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## The Section 68 Reasonableness Standard After *TransAlta*

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### PRÉCIS

Cet article examine la jurisprudence et la pratique administrative entourant l'article 68 de la Loi de l'impôt sur le revenu, qui a donné lieu à la récente décision de la Cour d'appel fédérale dans l'arrêt *TransAlta Corporation c. Canada*. Une attention particulière est portée à la façon dont les tribunaux ont défini et évalué l'achalandage, et leur interprétation du caractère raisonnable au cœur de l'article 68. L'auteur conclut que *TransAlta* fournit jusqu'à présent l'interprétation la plus claire fondée sur des principes de l'article 68 et que la Cour d'appel fédérale a trouvé un équilibre adéquat entre les principes concurrents de prévisibilité et d'équité du point de vue du contribuable, d'une part, et le besoin de discrétion judiciaire pour freiner l'évitement fiscal inadéquat, d'autre part. La Cour y est parvenue en rejetant un critère légaliste qui aurait exigé l'exercice d'une discrétion judiciaire importante, en faveur d'un critère qui correspond à un jugement d'affaires exercé de façon raisonnable. L'auteur conclut par des suggestions quant à la façon dont les principes dans *TransAlta* peuvent s'appliquer aux causes futures liées à l'article 68.

### ABSTRACT

This article examines the case law and administrative practice surrounding section 68 of the Income Tax Act, culminating in the recent Federal Court of Appeal decision in *TransAlta Corporation v. Canada*. Particular attention is paid to how courts have defined and valued goodwill, and their interpretation of the reasonableness standard at the core of section 68.

The author concludes that *TransAlta* provides the most articulate and principled interpretation of section 68 to date, and that the Federal Court of Appeal appropriately

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balanced the competing principles of predictability and fairness from the taxpayer's perspective, on the one hand, and the need for judicial discretion to curb inappropriate tax avoidance, on the other. The court achieved this by rejecting a legalistic test that would have required the exercise of significant judicial discretion, in favour of a test that is consistent with reasonably exercised business judgment. The author concludes with suggestions as to how the principles in *TransAlta* may apply to future section 68 cases.

**KEYWORDS:** ALLOCATION ■ CONSISTENCY ■ DISCRETIONARY ■ DISPOSITIONS ■ GOODWILL ■ VALUATION

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*Everything in the universe goes by indirection. There are no straight lines.*

Ralph Waldo Emerson

## INTRODUCTION

In *TransAlta Corporation v. Canada*,<sup>1</sup> the Federal Court of Appeal wrestled with one of the perennial issues in tax law: How broad should be the Crown's or a court's discretion to curb tax planning? The specific question was whether the minister was correct in using section 68 of the Income Tax Act<sup>2</sup> to overturn a purchase price allocation made by arm's-length parties.<sup>3</sup> The court rejected the Crown's attempt to

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1 2012 FCA 20; rev'g. (in part) 2010 TCC 375.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

3 By way of legislation enacted by SC 2013, c. 34, section 207, the preamble of section 68 was amended and new paragraph 68(c) was added to deal specifically with amounts that may reasonably be regarded as consideration for a restrictive covenant. The test articulated by the Federal Court of Appeal in *TransAlta* (discussed in the text below) should apply to interpret this new provision.

interpret section 68 so as to dramatically extend that section's scope,<sup>4</sup> as well as ministerial and judicial discretion regarding when the section should apply. The court also clarified section 68's foundational principles. As a result, *TransAlta* increases the ability of taxpayers and the Crown to predict when section 68 will apply.

In this article, I will summarize the section 68 case law that preceded *TransAlta* and analyze the Tax Court and Federal Court of Appeal judgments in that case. I will also comment on how *TransAlta* may influence future case law.

The case law and administrative dicta with regard to section 68, other than the Tax Court's decision in *TransAlta*, are mostly consistent with the Supreme Court of Canada's statement in *Canada Trustco Mortgage Co. v. Canada*<sup>5</sup> about the importance of interpreting the Act so as to promote consistency, certainty, predictability, and fairness from the perspective of taxpayers.<sup>6</sup> However, as illustrated by the minister's reassessment and the Tax Court's judgment in *TransAlta*, significant uncertainty existed as to how section 68 should be interpreted.

This kind of uncertainty with regard to the law's application is problematic for various reasons.<sup>7</sup> For example, the minister tends to take more aggressive reassessing

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4 For general principles of statutory interpretation applicable to the Act, see Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed. (Markham, ON: LexisNexis Canada, 2008); Neil Brooks, "The Responsibility of Judges in Interpreting Tax Legislation," in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications, 1997), 93-129; David G. Duff, "Interpreting the Income Tax Act—Part 1: Interpretive Doctrines" (1999) 47:3 *Canadian Tax Journal* 464-533, and "... Part 2: Toward a Pragmatic Approach" (1999) 47:4 *Canadian Tax Journal* 741-98; and Stephen W. Bowman, "Interpretation of Tax Legislation: The Evolution of Purposive Analysis" (1995) 43:5 *Canadian Tax Journal* 1167-89.

5 2005 SCC 54.

6 I use the words consistency, certainty, predictability, and fairness in this article as they were used by the Supreme Court in *Canada Trustco*, supra note 5, at paragraphs 1, 11, 12, 15, 42, 50, and 61. The court has also mentioned variants of this principle in a number of other recent tax cases, including *Daisbowa-Marubeni International Ltd. v. Canada*, 2013 SCC 29; rev'g, *Daisbowa Paper Manufacturing Ltd. v. Canada*, 2011 FCA 267; rev'g, *Daisbowa-Marubeni International Ltd. v. The Queen*, 2010 TCC 317; and *Fundy Settlement v. Canada*, 2012 SCC 14; aff'g, *St. Michael Trust Corp. v. Canada*, 2010 FCA 309; aff'g, *Garron Family Trust v. The Queen*, 2009 TCC 450. These words articulate the taxpayers' perspective and, in the context of *Canada Trustco*, are contrasted against the uncertainty necessarily caused by the general anti-avoidance rule (GAAR) as it restrains abusive tax avoidance. The importance of certainty in the interpretation of tax law has a long history. See Sullivan, supra note 4, at 530-36; Lisa Philipps, "The Supreme Court of Canada's Tax Jurisprudence: What's Wrong with the Rule of Law" (2000) 79:2 *Canadian Bar Review* 120-44. See Duff, supra note 4, "... Part 2"; Brooks, supra note 4; and Sullivan, supra note 4, at 528, for summaries of how the interpretation of tax law in Canada has evolved from strict construction.

7 In my view, this is an important issue. In this respect, I am more inclined to agree with Nik Diksic's account in "Some Reflections on the Roles of Legal and Economic Substance in Tax Law," in *Report of Proceedings of the Sixty-Second Tax Conference*, 2010 Conference Report (Toronto: Canadian Tax Foundation, 2011), 25:1-42, as opposed to the short shrift given to the problem by Brian Arnold and John Tiley in, respectively, Brian J. Arnold, "Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance" (2001) 49:1 *Canadian Tax Journal* 1-39, at notes 103 and 104; and John Tiley, "Judicial Anti-Avoidance Doctrines: Corporations and Conclusions" [1988] no. 4 *British Tax Review* 108-45, at 134-36.

positions when there is significant uncertainty as to how provisions of the Act should be interpreted. Many taxpayers have been reassessed pursuant to section 68 during the past decade or so on the basis of questionable valuation reports produced by the Canada Revenue Agency (CRA), such as the valuation reports used by the Crown at trial in *TransAlta*. And some taxpayers have settled with the minister, presumably on a basis that encouraged the similar reassessment of other taxpayers. Accordingly, the Federal Court of Appeal's approach to predictability in *TransAlta* is important and will be one of the lenses through which I will look at that case.

## SECTION 68 CASE LAW

The relevant aspects of section 68 can be paraphrased as follows:

Where an amount can reasonably be regarded as being consideration for the disposition of a particular property of a taxpayer, that amount shall be deemed to be proceeds of disposition of the particular property.

Section 68's purpose is evident within its text, namely, to prevent unreasonable purchase price allocations. The section has been interpreted not to apply as long as the taxpayer's purchase price allocation is not found to be clearly unreasonable. The case law has used various tests to determine reasonableness.

The two main issues regarding section 68 in *TransAlta* were, first, how goodwill should be defined and valued, and second, how the reasonableness principle in section 68 should be applied in light of the valuation and other evidence relative to the goodwill in question.

### Definition and Valuation of Goodwill

In a 1981 *Canadian Tax Journal* article that has been frequently cited with approval with regard to the meaning of goodwill, John Durnford shed light on the reasons for the use of different goodwill definitions in the tax case law.<sup>8</sup> Two types of definitions have been used. The first was developed by the common-law courts as they grappled with the question of whether goodwill existed and how to identify it. The second evolved later within the accounting and valuation professions as a means of valuing goodwill once it had been found to exist, and is referred to as the "residual" method of defining or, more accurately, valuing goodwill. By that method, the value of goodwill is what remains after the value of the other assets of a business has been accounted for. The other assets are, generally, tangible and identifiable intangible property.

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8 John W. Durnford, "Goodwill in the Law of Income Tax" (1981) 29:6 *Canadian Tax Journal* 759-807, at 796-97, cited in the following decisions: *USM Canada Ltd. v. The Queen*, 97 DTC 192, at paragraph 216 (TCC); *The Queen v. Demco Management Limited*, 85 DTC 5603, at 5610 (FCA); *Les Placements A & N Robitaille Inc. v. MNR*, 96 DTC 1062, at 1068-69 (TCC); and *Fortino et al. v. The Queen*, 97 DTC 55, at 59 (TCC).

Durnford noted that in 1981, the two kinds of goodwill definition were merging. Subsequent case law continued the trend he identified. For example, in *Les Placements A & N Robitaille Inc. v. MNR*,<sup>9</sup> the Tax Court cited Durnford with approval, referred to the traditional legal definition of goodwill for the purposes of determining whether goodwill existed, and then used the residual method to value goodwill. Similar results followed in *USM Canada Limited v. The Queen*,<sup>10</sup> *Teleglobe Canada Inc. v. The Queen*,<sup>11</sup> and *Petersen v. MNR*.<sup>12</sup> And *Interpretation Bulletin* IT-143R3 describes goodwill in terms resembling the legal definition before adopting the residual method of valuing goodwill.<sup>13</sup>

Residual valuation has also been used in a number of contexts other than section 68.<sup>14</sup> The justification is pragmatic: when allocating value between assets that have been jointly acquired, the best way to value each is to first value the asset that can be most reliably valued, and then derive the value of the other asset.<sup>15</sup>

### Reasonableness

*The Queen v. Golden et al.*<sup>16</sup> is the Supreme Court of Canada's only judgment addressing the reasonableness concept in section 68, and, as the trial judge in *TransAlta* noted, reasonableness was a side issue in the case.<sup>17</sup>

*Golden* concerned the allocation of consideration from the sale of a condominium project as between land and buildings. The Federal Court Trial Division applied section 68 to reallocate the taxpayer's proceeds of disposition. The Federal Court of Appeal overturned the Trial Division. Heald JA wrote the majority's judgment for the Court of Appeal, while Thurlow CJ concurred in the result for different reasons. The majority of the Supreme Court of Canada agreed with both Federal Court of

9 *Les Placements*, supra note 8, at 1070-72.

10 *USM Canada*, supra note 8.

11 2000 DTC 2493, at paragraph 67 (TCC); aff'd. 2002 FCA 408.

12 88 DTC 1040, at 1045 (TCC).

13 *Interpretation Bulletin* IT-143R3, "Meaning of Eligible Capital Expenditure," August 29, 2002, at paragraphs 5-6.

14 See, for example, David C. Nathanson, "The Price-Appportionment Issue" (1992) 1:3 *Tax Litigation* 30-36; *Elworthy v. The Queen*, 82 DTC 6067 (FCTD); *Interpretation Bulletin* IT-220R2, "Capital Cost Allowance—Proceeds of Disposition of Depreciable Property," May 25, 1990, at paragraphs 7 and 9; *167849 Canada Inc. v. The Queen*, 2000 TCC 641, at paragraph 63; and *Meyer v. BC (Minister of Transportation & Highways)* (1995), 55 LCR 94, at paragraphs 27-29 (BCECB).

15 For example, if the entire business is worth \$100 million and the assets other than goodwill can be reliably valued at \$80 million, the goodwill must be worth \$20 million.

16 [1986] 1 SCR 209; aff'g. *Golden v. The Queen*, 80 DTC 6378 (FCTD); rev'g. 83 DTC 5138 (FCA).

17 *TransAlta*, supra note 1 (TCC), at paragraph 43.

Appeal judgments as to the reasonableness of the purchase price allocation and hence, the non-application of section 68.<sup>18</sup>

Given *Golden's* continuing importance to the interpretation of section 68, I will review it with care.

The facts in *Golden* were that the purchaser (Nelson Skalbania, a well-known real estate developer in western Canada) initially offered \$5.6 million for a condominium project and proposed to allocate the purchase price as follows: \$2.6 million to land; \$2.4 million to buildings; and \$600,000 to miscellaneous assets. After negotiation, Skalbania acquired the project for \$5.85 million and allocated \$5.1 million to land and the balance of \$750,000 to buildings, equipment, and improvements.<sup>19</sup>

The CRA reassessed under section 68 on the basis that the vendor-taxpayer's price allocation was unreasonable. At trial, there was no evidence of specific negotiation with respect to the allocation of the purchase price. And the valuation evidence indicated that the purchase price allocation agreed upon by the parties was dramatically inconsistent with the fair market value.

The Federal Court Trial Division in *Golden* made two findings that are of particular importance:<sup>20</sup>

1. Only the vendor's perspective was relevant to the determination of reasonableness for the purposes of section 68; hence, the fact that the amount allocated to the land in question was reasonable from the purchaser's perspective was irrelevant.
2. The absence of "hard bargaining" with regard to the purchase price allocation meant that the taxpayer had not made out a prima facie case for a reasonable purchase price allocation; hence, the court was required to determine the reasonable allocation.

The Federal Court of Appeal disagreed. Heald JA for the majority held<sup>21</sup> that

1. both the purchaser's and the vendor's perspectives should be considered in determining reasonableness for the purposes of section 68;
2. the trial judge had found that the purchase price allocation was reasonable from the purchaser's perspective;
3. great weight should be given to an arm's-length agreement as to allocation; and
4. accordingly, section 68 did not apply in spite of the valuation evidence that the trial judge had accepted as the best indicator of the land's value for the purposes of section 68.

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18 *Golden*, supra note 16 (SCC), at paragraph 13.

19 *Golden*, supra note 16 (SCC).

20 *Golden*, supra note 16 (FCTD), at 6380.

21 *Golden*, supra note 16 (FCA), at paragraphs 6 and 14-15.

Thurlow CJ agreed with the result and the majority's reasons, and added that, among other things, an owner of assets may dispose of them as he sees fit and may "realize on the full potential of an asset of one kind even if as a result the greatest potential of a related asset cannot be realized in the transaction."<sup>22</sup> Thurlow CJ also noted that the purchase price allocation had a reciprocal effect, meaning that the vendor's gain, by avoiding recapture, would cause the purchaser to have less future depreciation.<sup>23</sup> The importance of predictability is clearly discernible in the chief justice's reasons.

As indicated above, the Supreme Court of Canada adopted the reasons of both Heald JA and Thurlow CJ with respect to the allocation of the purchase price and, accordingly, must be taken to have endorsed the broad deference to arm's-length price allocations stipulated by the chief justice. Regrettably, this was not picked up clearly in subsequent cases until the Federal Court of Appeal's judgment in *TransAlta*.

The Trial Division's judgment in *Golden* was consistent with prior case law with regard to the importance of specific bargaining to the reasonableness of purchase price allocations and the shift of onus to the Crown that would occur once the taxpayer had made out a prima facie case that hard or genuine bargaining had occurred. For example, in each of *The Queen v. Waldorf Hotel (1958) Ltd. et al.* (often referred to as "*Shok*"),<sup>24</sup> *Erawan House v. MNR*,<sup>25</sup> and *Robbins v. MNR*,<sup>26</sup> section 68 was applied to reallocate purchase prices on the basis that, while arm's-length parties had agreed to the allocation, they had not specifically bargained in that regard. This prevented the taxpayers in these cases from taking advantage of the presumption in their favour that arm's-length bargaining leads to reasonable purchase price allocations, and as a result, valuation evidence trumped the fact that the price allocation had been agreed upon by arm's-length parties.

It is, accordingly, of particular importance to note that neither the Federal Court of Appeal nor the Supreme Court of Canada in *Golden* mentioned specific bargaining with regard to the purchase price allocation as a factor meriting particular weight. Instead, they resolved the case in favour of the taxpayer on the basis of facts that were much less favourable to the taxpayer than those in prior cases in which section 68 had applied. In that context, the Federal Court of Appeal's ruling that an arm's-length relationship alone is an "important consideration" meriting "considerable weight" is crucial.<sup>27</sup>

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22 Ibid., at 5143.

23 Ibid.

24 75 DTC 5109 (FCTD).

25 76 DTC 1049 (TRB).

26 78 DTC 1669 (TRB).

27 *Golden*, supra note 16 (FCA), at 5142 and 5144.

It is also important to note that the Federal Court of Appeal's ruling was based, in part, on the trial judge's finding of fact that the purchase price allocation was reasonable from Skalbania's perspective.<sup>28</sup> On that point, the trial judge held:

It is not for me to speculate why Skalbania did not find it necessary to insist on a higher allocation to depreciable assets; he bought the land for \$5,100,000 and he paid for it and I have no reason to suspect, much less infer, that it was worth anything less to him.

I accept that the value of the Bel Air land to Skalbania in March, 1973, was \$5,100,000. That is what Skalbania, a *knowledgeable purchaser, dealing at arm's length*, agreed to pay for it on March 14, 1973.<sup>29</sup>

This aspect of the judgment appears to be based on Skalbania's well-known sophistication as a real estate developer and his arm's-length relationship to the vendor, rather than on anything about the price allocation or how it was determined per se.

At a minimum, in light of the facts and the Supreme Court's reasoning in *Golden*, as well as later cases that have applied that case, it is safe to conclude that the pre-*Golden* case law read section 68 too broadly. In particular, those cases overemphasized valuation evidence and specific bargaining relative to the goodwill allocation and put inadequate emphasis on arm's-length agreement and other indicia of reasonableness, such as the sophistication of the parties. The Supreme Court's judgment in *Golden* reduced judicial discretion to overturn arm's-length purchase price allocations under section 68.

Some of the most useful post-*Golden* section 68 cases were decided in favour of the Crown and define the kinds of unreasonable behaviour that must be found in an arm's-length purchase price allocation case for section 68 to apply. *Petersen*,<sup>30</sup> *H. Baur Investments Limited v. MNR*,<sup>31</sup> and *Staltari v. The Queen*<sup>32</sup> are examples.

*Petersen* stands for the proposition that, in arm's-length purchase price allocation cases that do not involve sham or subterfuge, the court must determine that an allocation of purchase price to goodwill is "clearly unreasonable" in order for section 68 to apply.<sup>33</sup> The facts in *Petersen* illustrate a clearly unreasonable case without defining the term. That is,

- there was no specific bargaining regarding the purchase price allocation to goodwill;
- there was a history of consistent losses;

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28 Ibid., at 5142-43.

29 *Golden*, supra note 16 (FCTD), at 6380 (emphasis added).

30 *Petersen*, supra note 12.

31 88 DTC 1024 (TCC); aff'd. 90 DTC 6371 (FCTD).

32 95 DTC 506 (TCC).

33 *Petersen*, supra note 12, at 1045-46. This language echoes the *Canada Trustco* requirement that abuse for GAAR purposes be clear (supra note 5).

- there was no prospect of future income;
- significant repairs were required; and
- there were problems with the government licence related to the business.

Other facts supported the Tax Court's finding that the allocation of any value to goodwill in that case was clearly unreasonable.

Both the Supreme Court's judgment in *Golden* and the Tax Court's decision in *Petersen* were considered by the Tax Court in *H. Baur*, where the vendor filed his tax return on the basis of a purchase price allocation that differed from what he had agreed upon in writing with the purchaser. The Tax Court was not persuaded by the appraisal evidence that was put forward to support the inconsistent price allocation, and, on appeal, the Federal Court Trial Division agreed.<sup>34</sup> This case demonstrates, among other things, the importance of arm's-length agreements with regard to the determination of reasonableness for the purposes of section 68 and the limitations of appraisal evidence. *H. Baur* is consistent with the Supreme Court's decision in *Golden* on both of these points.

It is fair to characterize *Petersen* and *H. Baur* as examples of clearly unreasonable purchase price allocations. Accordingly, section 68 should apply in those cases.

*Golden* and *Petersen* were again considered by the Tax Court in *Staltari*. There, the taxpayer had received \$185,000 from his former employer ("RRL") in settlement of an action for wrongful dismissal. The parties allocated \$100,000 to proceeds of disposition of the taxpayer's 50 shares in a related company ("RCPC"). An RCPC shareholders' agreement provided that in the event of cessation of the taxpayer's employment, RCPC or RRL had the option to purchase the shares for fair market value as determined by a specified appraisal process. The accounting firm Peat Marwick had valued the taxpayer's RCPC shares at \$12,375 in accordance with that appraisal process. At least one other arm's-length transaction had occurred on this basis at a similar value.

The minister disagreed with the allocation of \$100,000 to the RCPC shares and reassessed the taxpayer under section 68 to reallocate the settlement proceeds on the basis that \$15,000 was the amount reasonably allocated to those shares.

The Tax Court found that the settlement was "at arm's length and was not a sham or subterfuge,"<sup>35</sup> that each of the parties was aware of the tax consequences entailed by the settlement, and that the reason for settlement was the desire to avoid expensive litigation. The court observed that in such situations, transaction dynamics should not be expected to push parties toward a reasonable allocation for section 68 purposes. The court cited *Petersen* and, in particular, quoted Rip J's ruling that where an agreement, absent sham or subterfuge, stipulates an amount that is "clearly unreasonable," it is open to the court to apply section 68.<sup>36</sup>

34 *H. Baur*, supra note 31 (TCC), at paragraphs 6 and 13; (FCTD), at paragraph 5.

35 *Staltari*, supra note 32, at 509.

36 *Ibid.*, at 509, quoting from *Petersen*, supra note 12, at 1045-46.

The court then held that the taxpayer did not satisfy the onus on him to establish that the minister's reallocation was "unrealistic."<sup>37</sup> The taxpayer's allocation was found to be unreasonable in the circumstances, and so the Crown prevailed. The unreasonableness of the price allocation in this case was not as clear as it was in *Petersen* and *H. Baur*.

*Petersen* and *Staltari* each describe the generally applicable legal onus on taxpayers to prove that the minister's assumptions are incorrect. In addition to this legal onus, tax cases involve important practical or evidentiary onuses, as do all other types of litigation.<sup>38</sup> The practical onus depends upon the nature of the substantive test in question and the quality of the evidence led by each party.

For example, a purchase price allocation must be clearly unreasonable in an arm's-length case in order for section 68 to apply. As a result, the practical or evidentiary onus may shift as follows. The taxpayer will be required to establish that the transaction in question is a typical arm's-length transaction that did not involve sham or subterfuge. Then, the taxpayer will provide all of the evidence available with respect to reasonableness, including

- the degree of the taxpayer's and other parties' expertise and sophistication with regard to the matters in question;
- the extent of specific purchase price allocation negotiations and how much the parties had at stake in that regard;
- the extent to which the purchase price allocation was consistent with industry, audit, or valuation principles and practices; and
- any expert or other valuation evidence that would support the purchase price allocation.

The strength of that evidence will determine the nature of the practical onus that the Crown bears to establish that the purchase price allocation is clearly unreasonable. Accordingly, when the Tax Court in *Petersen* and *Staltari* held that the taxpayer had failed to discharge his burden, it was also indicating that, in light of the evidence provided by the taxpayers, the Crown had successfully discharged its practical onus to establish that the purchase price allocation was clearly unreasonable.

*Interpretation Bulletin* IT-220R2, dated May 25, 1990, provides a reasonable summary of the main facets of the case law, as follows:

Even where a value is specified in an agreement for each class or kind of property or service and the total consideration for the whole sale is reasonable, a re-allocation of the consideration between the various kinds or classes of property or services, may, nevertheless, be made by the Department if some or all of the values specified are considered

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37 *Staltari*, supra note 32, at 509.

38 Joel A. Nitikman, "The Onus of Proof in Tax Litigation and Other Litigation Matters Affecting GAAR," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 7:1-38.

unreasonable. Where, however, the parties to the agreement are dealing at arm's length, the agreement is prima facie evidence of the reasonableness of the allocation specified therein. The taxpayer's allocation is further supported where there is evidence of hard bargaining between the parties involved in arriving at that allocation.<sup>39</sup>

This administrative dictum is consistent with, if not as fine-grained as, the case law described above.

With that background in mind, I will proceed to a discussion of *TransAlta* itself, first at the Tax Court and then at the Federal Court of Appeal.

## **TRANSALTA TAX COURT JUDGMENT—JUDICIAL DISCRETION TRUMPS PREDICTABILITY**

The facts in *TransAlta* were straightforward. In 2002, TransAlta sold its electricity transmission business (“the transmission business”) to AltaLink, a privately owned limited partnership that was formed by a consortium for the purpose of acquiring that business.

TransAlta and AltaLink dealt with each other at arm's length and negotiated the purchase and sale agreement with respect to the transmission business in typical fashion. This negotiation included specific attention to the purchase price allocation clause, which applied approximately \$190 million of the \$818 million purchase price to goodwill. The final allocation to goodwill was approximately \$36 million less than TransAlta's starting position, while the amount allocated to depreciable property was correspondingly increased during negotiations. This purchase price allocation was consistent with (1) industry practice, as indicated by values determined by the relevant regulatory authority; (2) a wide variety of comparable transactions; (3) valuation evidence on which the auditors who approved AltaLink's financial statements must have relied; and (4) an expert valuation report prepared for TransAlta.

The minister reassessed on the basis that there could be no goodwill in this particular regulated industry, and attempted to use section 68 to reallocate to depreciable property all of the \$190 million the parties had allocated to goodwill. This reassessment converted a large gain from a disposition of eligible capital property<sup>40</sup> into fully taxable recaptured depreciation. TransAlta appealed to the Tax Court.

TransAlta's position was that the fair market value of tangible assets in this industry approximates the net book value of those assets for regulatory purposes, and supported this conclusion using valuation data provided by the industry regulator, valuers, and audit firms. In response, the Crown argued at trial and before the

39 IT-220R2, supra note 14, at paragraph 5. I note that while this administrative position acknowledges the onus shift required by *Golden* and *Petersen* on the basis of arm's-length parties, it does not specify that the minister establish that the purchase price allocation is clearly unreasonable. By the time this interpretation bulletin was published, *Petersen* had been on the books for almost two-and-a-half years.

40 Taxable on more or less the same basis as a capital gain.

Federal Court of Appeal that this evidence should be ignored because it resulted from a widespread desire to reduce taxes paid when regulated businesses are sold for more than book value. The Crown's sole support for this position was found in an expert report that did not value the assets in question, but rather attempted to establish a theoretical basis for the proposition that there was either no or only minimal goodwill in this kind of case.

The Crown also asserted the right to exercise a broad discretion to substitute the minister's judgment as to what was reasonable for that of arm's-length taxpayers, even though the purchase price allocation agreed to by those taxpayers was consistent with the broad range of regulatory, industry, and other third-party valuation evidence noted above.

The Tax Court held that 74 percent of TransAlta's allocation of the purchase price to goodwill should stand, and that 26 percent should have been allocated to depreciable property. The court also attempted to systematize the law related to section 68 and, in the course of doing so, raised novel interpretive issues. At the core of the court's reasons were the issues of how goodwill should be defined and valued, and how the reasonableness test should be applied for section 68 purposes.

### **Definition and Valuation of Goodwill**

At the root of the goodwill definition issue was the Tax Court's conclusion that the residual method of valuing goodwill was not a definition of goodwill.<sup>41</sup> The confusing nature of academic and judicial commentary respecting the residual method of valuing goodwill is likely responsible for this. However, the court's adoption of this approach may have caused it to avoid grappling with third-party evidence with regard to value on which this aspect of the case should have been decided. Instead, the court focused on the legal definition of goodwill (discussed below) and how goodwill in this case must be characterized in light of that definition. This, ironically, led the court to substitute its own ad hoc valuation for the only expert valuation evidence before it. That evidence agreed with the extensively tested valuation data produced by the regulatory system to which the transmission business was subject, as well as the valuation that could be inferred from the audited financial statements of AltaLink and its partners. For a number of years, the value that TransAlta and AltaLink had allocated to goodwill in those statements had not been questioned.

The approach adopted by the Tax Court indicated that future courts should exercise broad judicial discretion as a result of the many ways in which goodwill could be characterized in this kind of case.

At trial, the Crown's expert took the position that the tangible assets in question were the only source of revenue within the regulatory system in question, and hence all of the transmission business's revenue and value was attributed to those assets. The Tax Court rejected this position, largely on the basis that TransAlta's expert and other evidence indicated that the transmission business included a variety of

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41 *TransAlta*, supra note 1 (TCC), at paragraph 34.

actual and potential revenue sources that were unrelated to the regulated, tangible assets. These included various non-regulated business opportunities that AltaLink intended to pursue within the transmission business. AltaLink had attributes that suited it to capitalize on certain of those opportunities, and it was reasonable to expect that it would pay for those opportunities. The court found that this aspect of the transmission business was goodwill to which a significant portion of the purchase price was rightly allocated.

The Tax Court adopted the classic legal definition of goodwill that evolved to deal with questions of whether goodwill existed instead of what it is worth. That baroque formulation was articulated over 100 years ago by the House of Lords<sup>42</sup> and contains three important elements:

1. goodwill is hard to define;
2. goodwill has a source within the business in question; and
3. goodwill is a whole and judges should not attempt to break it into its component parts.

The Tax Court then found that two elements that TransAlta and its expert had described as contributing to the value of the goodwill that it had sold were not sufficiently tied to sources within the transmission business. These were the opportunity for AltaLink (1) to use more leverage than TransAlta had used and (2) to receive a reimbursement for taxes that would probably exceed the taxes that AltaLink's partners would actually pay (factors referred to, respectively, as "leverage" and "the tax allowance"). Each of these factors would increase AltaLink's net after-tax return. The court described these factors as "reasons" having to do with attributes of AltaLink that motivated AltaLink to pay more for the tangible assets, as opposed to attributes of the transmission business itself, including goodwill. Therefore, the court concluded, value attributable to these "reasons" could not reasonably be allocated to goodwill.<sup>43</sup>

The court's ruling on this point emphasized the House of Lords' comment that the goodwill of a business must emanate from a particular source within the business, while ignoring its counsel that goodwill cannot be parsed into its component parts.

On the basis of unstated valuation principles, the Tax Court concluded that the leverage and tax allowance elements had a combined value of between \$50 million and \$75 million, and applied section 68 to deduct the lower of those amounts from the portion of the purchase price that TransAlta was permitted to allocate to goodwill.<sup>44</sup>

The Tax Court's reasoning in this case raises a number of theoretical and practical difficulties. For example, the court did not explicitly reject TransAlta's expert valuation of the tangible assets. However, by virtue of its use of the goodwill definition

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42 *Inland Revenue Commissioners v. Muller & Co.'s Margarine Limited*, [1901] AC 217 (HL).

43 *TransAlta*, supra note 1 (TCC), at paragraphs 59-62.

44 *Ibid.*, at paragraphs 72-73.

described above, the court substituted its own unstated valuation theory with regard to tangible assets for that put forward by TransAlta's expert. So, instead of deciding section 68 cases on the basis of the most reliable valuation principles and evidence available, the Tax Court judgment requires that section 68 cases be decided on the basis of an archaic, complex definition of goodwill, followed by a valuation based on unstated principles.

In addition, there was no evidence before the court as to AltaLink's reasons for paying the purchase price. It would be rare for a vendor to have access to this type of information, given its strategic importance to the purchaser. Hence, the Tax Court's approach was likely to require a speculative goodwill valuation. And, unfortunately, once goodwill has been valued, the remainder of the business is valued by inference.

### Reasonableness

The Tax Court noted that section 68 uses a reasonableness test, and it laid out rules as to how reasonableness should be assessed in various circumstances to which section 68 might apply.<sup>45</sup> The pre-*Golden* case law generally accepts, as reasonable, price allocations that were specifically negotiated by arm's-length parties, and, as noted above, it is easy to see the unreasonableness of the allocations in the few arm's-length cases in which section 68 has been applied, such as *Petersen*. Furthermore, in *Golden*, the Supreme Court of Canada reduced judicial discretion to apply section 68 in arm's-length cases. The Tax Court distinguished the Supreme Court's decision in *Golden* on various bases.<sup>46</sup> With respect, the Tax Court's judgment is probably not reconcilable with that decision.

The Tax Court was, however, correct in noting that in *Golden*, the Supreme Court did not systematically interpret section 68, and that this needed to be done. In its attempt, the Tax Court articulated the arm's-length bargaining test to include new requirements, such as relative equality of bargaining power and the financial importance of the purchase price allocation relative to the deal as a whole. In addition, while pointing to industry practice as an important factor, the court did not put much weight on it, despite the fact that in this case the evidence indicated extensive industry valuation practices that supported the parties' agreed-upon allocation.<sup>47</sup> Likewise, the behaviour of third parties (such as the transmission business's regulator and AltaLink's auditor), which had different and important stakes in the determination of the existence of goodwill and its value, did not seem to bear weight in the Tax Court's reasoning.

In short, whereas the pre-*Golden* case law appears to generally exempt arm's-length taxpayers from the application of section 68 in cases where they bargained in the usual way with regard to purchase price allocation, and *Golden* may have

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45 Ibid., at paragraph 47.

46 Ibid., at paragraph 43.

47 Ibid., at paragraphs 64-65.

extended the scope of this exemption from section 68, the Tax Court in *TransAlta* limited the exemption to cases in which a virtually unheard-of kind of purchase price bargaining occurred. This means that the Tax Court significantly watered down what had been understood by taxpayers and treated by the courts as an arm's-length safe harbour from the application of section 68. The Tax Court's reasons therefore dramatically increased the opportunity for judicial discretion with regard to section 68, and accordingly augured against predictability.

Having found that the arm's-length bargaining in this case did not rule out the application of section 68, the court went on to decide how that section should be applied. The Tax Court held that it must determine the reasonable range for the purchase price allocated to a particular item of property, and where there is an agreed allocation between arm's-length parties within the reasonable range, that allocation will stand. Otherwise, the amount within the range closest to the parties' allocation will be the reallocated amount for the purposes of section 68.<sup>48</sup> According to the court, this deference to the parties' agreed allocation puts the kind of weight on it required by *Golden* and prior case law.<sup>49</sup> Since the court reserved for itself a wide discretion to establish the range, this deference was of little practical importance.

## **TRANSALTA FEDERAL COURT OF APPEAL JUDGMENT—PREDICTABILITY PREVAILS**

The Federal Court of Appeal disagreed with the Tax Court across the board.

### **Definition and Valuation of Goodwill**

With regard to the goodwill definition issue, the Court of Appeal noted<sup>50</sup> that

- both experts in this matter accepted the residual method of valuing goodwill for the purposes of applying section 68;
- the residual method had been applied in a number of section 68 cases; and
- nonetheless, the Tax Court judge rejected this method in favour of a goodwill definition that had been formulated over 100 years ago by the UK House of Lords in circumstances that differ significantly from today's.

The Court of Appeal then provided a detailed explanation of the way in which the regulatory system in question was designed to equate the fair market value of tangible assets with their net book value for regulatory purposes, and the court accepted that a purchase price allocation that is consistent with this kind of industry practice is reasonable for the purposes of section 68. The court also accepted the expert valuation evidence provided by *TransAlta*, which reached the same conclusion,

48 *Ibid.*, at paragraph 68.

49 *Ibid.*, at paragraphs 43-47 and 55.

50 *TransAlta*, *supra* note 1 (FCA), at paragraphs 68-71.

while rejecting the evidence provided by the Crown to the effect that no goodwill existed in this case.<sup>51</sup>

The court then outlined the deficiencies of the goodwill definition adopted by the Tax Court, and held that the residual method of valuing goodwill should be used for the purposes of applying section 68.<sup>52</sup> This led the Court of Appeal to conclude that the Tax Court judge should not have required a reduction of \$50 million in the amount that TransAlta had allocated to goodwill.<sup>53</sup> Four points are particularly noteworthy.

First, the Court of Appeal held that goodwill has three characteristics:

- (a) goodwill must be an unidentified intangible as opposed to a tangible asset or an identified intangible such as a brand name, a patent or a franchise;
- (b) it must arise from the expectation of future earnings, returns or other benefits in excess of what would be expected in a comparable business;
- (c) it must be inseparable from the business to which it belongs and cannot normally be sold apart from the sale of the business as a going concern.<sup>54</sup>

Second, the court rejected the Tax Court's distinction between goodwill and "reasons why a purchaser would pay more for tangible assets," holding that the trial judge misunderstood the decision in *The Queen v. Jessiman Brothers Cartage Ltd.*,<sup>55</sup> on which he had relied for his finding on this point.<sup>56</sup>

Third, the court held that the potential for leverage was an intangible asset, which, if prudently used, could potentially lead to additional income. Accordingly, it was part of TransAlta's goodwill.<sup>57</sup>

Fourth, the tax allowance was determined by the Court of Appeal not to be part of TransAlta's goodwill or tangible assets on the basis that the benefit of the use of the tax allowance by a non-taxable partner of AltaLink could not be viewed as an asset of TransAlta.<sup>58</sup> With respect, this conclusion is questionable since the potential for the tax allowance is latent in the transmission business as a result of the regulatory system to which the business is subject, in much the same way as that business offers the potential for leverage. That being said, the court's finding on this point is useful in that it demonstrates the reasonableness test's flexibility. That is, the court provided a number of reasons on the basis of which any value attributable to the tax allowance should not result in the application of section 68, including the following:<sup>59</sup>

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51 Ibid., at paragraphs 34-50 and 82-83.

52 Ibid., at paragraphs 51-58 and 69-71.

53 Ibid., at paragraph 65.

54 Ibid., at paragraph 54.

55 78 DTC 6205 (FCTD).

56 *TransAlta*, supra note 1 (FCA), at paragraph 57.

57 Ibid., at paragraph 62.

58 Ibid., at paragraph 64.

59 Ibid., at paragraphs 64 and 67-69.

1. The reasonableness test described below would, in any event, justify the parties' purchase price allocation.
2. It is improper to attempt to break down goodwill into its parts.
3. The use of the residual approach to valuing goodwill resolved this issue in TransAlta's favour because

[t]he fact that some intangible elements that do not constitute “goodwill” in the legal sense may be captured through [the application of the residual valuation method]—such as the potential tax allowance benefit—does not mean that the valuation method is wrong or improper. The method simply reflects the fact that these types of intangibles should be treated as goodwill for all practical purposes—including accounting and taxation purposes—even though they may not squarely fall under the legal concept of goodwill.<sup>60</sup>

This reasoning illustrates the way in which the reasonableness test and the use of the residual approach to valuing goodwill should be expected to limit section 68's scope and resolve in the taxpayer's favour cases that may appear to have the potential to be subject to section 68.

### Reasonableness

The Court of Appeal's analysis of the reasonableness test is the heart of the judgment. The court rejected the test formulated by the Tax Court and provided a new test for section 68 purposes, based on the reasonableness test set out by the Exchequer Court in *Gabco v. MNR*.<sup>61</sup>

According to the *Gabco* test, the minister or court should not substitute its opinion for that of the taxpayer in determining what is reasonable. Instead, the amount in question will be considered reasonable unless “*no reasonable businessman would have contracted to pay such an amount having only the business considerations of the appellant in mind.*”<sup>62</sup> After quoting the above passage from *Gabco* and referencing *Petro-Canada v. Canada*, in which the Federal Court of Appeal adopted the *Gabco* test for the purposes of section 67,<sup>63</sup> the court stated the reasonableness test for the purposes of section 68 as follows:

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60 Ibid., at paragraph 70. There is substantial commentary that supports this use for taxation purposes of legal constructs developed outside the tax system; see, for example, Lara Friedlander, “What Has Tort Law Got To Do with It? Distinguishing Between Employees and Independent Contractors in the Federal Income Tax, Employment Insurance, and Canada Pension Plan Contexts” (2003) 51:4 *Canadian Tax Journal* 1467-1519.

61 68 DTC 5210 (Ex. Ct.).

62 Ibid., at 5216, cited in *TransAlta*, supra note 1 (FCA), at paragraph 73 (emphasis added).

63 2004 FCA 158, at paragraphs 62 and 64. Section 67 is a general limitation in the Act providing that “[i]n computing income, no deduction shall be made in respect of an outlay or expense . . . except to the extent that the outlay or expense was reasonable in the circumstances.”

The concept of reasonableness under section 68 of the Act is similar to that used for the purpose of section 67 of the Act. Consequently, for the purpose of section 68 of the Act, I conclude that an amount can reasonably be regarded as being the consideration for the disposition of a particular property if a *reasonable business person, with business considerations in mind*, would have allocated that amount to that particular property.<sup>64</sup>

It is important to note that the Court of Appeal

- did not simply say that *Gabco* applied for section 68 purposes, but rather said that the reasonableness concepts in sections 67 and 68 are “similar”;
- did not use the same language as the Exchequer Court used in *Gabco* to articulate the test; and
- did not expressly indicate that it intended to change the *Gabco* test.

The question, accordingly, is whether the Court of Appeal has established different tests for sections 67 and 68, and if so, what the differences are?

### ***Comparison with the Decision in GlaxoSmithKline***

First, it is noteworthy that the court did not refer to the recent transfer-pricing decision in *Canada v. GlaxoSmithKline*,<sup>65</sup> in which the Federal Court of Appeal applied *Gabco* with respect to subsection 69(2).<sup>66</sup> Layden-Stevenson JA was a member of the Court of Appeal panel in both *GlaxoSmithKline* and *TransAlta*, and she concurred in the unanimous judgment in each case.

The purposes of section 68, combined with the facts and the Supreme Court of Canada’s reasons in *Golden*, justify broad deference to taxpayers’ decision making with regard to purchase price allocations. This is consistent with a literal reading of the *Gabco* passage referenced by the Court of Appeal in *TransAlta* and is at least not

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64 *TransAlta*, supra note 1 (FCA), at paragraph 75 (emphasis added).

65 2012 SCC 52; aff’g. *GlaxoSmithKline Inc. v. Canada*, 2010 FCA 201; rev’g. *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324. *GlaxoSmithKline* was a transfer-pricing case in which both the Federal Court of Appeal and the Supreme Court of Canada held that the process required to determine profit for transfer-pricing purposes must be realistic, instead of being determined on the basis of legal principles that would be counterintuitive to most business people. The Supreme Court also held that as long as the transfer price selected by the taxpayer was within a “reasonable range,” it should not be adjusted by subsection 69(2). The court’s deference to business principles and the judgment of taxpayers enhances predictability in this area of the law.

66 *GlaxoSmithKline*, supra note 65 (FCA), at paragraphs 69-75. Subsection 69(2) was the predecessor to the transfer-pricing provisions now found in section 247. Subsection 69(2) formerly provided, “Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm’s length as price . . . for or for the use or reproduction of any property . . . or for other services, an amount greater than the amount . . . that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length, the reasonable amount shall, for the purpose of computing the taxpayer’s income under this Part, be deemed to have been the amount that was paid or is payable therefor.”

inconsistent with the use of the *Gabco* test in *Petro-Canada*, which the Federal Court of Appeal also referenced with approval in *TransAlta*.

Arguably, the reasonableness test in *GlaxoSmithKline* is less deferential to the taxpayer. This is consistent with the different purposes of subsection 69(2), which was at issue in that case. Accordingly, the absence of a reference to *GlaxoSmithKline* in *TransAlta* may be an example of a contextual or purposive interpretation that supports the taxpayer-friendly interpretation of the reasonableness test for section 68 purposes required by a near-literal reading of the *Gabco* test.

### ***“Business Considerations in Mind”***

The reasonableness test set out by the Federal Court of Appeal in *TransAlta* dropped the word “only” preceding “business considerations” in the *Gabco* test quoted above. “Only” is a strong word. For example, if “only” business considerations must have been in mind, could the fact that a taxpayer considered the income tax consequences of the purchase price allocation exclude her from the protection provided by the *Gabco* test? The answer is unclear. The Court of Appeal may have excluded the word “only” in order to avoid this kind of confusion.

The purpose of section 68 is to prevent tax avoidance beyond an acceptable point. That is, tax planning is permitted by the case law interpreting the Act,<sup>67</sup> subject to specific provisions such as GAAR and section 68. It is accordingly reasonable to infer that by dropping the word “only,” the Court of Appeal intended to permit an element of non-business influence (including tax planning) in the allocation of purchase prices before section 68 would apply.

In determining how far a taxpayer should be able to go with tax planning or other non-business considerations before section 68 will apply, it is particularly important to note that the section does not use any purpose-oriented language, such as the “principal reason” language found in subsection 103(1).<sup>68</sup> The absence of this language suggests that tax-planning purposes are irrelevant to the section, except to the extent that they enter into the “reasonableness” equation. This is also consistent with the relatively weak phrase “business considerations in mind” used by the Federal Court of Appeal to formulate the section 68 test.

For example, if non-business considerations (including tax planning) are the dominant purpose or reason for the purchase price allocation, it will in most cases still be possible to say that the allocation was made with business considerations “in mind.” At what point do those business considerations become so weak that they are no longer “in mind”?

67 See, for example, *Canada Trustco*, supra note 5, at paragraphs 11 and 12; and *Coptborne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 123; aff’g. 2009 FCA 163; aff’g. 2007 TCC 481.

68 Subsection 103(1) provides the minister with discretion to adjust the basis of a partnership’s allocation of income or loss where the “principal reason” for the allocation may reasonably be considered to be the reduction or postponement of tax that would otherwise be payable under the Act.

This indicates a low hurdle for taxpayers who wish to establish that section 68 does not apply to their purchase price allocations, and is consistent with the *Gabco* test. Again, cases such as *Petersen* are useful touchstones when thinking about the kind of case to which section 68 should apply.

### *Positive Versus Negative Phraseology*

The Court of Appeal chose to frame the section 68 reasonableness test using positive instead of negative language.

As noted above, in *Gabco*, the Exchequer Court held that unreasonableness would be found only where “no reasonable businessman” would have contracted to pay the amount in question. Grammatical logic indicates that if a single reasonable business person would have contracted to pay the amount in question, then that amount would be reasonable. Since the Court of Appeal in *TransAlta* specified “a reasonable business person” instead of “any single reasonable business person” (or something similar), we must ask whether the court intended this language to differentiate the test in *TransAlta* from that in *Gabco*.

Another way to phrase the question is to ask whether the Court of Appeal’s reference to “a reasonable business person” was to any one of the possibly idiosyncratic, but still reasonable, business persons on the fringe of the population, or an average reasonable person, from nearer the centre, who represents the classic, objective reasonable person who appears in other parts of the common law.<sup>69</sup> This is important because the single reasonable person test is much easier for taxpayers to meet than the average reasonable person test.

Nothing in *TransAlta* suggests that the Court of Appeal meant to materially change this aspect of the *Gabco* test for section 68 purposes; hence, if a single reasonable business person can be found or reasonably imagined to exist who would have allocated the purchase price as did the taxpayer in question, then section 68 should not apply. The following supports this view:

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<sup>69</sup> *Arland and Arland v. Taylor*, [1955] OR 131, at 142 (CA): “[The reasonable person is] a mythical creature of the law whose conduct is the standard by which the Courts measure the conduct of all other persons and find it to be proper or improper in particular circumstances as they may exist from time to time. He is not an extraordinary or unusual creature; he is not superhuman; he is not required to display the highest skill of which anyone is capable; he is not a genius who can perform uncommon feats, nor is he possessed of unusual powers of foresight. He is a person of normal intelligence who makes prudence a guide to his conduct. He does nothing that a prudent man would not do and does not omit to do anything a prudent man would do. He acts in accord with general and approved practice. His conduct is guided by considerations which ordinarily regulate the conduct of human affairs. His conduct is the standard ‘adopted in the community by persons of ordinary intelligence and prudence.’” (Partially quoting from *Blyth v. Birmingham Waterworks Co.* (1856), 11 Exch. 781.) The foregoing passage from *Arland* was partially quoted by Major J in *Stewart v. Pettie*, [1995] 1 SCR 131, at paragraph 50.

- The phrase “a reasonable business person” can describe any single reasonable business person, including those at the fringes whose behaviour in any particular case may have little in common with the average person. More specific language is required to identify a particular type of reasonable business person, such as the average reasonable business person.
- Section 68 is written in the affirmative, and accordingly does not easily accommodate the negative phraseology used in *Gabco*. The Court of Appeal may have chosen positive language that can be read into section 68 so as to achieve the same result as the *Gabco* test. For example, if the term “any reasonable business person” had been substituted for “a reasonable business person” in this formulation of the *Gabco* test relative to section 68, this choice of wording could be taken to mean that “all reasonable business persons” would have been required to agree with the allocation in order for section 68 not to apply. This would move the test far from the intent of *Gabco*, *Petro-Canada*, *Golden*, and *Petersen*, each of which was cited with approval by the Court of Appeal.
- The Court of Appeal’s approval of *Petersen* is particularly noteworthy. That case interpreted *Golden* as requiring that a purchase price allocation be “clearly unreasonable” in order for section 68 to apply. The Court of Appeal approved that standard, which is consistent with a literal reading of the *Gabco* test and inconsistent with an average reasonable person test.
- The Supreme Court’s decision in *Golden* itself deferred to the business judgment of a single sophisticated taxpayer—Nelson Skalbania—whose idiosyncrasies were well known. This is consistent with a literal reading of the *Gabco* test, and may well go beyond the finding that was required by the facts in *TransAlta*.
- The *Gabco* test is consistent with the purposes of section 68; and with the Supreme Court of Canada’s emphasis in *Canada Trustco, Fundy Settlement v. Canada*,<sup>70</sup> and elsewhere on the importance of predictability in the application of the Act. An average reasonable person test would be inconsistent with the requirement of predictability by expanding judicial discretion as to when section 68 should apply.

The Court of Appeal in *TransAlta* went on to hold that the Tax Court erred by not placing more weight on industry practice, valuation practice, etc., and disagreed with the test articulated by the Tax Court on the basis that it is

complex and sets out no guiding principles. It is a test based partly on form, which allowed [the trial judge] to substitute his own subjective allocation for that agreed upon by the parties in compliance with industry and regulatory standards.<sup>71</sup>

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<sup>70</sup> *Fundy Settlement*, supra note 5.

<sup>71</sup> *TransAlta*, supra note 1 (FCA), at paragraph 81.

This holding is consistent with the importance of predictability. The Court of Appeal concluded that had the Tax Court judge properly applied the reasonableness test for section 68,

he would have been compelled to consider industry and regulatory standards, as well as accounting and valuation theory, which all point in the direction of the agreed allocation. That agreed allocation was reasonable precisely because of its compliance with industry and regulatory norms and its *consistency with standard valuation theory for regulated businesses and standard accounting principles applied in such industries*.<sup>72</sup>

The emphasized text in this passage contains the only reference to consistency or predictability in the Federal Court of Appeal's judgment. Specifically, according to the court, consistency with valuation practices and industry standards provides reference points that taxpayers can use to reliably determine when their agreed-upon valuation may be subject to section 68. This illustrates a theme with regard to the application of business principles and business judgment that appears elsewhere in the tax case law.<sup>73</sup>

In obiter dicta, the Court of Appeal noted that while a purchase price allocation agreed upon between parties to an arm's-length transaction is an important factor, the weight given to such an agreement will vary according to the circumstances. Where the parties have strongly divergent interests, the allocation will be given considerable weight, whereas if one of the parties is indifferent or where both parties' interests are aligned with the allocation, it will be given less weight. This finding reframes the arm's-length negotiation cases within the *Gabco* test as one way in which the reasonable person test may be satisfied. It is also generally consistent with the Supreme Court's decision in *Golden* and the post-*Golden* case law.

While a separate arm's-length test, or safe harbour, would create additional certainty, the breadth of the reasonableness test set out in *Gabco* and its application in cases such as *TransAlta* should provide adequate protection for most taxpayers who have bargained at arm's length with regard to a purchase price allocation.

The Court of Appeal did not refer to either the legal or the practical onus of proof. Accordingly, the way in which the case law works in that regard, as summarized above, continues to be applicable.

## IMPLICATIONS FOR FUTURE SECTION 68 CASES

Generally speaking, the Federal Court of Appeal's ruling in *TransAlta* provides welcome relief from the uncertainty created by the Tax Court's judgment and sets out the most certain, predictable, and fair basis to date for the application of section 68.

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72 Ibid., at paragraph 82 (emphasis added).

73 *Canderel Ltd. v. Canada*, [1998] 1 SCR 147; *Minister of National Revenue v. Atlantic Engine Rebuilders Ltd.*, [1967] SCR 477; and *Dominion Taxicab Association v. Minister of National Revenue*, [1954] SCR 82.

The development of a reasonableness test for section 68 based on *Gabco* is particularly noteworthy. This test generally defers to arm's-length taxpayers' price allocations, and puts a heavy practical onus of proof on the Crown to establish that purchase price allocations are unreasonable before section 68 will apply. This makes the application of section 68 more predictable, and accordingly decreases judicial and ministerial discretion.

It is important to note that the Federal Court of Appeal's statement of the test for the application of section 68 in *TransAlta* is not limited to purchase price allocations to goodwill. Rather, it should be relevant to section 68 generally, and accordingly can be applied in arm's-length cases as follows:

- In cases involving goodwill, it should not be necessary, as a first step, to identify goodwill using the modified legal test articulated by the Court of Appeal. Rather, the first step in the analytical process should be to apply the reasonableness test. This is important because it can be done in most cases without the assistance of legal counsel or other experts, thereby dramatically improving cost-effective predictability from the perspective of both the taxpayer and the Crown.
- The reasonableness test precludes the application of section 68 if the purchase price allocation would have been agreed to by a reasonable person, bearing business considerations in mind. Facts such as those in *Golden* and *TransAlta* must be presumed to satisfy that test, whereas facts like those in *Petersen* exemplify how unreasonable a purchase price allocation must be to fail the same test.
- The taxpayer bears the legal onus to adduce evidence sufficient to overturn the Crown's assumptions on the balance of probabilities. Examples of this kind of evidence are provided below.
- As the taxpayer adduces evidence to support the reasonableness of his purchase price allocation, the practical onus of proof shifts to the Crown. As a result, the Crown must adduce evidence of its own, or alternatively discredit the evidence provided by the taxpayer, and by so doing, establish that the purchase price allocation is unreasonable on the balance of probabilities. If the Crown falls short, the taxpayer should win by default.<sup>74</sup>
- The trial judge will consider all of the relevant circumstances and determine, on a balance of probabilities, whether the purchase price allocation is clearly unreasonable. If doubt remains, this inquiry should be resolved in the taxpayer's favour.<sup>75</sup>

A taxpayer may provide a variety of evidence to satisfy section 68's reasonableness test as it is set down by *TransAlta*. For example:

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74 Sullivan, *supra* note 4, at 534-35.

75 *Gabco*, *supra* note 61.

- If the purchase price allocation is consistent with industry standards or valuation principles, then section 68 should not apply.
- Any allocation to an asset that is permitted on audited financial statements should not be subject to section 68 since the price allocation presumably meets the valuation tests used by audit firms, and thus should easily pass the reasonable person test.
- As little as one comparable transaction, entered into by the kind of reasonable person described above, should be sufficient to exclude section 68.
- Arm's-length negotiation with regard to the purchase price allocation is an indicator of reasonableness, the strength of which will vary with the circumstances. Where one party has no motivation to bargain because, for example, the allocation has little financial impact on her, this factor may be weak. Where both parties have something material to gain or lose as a result of the price allocation, this factor may be determinative.
- If the parties are sophisticated with regard to the kind of transaction in question, this may be enough to avoid section 68, as it was in *Golden*.
- The reasonable person need not be actual. Rather, if it is reasonable to assume that some taxpayers in similar circumstances would use similar purchase price allocations, that should be sufficient to exclude section 68.
- Finally, where goodwill is identified using the modified legal test articulated by the Court of Appeal, it should not be broken down into its component parts for valuation purposes. Rather, any valuation of goodwill should use the residual method of valuing goodwill, and in most cases, the reasonableness test should exempt arm's-length parties from the application of section 68.

Cases like *Staltari* will still provide an interesting test for section 68. The settlement of litigation is a business consideration that regularly motivates assessments of value that deviate from fair market value. Furthermore, the parties in *Staltari* were relatively sophisticated, and it appears that they had materially opposing financial and taxation interests with regard to the allocation of the settlement proceeds.<sup>76</sup> That is, the allocation of settlement proceeds to shares deprived the employer of a deduction at the same time as it provided the employee with a taxable capital gain instead of fully taxable employment income. This arm's-length tension was referenced by the Supreme Court in *Golden* as a factor that should be counted on to move the parties toward a reasonable price allocation.

*Staltari* also raises an interesting issue relative to the principle articulated by *TransAlta* and *Golden* that arm's-length agreements should bear a great deal of weight in determining reasonableness.<sup>77</sup> In *Staltari*, the terms of the arm's-length

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76 The allocation to shares would cause the employer to lose a deduction, while the employee would receive preferential tax treatment on a capital gain.

77 While *Daisbowa*, supra note 5 (SCC), is not on point, it can also be used to support this aspect of *Staltari*.

shareholders' agreement contradicted the terms of an arm's-length settlement agreement. This distinguishes *Staltari* from *H. Baur*, where the taxpayer tried to overcome an arm's-length agreement to allocate the purchase price on the basis of valuation evidence alone. It is my view that the arm's-length settlement agreement in *Staltari* does not trump or even neutralize the earlier shareholders' agreement. This factor would weigh in the balance on the side of applying section 68.

In my view, future cases like *Staltari* will probably be decided in favour of the taxpayer. The reasonableness test can be met by finding business people who for business reasons would allocate in more or less the same way as the parties did in *Staltari*. It will be possible in many cases to produce evidence to support this position, and that should outweigh other factors such as arm's-length agreements or valuation evidence, which previously received too much weight, particularly in the pre-*Golden* case law. This approach illustrates the way in which *TransAlta* promotes the importance of predictability and reduces judicial discretion.

It is also interesting to consider the potential impact of the Supreme Court of Canada's decision in *Fundy Settlement*<sup>78</sup> on future section 68 cases. Arguably, the requirement in that case that the party arguing for the exercise of judicial discretion provide "good reasons"<sup>79</sup> for that exercise should make it more likely that borderline section 68 cases will be decided in favour of taxpayers. It is my view that this is consistent with *TransAlta*'s adoption of the *Gabco* reasonable person test, and its endorsement of the rule in *Petersen* that the purchase price allocation must be clearly unreasonable in order for section 68 to apply.

## CONCLUSION

The Federal Court of Appeal ruling in *TransAlta* provides a principled interpretation of section 68 that is generally consistent with the case law post-*Golden*. Of particular importance is the court's articulation of the reasonableness standard on which the application of that section depends.

*TransAlta* also provides a textbook illustration of the way in which the importance of predictability in the interpretation of the Act should be balanced against judicial discretion. The court rejected a legalistic test that would have created great uncertainty for future cases, in favour of a test that is consistent with taxpayer expectations based upon the exercise of reasonable business judgment. This follows the Supreme Court of Canada's emphasis in *Canada Trustco* on the importance of consistency, certainty, predictability, and fairness from the taxpayer's perspective.

*TransAlta* therefore continues what is in my view a constructive trend—our highest courts' increasing tendency to interpret the Act in a manner that is consistent with reasonably exercised business judgment as opposed to legalistic tests. This should reduce litigation time and expense, and is to be applauded for that reason.

<sup>78</sup> *Fundy Settlement*, supra note 5.

<sup>79</sup> *Ibid.*, at paragraph 16.

