Docket: 2003-2892(IT)G

BETWEEN:

DOUGLAS ZELLER AND LEON PAROIAN,
TRUSTEES OF THE ESTATE OF MARJORIE ZELLER,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on February 27, 28, March 1 and 2, 2006, October 23, 24, 25, 26 and 27, 2006, March 26, 27, 28 and 29, 2007 and July 17 and 18, 2007 at Windsor, Ontario

Before: The Honourable Justice Diane Campbell

Appearances:

Counsel for the Appellant: Bruck R. Easton, Q.C.
Counsel for the Respondent: Michael Ezri and Roger LeClaire

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## JUDGMENT

The appeal from the assessment made under the *Income Tax Act* for the 1998 taxation year is allowed and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

The matter of costs is reserved. The parties have 60 days from the date of my Reasons to reach an agreement on costs but if they are unable to agree within the timeframe, they will provide written submissions on the issue of costs within 30 days of the expiration of the initial 60 day period.

Signed at Charlottetown, Prince Edward Island, this 30th day of July 2008.

"Diane Campbell"

Campbell J.

Citation: 2008 TCC 426
Date: 20080730
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## **REASONS FOR JUDGMENT**

**Campbell J.**

[1] On October 20, 1998, Marjorie Zeller, the sole shareholder of 701221 Ontario Limited ("701"), died. In filing the terminal tax return, the Trustees of her estate determined that the fair market value ("FMV") of 701 was $958,548, pursuant to the deemed disposition provisions contained in subsection 70(5) of the *Income Tax Act* (the "*Act*"). Canada Revenue Agency ("CRA") reassessed the estate's return and increased the FMV of 701 to $5,524,548. This value was based on an expert report by Mike Albert (the "Albert Report"). In response, the Appellant enlisted the firm of Wise, Blackman to do a valuation. The Wise, Blackman Expert Report (Exhibit A-26) concluded that 701 had an en bloc value of $2.2 million, being the mid-point of an overall range of $2.1 to $2.3 million assigned to 701. The Respondent had a second expert report prepared by Tim Dunham, which assigned a FMV to 701 of $6.38 million, on the valuation date of October 20, 1998. Although both the Wise, Blackman & Dunham Reports used the same valuation methodology, the Earnings Method, to determine the FMV, the outcomes are markedly different.

[2] The Albert Report also used the same method to determine the FMV of 701. However, no expert witness was called to testify on the findings in the Albert Report and I had little evidence respecting the underlying rationale behind that

report's conclusions. Mr. Dunham, who authored the Respondent's second report, testified that he did not read or consult with the earlier Albert Report when he prepared his own report. Consequently, I am giving no weight to the Albert Report.

[3] The sole issue is the FMV of the shares of 701 on October 20, 1998.

The Facts

[4] 701 has no assets or liabilities other than its interest in Thompson Emergency Freight Systems ("Thompson"). Thompson is in the expediting trucking industry, delivering a niche service as an emergency freight carrier to support "just-in-time" delivery of inventory and parts in the automobile manufacturing industry. In the 1980s, when large trailers failed to deliver the requisite freight, expediting trucking companies, such as Thompson, filled this niche in the automotive industry and sent smaller trucks to ensure on-time delivery. If inventory or parts were required on short notice to keep automotive assembly lines moving, Thompson contracted to transport those items as quickly as possible to minimize downtime at a plant. Mike Ouellette, the President of Thompson, aptly described the business as "… a fireball service or an ambulance service in the trucking industry" (Transcript page 297). Thompson was formed in the summer of 1985 by George Zeller and Michael Ouellette. A third shareholder, Jerry Thompson, joined them to provide the transport licenses, which were essential prior to deregulation in the industry. The capital investment of each shareholder was $42,000. 701 was the corporate vehicle through which George Zeller held his interest in Thompson. Douglas Zeller, George's son, was involved with Thompson from its inception as its general manager.

[5] Thompson operated through two companies, 890557 Inc. ("890") and its American affiliate, a Michigan corporation, known as 123 Inc. ("123"). Despite these different companies, Thompson maintained only one office and central terminal located in Windsor, although it serviced eastern Ontario, Québec and the eastern United States. Items delivered and remaining within Canada were handled by 890 while 123 looked after the United States branch of the business. Revenue was allocated between 890 and 123 depending on whether the income was derived from an American or Canadian based truck. The revenue in 890 was approximately two to three times larger than that of 123.

[6] Thompson owned no trucks. Instead it engaged independent owner/operators known as brokers or 100s. These brokers supplied their own trucks to move the freight. Thompson supplied the temporary license plates, together with the

information pertaining to pick up and delivery of the freight. Michael Ouellette described these brokers as migratory in that they worked with the expediting company that could give them the best deal or the most work. Since there was no binding contract, once a broker moved freight he could hand in his license plate and move freely to provide services to a competing expediting company. If Thompson contracted to transport freight, it was essential that brokers were available, otherwise, third-party dispatchers had to be engaged, a practice known as interlining freight. Depending on the rates charged by these third-party dispatchers, compared to the brokers, Thompson could incur a profit or loss. Interlining freight also brought with it an increased exposure to liability. The Canadian brokers were unionized and were represented initially by the Brotherhood of Railway Workers until the early 1990s when it was taken over by Canadian Auto Workers Union ("CAW").

[7] In the early 1990s, a number of events occurred that would have significant impact on Thompson's activities. Thompson's primary and most important client, General Motors National Logistics ("GM"), provided 75 to 85% of its business base. Thompson was under contract as the first call provider of emergency freight services to GM. However, because GM retained the right to cancel on thirty days notice, Thompson remained in a precarious position. In addition, George Zeller, one of the founding shareholders and the President of the company, retired and several months later died on May 18, 1991. His interest in Thompson, held via 701, was bequeathed to his spouse, Marjorie Zeller. At the time of his death, 701 owned a third interest in 890 and a third interest in 123, the remaining interests belonging equally to Mike Ouellette and Jerry Thompson. The following year, in November 1992, the third shareholder in Thompson, Jerry Thompson, went bankrupt. His one-third interest in 890 was sold to the two holding companies owned by the two remaining shareholders, Mike Ouellette and Marjorie Zeller for $75,000. Mr. Thompson retained his one-third interest in 123, along with the other two shareholders. As a result, 701 owned a 50% interest, along with Mike Ouellette's holding company, in 890 and a 33 1/3% interest in 123 with Mike Ouellette and Jerry Thompson.

[8] With the death of George Zeller and the Thompson bankruptcy, Douglas Zeller became an officer and director of 890 and 123 and since Marjorie Zeller, his mother, was never actively involved in the business, he was designated as her representative in Thompson. Michael Ouellette took George Zeller's position as President. In June 1991, Thompson was able to re-establish its foothold in the automotive industry by obtaining a large contract with GM in Detroit. According to the evidence of Michael Ouellette, during the

1990s a strong expediting freight business required a core account such as the GM account. He explained that the GM contract designated Thompson as its first call provider for expediting GM freight. This allowed Thompson to spread broker vehicles over a large geographical area, resulting indirectly in increasing its exposure to the possibility of moving other freight in addition to GM's freight. He stated that "…the reason why Thompson became, you know, a real player in the international expedite industry between Canada and the US, was the GM business" (Transcript page 315).

[9] Although GM was at the core of most of Thompson's revenues, the fact that the relationship could be terminated by GM upon 30 days notice, gave GM a strong bargaining tool which it used periodically to "strong arm" Thompson into reducing mileage rates. Several occurrences respecting this GM contract significantly impacted upon Thompson's business in 1998 but first I want to review the relationship between Douglas Zeller, Michael Ouellette and Marjorie Zeller, the three key players immediately following the death of George Zeller.

[10] The evidence of both Douglas Zeller and Michael Ouellette was basically that their working relationship in Thompson was, to put it mildly, full of strife. It was clear from Mr. Zeller's evidence that he found himself in a no-win situation because Marjorie Zeller rarely supported his decisions as her representative in Thompson. Added to this mix, he and Mr. Ouellette had a very strained working relationship. Patrick Kennedy, Marjorie's son-in-law, who eventually replaced Douglas Zeller as Marjorie's representative in Thompson, testified that Marjorie Zeller would withhold her support for Douglas Zeller's business decisions based on family issues. According to Mr. Kennedy's evidence, Marjorie Zeller was always on the "outs" with one of her children. He stated that "She would turn you off like a light switch…" (Transcript page 632). "It seemed like she just couldn't love all her children at once" (Transcript page 631). It is not surprising that Douglas Zeller informed his mother that he intended to leave the business. Patrick Kennedy replaced him in March 1997 as Marjorie's representative in Thompson.

[11] Douglas Zeller and three employees of Thompson established Genesis Express, a competing company in the expediting freight industry. Genesis Express was established with a total investment of $48,000 approximately six weeks after his departure from Thompson. Douglas Zeller possessed insider knowledge respecting Thompson's mileage rates, sensitive information which could enable Genesis Express to undercut Thompson for future contract bids. In

March 1997, Michael Ouellette believed this threat serious enough that he instituted legal proceedings to prevent Genesis Express from soliciting Thompson's clients, employees and brokers. Settlement was reached in April 1997. One of its primary terms provided for an eighteen month injunction against Genesis Express soliciting the GM expedite work, Thompson's main client. In return, Thompson agreed to use Genesis Express for a six month period as its first expediting back-up call, although this rarely occurred.

[12] Patrick Kennedy came to Thompson with very little knowledge of the expediting business and no prior management experience. Despite this fact, he negotiated a salary with Marjorie Zeller that was comparable to that of Douglas Zeller and Michael Ouellette. Mr. Ouellette described Thompson's executive compensation package as incentive based and consisting of a base salary and bonuses. In addition to the "… craziness of what was going on with the family" (Michael Ouellette's evidence, Transcript page 343) and the legal wranglings and confidentiality issues with Douglas Zeller, he was wary of the inexperienced newcomer, Patrick Kennedy. In the summer of 1998, the GM contract was also nearing its termination date and would be up for renewal in January 1999. In addition GM was in the midst of a 57 day strike which inevitably affected Thompson's revenue. Throughout the summer of 1998, Mr. Ouellette was also involved with renegotiating a contract with CAW. The union negotiations concluded in November 1998, subsequent to the valuation date, and the new CAW contract increased broker expenses for Thompson. This new rate system, based on a fixed rate per mile for brokers, increased Thompson's risks to foreign exchange fluctuations, according to Mr. Ouellette's evidence.

[13] With all of these events playing out, Mr. Ouellette considered terminating his business relationship with Marjorie Zeller and eventually made what Appellant counsel characterized as a binding offer through the corporate solicitor, Gerald Trottier. A follow-up counter offer was made by Arthur Weingarden, solicitor for Marjorie Zeller. Mr. Ouellette did not accept this counter offer. Respondent counsel characterized these events as discussions entered into by Mr. Ouellette respecting a possible offer to buy Marjorie Zeller's share of the business or to sell his interest in Thompson to her. However, the Respondent contends that these negotiations did not constitute a formal offer.

[14] By a letter dated July 13, 1998, Mr. Trottier forwarded a draft Agreement of Purchase and Sale of Shares to Mr. Ouellette in which it was proposed that Mr. Ouellette purchase 701's shares in both 890 and 123 or sell his interest in Thompson to Marjorie Zeller for $600,000 plus the repayment of the other

shareholder's loans. This draft offer excluded the usual representations and warranties typical of a share purchase agreement and contained no provision for a non-competition agreement. It was never finalized or forwarded to anyone but on August 11, 1998 Mr. Trottier telephoned Arthur Weingarden, Marjorie Zeller's solicitor, in respect to this share purchase. According to Mr. Weingarden's evidence, Marjorie Zeller had also talked to him about the possibility of purchasing Mr. Ouellette's interest in Thompson in the month or so prior to the August 11, 1998 call from Mr. Trottier. According to Mr. Weingarden, Mrs. Zeller wanted to purchase Mr. Ouellette's interest and obtain a non-competition agreement from him, with the intention of turning the company over to her son, Douglas Zeller. These events culminated in a letter dated September 29, 1998 (Exhibit A-1, Tab 42) from Mr. Weingarden to Mr. Ouellette, enclosing a draft share purchase agreement. Mrs. Zeller was offering to purchase Mr. Ouellette's shares but, unlike Trottier's draft agreement, this one included the typical representations and warranties, as well as a requirement for a non-competition agreement. By letter dated October 6, 1998 Mr. Ouellette advised that he no longer wished to pursue this transaction. Mrs. Zeller died on October 20, 1998, just several weeks after these events. According to her medical records, she was diagnosed with terminal lung cancer around September 5, 1998.

The Expert Reports

[15] The authors of both reports are all highly qualified, experienced business valuators. Richard Wise has had numerous publications. In fact, Timothy Dunham in his expert report referenced one of Mr. Wise's co-authored publications. He has appeared as an expert in this Court on numerous occasions as well as other Courts, including the U.S. Tax Court. Drew Dorweiler is a principal with Wise, Blackman and has been with this firm for 17 years. He has been testifying as an expert witness in various Courts in Québec, Ontario and the U.S., although this was the first appearance as an expert witness in this Court.

[16] Timothy Dunham has designations as both a Chartered Business Valuator and Chartered Financial Analyst and has been with CRA in the valuation section for 17 years. He has given evidence as an expert witness before this Court on one other occasion. I conclude that the Respondent's argument that Mr. Wise was not directly responsible for the Wise, Blackman Report is unfounded. I accept Mr. Wise's evidence in this respect because I believe, based on what he told the Court, that his expertise, experience and judgment were utilized throughout, in collaboration with Mr. Dorweiler, in producing their expert report.

[17] There are three generally accepted approaches used in valuing a business or a business interest on a "going concern basis": the asset based approach, the income approach and the market approach.

[18] 701 is a holding company, not an active business. Therefore its interest in the operating companies, 890 and 123, which together comprise Thompson's activities, must be determined as of October 20, 1998. The Respondent described the approach as an asset approach to valuing 701, using the capitalized earnings method to determine the value of the operating companies, 890 and 123. Essentially, it was this approach that was utilized in both expert reports, as 701's value lies in its interest in 890 and 123. This method determines the level at which the earnings on valuation day can be maintained in the future by applying various discounts for risk factors that could affect the constant future growth rate. The capitalized earnings approach bases the FMV on the perceived ability of a business to generate future earnings or a cash flow stream to provide a fair return on invested capital. It is this future indicated cash flow stream that a notional purchaser would want to acquire. A notional purchaser, in addition to the potential future yield to the investment, would also weigh this factor against a number of internal and external factors, such as the future prospects of the business, the rates of return on alternative investments, the business and financial risks involved and the liquidity of the investment.

[19] Although both reports use the same valuation methodology, to determine the FMV of 701's shares, each report reached surprisingly different results in respect to the capitalization of those earnings and the risk that would attach to those earnings on a going forward basis. The key differences, between these two reports, arise in the determination of the maintainable earnings, the build up rates of capitalization and multiplier, the discounts applied for minority and marketability and finally whether or not a discount should be taken for trapped-in tax liabilities. In addition, the Dunham Report calculated a single multiplier for combined Canadian and U.S. operations. The Wise Report, however, calculated two multipliers, one for 890 and another for 123. Finally, it should be noted that Mr. Dorweiler interviewed the corporate management team but Mr. Dunham did not.

[20] The Earnings Method, used to valuate 890 and 123, involves three steps. First, a determination is made to establish the maintainable after tax income that Thompson could generate in the future after adjusting for discretionary, non-operational, non-recurring or non-arm's length income and expense items. This determination provides an estimate of the future earning potential of the company. Second, the figure from the first step, the maintainable earnings, is

multiplied by an appropriate factor, known as the inverse of the "capitalization rate" or the price/cash flow multiplier, which reflects the various risks to the earnings potential and rates of return on the investment in Thompson in comparison to those in alternative investments in publicly traded companies. Third, 701's *pro-rata* interest in 890 and 123 is determined after minority and marketability discounts are applied, which reflect inherent risk, such as lack of control and illiquidity. The Appellant took additional discounts for embedded tax liabilities that a potential purchaser might be responsible for in respect to capital gains, personal taxes due to dividend payout and a contingent asset in the form of refundable dividend tax on hand.

[21] The Dunham Report utilized the fiscal years, 1997, 1998 and 1999 in its calculations of maintainable earnings while the Wise Report used the 1996, 1997 and 1998 fiscal years. The use of different years resulted in an overall FMV difference of $1.7 million for Thompson. Mr. Dorweiler's sensitivity analysis showed that the selection of the 1999 fiscal year by the Dunham Report had a $760,000 impact on the FMV of 701. He described the use of the 1999 fiscal year as an inappropriate use of hindsight. The Dunham Report gave equal weight to the earnings in each of the fiscal years 1997 to 1999. The inclusion of 1999 meant that the Dunham Report relied on seven months of post valuation day information. This included events such as the CAW negotiations, which concluded in November 1998, the emergence of internet contract bidding, the outcome of the GM strike, the ongoing management and shareholder dissension, and the negotiations for the GM contract renewal, which remained unresolved at the valuation date.

[22] The Respondent argued that the Appellant's inclusion of 1996 would not be appropriate because Thompson was still growing and was in a very different position in 1996 than in subsequent years. Revenues jumped 21% from 1996 to 1997. The Respondent criticized the Wise Report for its use of post valuation date information such as deducting costs for the CAW contract, the use of Ibbotson size premium data from a 2001 survey, the comparison with trucking salaries in 1999 to adjust for executive salaries and the use of stock market data from the 1998 calendar year.

[23] The reports also took different approaches to the shareholder loans. The Dunham Report considered the 10% interest rate paid on these loans to be excessive. In addition, the Dunham Report considered that management compensation and dividend payment policies were excessive and that, coupled with the interest amounts, they were simply mechanisms for the shareholders to

extract profits from the company. The Respondent criticized the Wise Report because it failed to take into account interest amounts which the Dunham Report considered redundant cash balances which could be used to pay off the shareholder loans of $2 million. The Dunham Report normalized the interest expenses on the loans by comparing Thompson's working capital ratios to other trucking companies. This had an overall impact in their report of increasing the FMV of 701 by $380,000.

[24] The Dunham Report also adjusted the maintainable earnings for excessive management compensation which increased the FMV of 701 by $330,000. The Dunham Report arrived at this conclusion by comparing the salaries to other executives in a trucker survey published in 2002 entitled "Executives and Middle Management, Greater Toronto Area (GTA) Salaries Guide". Mr. Dunham began with the $90^{th}$ percentile executive salaries from the survey, adjusted for inflation, and then applied a 78% reduction to account for general salary disparities between Toronto and Windsor.

[25] The Appellant argued that the Dunham Report ignored the specific nature of the company and the emergency freight industry in general and failed to interview and consult with Thompson's management team as to the reasons the shareholder loans, interest ratio and dividend policies were structured in this way. The Wise Report analyzed executive salaries of public companies as guidelines to determine that Thompson's compensation package was appropriate. Consequently, no adjustment was made. The Respondent criticized the use of data respecting public companies as inappropriate because those companies all had revenue much greater than Thompson's revenue by a factor of 10.

[26] Each of these reports also utilized different capitalization rates. A capitalization rate reflects the overall risks and rate of return inherent to a particular investment and compares the risks involved with investing in a private firm to trading in a public company. The aim is to give a forecast of future maintainable earnings. The multiplier is the reciprocal of the capitalization rate.

[27] The capitalization rate used in the Dunham Report was 19.7% and the multiplier was 5.08. The Wise Report applied two different capitalization rates for each of the operating companies, 890 and 123, to reflect the inherent investment differences in the Canadian and American environments. The Wise Report, after its analysis of internal and external factors, concluded that the capitalization rate was between 24.4% and 27%, with a median of 25.7, and therefore yielding a multiplier at the valuation date in the range of 3.7 to 4.1 for both 890 and 123. In applying a

multiplier of 3.7 to 4.1 to the maintainable earnings of 890 ($1,465,000) and to the maintainable earnings of 123 ($292,000), the en bloc FMV on the valuation date was determined to be $5,420,000 to $6,010,000 for 890 and U.S. $1,080,000 to U.S. $1,200,000 for 123. The Wise Report then took a *pro-rata* portion of the en bloc value for each operating company as follows:

701's - 50% interest in 890 = $2,710,000 to $3,005,000; and
701's - 33 1/3% interest in 123 = U.S. $360,000 to U.S. $400,000.

[28] The primary differences between the capitalization rates in the two reports relate to three factors used in determining the rate of return required by a notional purchaser: size risk premium, company specific risk premium and growth rate adjustment. The remaining components of the build-up rate followed standard valuation practices, with few differences between the reports. The size risk premium, the extra return that an investor might require to compensate for the increased risk of investing in a smaller sized company, was 7% in the Wise Report as compared to 3% in the Dunham Report. The Dunham Report selected 3% based on an analysis of similar trucking companies, noting their maintainable earnings and data from the 2001 Ibbotson reference materials [Ibbotson Associates, Stocks, Bonds, Bills and Inflation: Valuation Edition 2001 Yearbook (Ibbotson, 2001) at 109-117]. The size premium reflects issues that small companies, as opposed to publicly traded companies, face in accessing capital and dealing with competition in the market. Since Thompson maintained adequate financing through its shareholder loans and, because double counting or overlapping can occur between size premium and company specific risk factors, Mr. Dunham chose and applied a conservative factor of 3%. Mr. Dorweiler testified that the use of 3% by Mr. Dunham may have occurred because of the erroneous use of the micro-cap which, according to the documentation, aggregates the stocks in group deciles 9 and 10 [Ibbotson Associates at page 97]. The micro-caps for decile 9-10 have a range of 2.62 to 3.01 (Ibbotson Associates, pages 117, 123). The Wise Report used the 1999 Ibbotson reference materials, with tables dated September 20, 1998, which reference the increased risk and volatility for smaller sized companies on the New York Stock Exchange. The Ibbotson materials separated the smallest group decile 10 into two further classifications 10A and 10B. The 10B group accounted for the smallest companies, those under the $48 million range with a size premium for the 10B decile of 8.42%. The Wise Report chose what it believed to be a conservative 7% size premium to avoid what it perceived as a problem of hindsight in using the 2001 Ibbotson reference materials.

[29] The experts each testified as to how and why various judgments were made in arriving at the company specific risks. The Dunham Report applied an 8% factor to the rate of return required by a notional purchaser while the Wise Report used 15% for 890 and 12.28% for 123. The Respondent claimed that the Wise Report's analysis overstated or double counted the industry specific risks, the financial risks and the CAW contract risks. In respect to 890, the Wise Report added 3% of premium because of 890's high level of current indebtedness and thus weak working capital ratio, while deducting 2.34% of risk from 123 because it had a better ratio of current assets to current liabilities. Unlike the Wise Report, Mr. Dunham found no particular financial risk to 890. Each viewed the shareholder loans differently. Mr. Dunham considered these loans to be quasi equity that posed no financial risk to the company, whereas Mr. Wise accepted the Thompson accountants' classification of these loans as short-term debt.

[30] The Wise Report also added a 1.5% risk premium to 890 due to the increased costs relative to the CAW negotiations. The Respondent argued that this represented another double counting by the Appellant's experts because they had already applied $79,000 per year on a go forward basis and reduced the maintainable earnings of Thompson to account for anticipated increased costs in the CAW contract. By adding another 1.5% premium to 890, this reduced its value by over $300,000. In determining the company specific risks, the Wise Report looked at various internal and external factors which impacted upon Thompson such as reliance on the GM contract with its 30 day cancellation clause, foreign exchange fluctuations, management experience, industry trends, competitors and the cyclicality of the industry.

[31] In respect to growth rate, the Dunham Report combined the revenues of 890 and 123, converted the US dollar amount to Canadian dollars, and then compared the annual growth rate and compound annual growth rate from the end of fiscal year 1995 to the end of fiscal year 1999 to its industry peer group, according to an S&P Industry Survey dated January 28, 1999. It concluded that the Thompson freight operations had grown historically at a faster rate when measured against the larger trucking industry data. A sustainable growth rate of 4% discount was therefore applied to the rate of return. The Wise Report selected a more conservative growth factor of 2%.

[32] There were also major differences in how the two Reports treated minority and marketability discounts. The minority discount will be applied as necessary in the circumstances to reflect a minority shareholder's lack of control in a company as opposed to that of a majority shareholder. The Dunham Report did not apply a

minority discount in respect to 701's interest in 890 and 123 while the Wise Report applied a 15% discount for lack of control. In the case of 890, although 701 controlled a 50% *pro-rata* share in 890, Mr. Wise discussed a number of authorities supporting a discount where a 50/50 shareholding exists. Mr. Dunham rejected the application of a discount because, in his opinion, a minority discount is warranted only in cases where the shareholder has less than a 50% interest. Mr. Dunham felt that such a discount was out of step with other authorities that state little, if any, discount should be taken in valuing a 50% interest. In addition, the Appellant's discount overlooked 701's ability to block corporate actions, one of the very factors Mr. Wise ignored here but which was included in a paper authored by Mr. Wise.

[33] In respect to 123, the Wise Report also applied a 15% minority discount where 701's interest in 123 was clearly a 33 1/3% minority interest. Another reason Mr. Dunham refused to apply a minority discount in respect to 123 was because he viewed 890 and 123 as forming one single operation, that is, he viewed Thompson as one entire entity and because of this a notional purchaser would not buy only 890's interest. Consequently, the special purchaser market would offset any discount for lack of control. Mr. Dunham viewed the two other shareholders of 123 as representing an internal market for 701's one-third interest in 123 who would pay the full *pro-rata* value.

[34] The two reports also applied very different marketability discounts. This discount represents the cost of selling 701's interest in Thompson. It is taken to compensate for illiquidity issues involved in purchasing a private company as compared to a publicly traded company. Private companies tend to require longer time periods to complete a sale and receive liquid funds. Mr. Dunham accorded a 3% marketability discount based on the size of the interest, the pool of potential buyers, the size of dividends, any restrictive transfer provisions, prospects for public offering, and transaction costs associated with the sale. The Dunham Report considered that Thompson's long-term investment horizon and a stable dividend stream mitigated the marketability discount. Mr. Dorweiler considered that this 3% discount would cover only transaction fees and sale commissions incurred in a sale.

[35] The Wise Report applied four distinct marketability discounts: 10% each for 890 and 123, in calculating the earnings capitalization rate for each operating company, and then at the level of 701's interest a further 20% discount for 890 and 25% for 123. These discounts were defended on the basis that at the level of the operating companies a 10% discount was appropriate given the sale of a private company. At the level of the en bloc enterprise, a further discount was applied to reflect the difficulty of selling a 50% shareholding. 123's marketability discount is

even greater to reflect the increased risk and difficulty in the sale of a one-third interest. The Respondent argued that the Appellant's approach resulted in a double-counting of both the marketability and minority discounts, once when valuing Thompson's en bloc and once when valuing 701's *pro-rata* share of Thompson.

[36] The last major difference in these reports originates with the application by the Wise Report of a discount to reduce the FMV of 701 for embedded or trapped-in tax liabilities. These contingent liabilities are a controversial issue within the valuation community and CRA. The Wise Report estimated the taxable capital gain on the disposition by 701 of its interests in 890 and 123 at $1,621,746. The income tax rate was then discounted by 50% (51.29% x 50%) or 25.65% to account for any uncertainties, which resulted in an estimated capital gain tax liability of $416,000 on a notional disposition. The Wise Report then determined the personal tax rate of Marjorie Zeller and, noting that the capital dividend account was nil on the valuation date, the personal income tax rate was discounted by 50% (33.7% x 50%) or 16.87% to again account for uncertainties. This resulted in an estimated personal tax liability on the dividend of $243,670.

[37] Finally the Wise Report calculated the RDTOH as a contingent asset following this notional dividend payout by 701. A 50% discount was applied to the RDTOH estimated rate of 26.67%. The opening RDTOH balance was $51,619. The RDTOH decreased the tax liability of 701 by $242,000. According to the Wise Report, the final impact of the embedded capital gains tax, tax liability on distribution and RDTOH is a reduction in the FMV of 701 by $417,670. The Respondent did not consider that any discount would be appropriate here because a prudent buyer and seller would use one of several available tax planning options to defer or avoid paying the potential trapped-in capital gains taxes.

Analysis

[38] The determination of FMV, although based on expert opinion, is a question of fact that the Court must ultimately decide. There is ample authority for the proposition that as the trier of fact I am not bound to accept the evidence of any expert witness or to accept one expert's report over another. It is entirely open to me to accept neither report in its entirety but to accept the best from both reports and to draw my own conclusions. I must conduct an analysis of the evidence of each of the experts and their respective conclusions to assist me in coming to a determination of the value of 701's shares on October 20, 1998. In discussing the role of an expert in valuation appeals, Chief Justice Bowman in *Hallatt et al. v. The Queen*, 2001 DTC 128, at paragraph 43 quoted Robertson, J.A. as follows:

> In cases where the determination involves questions of fact, law and opinion (as, for example, in scientific research cases such as *Northwest Hydraulic Consultants Limited v. The Queen*, 98 D.T.C. 1839) the matter becomes even more complex. It is important to recognize what the role of the expert is. Robertson J.A. in *RIS-Christie Ltd v. The Queen*, 99 D.T.C. 5087, put it as follows at p. 5089:
>
> (11) As a preliminary matter, the parties raised the issue of the proper role of expert witnesses in interpreting the scientific research provisions of the Act. In light of Dr. Razaqpur's conclusion that repeatability is an essential element of scientific research, some guidance on this issue is required.
>
> (12) What constitutes scientific research for the purposes of the Act is either a question of law or a question of mixed law and fact to be determined by the Tax Court of Canada, not expert witnesses, as is too frequently assumed by counsel for both taxpayers and the Minister. An expert may assist the court in evaluating technical evidence and seek to persuade it that the research objective did not or could not lead to a technological advancement. But, at the end of the day, <u>the expert's role is limited to providing the court with a set of prescription glasses through which technical information may be viewed before being analyzed and weighed by the trial judge. Undoubtedly, each opposing expert witness will attempt to ensure that its focal specifications are adopted by the court. However, it is the prerogative of the trial judge to prefer one prescription over another</u>. (Emphasis added)

[39] This summarizes the proper role of the expert witness. However, it is important to remember that valuation is, by its very nature, not an exact science and experts may often have an inclination, although unintentional, to become advocates of the party that engages them to complete the report. Chief Justice Bowman in *Western Securities Limited v. The Queen*, 97 DTC 977, at page 979 stated:

> One further problem arises in valuation cases of this type. Typically both parties call expert witnesses. In many cases, these witnesses are not divided on any serious question of principle, although occasionally they may differ on the highest and best use of the property being appraised. <u>The major difference usually lies in the choice of comparables used and the positive or negative adjustments to be made to particular comparables based on such factors as location, the timing of the sale, or other physical characteristics of the property. It frequently happens that the judge determines a value somewhere between the opposing positions of the experts, not because of any desire to reach a Solomonic compromise, but because of a recognition that the positions adopted by the experts represent the polarized extreme ends of value</u>. There is a danger that experts, albeit in good faith, may become advocates and their positions may become adversarial. For this reason a disinterested arbiter must often conclude that it is unwise to adopt entirely the position of one or

> the other and that it is more likely that a fair -- I hesitate to use words such as “right” or “correct” in the necessarily imprecise area of valuation –value is likely to be somewhere between the two extremes. (Emphasis added)

It is this point between the two expert valuations of $2.2 million and $6,389,000 that I must determine the highest price for 701’s shares that willing and informed vendors and purchasers freely negotiating at arm’s length in the open marketplace would have settled upon on October 20, 1998. Provided there is no compulsion to buy or sell, this reflects the generally accepted definition of FMV.

[40] In discussing the two expert reports, the actual valuations assigned by each report to the shares are secondary to the reasoning employed by each report in arriving at their respective valuations.

Maintainable Earnings:

[41] The first step in the methodology approach taken in both expert reports was to determine maintainable after tax earnings that the company was capable of generating after consideration of the non-recurring and arm’s length income and expense items. Mr. Dunham’s Report placed Thompson’s maintainable earnings considerably higher than the Wise Report based primarily on the choice of the equal weight given to the earnings in each of the fiscal years, May 1997 to May 1999, the years used to establish future maintainable earnings, adjustments made to account for interest payments on shareholder’s loans and adjustments made by Mr. Dunham for amounts he considered to be excessive executive salaries. The Dunham Report’s inclusion of the 1999 fiscal year meant that seven months of post valuation day information had been relied upon. While the Appellant criticized the Dunham Report for its reliance on post valuation data, the Respondent levied the same criticism against the Wise Report for its reliance on post valuation data such as use of Ibbotson size premium data from a 2001 survey, stock market data for all of 1998, comparative trucking salaries stretching into 1999, and CAW labour contract costs, which were not concluded until November 1998. The Appellant relied on several cases in support of its use of this data. [*Allred Estate v. Canada (Minister of National Revenue - M.N.R.)*, 86 DTC 1479), *Debora v. Debora*, [2004] O.J. No. 4826 aff’d [2006] O.J. No. 4826, *Ross v. Ross*, [2006] O.J. No. 4916].

[42] The general position is that hindsight is inadmissible except to test the reasonableness of the assumptions made by the valuators. Justice Rip, as he was then, in *McClintock v. Canada*, 2003 TCC 259, stated at paragraph 54:

> … First of all, it is the trial judge who must exercise his discretion whether or not, in the particular facts of an appeal, to use hindsight to assist in deciding whether a purported value of property is correct or in setting a value. This is particularly so when there are no sales of any comparable property immediately prior to the valuation date.

[43] Although each of the reports relies on post valuation data, I believe the use of the fiscal year 1999 by Mr. Dunham, in calculating maintainable earnings, is a clear breach of the general hindsight rule because actual revenue results were used from the period after the valuation date. Generally, hindsight should not be used in notional market valuations except in very limited circumstances. Use of this information resulted in a significant increase of approximately $760,000 on the FMV of 701. The Wise Report did rely on post valuation data as well but its reliance was conservative and limited. Mr. Dunham criticized the Wise Report's inclusion of the 1996 fiscal year on the basis that it was not a useful comparable year because Thompson was still growing and it was therefore not the same company in 1999 as it was in 1996. However, the information utilized by Mr. Dunham in the seven months subsequent to October 20, 1998 would not have been available to a purchaser on that date. Although the Wise Report could have, and perhaps should have, assigned less weight to 1996 in comparison to 1997 and 1998, I am less inclined to accept Mr. Dunham's reliance on 1999 in his analysis. The fact that Thompson's revenue in the 1996 fiscal year grew, while in 1998, due to the GM 57 day strike, it diminished, does not invalidate the use of the 1996 earnings in generating maintainable earnings. Therefore, I believe the appropriate years that should be used in establishing maintainable earnings are Wise's fiscal years 1996, 1997 and 1998.

[44] In dealing with maintainable earnings, the Dunham Report also considered that the 10% interest paid on shareholder loans was excessive and therefore made adjustments in its calculations. The Respondent argued that these interest payments were one of the mechanisms employed by the shareholders to extract excessive amounts from the company. The Wise Report made no similar adjustment for the interest amounts. The directors, including Douglas Zeller, testified that the shareholder loan policy had been in place since the company's inception and that this policy existed to limit the potential exposure to risk and litigation specific to this niche service within the trucking industry. The potential for lawsuits arising from road accidents with brokers' trucks all across the country was a very real possibility and the liability issues increased significantly in interlining freight through third-party dispatchers. The retained earnings were protected through this practice and the company was able to finance itself through shareholder loans. It

was a business decision made by experienced businessmen with knowledge of the realities of the freight expediting industry. Mr. Ouellette explained that the interest rate was basically the same as an operating line of credit would be from a bank.

[45] In addition, the evidence was that much of Thompson's information, such as mileage rates, was so sensitive that the corporate players did not want to expose this protected data to a bank to finance its operations. This was reflected in the concerns that Mr. Ouellette had in respect to Douglas Zeller's insider knowledge which he possessed when he exited the company to form Genesis Express. I accept Mr. Ouellette's evidence respecting the security concerns and that these played a significant role in the decision to opt for shareholders' loans to finance corporate operations over bank loans and lines of credit. The evidence supports that they were *bona fide* loans which were subject to a reasonable rate of interest. In fact, as Mr. Dunham testified, removal of these loans would create a liquidity crisis leading to immediate operational difficulties, such as the payment of broker salaries, at least in the interim until GM receivables were paid. The Dunham Report normalized this interest expense by comparing Thompson's working capital ratios to other trucking companies. The overall impact in the Dunham Report's normalization was to increase the FMV of 701 by $380,000. The Respondent's own argument, that leaving these shareholder loans meant a working capital ratio that would be comparable to other trucking companies, leads to the inference that the interest expense on the shareholder loans is within reasonable limits.

[46] I believe that Mr. Dunham should have talked directly to management and that, if he had, he would have gained a better understanding of these loans and the fact that they were required for *bona fide* operational purposes, were not a discretionary expenditure and that they had been influenced from the beginning by the company's experience in the expediting industry. Because of the very nature of this business, I believe a potential purchaser would look long and hard at the financing choices and practices that this company had in place and that there would be a strong incentive to adopt and follow those well established initiatives that had worked successfully for this company. Therefore I am not allowing any adjustment to interest on shareholder loans as Mr. Dunham did in his calculations.

[47] The last factor considered in both reports in calculating maintainable earnings was the management compensation, which the Dunham Report felt was excessive. The compensation for executives at Thompson consisted of a base salary and a bonus of 8% of pre-tax profits for an overall income of approximately $230,000-$240,000 yearly. A further 6% of pre-tax profits was allotted as bonus

for the non-executive employees. The Dunham Report criticized the compensation because it was not subject to arm's length negotiations nor was it commensurate with industry standards. That Report normalized the executive salaries to market levels using a 2002 Ontario Truckers Association survey entitled "Executive and Middle Management, Greater Toronto Area (GTA) Salaries Guide". Mr. Dunham adjusted for inflation to arrive at market salaries for the fiscal years he chose and also applied a factor of 78% to those salaries to reflect the earnings difference between Windsor and Toronto (where the survey was based). The Appellant criticized the use of data from this post valuation day publication, although, as Mr. Dunham noted, this exact technique had been endorsed by Mr. Wise in his "Valuewise" publication of April 2006. Mr. Dorweiler compared the salaries to data existing through Securities and Exchange Commission filings for publicly traded trucking companies having over $100 million in sales. Of course, it is always preferable to use comparables from similarly situated companies. The Respondent noted that Mr. Dorweiler's comparison companies were in some cases 15 times as large when measured in respect to earnings.

[48] So where does all of this point in terms of which position I should choose? On one hand, Mr. Dunham worked with a technique, endorsed by Mr. Wise, of taking the best available data and working back to the valuation date by adjusting for inflation and other factors. However, I do not believe that this approach can ever be 100% correct in every instance as it is arbitrary and involves the use of hindsight. It was simply the best available technique that an expert believed would assist him in arriving at the appropriate measurement for this factor of management compensation. My thinking, in respect to the comparables used in the Wise Report, is that they are somewhat inappropriate because the comparable public companies all have revenues much greater than Thompson. However, I believe that if Mr. Dunham had interviewed management, he would, or should have, incorporated a further adjustment in his analysis to reflect the commercial reality of this company. One witness referred to it as a "heart attack" business. The method that worked to get the hours and the dedication from an individual was essentially a performance bonus. In fact when I compare the T4's and the amounts of the bonuses at Tabs 7 and 12 of Exhibit A-1 for the fiscal years 1998 to 1999 more than half of the executive compensation is made up of bonus reflecting the evidence of Mr. Ouellette as to the importance of the bonus component:

> … If you had to pay someone to do your job what would you --
>
> **A.** I would have them on the same program I'm on. What would be in the industry for the President of the company, my salary is considered low. I would

put them on a real strong commission basis, based on earnings, the same way I am.

**Q.** The performance bonus is what you're calling your commission?

**A.** That's how you get the hours, the night work, the travel, the eighty hours a week. That's how you get the work. You don't want someone on a big heavy salary in a top level position of a company, not incentive based. You want them to drive the company like it's their own.

Profit is a good driver. Incentive is a good driver for upper management.

(Transcript pages 432-433)

[49] I employ common sense, reflecting the commercial reality of this industry as presented in the evidence, when I state that I simply cannot ignore this evidence and accept Mr. Dunham's analysis. So what do I do? Not being an expert in valuation but entrusted with the job of arriving at an amount that is fair and reasonable and being an amount that a prudent buyer would assign in his/her formulation of arriving at a figure to pay for 701's shares on valuation day, I believe that a potential purchaser would continue a similar compensation package. Therefore, I conclude that no adjustment is required with respect to management compensation. I simply believe it is the reasonable course to take in the circumstances as it best represents the reality of the Thompson operations within the industry.

<u>Build-Up of Capitalization Rate</u>:

[50] Both expert reports relied upon the build-up method in determining the capitalization rate for Thompson. Starting with the risk free capitalization rate, the reports then accounted for incremental risks that a prospective investor would face. These included the general equity risk premium, size premium, industry premium and company specific premium that were applicable on the valuation date. Since the determination of these premiums is not a science, discrepancies exist between these two reports:

| | Risk-free rate | Equity risk premium | Size premium | Company specific risk premium |
|---|---|---|---|---|
| Wise report | 5.14% for 123 | 5.85% for 123 | 7% for 123 | 12.28% for 123 |

| | | | | |
|---|---|---|---|---|
| | 5.38% for 890 | 2.56% for 890 | 7% for 890 | 15% for 890 |
| Dunham report | 4.85% | 7.85% | 3% | 8% |

[51] Based on the various risk factors associated with this particular investment, the Dunham Report applied a capitalization rate of 19.70% and a multiplier of 5.08. The Wise Report applied two different capitalization rates to reflect the American component in 123 and concluded that a range of capitalization rates from 24.4% to 27% (25.7 median) with multiples from 3.7 to 4.1 were appropriate.

(a) The Risk Free Rates:

[52] The Risk Free rate is the yield that an investor could obtain from a "risk free" guaranteed investment. For the risk free rate, the Dunham Report selected the yield on 10-year debt issued by the Government of Canada, which was 4.85% in October 1998. The Wise Report selected two risk free rates – one for 890 and a different rate for 123. For 890, the Wise Report selected the rate of return on Government of Canada long-term bonds, which was 5.38% at valuation date. For 123, the Wise Report adopted the yield-to-maturity on long-term U.S. bonds, which was 5.14% at valuation date. I find that it is appropriate to have a different risk free rate for 890 and 123. Therefore, I am adopting the figures used in the Wise Report for the risk free rates.

(b) The Size Premium:

[53] The choice and application of a specific size premium will have a significant impact on the overall value of 701's shares.

[54] At page 12 of his report, Mr. Dunham stated the following with respect to size premium:

> … Long–term studies have also shown that smaller-size companies are inherently riskier and therefore a size premium was warranted in 1998 to compensate for this important distinction. Ibbotson Associates report that the long-term size premium in 1998 was 300 basis points, and accordingly we have added 3.0% in to our build-up model.

At page 35 of the Wise Report, it states:

> … The extra return sought by an equity investor to compensate for the (small) size of the subject company. We selected a size premium of 7.00%.

[55] The overall impact of the choice of this premium by the Dunham Report compared to the Wise Report is significant and amounts to $1,020,000 overall on the FMV of 701. Both reports reference Ibbotson Associates in support of its choice of size premium. The Wise Report specifically referenced the Ibbotson's 2001 yearbook, in which it was suggested that the smallest companies on the New York Stock Exchange, those in the "10B" decile of the exchange, were more volatile and therefore required greater rates of return in order to attract potential investors. The largest company in the 10A decile had a market capitalization of $84 million, whereas the largest company in the 10B decile had a market capitalization of $48 million. The Respondent argued that the size premium of decile 10B was anomalous because the 10B decile was less volatile than the 10A decile, which consists of larger companies than those in the 10B decile. Therefore, according to the Respondent, the data is inconsistent in that it shows a significant premium for decile 10B with no real increased risk (volatility over 10A). Whether the increased risk of companies in the 10B decile is real or not, the data in Ibbotson's 2001 yearbook demonstrates that as companies get smaller their size premium decreases. Table 6-10 of Ibbotson's shows that the size premium for companies in the 10B decile was 8.42%. Clearly Mr. Dunham chose what I consider to be a more conservative size premium of 3% to account for potential double counting that may occur between this premium and the other risk factors. Therefore I believe that a size premium of 5% is a reasonable compromise that recognizes the problems with both expert approaches.

(c) The Company Specific Risk Premium:

[56] Mr. Dunham was again of the view that this factor overlapped with and would therefore be captured to some extent by the size premium factor because both factors reflect the fact that small companies have less access to capital and face greater competitive pressures from larger corporate chains. The Dunham Report uses an 8% factor in part to account for the potential double counting of these factors. In addition, the Respondent criticizes the Wise Report for overstating the industry risks for this company. The distinction between size premium and company specific risk premium is not well defined. For example, the Wise Report, in calculating the company specific risk premium, considers factors such as market share and diversification of customers, which are also dependent upon the size of the company. Clearly some double counting can occur when determining these premiums. The Respondent criticized the Wise Report's choice of 15% for 890 and 12.28% for 123 on three grounds: (1) the Wise Report unnecessarily added risk specific data when the 2001 Ibbotson data showed that the trucking and automotive industry was less risky than other sectors in the economy; (2) the addition of a 1.5% risk premium for the

increased CAW contract costs; and (3) the Wise Report improperly added financial risk to 890. I believe that some of these criticisms are valid and therefore the company specific risk premium contained in the Wise Report is inflated to some extent.

[57] I agree with Mr. Dunham's criticism of the CAW contract adjustment in the Wise Report which reduced the value of 890 by $300,000, representing almost three times the actual cost of the CAW contract. The explanations provided by Mr. Dorweiler and Mr. Wise contradicted each other. I also agree that the Wise Report improperly added financial risk to 890 by classifying the shareholder loans as long-term debt in the case of 123 and short-term debt for 890. This resulted in a seemingly increased risk for 890, relative to that of 123, since the working capital ratio examines only short-term debt. On cross-examination, Mr. Wise was of the opinion that the shareholder loans were a contribution of equity structured as a secure loan. The Respondent criticized Mr. Wise's testimony arguing that Mr. Wise should have known that the shareholders would never call in these loans and demand repayment. I agree that the shareholder loans in respect to 890 should have been classified as long-term debt. However, I believe that for this specific company, which filled a particular niche of expedited freight, unlike other sectors within the trucking industry, additional company specific risk must be allocated because of the heavy reliance upon its primary customer, GM, as well as its unionized workforce of brokers.

[58] Several factors that were present at valuation date need to be considered: Thompson was on the cusp of the GM contract renewal, the anticipated increased broker expenses flowing from the CAW contract negotiations were anticipated, the presence of foreign exchange fluctuations and the advent of National Logistics with internet bidding on contracts. Mr. Durham did agree, on cross-examination, that internet bidding changed the nature of the marketplace but he felt it was nothing he could quantify. Ultimately, I must decide whether Mr. Dunham's calculations assign sufficient weight, as part of his company specific risk percentage, to account for the items which I have listed. I have little evidence upon which to make this determination but to assume that, in listing these factors in his Report, he has fully canvassed those factors. However, based on Mr. Dunham's remarks respecting his inability to quantify the internet bidding factor and again the fact that he never spoke to management directly, concerning the very factors which I consider would highly influence the company specific risk factor, I am going to increase Mr. Dunham's 8% assigned calculation to 10%.

(d) The Growth Rates:

[59] The Dunham Report applied a 4% discount to the rate of return to account for future revenue growth while the Wise Report applied 2%. The Dunham Report noted that the combined operations of 890 and 123 experienced an average annual growth rate of 6.45% with a compound annual growth ratio of 5.53% from the end of fiscal year 1995 to the end of fiscal year 1999. That report went on to note that the growth of Thompson's peer group was 3.6% during the 1990s, according to an S & P Industry Survey dated January 28, 1999. Mr. Dunham concluded that a 6.45% growth rate would be sustainable and that Thompson had grown historically at a faster rate than its larger competitors. Since the Wise Report provided little explanation as to the basis for their figure, I accept the Dunham Report analysis.

Marketability and Minority Discounts:

[60] These discounts are applied when it is necessary to make an adjustment or discount for a lack of control associated with a minority shareholding (minority discount) and an adjustment to reflect illiquidity as well as the costs and timelines to ready the operation for sale in the marketplace (marketability discount). In *McClintock supra* at paragraph 33, Mr. Dunham is quoted in describing the concept of a marketability discount as "…the ability to convert the property to cash quickly, with minimum transaction costs, with a high degree of certainty of realizing the expected amount of net proceeds".

[61] Mr. Dunham applied a 3% discount for marketability taking into account the size of the interest being purchased, Thompson's long-term investment horizon, its stable dividend stream, lack of evidence of volatility based on Thompson's stability and growth and the readily available pool of purchasers, including employees and competitors. Mr. Dorweiler criticized Mr. Dunham's 3% marketability discount because he felt that it would cover only transaction fees and sales commissions incurred in preparing for the sale of a private corporation. The Wise Report applied four distinct marketability discounts (10% each for 890 and 123 to reflect the sale of a private company and a further 20% discount for 701's interest in 890 and 25% for 123) to reflect the difficulty of the sale of a 50% shareholding and a 33 1/3% interest in the case of 123 at the en bloc level.

[62] In respect to the minority discount, the Wise Report applied a 15% discount for both 890 and 123 while Mr. Dunham applied no discount at all. Mr. Dunham did not apply any discount with respect to 890 because 701 held a 50% interest in 890 which he felt by definition would not be a minority interest. He also declined to apply

a discount to 123 because he viewed 890 and 123 as forming a single operation where the two other shareholders in 123 would provide an internal market paying full *pro-rata* value for 701's 33 1/3% interest in 123.

[63] The Respondent argued that the Wise Report analysis has double counted marketability and minority discounts or counted some of the discounts a number of times based on use of the same factors in each category. Specifically, the Wise Report takes the marketability discount twice, once when valuing Thompson en bloc and again when valuing 701's *pro-rata* share of Thompson. I agree with this criticism. The Appellant did not provide any legal authority for taking two sets of discounts for marketability. I see this factor as the main problem with the Wise Report analysis although there may be some additional double counting in respect to other factors. I simply cannot accept that any prudent purchaser would be persuaded to incur marketing costs twice. It is purely common sense that they will incur either the cost of buying all of Thompson or the cost of buying a part of it. I do not accept Mr. Dorweiler's explanation for applying two sets of transaction costs.

[64] As a result, I would disallow the second set of marketability discounts applied in the Wise Report of 20% and 25% for 890 and 123 respectively. I am left with Dunham's marketability discount of 3% and the Wise Report discounts of 10% each for 890 and 123. I believe the 3% discount is on the low side as it would seem to reflect only the actual transaction costs and commissions to ready the operation for sale. To counter the potential double counting criticism of the Wise Report and to allow a marketability discount that is reflective of additional inherent costs and factors, I believe one discount of 7% should be applied.

[65] Mr. Dunham relied on several authorities to support his decision not to apply a minority discount in valuing a 50% interest [*Ian R. Campbell, Canada Valuation Service*, looseleaf vol. 1; W. Goodman, "Valuation of a Fifty Percent Shareholding" Paper presented to the Fifth Biennial Conference of the Canadian Association of Business Valuators held in Toronto, (October, 1980), [1981] 7 Journal Business Valuation, 19]. These authorities suggest that either no discount or at best only a nominal minority discount should be taken for 50% shareholdings. Mr. Dunham's primary criticism of the Wise Report's decision to apply a minority discount stems from the Report's omission to consider 701's ability to block corporate actions by 890, one of the factors established in a paper written by Mr. Wise. This is certainly one of the most important elements of control because of the protection it affords a shareholder. Mr. Dunham also criticized Mr. Dorweiler's use of office "boiler plate" policy to apply this discount.

[66] Owning a 50% interest in a company is clearly not one and the same as ownership of a 51% interest. A majority shareholder will always control that additional percentage point or some portion thereof beyond the 50% interest. As I understand the evidence of both experts, minority discounts are given to reflect a lack of control relative to the majority shareholder. It would appear therefore that logically some discount should be applied to an owner of a 50% interest, even though it would be less than the discount applicable to a minority shareholder of less than 50%. While I recognize the comments of the authorities within the valuation community, my findings are the end result of my analysis of these particular facts and evidence specific to this appeal. Within this corporate environment there existed monumental control issues being played out on a daily basis. The evidence of all of the corporate players confirmed this very fact. Marjorie Zeller, although never involved in the day-to-day operations of the company and without knowledge of the actual business, was able to wield substantial control and influence over her son-in-law, Patrick Kennedy, and her son, Douglas Zeller, including his eventual decision to leave the company. This in effect had a powerful trickling effect on Mr. Ouellette, leading to his proposal to Marjorie Zeller in the summer of 1998 to either acquire control over Thompson or to leave the company himself.

[67] On paper, Marjorie Zeller held a 50% shareholding but the evidence points to her being a larger than life figure who was able to manipulate most of the male figures in this traditionally male dominated industry - with all of it accomplished from the comfort of her home and with little or no knowledge of how this business operated. Although the experts were for the most part silent on this point, I believe the facts, as I see them, warrant the application of a minority discount. I would therefore continue the Wise Report’s suggestion of a 15% discount for lack of control for 123 and a smaller discount of 10% for 890.

<u>Trapped In Capital Gains</u>:

[68] The Appellant contends that the trapped-in capital gains taxes and the corresponding RDTOH refund need to be discounted, which would have the result of reducing the FMV of 701. Mr. Dunham rejected any discount based on: (1) the taxes in question are triggered on disposition but the assumption underlying the appraisal problem is that the buyer of 701 purchases it in order to acquire a going concern in perpetuity and not to sell at a defined point in the future; (2) the tax is speculative and an informed buyer would avail himself of provisions in the *Income Tax Act* to prevent triggering this tax; and (3) the tax would only be triggered by selling 890 and 123, not by a sale of 701, which is the target of the appraisal.

[69] The Appellant relied on an article written by Dennis Turnbull, a senior CRA valuator, suggesting that CRA has no unified policy approach with regard to discounting latent taxes in FMV appraisals and instead each case must be reviewed on its merits. [Dennis Turnbull, Establishing Valuation Policies: National Revenue's Policy (Edmonton, June 4/99) Exhibit A-3, Tab 26]. The Appellant also relied on the case of *Canadian Rocky Mountain Properties Inc.,* 2006 ABQB 251, to support its application of a discount for trapped-in tax liability. The Respondent referred me to the U.S. case of *Estate of Jelke v. Commissioner of Internal Revenue*, 89 T.C.M. (CCH) 1397 (which was referenced in the *Canadian Rocky Mountain* case) where the Court held that such a discount should be based on evidence as to when the tax liability would be incurred.

[70] The Respondent provided me with several options that prudent sellers and buyers would utilize in tax planning to defer or avoid paying these trapped-in capital gains taxes. However, those arguments have not convinced me. For example, the Respondent stated that "the capital gains tax at issue may be avoided by selling all of 701 instead of selling 701's interest in 890 and 123" (page 39 of Respondent's Written Submissions). I simply do not follow this line of thinking as 701's value equals the value of its interest in the underlying assets, namely 890 and 123. Therefore it is unclear how the Respondent reaches the conclusion that capital gains on a sale of 701 can be avoided. With respect to the second reason given by Mr. Dunham (that the tax is speculative), the Respondent notes that a prudent investor could avail himself of section 88 to structure the share sale of 890 and 123 so as not to trigger the imposition of capital gains tax. However, section 88 is available only to the wind-up of Canadian corporations and would not be applicable to 123.

[71] As a result I agree with the conclusion in the Wise Report that the FMV of 701 should be adjusted to account for trapped-in capital gains tax and the RDTOH refund.

Allocation of Goodwill to Non-Competition Agreement:

[72] The Appellant argued that the value of a non-compete agreement for Mike Ouellette should be included when valuating 701's shares. It was argued that in respect to the other corporate players, a non-compete agreement would have been of no value from Marjorie Zeller as she was not active in the business. However, I am not so sure I agree with that conclusion given the far-reaching force of her influence in the company. The Respondent claimed that Mr. Kennedy was too inexperienced to pose a significant risk, making a non-compete agreement unnecessary from him. Although I think this contention debatable based on the evidence, the Appellant did not claim that a non-compete agreement would be necessary for Mr. Kennedy either.

[73] Mr. Dunham attributed no value to non-compete agreements in his report. Mr. Wise in giving his evidence does discuss the implications of obtaining non-compete agreements and the role that would be attributable to such agreements in realizing the en bloc or enterprise value. However, as the Respondent noted, Mr. Wise went on to testify that an allocation of value to a non-compete agreement is not typically done by a valuator but is normally completed through negotiation between the parties. The Respondent also noted that in October 1998, allocations of values to non-compete agreements were not common in Canadian business transactions. Although this alone would not deter me from attempting to place a value on a non-compete agreement, I have decided that no value will be attributed to a non-compete agreement because no value was proposed by the Appellant and in addition this argument was not raised in the pleadings. Although considerable evidence was adduced concerning the alleged existence of an offer by Mike Ouellette in the summer of 1998, I do not believe that it provides any actual assistance in arriving at my conclusion. Therefore, I make no finding on whether the Ouellette's offer was in essence an actual offer.

Tax Rate Error:

[74] During cross-examination, Mr. Dunham agreed that he had applied an effective tax rate of 41% when he should have used 43.34% in October 1998. This error had the impact of increasing the FMV of 701 in the Dunham Report by $503,000 which I will account for in the following summary of adjustments:

Summary of Adjustments and Conclusion:

| **Appendix A - FMV of 701** |
| --- |

| | | | | |
|---|---|---|---|---|
| Shareholder's Equity as of Oct. 1998 | | | | 515,000 |
| Add: | | | | |
| | FMV of 123 - Appendix B | 344,918 | | |
| | Convert to CAD @ 1.5461 * | 533,277 | | |
| | Less: Book value** | | 156,456 | 376,821 |
| | FMV of 890 - Appendix B | | 3,210,371 | |
| | Less: Book value*** | | 10 | 3,210,361 |
| Adjusted shareholder's equity before income tax considerations | | | | $4,102,182 |
| Less: | Income taxes on capital gains - Appendix F | | | 690,084 |
| Add: | Refundable dividend taxes to be recovered - Appendix F | | | 384,573 |
| Amount available for distribution to shareholder | | | | $3,796,671 |
| Less: | Notional tax liability on distribution to shareholder - Appendix F | | | 402,326 |
| **FMV of shares, *en bloc*** | | | | **$3,394,345** |

* Exchange Rate per Bank of Canada *Review*, as per Wise Report
** Schedule A-4 of Wise Report
*** Schedule A-4 of Wise Report

## Appendix B - FMV of 890 and 123

### FMV of 890

| | | |
|---|---|---|
| Normalized maintainable earnings - Appendix C | 1,465,120 | |
| Multiple applied - Appendix E | 5.28 | |
| FMV of 890 | $7,735,834 | |
| Pro-rata 50% interest | | 3,867,917 |
| Less: | | |
| Minority discount - 10% * | | -386,792 |
| Marketability discount - 7% ** | | -270,754 |
| **Pro-rata FMV of 890** | | **$3,210,371** |

* 0% in Dunham Report; 15% in Wise Report
** 3% in Dunham Report; 20% in Wise Report

### FMV of 123 (USD)

| | | |
|---|---|---|
| Normalized maintainable earnings - Appendix D | 291,565 | |
| Multiple applied - Appendix E | 4.55 | |
| FMV of 123 | $1,326,621 | |
| Pro-rata 33.3% interest | | 442,202 |
| Less: | | |
| Minority discount - 15% † | | -66,330 |
| Marketability discount - 7% †† | | -30,954 |
| **Pro-rata FMV of 123 (USD)** | | **$344,918** |

† 0% in Dunham Report; 15% in Wise Report
†† 3% in Dunham Report; 25% in Wise Report

**Appendix C - Calculation of maintainable earnings for 890**

| | | 1998 | 1997 | 1996 |
|---|---|---|---|---|
| Pre-tax income* | | 3,149,630 | 3,056,702 | 2,431,002 |
| Adjustments** | | | | |
| | Loss on disposal of capital assets | | 2,471 | 904 |
| | Miscellaneous income | -80,027 | -50,563 | -46,577 |
| | Foreign exchange | -111,294 | -168 | 1,174 |
| | Charitable donation | 5,100 | | |
| | Worker's compensation adjustment | -115,936 | | |
| | Satellite Expenses | | -18,000 | -21,000 |
| | Sales salaries | | | 30,000 |
| | Traffic car allowance | | -8,554 | -12,000 |
| | Rent | | | -48,000 |
| | Bad Debts | -131,000 | -40,000 | -22,000 |
| | ISO 9000 | | -11,000 | -11,000 |
| | Dues and fees | | | 13,000 |
| | Legal | | 23,000 | 10,000 |
| Adjusted pre-tax income from operations | | 2,716,473 | 2,953,888 | 2,325,503 |
| Weights | | 1 | 1 | 1 |
| Indicated pre-tax income - simple average (1996-1998) | | | 2,665,288 | |
| Less: | Estimated CAW contract-related expense increases*** | | 79,300 | |
| | | | $2,585,988 | |
| Less: | Federal income taxes: | | | |
| | Income taxes on first $200,000 @ 13.12% | | 26,240 | |
| | Balance @ 29.12% | | 694,800 | |
| | Ontario income taxes | | | |
| | Income taxes on first $200,000 @ 9% | | 18,000 | |
| | From $200,000 to $500,000 @19.5% | | 58,500 | |
| | Balance @ 15.5% | | 323,328 | |
| **Indicated maintainable after-tax earnings for 890** | | | **$ 1,465,120** | |

* Pre-tax income: See Schedule B-3 of Wise Report.

** Adjustments: See Schedule B-2 of Wise Report.

*** CAW contract expenses: See Schedule B-6 of Wise Report

**Appendix D - Calculation of maintainable earnings for 123 (USD)**

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| Pre-tax income* | 331,920 | 274,764 | 561,587 |
| Adjustments** | | | |
| Sundry income | -43,682 | -698 | -2,216 |
| Loss/gain on foreign exchange | | | 276,158 |
| Sales salaries | | 80,000 | |
| Bad Debts | -69,000 | -38,000 | -18,000 |
| Audit and consulting | | | 6,000 |
| Office supplies and expenses | | 15,000 | |
| Adjusted pre-tax income from operations | 219,238 | 331,066 | 823,529 |
| Weights | 1 | 1 | 1 |
| Indicated pre-tax income - simple average (1996-1998) | | $457,944 | |
| Less: Federal income taxes: | | | |
| Income taxes on first $50,000 @ 15% | | 7,500 | |
| From $50,000 to $75,000 @25% | | 6,250 | |
| From $75,000 to $100,000 @ 34% | | 8,500 | |
| Balance @ 39% | | 139,598 | |
| Michigan taxes***: | | | |
| Estimated @ 2.3% | | 4,531 | |
| **Indicated maintainable after-tax earnings for 123 (USD)** | | **$291,565** | |

* Pre-tax income: See Schedule C-3 of Wise Report.

** Adjustments: See Schedule C-2 of Wise Report.

*** Based on sum of pre-tax Michigan income; see Schedule C-2 of Wise Report

## Appendix E - Calculation of multipliers

**Multiplier for 890**

| | | |
|---|---|---|
| Risk free rate* | 5.38 | |
| Equity risk premium** | 2.56 | |
| Size Risk premium *** | 5 | |
| Company and industry specific risk† | 10 | |
| Discount Rate | 22.94 | |
| Less: | | |
| Estimated compounded annual growth‡ | -4 | |
| Capitalization Rate | 18.94 | |
| **Maintainable earnings multiplier for 890** | | **5.28** |

* yield on 10-year Govt of Canada bonds, as per Wise Report
** *Stocks, Bonds, Bills and Inflation 1999 Yearbook-Valuation Edition, Ibbotson Associates*, as per Wise Report
*** Wise Report used 7%; Dunham Report used 3%
† Dunham Report used 8%; Wise Report used 15%
‡ As per Dunham Report

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**Multiplier for 123**

| | | |
|---|---|---|
| Risk free rate§ | 5.14 | |
| Equity risk premium¶ | 5.85 | |
| Size Risk premium§§ | 5 | |
| Company and industry specific risk¶¶ | 10 | |
| Discount Rate | 25.99 | |
| Less: | | |
| Estimated compounded annual growth | -4 | |
| Capitalization Rate | 21.99 | |
| **Maintainable earnings multiplier for 123** | | **4.55** |

§ Value Line *Selection & Opinion*, 30 October 1998, as per Wise Report
¶ *Stocks, Bonds, Bills and Inflation 1999 Yearbook-Valuation Edition, Ibbotson Associates*, as per Wise Report
§§ Wise Report used 7%; Dunham Report used 3%
¶¶ Dunham Report used 8%; Wise Report used 12.28%

## Appendix F - Calculation of capital gains, RDTOH and notional tax

### Estimated Capital Gains

| | 123 | 890 | Total |
|---|---|---|---|
| FMV (CAD) | 533,277 | 3,210,371 | 3,743,648 |
| Less: ACB of Investments | 156,456 | 10 | 156,466 |
| Notional capital gain | 376,821 | 3,210,361 | 3,587,182 |
| Non-taxable portion @ 25% | | | -896,796 |
| Taxable capital gain | | | $2,690,387 |
| **Estimated income taxes at 25.65%** | | | **$690,084** |

### Refundable Dividend Tax on Hand

| | |
|---|---|
| Opening balance - 28 Feb. 1998 | 51,619 |
| Add: Refundable portion of taxable gain - 26.67% of 2,690,387 | 717,526 |
| Refundable dividend tax to be recovered | $769,145 |
| **Refundable dividend tax to be recovered, discounted by 50%** | **$384,573** |

### Notional tax liability on Distribution

| | |
|---|---|
| Amount available for distribution - Appendix A | 3,796,671 |
| Less: | |
| Paid-up capital | -2 |
| Capital dividend account as of October 20, 1998 | 0 |
| Non-taxable portion of capital gain on deemed disposition of investments | -896,796 |
| Retained earnings* | -515,012 |
| Amount of distribution subject to tax | $2,384,861 |
| **Notional tax liability on distribution @ 16.87%**** | **$402,326** |

*Schedule A-4 of Wise Report; transcript page 1773
**33.74%(personal tax rate on dividends), discounted by 50%

[75] The appeal is allowed and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with my Reasons and the summary of adjustments. The matter of costs is reserved. The parties have 60 days from the date of my Reasons to reach an agreement on costs but if they are unable to agree within the timeframe they will provide written submissions on the issue of costs within 30 days of the expiration of the initial 60 day period.

Signed at Charlottetown, Prince Edward Island, this 30th day of July 2008.

"Diane Campbell"

Campbell J.

| | |
|---|---|
| CITATION: | 2008 TCC 426 |
| COURT FILE NO.: | 2003-2892(IT)G |
| STYLE OF CAUSE: | Douglas Zeller and Leon Paroian, Trustees of the Estate of Marjorie Zeller and Her Majesty the Queen |
| PLACE OF HEARING | Windsor, Ontario |
| DATES OF HEARING | February 27 and 28, March 1 and 2, 2006, October 23, 24, 25, 26 and 27, 2006, March 26, 27, 28 and 29, 2007 and July 17 and 18, 2007 |
| REASONS FOR JUDGMENT BY: | The Honourable Justice Diane Campbell |
| DATE OF JUDGMENT | July 30, 2008 |
| APPEARANCES: | |
| Counsel for the Appellant: | Bruck R. Easton, Q.C. |
| Counsel for the Respondent: | Michael Ezri |
| COUNSEL OF RECORD: | |
| For the Appellant: | |
| Name: | Bruck R. Easton, Q.C. |
| Firm: | Belowus, Easton, English<br>Windsor, Ontario |
| For the Respondent: | John H. Sims, Q.C.<br>Deputy Attorney General of Canada<br>Ottawa, Canada |