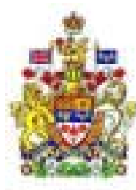
Federal Court of Appeal



Cour d'appel fédérale

Date: 20120120

Docket: A-350-10

Citation: 2012 FCA 20

CORAM: **EVANS J.A.**
LAYDEN-STEVENSON J.A.
MAINVILLE J.A.

BETWEEN:

TRANSALTA CORPORATION

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Calgary, Alberta, on December 13, 2011.

Judgment delivered at Ottawa, Ontario, on January 20, 2012.

REASONS FOR JUDGMENT BY: **MAINVILLE J.A.**

CONCURRED IN BY: **EVANS J.A.**
LAYDEN-STEVENSON J.A.

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REASONS FOR JUDGMENT

MAINVILLE J.A.

[1] This appeal concerns the existence, valuation and price allocation of commercial goodwill in regulated industries for income tax purposes.

[2] In 2002, TransAlta Corporation ("TransAlta") sold its regulated electricity transmission business in Alberta to AltaLink, L.P. ("AltaLink") at a price negotiated as 1.31 times the net regulated book value of its tangible assets. The bulk of the 31% premium over net regulated book value – an amount of $190,824,476 – was allocated by the parties to goodwill. This was a standard

allocation for regulated industries, which was supported by valuation theory, audited financial statements and long-standing industry practice.

[3] The Minister of National Revenue (“Minister”) challenged this allocation on the ground that no goodwill exists in a regulated industry. Consequently, the Minister reassessed TransAlta under section 68 of the *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.) (“Act”) – which allows for a price reallocation on a reasonableness standard – by reallocating the entire goodwill amount of $190,824,476 to tangible assets. The Minister contends that the long-standing practice of regulated industries to allocate to goodwill the premiums paid above the net regulated book value of their tangible assets is unreasonable since it allows the vendors to avoid recapture of capital cost allowances.

[4] That reassessment was challenged by TransAlta before the Tax Court of Canada, and in reasons cited as 2010 TCC 375, Justice Campbell Miller of the Tax Court of Canada (“Tax Court judge”) concluded that goodwill can exist in a regulated industry and was in fact sold in this case with TransAlta’s regulated electricity transmission business. However, on the basis of a definition of goodwill developed well over a century ago by Lord Macnaghten in *The Commissioners of Inland Revenue v. Muller & Co.’s Margarine, Limited*, [1901] A.C. 217 (“*Muller*”), the Tax Court judge concluded that two items which were said to represent goodwill – the potential for leverage and a potential tax allowance benefit – were in fact attached to the tangible assets sold. He assessed the value of those two items at $50,000,000 which he deducted from the allocation to goodwill

made by the parties to the transaction. TransAlta is appealing from this judgment, and the Crown is cross-appealing.

[5] The concept of goodwill has evolved considerably since the beginning of the 20th century. Whereas business goodwill was formerly considered to pertain to good name, reputation and connection principally with respect to customer relations, the concept has now taken on a broader meaning influenced by economic, accounting and valuation theories.

[6] Goodwill has three characteristics: (a) it must be an intangible; (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. If these three characteristics are present, it can reasonably be assumed that goodwill has been found.

[7] In order to determine if an amount can reasonably be regarded as the consideration for the disposition of a particular property, section 68 of the Act requires considering whether a reasonable business person, with business considerations in mind, would have allocated that amount to that particular property. Consequently, long-standing regulatory and industry practices, as well as auditing and valuation standards and practices, are relevant to such a determination.

[8] Because of the very nature and purpose of the regulatory process, the net regulated book value of the regulated tangible assets of the transmission business at issue in this case may

reasonably be understood as reflecting the fair market value of those assets. The regulated book value of the regulated assets is one of the bases upon which the regulatory authorities determine the regulatory rate of return. The industry standard allows for the allocation to goodwill of any premium paid above the net regulated book value of those assets. Such a premium can reasonably be understood as the value of the special advantages of the transmission business which allow it to potentially achieve returns in excess of what is deemed by its regulator to be a normal market return. The reasonableness of this long-standing industry practice is supported in this case by the regulatory process itself and by valuation and accounting theory and practice. The allocation of such a premium to goodwill can thus be regarded as reasonable for the purposes of section 68 of the Act.

[9] I would therefore allow TransAlta's appeal and dismiss the Crown's cross-appeal with costs.

Background to these proceedings

[10] TransAlta's electricity transmission business – which it owned through subsidiaries – consisted of approximately 11,600 km of transmission lines and 260 substations that supplied almost 60% of the Alberta population with electricity. The original cost of the transmission assets was approximately $1.4 billion. Depreciation of those assets for accounting purposes throughout TransAlta's ownership was approximately $780 million, which resulted in a book value for accounting purposes of approximately $640 million.

[11] At the time of the transaction, TransAlta's transmission business was regulated by the Alberta Energy and Utilities Board ("Board") pursuant to the *Electric Utilities Act* (Alberta), S.A.

1995, c. E-5.5. The Board is an independent, quasi-judicial agency of the Government of Alberta, which is responsible for regulating the Alberta electricity transmission industry. At all material times, the Board set the rates that the transmission business could charge for its services based on a cost-of-service regulatory approach. These rates were usually set on the basis of forecasts submitted to the Board by TransAlta so as to allow its transmission business to: (a) recover the net regulated book value of its assets as they depreciated for regulatory purposes; (b) recover the estimates of the operating expenses the transmission business planned to incur, including interest with respect to its debt, taxes and other amounts; and (c) earn a reasonable return on the equity investment portion of the net regulated book value of its assets that the Board deemed fair.

[12] The debt-to-equity ratio was set at 35% equity and 65% debt for rate-making purposes. The Board-approved after-tax return on equity at the time of the transaction was 9.75%. The actual return on equity earned by TransAlta from the transmission business ranged from 11.79% in 1999 and 2000 to 13.57% in 2001.

[13] The rate revenues were not retroactively adjusted to reflect actual costs incurred, except in the case of certain capital additions. Consequently, when expenses were lower than forecast as a result of efficiencies, the resulting excess net income was retained by TransAlta.

[14] In 2001, TransAlta resolved to divest itself of its transmission business and initiated a bidding process. The transaction contemplated by the bid documents was that of a sale of shares in a new subsidiary which would hold the transmission business assets but none of its debt. In addition

to the existing regulated transmission business, the bid documents identified significant business opportunities resulting from the sale, including the potential to construct major additional transmission capacity in Alberta, the potential introduction of performance-based regulation by which cost efficiencies would be shared by the regulator between the clients and the owner of the transmission business, and the potential to grow non-regulated earnings in the areas of telecommunications, merchant transmission, engineering, procurement and construction management services, as well as operating and maintenance services.

[15] Various bids were received. The bidders proposed to buy the transmission business at various prices which varied from the net regulated book value of the regulated assets to various premiums on that value. The consortium which eventually formed AltaLink submitted what was considered the best offer. That consortium was comprised of SNC Lavalin Inc. (50%), Ontario Teachers' Pension Plan Board ("Teachers") (25%), Macquarie North America Ltd. (15%) and a wholly-owned subsidiary of Trans Elect Inc. (10%). It is not disputed that these were knowledgeable and experienced investors dealing with TransAlta at arm's length.

[16] The consortium's revised proposal was to purchase the transmission business through a limited partnership structure at a book value multiple of 1.31 at closing. During the course of the negotiations resulting from this proposal, certain assets were excluded from the transaction and various other adjustments were made. Moreover, an additional $36 million of the purchase price was allocated to depreciable assets over what TransAlta had originally proposed to the consortium.

[17] The final purchase and sale agreement was executed on July 4, 2001 and amended on January 21, 2002. For the purpose of this appeal, the key elements of that amended agreement are sections 2.1 and 2.2 and the definitions of “Assets”, “Business”, “Net Regulatory Book Value” and “Rate Base” in Appendix A:

> 2.1 Purchase and Sale
>
> In consideration for the payment to the Vendor by the Purchaser of the Purchase Price and assumption by the Purchaser of the Assumed Liabilities, and upon and subject to the terms and conditions hereof, at the Time of Closing the Vendor shall assign, transfer and set over to the Purchaser, and the Purchaser will acquire from the Vendor as a going concern, the Assets and the Business […]
>
> 2.2 Purchase Price
>
> (1) The purchase price to be paid to the Vendor by the Purchaser (the “Purchase Price”) shall be the sum of the amounts set forth in Sections 2.2(1)(a) and (b) below:
>
> (a) The Net Regulatory Book Value at December 31, 2000 (which the Parties agree is $613,200,000), less $8,565,705 (which represents the Parties estimate of that portion of the Net Regulatory Book Value allocated to the Withheld Assets (…)) equalling $604,634,295, multiplied by 1.31 for a total of $792,070,926.50 (the “Base Purchase Price”); and
>
> (b) The amount determined by the adjustments set forth in Section 2.3 hereof.
>
> […]
>
> (2) The Vendor and the Purchaser shall allocate the Purchase Price among the Assets in accordance with Schedule 2.2(2) hereof; and the Purchaser and the Vendor, in filing their respective income tax returns, shall use such allocation of the Purchase Price.
>
> APPENDIX A
>
> GLOSSARY

"**Assets**" means the undertaking and all tangible or intangible property (whether real, personal or mixed, choate or inchoate), rights, benefits, privileges, assets or entitlements owned by the Vendor or TransAlta Utilities Corporation or any of their Affiliates, or to which the Vendor or TransAlta Utilities Corporation or any of their Affiliates is entitled and used exclusively or Primarily in the Business, of every kind and description and wheresoever situate. Without limiting the generality of the foregoing, the Assets include:

(i) the Sites and Buildings;

(ii) the Equipment;

(iii) the Land Rights;

(iv) the Current Assets;

(v) the full benefit of the Contracts and all other contracts or commitments to which the Vendor or TransAlta Utilities Corporation or any of their affiliates is entitled in connection with the Business […]

(vi) the Warranties, if any;

(vii) the Permits;

(viii) computer software listed in Schedule 1.1(a);

(ix) the goodwill of the Business including, without limiting the generality of the foregoing,

a. the exclusive right of the Purchaser to represent itself as carrying on the Business in continuation of and in succession to the Vendor and TransAlta Utilities Corporation and the non-exclusive right to use any words indicating that the Business is so carried on, and

b. to the extent transferable, all customer lists and supplier lists of the Business.

(x) All plans and specifications […]

(xi) All Records;

But excluding, in any event, the Excluded Assets.

"**Business**" means the existing electrical transmission business carried on by the Vendor or TransAlta Utilities Corporation or any Affiliate on their behalf, including Transmission Facilities and associated systems and services in the Province of Alberta and the operations, maintenance and construction of facilities service business, telecommunications initiatives, the engineering procurement and management services and the merchant transmission

> services; the all of which are to be transferred to the Purchaser as a going concern but does not include the Generation Facilities or Excluded Assets;
>
> "**Net Regulatory Book Value**" means the total cost of the Vendor's and TransAlta Utilities Corporation's assets (other than current assets) forming the Assets and the Withheld Assets, less the accumulated depreciation (which excludes accumulated amortization of Customer Contributions) thereon and unamortized Customer Contributions, as determined in accordance with generally accepted accounting principles and which would be included in Rate Base;
>
> "**Rate Base**" means all Assets of the Business used in the determination of regulated transmission revenue requirements as approved by the AEUB [Alberta Energy and Utilities Board] from time to time, including, without limiting the generality of the foregoing, transmission property, allocated corporate property, allowance for working capital and customer contributions;

[18] Under the amended schedule 2.2(2) of the purchase and sale agreement, the parties agreed on the formula for the allocation of the purchase price. The final agreed purchase price –including the Base Purchase Price and the adjustments – was set at $818,150,705. The allocation under the agreed allocation formula was as follows:

a. $590,582,039 to depreciable assets;

b. $11,897,581 to land;

c. $14,583,208 to land rights;

d. $10,263,401 to working capital; and

e. $190,824,476 to goodwill.

The amounts allocated to depreciable assets and land were equal to TransAlta's net regulatory book value of the transmission business on the effective date of the transaction, being a total of $602,479,620.

[19] This allocation was reviewed by the chartered accounting firm of Ernst & Young as part of its audit procedures for AltaLink. Though some reservations were expressed about items which are not in dispute in these proceedings, no reservation was made in respect of the allocation to goodwill: letter of August 22, 2002 reproduced at p. 949 and following of the appeal book. This allocation to goodwill has since been recorded in the audited financial statements of AltaLink.

[20] The purchase and sale transaction was subject to regulatory approval. The Board approved the transaction on March 28, 2002 in its Decision 2002-038. In this process, the potential recapture of the premium paid over the net regulated book value and the impacts on ratepayers were expressly considered. The principles applied by the Board for such purposes are known as the "no-harm test". The no-harm test determines whether a proposed transaction can proceed in a fashion that ensures ratepayers are left at least no worse off than they were prior to the proposed transaction. This may be in the form of financial compensation – such as a recapture of the premium – the setting of appropriate conditions or a combination of measures. The Board had extensively considered the no-harm test in its prior Decision 2000-41 in which it approved the transfer of the electricity distribution business of TransAlta at 1.5 times the net regulatory book value of the tangible assets of that business.

[21] AltaLink committed to abide by a condition under which the closing net regulatory book value – or closing rate base balance – of TransAlta would be equal to the opening net regulatory book value – or opening rate base – of AltaLink. Any premium paid over net regulatory book value would thus not be included in the future rate base of AltaLink. The Board considered this condition

appropriate and consistent with its prior Decision 2000-41 regarding the recovery of a purchase premium, and therefore did not order a recapture of the premium in favour of the ratepayers.

The reasons of the Tax Court judge

[22] The Minister reassessed by reallocating to the tangible assets the full amount of $190,824,476 which had been allocated to goodwill by the parties to the transaction. TransAlta appealed this reassessment to the Tax Court of Canada.

[23] The principal evidence relied upon by the Minister in the Tax Court of Canada in support of that reallocation was an opinion report of Mr. Scott S. Lawritsen which concluded that no goodwill exists when a purchase or sale of regulated assets occurs.

[24] The Tax Court judge rejected this contention, principally on the ground that TransAlta had created significant additional profits from its efficient cost-conscious business culture, and that an intangible business culture was something a buyer would pay for; this constituted goodwill: reasons at paras. 37, 64 and 65.

[25] While there was no direct evidence submitted to the Tax Court judge as to why AltaLink paid the 31% premium over net regulatory book value, the Crown and TransAlta agreed that the premium was paid at least in part because of a potential tax allowance benefit and the potential for leverage.

[26] The potential tax allowance benefit would have resulted from the Board's consideration of taxes for the purposes of setting the rates for the transmission business. In light of this, AltaLink may have expected that it would receive as part of its annual revenues permitted by the Board an allowance for income taxes that would exceed the income tax actually paid by at least one of the partners, namely Teachers. As a limited partnership, AltaLink was not itself subject to income tax, but the tax liabilities associated with its operation of the transmission business would flow to its partners, of which one was a non-taxable pension fund. Consequently, there may have been an expectation that 25% of the allowance for income tax authorized by the Board – representing Teachers' interest in the limited partnership – might potentially flow to Teachers on a tax free basis.

[27] It was also believed that AltaLink could potentially arrange its affairs to use more leverage than was assumed by the Board for ratemaking purposes. Although, as a minimum, the 65:35 debt-to-equity ratio would be maintained in AltaLink, the partners could finance part of their equity participation in AltaLink itself through loans, thus leveraging their respective expected returns.

[28] During the regulatory approval process relating to the transaction, AltaLink represented to the Board that the premium could be justified on the basis that:

a. a performance-based regulation plan could possibly result in a sharing of benefits with customers that would enhance earnings; this was being considered by the Board at the time of the transaction;

b. the possibility of sustained growth in the regulated base could dilute the size of the premium; important capital investments were indeed expected in the electricity transmission business which could potentially yield additional returns; and

c. the existence of competitive merchant transmission projects could provide opportunities to enhance earnings and growth.

The Tax Court judge recognized that these items constituted goodwill: reasons at paras. 36, 38 and 63.

[29] However, he also concluded, adopting the definition of goodwill developed by Lord Macnaghten in *Muller*, that the potential for leverage and the potential tax allowance benefit described above could not be attributed to any goodwill sold by TransAlta: reasons at paras. 33, 34 and 39. He also interpreted the decision of Mahoney J. in *R v. Jessiman Brothers Cartage Ltd.*, [1978] C.T.C. 274, 78 D.T.C. 6205 ("*Jessiman*") as drawing a distinction between "goodwill" and "reasons why a purchaser would pay more for tangible assets": reasons at paras. 56 to 58.

[30] The Tax Court judge then proceeded to discard the allocation of the purchase and sale price which had been agreed to between TransAlta and AltaLink. Although he recognized that the parties had negotiated at arm's length, he found that no hard bargaining had taken place between them concerning the allocation. He reached that conclusion on the basis of his findings that "the amount was not significant in the context of the overall deal, there was indifference on one side and the Parties ended up where the industry norm and business logic in the regulated industry would naturally take them": reasons at para. 53. He consequently found that TransAlta had not made out a

prima facie case of reasonableness, and proceeded to determine what he considered to be a reasonable allocation based on his own valuation: reasons at para. 54.

[31] In light of his findings that the potential for leverage and the potential tax allowance benefit were not part of the goodwill of TransAlta, the Tax Court judge deducted their respective value from goodwill and allocated their combined value to the tangible assets. For this purpose, he determined a value in the range of $25,000,000 to $50,000,000 for the tax allowance benefit and a value of $25,000,000 for leverage. The Tax Court judge provided limited explanations as to the valuation methodology he used to determine these amounts. Using the lower range of his valuation, he deducted $50,000,000 from the agreed allocation of $190,824,476 to goodwill.

The issues

[32] The first series of issues to be addressed in this appeal concern the concept of goodwill in regulated industries. The Crown contends that no goodwill exists in a regulated industry, while the Tax Court judge concluded that the potential for leverage and the potential tax allowance benefit did not form part of the goodwill sold in this transaction. These issues call for a review of both the legal framework governing the regulated transmission business and the legal concept of goodwill. These are primarily questions of law, to be determined on a standard of correctness: *Housen v. Nikolaisen*, 2002 SCC 33, [2002] S.C.R. 235 at paras. 8 and 9.

[33] The second series of issues to be addressed are whether the Tax Court judge erred in ruling that the allocation agreed to between TransAlta and AltaLink was unreasonable under section 68 of

the Act, and whether he could substitute his own allocation based on his own valuation. These issues raise questions concerning: (a) the legal test under section 68, which is a question of law to be decided on a standard of correctness: *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62, [2001] 2 S.C.R. 1082 at para. 34; and (b) the application of that test to the facts in this case, a question of mixed fact and law to be decided in this appeal on a standard of reasonableness.

First Series of Issues: Goodwill in regulated industries

The expert opinions

[34] The Minister's expert, Mr. Lawritsen, expressed the opinion that what is acquired in a purchase and sale transaction involving a regulated business is the cash flow – or revenue stream – generated by the tangible regulated assets of that business. Thus, even though the negotiations between TransAlta and AltaLink were premised on a multiple of the net regulated book value of the tangible assets of the transmission business, the price paid for the business was in effect directly tied to the revenue stream that would be generated by those assets. Consequently, the entire purchase price must be allocated to these tangible assets.

[35] Mr. Lawritsen recognized that his opinion diverged from standard industry and valuation practices. In essence, he – and by necessary implication, the Minister – challenged the validity of the economic and legal theories underlying the regulatory system. The following exchange at the end of Mr. Lawritsen's cross-examination clearly illustrates his position (Transcript at pages 499 to 501, reproduced in the appeal book at pages 1661 to 1663):

Q […] So, if you - - if you disagree with the conclusion, then you're disagreeing with the validity of the economics underlying the regulatory system. Is that - - is that correct?

A Absolutely. I mean, there's - - there's a couple fundamental distinctions here, right? The - - the regulator was saying that, "We're targeting a 9.75 percent rate of return." In reality, we saw 12 - - 11, 12, 13 percent rates of return being realized.

Q Yeah.

A As well, there's no market determining that that 9.75 percent is a - -

Q Correct.

A - - market rate of return. It's up to the individual buyers. So, each individual buyer would, in fact, not be looking at this, per se: would be going out there and saying, "Look, I've got $105 million of EBITDA. It attaches to these assets. What do I want to pay for those assets?"

Q Right.

A Well, if I can pay $800 million for [$]105 EBITDA in 2002 in a volatile economy, I'm going to be happy.

[…]

Q So, this last question, Mr. Lawritsen, and then I promise I'm done. So, the - - the basic disagreement is over the legitimacy of the - - of the numbers that are coming out from the Board as market proxies? That's - - that's the score of your concern with Ms. Glass's - -

A Yeah, in - -

Q - - NPV model?

A Miss Glass says NRBV [net regulatory book value] equals fair market value of the - -

Q No, I'm - -

A - - tangible assets because the regulator says so.

[36] The comprehensive valuation report prepared by TransAlta's expert witness, Ms. Susan H. Glass of KPMG, expressed a different view. Ms. Glass opined that (a) businesses that operate in rate-regulated industries are subject to restrictions that typically reduce the multiple of net book

value that a purchaser is willing to pay for the business, which in turn might reduce, but would not eliminate, the potential for goodwill; (b) these same restrictions generally result in the fair market value of rate-regulated tangible assets being equal to the net regulated book value of those same assets; and (c) as a result, in a rate-regulated industry, any premium over net regulatory book value would normally be attributable to goodwill or other intangible assets: KPMG valuation at para. 177, reproduced at p. 1082 of the appeal book.

[37] Ms. Glass further explained that the standard valuation method in such circumstances is to assess the fair market value of the tangible assets and identifiable intangible assets, and to allocate to goodwill the difference between that fair market valuation and the actual price paid for the assets.

[38] She valued the tangible assets which were part of the TransAlta transaction in accordance with the income valuation approach – or discounted cash-flow approach – which she determined as the most appropriate valuation approach in the circumstances. This valuation resulted in a fair market value for the assets of $600,698,000, which was within 2.7% of the net regulated book value of these assets, and well within an acceptable margin of error: KPMG report at paras. 371 to 373, reproduced at p. 1118 of the appeal book.

[39] To illustrate further, Ms. Glass identified a number of goodwill factors related to excess earnings, excess returns, growth and strategic benefits that could and likely would have had an impact on the price AltaLink was willing to pay for the transmission business. She recognized that these factors cannot be precisely quantified; nevertheless, their rough quantification supported her

expert opinion that, as of the closing date of the transaction: (a) the fair market value of the tangible assets and intangible land rights sold by TransAlta equalled the net regulatory book value of the assets; (b) the fair market value of goodwill related to the transmission business equalled the full purchase premium paid by AltaLink; and therefore (c) the purchase price allocation negotiated by TransAlta and AltaLink was in accordance with the fair market value of the tangible and intangible assets bought and sold: KPMG report at paras. 401 and 414, reproduced at pp. 1123 and 414 of the appeal book.

The legal framework of the regulatory system

[40] The core purpose of regulating, through rates, the prices charged by TransAlta's transmission business is to control potential abuses of the monopoly position of that business. TransAlta's electricity transmission business is thus regulated in order to ensure an efficient and cost-effective essential service to its clients, while also ensuring a fair and reasonable rate of return for the capital required to provide that service.

[41] The process for setting rates in a regulated industry has been described in *Northwestern Utilities Ltd. v. City of Edmonton*, [1929] S.C.R. 186. In that case, the Board of Public Utility Commissioners of Alberta made an order in 1922 fixing rates chargeable for gas supplied in the City of Edmonton. The Board fixed the rates on the basis of an allowance of 10% as a fair return on the investment in the enterprise. In 1926, Northwestern Utilities applied for a continuation of the rates. In determining the rates, the Board reduced the return to 9% in view of altered conditions in the money markets. In rejecting the appeal, Justice Lamont made the following comments [at pp. 192-193]:

> The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested. By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise. In fixing this net return the Board should take into consideration the rate of interest which the company is obliged to pay upon its bonds as a result of having to sell them at a time when the rate of interest payable thereon exceeded that payable on bonds issued at the time of the hearing. To properly fix a fair return the Board must necessarily be informed of the rate of return which money would yield in other fields of investments. Having gone into the matter fully in 1922, and having fixed 10% as a fair return under the conditions then existing, all the Board needed to know, in order to fix a proper return in 1927, was whether or not the conditions of the money market had altered, and, if so, in what direction, and to what extent.
>
> [Emphasis added]

[42] This process was adopted in Alberta for the purpose of setting the rates for the transmission business at the time of its sale by TransAlta. Under that regulatory process, the rates set by the Board provided enough revenue not only for operating expenses, but also for the capital costs of the business financed through debt and equity participation. The rate of return and associated debt-to-equity ratio was determined by the Board and revised periodically, usually after public hearings. The regulatory process thus served as a form of proxy to a market environment.

[43] Consequently, under the theory supporting the system of regulation operated by the Board for the transmission business at issue, returns to equity holders determined for regulatory purposes should normally be equivalent to the returns these equity holders would obtain through investments in other businesses having comparable risks.

[44] This legally mandated result has important consequences for the purpose of determining the fair market value of the assets underlying a regulated business. Since returns on equity are determined on the basis of a fair market approach, the market value of the tangible assets of a regulated business should normally reflect the regulated book value of these assets. This is an inherent consequence of the legal mandate under which the regulator operates.

[45] In reality, regulated industries may sometimes achieve returns on equity which are higher than those approved by a regulator for rate-making purposes.

[46] These additional returns may result from the fact that the managers of the regulated business have achieved exceptional performances beyond those achieved in comparable businesses. Efficient management controls of costs may allow for more of the regulated income streams to be directed towards equity returns and thus providing above-market returns for an investment at a comparable level of risk. Additional returns on equity may also be achieved through new business opportunities generating additional earnings. These efficiencies and new opportunities may be explicitly or implicitly encouraged by the regulatory environment since they may potentially be recaptured in whole or in part for the benefit of the ratepayers.

[47] Furthermore, even without additional returns, a regulated business may present strategic business opportunities which enhance its value as a business without necessarily enhancing the value of its underlying tangible assets. These strategic factors may vary considerably, but the opportunity for new market developments is surely an important one.

[48] The nature of the regulatory system results in the fair market value of the tangible assets sustaining the regulated business being largely equivalent to the regulated book value of those assets. As noted above, this is a result flowing from the legislated regulatory framework adopted for this industry. Consequently, any increased value of the business achieved through excess returns resulting from exceptional business management, from new business opportunities or other strategic factors should normally be allocated to goodwill.

[49] The Board itself implicitly recognized this. As occurred in this case, a regulated business may be sold at a premium to the regulated book value of its underlying tangible assets. This premium may result from the fact the regulator has not accurately assessed the market returns on equity for comparable investments and has thus set the regulated rate of return too high. This premium may also result from abrupt market changes since the last regulatory rate determination. However, in regulatory theory, such errors or abrupt market changes would normally be rapidly corrected through subsequent regulatory rate renewal determinations.

[50] The Board commented as follows on this issue in its Decision 2004-052 concerning the generic cost of capital, under the heading "Market-to-Book Ratios and Acquisition Premiums":

> <u>The Board agrees with the Applicants that there are a number of factors impacting market-to-book ratios of utility holding companies and that one has to be cautious making inferences regarding the regulated utilities. The Board also agrees that there may be strategic factors affecting the price that is paid to acquire a utility.</u>
>
> For example, NGTL submitted that its parent did not acquire a further interest in the Foothills pipeline, paying 1.6 times book value, for the opportunity to earn a return at the NEB formula rate; rather, the investment was made in an effort to increase the probability that TCPL will participate in a Northern pipeline project. <u>The Board also</u>

> recognizes that, in some cases, a premium might be paid for regulated assets in anticipation of significant future growth in rate base, to achieve geographic diversification or to obtain a foothold in a new market. However, parties are also aware of the constraints placed on regulated utilities with respect to affiliate transactions, particularly those with unregulated affiliates.
>
> In the absence of such strategic factors, the Board would not expect a prudent investor to pay a significant premium unless the currently awarded returns are higher than that required by the market. The Board acknowledges the views of some parties that payment of a premium over book value for a regulated utility indicates that the recent ROE awards may have been higher than required by the market. The Board is not aware of the strategic factors that may have affected the price paid to acquire Alberta utilities in recent years. Nevertheless, the experience regarding the market-to-book values of utilities and the experience regarding the acquisition of Alberta utilities in recent years gives the Board some comfort that its recent ROE awards have not been too low.
>
> […]

The concept of goodwill

[51] The Tax Court judge relied on the following definition of goodwill set out by Lord Macnaghten in *Muller* at pp. 223-224:

> What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation, and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start. The goodwill of a business must emanate from a particular centre or source. However widely extended or diffused its influence may be, goodwill is worth nothing unless it has power of attraction sufficient to bring customers home to the source from which it emanates. Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here and another element there. To analyze goodwill and split it up into its component parts, to pare it down as the Commissioners desire to do until nothing is left but a dry residuum ingrained in the actual place where the business is carried on while everything else is in the air, seems to me to be as useful for practical purposes as it would be to resolve the human body into the various substances of which it is said to be composed. The goodwill of a business is one whole, and in a case like this it must be dealt with as such.

[52] This definition was developed well over a century ago at a time when a client base and good reputation were understood as the principal elements of goodwill. Although this definition is still useful, important developments in the fields of business, accounting, valuation and law in the last century also need to be taken into account in order to better understand the modern concept of goodwill.

[53] As noted by Lord Macnaghten, goodwill is a concept which is difficult to define. It is composed of a variety of elements, and its composition varies according to different trades and different businesses in the same trade. Consequently, even after much study and numerous publications on the subject, a proper definition of goodwill has eluded both the legal and the accounting professions. Like the accounting profession, I conclude from this that any attempt to define goodwill is doomed to failure. Rather, various characteristics inherent to the notion of goodwill should be identified and then used to ascertain goodwill on a case-by-case basis.

[54] As noted at the outset of these reasons, three characteristics must be present in order for goodwill to be found: (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. If these three characteristics are present, it can be reasonably assumed that goodwill has been found: see John W. Durnford, "Goodwill in the Law of Income Tax" (1981), 29(6) Canadian Tax Journal 759 ("Durnford"), at pp.

763 to 775; see also *Muller* above; *Manitoba Fisheries Ltd. v. Canada*, [1979] 1 S.C.R. 101; *Dominion Dairies Limited v. Minister of National Revenue* (1965), 66 D.T.C. 5028 (Ex. Ct.); *Les Placements A & N Robitaille Inc. v. The Minister of National Revenue* (1994), 96 D.T.C. 1062 (T.C.C.); *FCT v. Murray* (1998), 155 ALR 67 (Aus. H.C.).

[55] An established reputation, customer satisfaction, a unique product or process leading to a monopolistic position, good or astute management, favourable location, manufacturing efficiency, harmonious labour relations, advertising, quality of products, and financial standing have all been found to constitute goodwill insofar as they meet the three characteristics: Durnford at pp. 772-773.

[56] Consequently, in this case, efficient management by TransAlta and the potential for new business opportunities flowing from TransAlta's transmission business can thus be viewed as goodwill. These intangible assets arise from the expectation of future earnings, returns or other benefits in excess of what would be expected in a comparable business; they are inseparable from the business to which they belong, and they cannot normally be sold apart from the sale of the business as a going concern. All of these are characteristics of goodwill.

[57] Finally, I address the distinction between "goodwill" and "reasons why a purchaser would pay more for tangible assets" drawn by the Tax Court judge from *Jessiman*. At issue in *Jessiman* was the sale of postal trucks, not the sale of the postal delivery business as a going concern to which the trucks belonged. Since one of the characteristics of goodwill identified above is that it can only be sold with the business as a going concern, no goodwill could therefore be transferred or sold in

the context of the sale of trucks considered in *Jessiman*: see *FCT v. Murray*, above. *Jessiman* stands for no more than this.

[58] In conclusion, I agree with the Tax Court judge that the Minister was wrong in law to take the position that no goodwill could exist in a regulated industry.

Did the Tax Court judge err in finding that leverage and the tax allowance were not part of goodwill?

[59] As the Tax Court judge found, goodwill was sold and purchased in this transaction. The business being purchased and sold included not only the transmission business, but also the "maintenance and construction of facilities service business, telecommunications initiatives, the engineering procurement and management services and the merchant transmission services": see the definition of "Business" in final amended purchase and sale agreement reproduced above. These were all potential sources of revenues and returns which TransAlta had marketed to potential buyers in it bidding process. Similarly, the Tax Court judge found that many other elements justifying the premium paid over net regulatory book value could be attributed to goodwill.

[60] However, he also concluded that the potential for leverage and the potential tax allowance benefit were not part of the goodwill sold by TransAlta, but their value should be allocated to TransAlta's tangible assets: reasons at paras. 60 to 62. Did he err in so concluding?

[61] The Tax Court judge excluded the potential for leverage from goodwill based on his definition of goodwill (reasons at para. 72):

> They [amounts related to leverage] relate more closely to the rate of earnings based on the NRBV [net regulatory book value] of the tangible assets, and specifically AltaLink's ability to eke out more return from those assets, not due to anything Transalta (sic) did to retain or expand its customer base and are, therefore, properly allocated to those tangible assets.

[62] Contrary to the narrow concept of goodwill applied by the Tax Court judge, goodwill is not limited to the retention or expansion of a customer base. Goodwill will also arise if a business can potentially generate returns in excess of what would be expected in a comparable business. The potential for leverage in the transmission business is an intangible asset which, if prudently used, can potentially lead to additional returns. The fact that TransAlta itself did not leverage its investment in its electricity transmission business does not mean that the potential for excess returns resulting from leverage is not one of the intangible assets which it held in that business. The potential for leverage is an intangible asset which can be marketed and sold to potential purchasers of a business who have the ability to use it.

[63] The potential for leverage is an intangible asset which may sustain an expectation of future returns in excess of those in a comparable business; leverage is inseparable from the business, and the potential for leverage cannot be sold apart from the sale of the business as a going concern. The potential for leverage thus holds all the characteristics of goodwill discussed above. Barring a good reason to find otherwise (which is not present here), the potential for leverage was thus part of the goodwill sold with the transmission business.

[64] The Tax Court judge also concluded that the potential tax allowance benefit was not goodwill since it resulted from the way TransAlta had structured itself. The benefit of the use of a

tax allowance by a non-taxable partner could not therefore be viewed as an asset of TransAlta. I agree. However, that same reasoning also leads to the conclusion that the potential tax allowance benefit cannot be attached to the tangible assets sold by TransAlta. Consequently, the potential tax allowance benefit, in law, was neither part of TransAlta's goodwill nor attached to TransAlta's tangible assets. Rather, it was an intangible of AltaLink or of Teachers.

[65] Does this conclusion justify deducting on this basis between $25,000,000 and $50,000,000 from the goodwill allocation – representing between 13% and 26% of the premium paid by AltaLink – as the Tax Court judge did in this case? For three distinct reasons, it does not.

[66] First, the value of this potential tax allowance benefit was much lower than that assessed by the Tax Court judge. Although both TransAlta and the Crown believe that AltaLink may have considered the potential tax allowance benefit in setting the premium it paid for the transmission business, they have not agreed on the value which TransAlta may have attributed to this potential benefit. The only valuation submitted as evidence in this case was the KPMG valuation report. In that report, the KPMG expert valuator, Ms. Glass, concluded that "only a small portion of the premium might have been paid as a result of the tax allowance": KPMG valuation report at para. 135, reproduced at p.1075 of the appeal book, emphasis added. She also noted that in accordance with valuation theory, none of this allowance could be attributed to the value of the tangible assets: KPMG valuation report at para. 168, reproduced at p.1080 of the appeal book. The expert valuator also noted that no goodwill impairment was recorded after the tax allowance was adjusted by the Board to account for Teachers' participation in the limited partnership: KGMP valuation report at

para. 150, reproduced at p. 1078 of the appeal book. In light of the contingent and uncertain nature of this potential benefit, it is likely that a prudent investor would have largely discounted its value.

[67] Second, even if a small portion of the premium which was paid could be attributed to the potential tax allowance benefit, it was not unreasonable for the parties to the transaction to allocate that portion to goodwill for the purposes of section 68 of the Act. Indeed, as I have already noted, the potential tax allowance was neither part of TransAlta's goodwill nor of its tangible assets. As further discussed below, section 68 sets up a reasonableness test for the purposes of a price allocation. Thus, an amount which is not "goodwill" in the legal sense of the concept may still be allocated to "goodwill" for accounting and taxation purposes if such an allocation can be regarded as reasonable. In this case, since the allocation of the potential tax allowance benefit cannot be made to the tangible assets which were sold, any portion of the premium which could be attributed to the potential tax allowance benefit, for accounting and taxation purposes, would receive the same treatment as if it were goodwill. In such circumstances, the parties' allocation of that portion to goodwill can be regarded as reasonable for the purposes of section 68 of the Act.

[68] Finally, when dealing with a multitude of goodwill elements, it is improper to assign a specific separate value to each of its constitutive elements. Goodwill is inherently difficult to value, since different aspects of goodwill will be given different values depending on the circumstances. As noted by Lord Macnaghten in *Muller* (at p. 224):

> One element may preponderate here and another element there. To analyze goodwill and split it up into its component parts [...] seems to me to be as useful for practical purposes as it would be to resolve the human body into the various substances of which it is said to

> be composed. The goodwill of a business is one whole, and in a case like this it must be dealt with as such.

[69] This is why the residual approach to valuing goodwill is preferred. Under that approach, the more easily valued assets (such as tangible assets) are first given a fair market value, and any consideration paid in excess of this fair market value is assigned to goodwill. In this case, that was the valuation method on which both the Minister's expert and TransAlta's expert were in agreement. The following extract from the cross-examination of Mr. Lawritsen is instructive [at pp. 432 and 443-444 of the transcript, reproduced at pp. 1594 and 1605-1606 of the appeal book]:

> Q So, as it - - so, what you're saying is that - - that goodwill is a residual concept? You and Ms. Glass agree on that, basically?
>
> A Yes.
>
> […]
>
> Q Okay, thank you. Now, Mr. Lawritsen, I asked you a moment ago about your - - the residual nature of goodwill, and I think you and I agreed in paragraph 5.05(3), in one of your definitions, you mention:
>
> > Goodwill cannot be quantified/determined specifically (directly). It is only the excess of the purchase price over the identifiable net assets.
>
> I think that's what you and I agreed on a few minutes ago.
>
> A It's a typical type of definition reference that an appraiser would use.

[70] The fact that some intangible elements that do not constitute "goodwill" in the legal sense may be captured through such a 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.

[71] Consequently, in accordance with the unanimous opinion of the experts who testified in this case, goodwill should normally be valued as a residual whole. The Tax Court judge had no basis to conclude otherwise.

Second Series of Issues: The Reasonableness of the Goodwill Allocation

The test under section 68 of the Act

[72] Section 68 of the Act reads as follows:

68. Where an amount received or receivable from a person can reasonably be regarded as being in part the consideration for the disposition of a particular property of a taxpayer or as being in part consideration for the provision of particular services by a taxpayer,

(*a*) the part of the amount that can reasonably be regarded as being the consideration for the disposition shall be deemed to be proceeds of disposition of the particular property irrespective of the form or legal effect of the contract or agreement, and the person to whom the property was

68. Dans le cas où il est raisonnable de considérer que le montant reçu ou à recevoir d'une personne est en partie la contrepartie de la disposition d'un bien d'un contribuable ou en partie la contrepartie de la prestation de services par un contribuable :

a) la partie du montant qu'il est raisonnable de considérer comme la contrepartie de cette disposition est réputée être le produit de disposition du bien, quels que soient la forme et les effets juridiques du contrat ou de la convention, et la personne qui a acquis le bien à la suite de cette

disposed of shall be deemed to have acquired it for an amount equal to that part; and

disposition est réputée l'acquérir pour un montant égal à cette partie;

(*b*) the part of the amount that <u>can reasonably be regarded</u> as being consideration for the provision of particular services shall be deemed to be an amount received or receivable by the taxpayer in respect of those services irrespective of the form or legal effect of the contract or agreement, and that part shall be deemed to be an amount paid or payable to the taxpayer by the person to whom the services were rendered in respect of those services.

[Emphasis added]

b) la partie du montant qu'il est <u>raisonnable de considérer</u> comme la contrepartie de la prestation de services est réputée être un montant reçu ou à recevoir par le contribuable pour ces services, quels que soient la forme et les effets juridiques du contrat ou de la convention, et être un montant payé ou payable au contribuable par la personne à qui ces services ont été rendus.

[Je souligne]

[73] As is apparent from the language of section 68, the applicable test is one of reasonableness. The concept of reasonableness for taxation purposes was reviewed by Cattanach J. in *Gabco Limited v. Minister of National Revenue* (1968), 68 D.T.C. 5210 (Ex. Ct.) ("*Gabco*"), albeit in a different statutory context. The following test was applied in that case (at p. 5216):

> It is not a question of the Minister or his Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.

[74] The *Gabco* test was adopted by this Court for determining if the deduction of an expense was reasonable for the purposes of section 67 of the Act: *Petro-Canada v. Canada*, 2004 FCA 158, 2004 D.T.C. 6329 at para. 62.

[75] 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. In this context, long-standing regulatory and industry practices, as well as auditing and valuation standards and practices, are relevant.

[76] TransAlta also submits that where parties dealing at arm's length have agreed to the allocation of the proceeds of the disposition of a property, considerable weight must be given to their agreement, particularly if the parties have specifically negotiated with respect to the allocation: *The Queen v. Golden et al*, [1986] 1 S.C.R. 209, 86 DTC 6138 and *George Golden v. Her Majesty The Queen*, 83 D.T.C. 5138 (F.C.A.).

[77] An allocation agreed between the parties to an arm's length transaction is an important factor to consider for the purpose of section 68 of the Act. However, the weight to be given to such an agreement will vary according to the circumstances. An agreement where the parties have strong divergent interests concerning the allocation will be given considerable weight, while an agreement where one of the parties is indifferent, or where both parties' interests are aligned as regards the

allocation, will be given less weight: *R.L. Petersen v. The Minister of National Revenue* (1987), 88 D.T.C. 1040 at pp. 1046-1047.

[78] The fact that the parties have agreed to an allocation does not trump the reasonableness test under section 68 of the Act. As I have already noted, that test is whether a reasonable business person, with business considerations in mind, would have made the allocation. That the parties to an arm's length transaction have agreed on an allocation is an important factor to consider, but an agreed allocation which does not meet the reasonableness test may still be challenged under section 68.

The application of the test

[79] The Tax Court judge understood the reasonableness test under section 68 as a two-tiered process:

> (a) first determine if the allocation agreed to by parties to an arm's length transaction was the result of "real bargaining with respect to the allocation between such parties with relatively equal bargaining positions"; if such is the case, that agreed allocation is *prima facie* proof of the reasonableness of the allocation which can only be challenged by the Minister if there is "a fundamental mistake in the foundation of the parties agreement": reasons at subparagraphs 47(iii) and (iv);
>
> (b) failing real bargaining in an equal bargaining position, "the Court shall determine a range of what is reasonable", such range being understood as a range of possible

> fair market values based on the nature of the asset and the industry, the context of the transaction and "other relevant factors": reasons at subparagraph 47(v) and paras. 26 to 28.

[80] The Tax Court judge concluded that the parties to the transaction had failed to engage in real bargaining. He found that AltaLink was indifferent to an allocation of the price to goodwill beyond the net regulatory book value of the tangible assets. He reached this finding on the basis that TransAlta's post-transaction rates for capital cost allowances would be similar whether the price allocation went to tangible assets or to goodwill: reasons at para. 51. This indifference resulted in "the Parties end[ing] up where the industry norm and business logic in the regulated industry would naturally take them": reasons at para. 53. This conclusion allowed the Tax Court judge to proceed with his own valuation.

[81] The test used by the Tax Court judge is complex and sets out no guiding principles. It is a test based partly on form, which allowed him to substitute his own subjective allocation for that agreed upon by the parties in compliance with industry and regulatory standards.

[82] Had the Tax Court judge applied the correct test, and considered whether a reasonable business person, with business considerations in mind, would have allocated the amount of $190,824,476 to goodwill, 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.

Conclusions

[83] For the reasons set out above, I would allow the appeal, set aside the Tax Court of Canada's judgment, dismiss the cross-appeal, allow the appeal of the Minister's reassessment of TransAlta Energy Corporation, the appellant's predecessor by way of amalgamation, and remit the matter to the Minister for reassessment in accordance with these reasons. I would also award costs to TransAlta.

"Robert M. Mainville"
J.A.

"I agree.
John M. Evans J.A."

"I agree.
Carolyn Layden-Stevenson J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-350-10

APPEAL FROM A JUDGMENT OF MR. JUSTICE MILLER OF THE TAX COURT OF CANADA, DATED JULY 13, 2010.

STYLE OF CAUSE:	Transalta Corporation v. Her Majesty The Queen
PLACE OF HEARING:	Calgary, Alberta
DATE OF HEARING:	December 13, 2011
REASONS FOR JUDGMENT BY:	MAINVILLE J.A.
CONCURRED IN BY:	EVANS J.A. LAYDEN-STEVENSON J.A.
DATED:	January 20, 2012

APPEARANCES:

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