts: Myth or Reality?

Elizabeth Shultis and Stephen Smith*

PRÉCIS

Des causes, entendues de 1971 à 1991, ayant trait à l'impôt sur le revenu et comportant des questions d'évaluation, sont examinées dans cet article. La recherche visait à établir la véracité de la notion largement répandue selon laquelle les tribunaux statuant sur des questions fiscales établissent des valeurs de compromis entre celles présentées par les parties en litige. Par suite de la recherche, l'auteur conclut que des valeurs de compromis se retrouvent dans un nombre infime de causes.

ABSTRACT

This article examines income tax cases involving valuation issues from 1971 to 1991. The purpose of the research was to determine the truth of the widely held notion that the tax courts find compromise values between alternatives presented by the litigants. On the basis of the research, the article concludes that compromise values are found in only a small percentage of cases.

INTRODUCTION

In dealing with V-day valuations and other income tax related valuation matters, professionals and taxpayers often question how the matter would be decided if it came to litigation. Many seem to think that the process merely involves having the taxpayer and the minister employ experts to take extreme positions on the value of the business or property interest and relying on the court to determine a compromise value. The question that needs to be answered is whether this is a realistic view of what actually happens in income tax litigation.

In 1963, an American economics professor, Chelcie C. Bosland, wrote an article entitled "Tax Valuation by Compromise."[1] His thesis was that, in valuation matters before the courts, there is a tendency to find a compromise value between the opposing positions taken by the taxpayer and the Internal Revenue Service. In his opinion, the extreme positions taken by the parties work against a moderate approach to valuation and "place

* Ms Shultis is of Revenue Canada, Taxation, and Mr. Smith is of Peat Marwick Thorne, Mississauga, Ont.

[1] Chelcie C. Bosland, "Tax Valuations by Compromise" (November 1963), 19 *Tax Law Review* 77-89.

a premium on highly polarized valuation positions which make sound decisions much more difficult for the court."[2]

Bosland based his study on 106 valuation cases involving 133 valuations covering estate or gift tax, income taxation, and capital gains taxation during the period 1944 to 1960. His interest in the research arose because of the difficulties in valuing ownership interests where there is no listed market price, as in the case of shares in closely held businesses. Usually, a "fair market value" determination is required for tax purposes.

At the Second Joint Business Valuation Conference of the Canadian Institute of Chartered Business Valuators and the American Society of Appraisers in 1990, Alan Jones, the chief valuator for Revenue Canada, Taxation, challenged the Canadian business valuation profession to make a similar study.

THE PRELITIGATION PROCESS

In order to assess the results of the research on Canadian cases, one must consider the context within which valuation matters are dealt with by Revenue Canada and Canadian taxpayers. Mr. Jones provided an overview of how valuation matters between taxpayers and the minister are dealt with by Revenue Canada,[3] and we repeat it here because it is integral to our research. The three-step prelitigation process can be summarized as follows:

1) Revenue Canada valuators are provided with all required information.

2) The client's representative may seek an explanation of Revenue Canada's valuation.

3) The parties negotiate.

Step 1 of the process deals with the need to provide Revenue Canada's valuator with all of the information requested as early as possible. These information requirements are set out in *Information Circular* 89-3, paragraph 16, and may include such documentation as the basis for declared values, financial statements, copies of relevant appraisals, shareholders' agreements, arm's-length offers, shareholder lists, and other information.[4]

Step 2 involves a process whereby the taxpayer or, more likely, a valuator engaged by the taxpayer has an opportunity to ask for explanations of Revenue Canada's valuation.

Step 3 is the negotiation process. Mr. Jones noted that "[t]he Departmental valuator is required to try to reach a settlement. Both sides should be willing to listen to the other side's position, and should be prepared to

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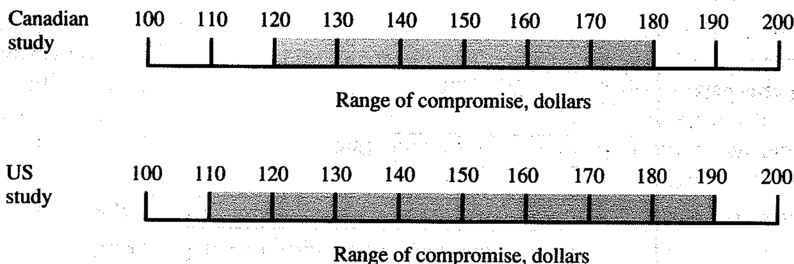
[2] Ibid., at 78.

[3] D. Alan Jones, "Current Tax Issues Affecting Valuations in Canada" [1991] *The Journal of Business Valuation* 177-84.

[4] *Information Circular* 89-3, "Policy Statement on Business Equity Valuations," August 25, 1989, paragraph 16.

Figure 1 Definition of Compromise in Canadian and US Studies



make concessions based on facts. There should be an attempt by both sides to see the merits in the other's arguments, and to arrive at a conclusion satisfactory to both parties."[5]

Under the process of negotiation described by Mr. Jones, one might assume that valuation matters would be litigated only in cases in which extreme views were held. After all, there seems to be ample opportunity for compromise on the way to the courtroom. However, between 1971 and 1991, there were a number of instances in which the process of negotiation that Mr. Jones described did not work, and the matters were litigated. One wonders whether these valuation matters were at all conducive to compromise or negotiation.

CASE REVIEW

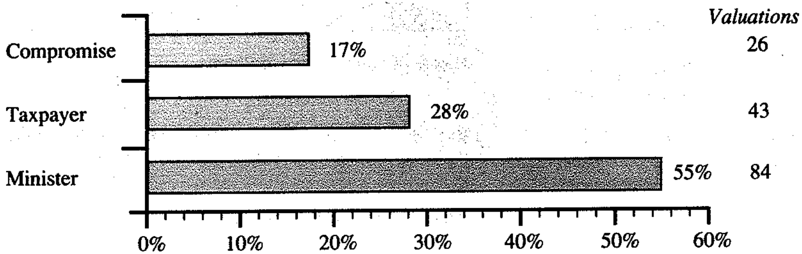
From a comprehensive database of reported Canadian federal income tax cases involving valuation issues, we researched the case results in order to determine whether the court decisions support the theory that the courts tend to find a compromise. We reviewed 130 reported cases, including appeals, heard from 1971 to 1991. Included in these cases were 153 valuation issues involving shareholdings in private and public companies as well as various other business interests.

For the purposes of our study, the range of compromise was defined as 60 percent of the difference between the values contended. This is illustrated in figure 1. (For illustrative purposes, the valuations in figure 1 are assumed to be $100 and $200.) This range of compromise is somewhat narrower than that chosen by Bosland for the purposes of the US study; he used 80 percent of the difference, as illustrated in figure 1. We used the 60 percent range because we believed that it would provide a more meaningful definition of compromise.

Figure 2 demonstrates that the minister's position was favoured in almost 55 percent of the valuation issues reviewed. In 28 percent of the valuations, the taxpayer's position was favoured. Quite surprisingly, and

[5] Supra footnote 3, at 184.

Figure 2 Rate of Success by Minister and Taxpayer and Incidence of Compromise



contrary to popular belief, the courts found a compromise value in only 17 percent of the valuations.

What surprised us was that, in many of the cases, the decision was squarely in favour of one party or the other and the court agreed fully with one of the values contended. As the following illustrates, this was the case in over 75 percent of the valuations at issue.

	Number of valuations	*Percent*
Exactly the same as taxpayer's valuation	42	27.5
Within 20 percent of taxpayer's valuation	1	0.7
Exactly the same as minister's valuation	74	48.3
Within 20 percent of minister's valuation	10	6.5
Within range of compromise	26	17.0
	153	100.0

This tends to support the belief that the majority of the compromises occur before litigation and that many matters that are litigated are not capable of being negotiated. It certainly does not support the notion that compromise values are routinely found by the tax courts.

In an attempt to determine whether the sample was biased for some reason, we examined separately the private company share valuations. These results are shown in figure 3.

Figure 3 Summary of Cases Involving Private Company Shareholdings

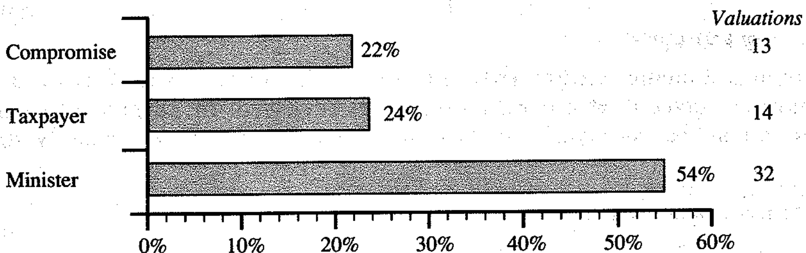
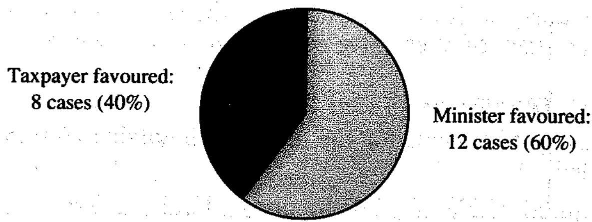


Figure 4 Public Share Cases: No Compromise



The results of the 59 private company share valuations closely parallelled those of the entire body of valuations reviewed. In fact, the taxpayers' success rate in litigating private company share values (24 percent) was lower than their overall success rate (28 percent). The courts were marginally more likely to favour compromise in private company share valuations—they did so in 22 percent of these cases but in only 17 percent of all valuations reviewed.

Another surprising statistic, illustrated in figure 4, is that none of the 20 cases involving the valuation of public company shares resulted in a compromise value. Sixty percent of these cases were decided clearly in the favour of the minister.

An analysis of these results showed that the stock market price was the foremost determinant of fair market value. Other factors considered were

- a discount from market price for blockage;
- a premium for the retention value inherent in voting trust certificates;
- the market price on the date of exercising rather than on the date of granting an option; and
- an arm's-length offer for a large block of shares.

We cannot generalize about the trend in the number of tax cases litigated in the 21-year period. However, the peak numbers appear to be clustered around the mid-1970s to the mid-1980s. It is hoped that the number of cases heard by the courts will continue to be small; such a trend would indicate a more reasonable approach to the resolution of valuation cases before they reach the litigation stage.

USE OF EXPERTS

Several comments can be made with respect to the use of expert evidence by both taxpayers and the minister. In general, it appears that litigants were less inclined to use expert evidence in the early 1970s than they are today. From 1971 to 1980, the taxpayer engaged an expert in 51 percent of the valuation cases, and the minister presented an expert to give testimony in 57 percent of the cases. During the period 1981 to 1991, these figures increased to 70 percent for the taxpayer and 68 percent for the minister.

No linkage could be drawn between the high success rate of the minister and a more frequent use of expert testimony. In many of the cases in which one side or the other did not bring expert evidence, the court decided in favour of the party with the expert. Often, the reason for the judgment in these cases was lack of alternative evidence regarding value.

COMPROMISE DECISIONS

The wide variety of reasons for the decisions involving compromise judgments included

- use of questionable methods by one or both parties;
- lack of confidence in either of the party's valuations;
- balancing of optimism of one party against pessimism of the other;
- credibility of the expert witnesses involved;
- deficiencies in evidence or valuation approach;
- adjustment of mathematical calculations;
- reliance on basic valuation principles and practices;
- arbitrary basis of allocation of values;
- evidence of bona fide third-party offers;
- substance and form of the transactions;
- voting rights of various classes of shares; and
- unsubstantiated estimates of value.

Many of the reasons we noted were not consistent with the notion of a desire to find a compromise between widely divergent valuations, thus further dispelling the myth regarding compromise in the tax courts.

THE JUDGES

Table 1 summarizes the decisions of the judges who heard more than four of the valuation issues reviewed.

Table 1 Summary of Individual Judges' Results

	Valuation favoured			
Judge	Taxpayer	Compromise	Minister	Total
A	1	1	18	20
B	8	1	3	12
C	4	4	4	12
D	2	0	8	10
E	2	3	3	8
F	1	2	3	6
G	5	0	0	5
H	0	0	5	5
I	3	0	1	4
J	0	2	2	4
K	0	3	1	4
L	0	3	1	4
M	0	0	4	4
N	0	0	4	4

It appears that judges A and D were biased toward the cause of the minister. Judge A found 90 percent of his cases in favour of the minister, while judge D did so in 80 percent of his cases.

The results for judge B include 4 valuation issues heard in 1 case and 3 more heard in another case. In all 7 issues, judge B found in favour of the taxpayer. It appears that judge C took a more even-handed approach, with 4 decisions in favour of the taxpayer, 4 in favour of the minister, and 4 compromises among 12 separate cases heard over a period of seven years.

Without a more probing study of the cases to determine whether the problems faced and the issues presented were comparable, we cannot make a clear statement about the tendencies of individual judges to find in favour of one party or the other, or to find a compromise.

COMPARISON WITH THE US STUDY

The following compares the results of the Bosland study with those of our study.

	Valuation favoured by courts		
	Taxpayer	Compromise	Taxing authority
		percent	
Canada	28.6	16.9	54.5
United States	28.0	48.0	24.0
Canada, with compromise redefined to match US study	27.9	20.8	51.3

The US tax courts appear to have been kinder to the taxpayer in the period 1944 to 1960 than the Canadian courts were from 1971 to 1991. Certainly, there was a greater tendency to compromise on valuations. We have also projected the results that we would have reached if we had redefined the range of compromise to mirror the Bosland definition; the difference between the results of the US study and ours would still have been significant.

Bosland's conclusions included the following:

- Compromise defeats the side with the more meritorious case and leads to unfairness and controversy.
- Compromise provides a questionable sense of justice, because both sides obtain "something."
- A tendency to compromise defeats justice when it is substituted for a rigorous application of basic valuation principles.

The Canadian experience shows a much lesser tendency to reach a middle ground in settling valuation cases before the tax courts. This could be due in part to the willingness of valuators for both sides to settle the majority of cases before they reach the costly and risky tax court arena. It must be noted, however, that compromise is not a universal solution to valuation problems arising in income taxation.

Compromise does not always lead to unfairness and controversy. If valuators do not agree on anything else, surely they agree that most valuation issues being discussed or litigated do not involve issues that are strictly black and white. It is in the grey areas, such as the inexactitude of judgment and the interpretation and application of principles, where negotiations can lead to compromise in the determination of fair market value. A willingness to evaluate objectively the merits of opposing positions should lead valuators in Revenue Canada and in private practice to take less adversarial roles and to reach more equitable conclusions.

On the other hand, compromise can tend to defeat justice when it is substituted for adherence to basic valuation principles and practices. All practitioners should strive to ensure that valuation principles are not overlooked merely for the sake of achieving compromise settlements and avoiding the litigation process.

CONCLUSIONS: THE MYTH DISPELLED

We and other practitioners were surprised by the results of the research. On the basis of the results, there appears to be some tendency in the courts to find compromise values. However, this tendency is much less pronounced than one might have expected. We do not think anyone would have expected the research to show that the litigation of valuation matters in the tax courts has resulted in one-sided decisions in more than 75 percent of the reported cases since 1971. The findings show that it is important to attempt to achieve a reasonable and supportable compromise before entering into litigation. The research supports the view that the litigation of valuation matters in the tax courts is often very risky.

PRACTITIONERS EXPLAIN WHY

After completing our study, we asked certain valuation practitioners for their views about why the decisions appear to be so one-sided. Their comments included the following:

- Unskilful self-representation by the taxpayer in the tax court contributes to the one-sided nature of the results.

- Revenue Canada is conservative in determining which cases it should litigate. This translates into a higher success rate for the minister than would otherwise be the case. This view was held to varying degrees by valuators in public practice and some Revenue Canada valuators.

- Revenue Canada valuators are *required* to try to reach a settlement. This may result in the taxpayer's having more "wins" outside the courts.

We hope that any or all of these explanations are valid. If not, the research could be said to be indicative of inherent unfairness in the Canadian tax courts with regard to settling valuation matters, which would be an undesirable state of affairs.