

Docket: 2011-154(IT)I

BETWEEN:

CANADIAN WINESECRETS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on May 16, 2011, at Calgary, Alberta.

Before: The Honourable Justice François Angers

Appearances:

Agents for the Appellant: Douglas Cageorge
 Douglas Porter

Counsel for the Respondent: Robert Neilson

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2005 taxation year is dismissed in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 16th day of September 2011.

« François Angers »

Angers J.

Citation: 2011 TCC 390

Date: 20110916

Docket: 2011-154(IT)I

BETWEEN:

CANADIAN WINESECRETS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

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REASONS FOR JUDGMENT

Angers J.

[1] This is an appeal of the reassessment of the appellant for its 2005 taxation year. In reassessing the appellant, the Minister of National Revenue (the "Minister") assessed a 15% withholding tax pursuant to subsection 215(1) of the *Income Tax Act* (the "*Act*"). The withholding tax was assessed as a result of a rollover ("rollover") done in accordance with the provisions of section 85 of the *Act*. The Minister takes the position that the appellant did not acquire any goodwill when one Eric T. Dahlberg, a non-resident, rolled his assets over into the appellant. The Minister is of the view that the goodwill amount in question is a deemed dividend pursuant to section 212.2 of the *Act* and that the appellant is subject to withholding tax pursuant to subsection 215(1) of the *Act*.

[2] The appellant was incorporated on November 8, 2004. Prior to the incorporation, Eric T. Dahlberg, a non-resident, had been operating the business as a sole proprietorship since 2002. On January 1, 2005, the appellant acquired the proprietorship assets of Mr. Dahlberg. At that time, the proprietorship had assets in the form of cash, short-term investments and accounts receivable for a total of \$118,342, and accounts payable totalling \$181,357. It was claimed by the appellant that, at the time of the rollover, the difference of \$63,015 was goodwill.

[3] It was admitted at trial that prior to the rollover, the appellant had no proprietary process, nor did it have any long-term contracts in place. The Minister assumed as a fact that there was no attempt to value the goodwill in the business prior to the rollover. Although that assumption was denied by the appellant at trial, no evidence was led by the appellant to contradict the assumption and it must accordingly be accepted as accurate.

[4] It was also admitted that, prior to the rollover, the proprietorship reported continuous losses.

[5] While those facts were admitted, it must be said that the appellant did not call any witnesses to substantiate the information relied upon by its expert witness who was called to establish the existence of goodwill at the time of the rollover. The respondent's only witness was also an expert witness on whom the respondent relied to show that the goodwill amount of \$63,015 claimed by the appellant was unreasonable or that no goodwill at all, or that matter, existed prior to the rollover.

[6] From the evidence of both experts in business valuation and their respective reports with attachments, it can be seen that the appellant is in the business of providing mobile wine finishing technologies in various forms to wineries or wine producers in order to improve the quality of their wines. The appellant provides to its clients the equipment needed to ensure this improved quality.

[7] The issue is basically whether the appellant acquired any goodwill when the proprietorship assets were rolled over into the appellant pursuant to section 85 and what the value of the goodwill, should there be any, is. Put differently, does the evidence of the appellant's expert rebut the Minister's assumption and the respondent's expert evidence that there was no goodwill or that it had no value?

[8] As mentioned earlier, the only evidence heard was that of the parties' respective expert witnesses. In order to prepare their reports, both experts were provided with documents concerning the business prior to and after the rollover. Some of those documents were attached to the respondent's expert report but none were produced with the appellant's expert report, although I must say that some of the documents used by the appellant's expert were similar to those used by the respondent's expert.

[9] Goodwill is not defined in the *Act*. In *Black's Law Dictionary*, "goodwill" is defined as:

A business's reputation, patronage, and other in tangible assets that are considered when appraising the business, esp. for purchase; the ability to earn income in excess of the income that would be expected from the business viewed as a mere collection of assets.

[10] The Supreme Court of Canada in *Gifford v. Canada*, [2004] 1 S.C.R. 411, identified goodwill as an asset which can be treated as being capital in nature if it is an asset of enduring benefit that provides a lasting advantage. Vern Krishna, in his work entitled *The Fundamentals of Income Tax Law*, at page 347, states that goodwill may result from "location, reputation, brand loyalty, competent management, good labour relations and trademarks". Finally, Lord Eldon, L.C., in *Cruttwell v. Lye*, 34 E.R. 129, at page 134, said that goodwill is "the probability, that the old customers will resort to the old place."

[11] *Black's Law Dictionary* also defines what is called personal goodwill as goodwill attributable to an individual's skills, knowledge, efforts, training or reputation in making a business successful. It is also termed professional goodwill, separate goodwill and individual goodwill. That kind of goodwill is not necessarily transferable.

[12] I also note that goodwill has a different definition in accounting in that it does not require that the asset be of enduring value or that there be any promise of continued relations with customers. Barry J. Epstein, Ralph Nach and Steven M. Bragg (*Wiley GAAP 2007 – Interpretation and Application of Generally Accepted Accounting Principles*, at page 444) define goodwill as "the excess of the cost of the acquired interest in an investee over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed", which translates into the difference between the value of a business and what is actually paid for it.

[13] The appellant has the burden of proof. It must establish, on a balance of probabilities, the value attributed to goodwill on the rollover from Eric Dahlberg and the appellant.

[14] In *Marcon v. Canada*, 2008 TCC 116, Justice Favreau held that an appellant has the burden of showing the existence of significant goodwill in the appellant's business. He further said that this must be done using reliable and precise methods and that if the respondent produces an expert report supporting the respondent's

valuation of goodwill, the appellant must provide evidence that at least contradicts the report's findings.

[15] The appellant's expert came to the conclusion that at the time of the rollover there was commercially marketable goodwill inherent in the unincorporated operations of Mr. Dahlberg such that the amount of \$63,015 for goodwill is reasonable and within the range between nil value and fair market value. In arriving at that conclusion, the appellant's expert used one of the three generally accepted approaches for determining the value of an investment in a privately held corporation, namely, the income or cash flow approach, in which the appellant's expected future normalized after-tax cash flow or earnings are discounted to present value using an appropriate capitalization rate. Relying on documents provided to him for the preparation of his report — in particular the appellant's business plan and its management's forecast of after-tax earnings of approximately \$75,000 for 2005 — and applying discount rates of 30% and 40% appropriate for an early-stage investment in a similar business, the expert arrived at a valuation of between \$187,500 and \$250,000, and therefore concluded that the \$63,015 value assigned in this instance to commercially marketable goodwill is reasonable as it is within the allowable range, that is, between \$0 and the estimated fair market value of the appellant's business (\$187,500 to \$250,000). None of the documents relied upon and used by the appellant's expert were introduced in evidence.

[16] The respondent's expert clearly makes the distinction between commercial goodwill and personal goodwill. The expert defines those terms as follows:

Commercial goodwill concerns clients' favourable attitudes toward a business. Its value often reflects the benefits it provides certain prospective purchasers in allowing them to enter business quickly and economically by acquiring the existing practice's reputation, established client base, in-place and operational organization, trained and experienced staff, locational advantages, office facilities, and other advantages of an established practice. It is generally recognized that commercial goodwill follows the business, can be transferred to different owners, and therefore, can have material value.

Personal goodwill relates to the ability, skills, experience, contacts, and reputation of individuals. It resides with the individual, is not transferrable per se, and has little or no commercial value.

[17] The expert then goes on to conclude that the goodwill in the business was personal to Mr. Dahlberg and that it could therefore not be transferred to the appellant. The expert's conclusion is based on conclusions drawn from documents

(some of which were attached to the report) or information provided by the appellant. It was found in the report that there was no trained and experienced office staff, no established client base, no office facilities, no evidence of an exclusive contract between Mr. Dahlberg's business and its suppliers that could be transferred to the appellant. It was further found that the services provided were neither novel nor exclusive and were easily obtainable from other providers, that the sole proprietorship of Mr. Dahlberg had no skilled staff or substantial fixed assets before the rollover, that the sole proprietorship had an accumulated loss of over \$61,000 prior to the rollover, and that this loss was before drawing any reasonable salary for the previous three years, so the business was not in a good financial position. Finally the expert relied on a statement by the appellant's accountant that:

At the time of incorporation, value in excess of assets transferred was provided by the proprietor to allow continued operations under the new structure. This was derived from two primary concerns, (i) those being reasonable access to the equipment required and (ii) the technical and management ability to introduce, operate and sustain this service business.

The equipment at that time was provided primarily on a piece-work basis from sources developed through Dahlberg's existing relationships with owners of equipment available for back rental.

The expert came to the following conclusion:

There does not appear to be any evidence that discernable or quantifiable business goodwill existed prior to the rollover, and merely the continuity of the business activity of the taxpayer without noticeable interruption, at the time of the transfer of business, created of itself no goodwill.

It is my view that Mr. Eric T. Dahlberg's sole proprietor Winesecrets operation had no commercial goodwill on the day of the transfer. Though the taxpayer sent in documents to show some repeat business from three clients for 2004 and 2005, they are insufficient to show saleable goodwill. On this basis, the goodwill of \$63,015 claimed by the taxpayer is unreasonable.

[18] As mentioned earlier, the burden of proof is on the appellant. It must be established on a balance of probabilities that commercial goodwill was transferred from Mr. Dahlberg to the appellant. In this instance, the appellant's expert's calculation of goodwill simply came down to determining the value of the assets and liabilities of Mr. Dahlberg's sole proprietorship based on the estimate of earnings for 2005 given by the appellant, and applying discount rates of 30% and 40% to produce a value for the business which enabled the expert to conclude that the value of

\$63,015 assigned to goodwill is reasonable because it is within the range between nil value and fair market value. Such a valuation, in my opinion, would have been more reliable had the expert used the figures for the proprietorship before the rollover in order to estimate the range of values within which goodwill could reasonably fit, instead of relying on the estimated projected earnings of the appellant.

[19] The appellant's expert report also states that it is not a formal opinion on value or a formal estimate of value. The appellant's expert admitted that such an estimate would have required more thorough investigation, including inspecting the facilities and studying the market for these particular services. The appellant's expert report did not consider whether Mr. Dahlberg had transferred to the appellant any assets that constitute commercial goodwill in the sense that they are of an enduring nature and will ensure continued business. There is no information concerning a client's list or regarding reputation, location or brand loyalty. Reference was made to an exclusivity agreement but there is little if any evidence to support the existence of any such agreement.

[20] The appellant's expert report is of no assistance in determining, for the purposes of this appeal, if there was commercial goodwill sold to the appellant. It fails to rebut the respondent's assumption that no goodwill passed from Mr. Dahlberg to the appellant.

[21] As can be seen from *Les placements A & N Robitaille Inc. v. M.N.R.*, 96 DTC 1062, the question to ask to determine whether goodwill is personal is this: if the person withdraws from the business will any goodwill remain? The respondent's expert report suggests to one the following way of putting the question in this instance: if Mr. Dahlberg had passed away, retired, lost interest in the business or left it for some other reason, would there be any business left? The expert's answer was no. Any goodwill that did exist, such as his business know-how and his access to equipment would have gone with Mr. Dahlberg. In my opinion, if there was any goodwill, it was personal in nature and could not be transferred.

[22] The appellant has failed to rebut either the Minister's assumption or the expert opinion showing that no goodwill was transferred from Mr. Dahlberg to the appellant. The appeal is dismissed.

Signed at Ottawa, Canada, this 16th day of September 2011.

« François Angers »

Angers J.

CITATION: 2011 TCC 390

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STYLE OF CAUSE: Canadian Winesecrets Inc. v. Her Majesty the Queen

PLACE OF HEARING: Calgary, Alberta

DATE OF HEARING: May 16, 2011

REASONS FOR JUDGMENT BY: The Honourable Justice François Angers

DATE OF JUDGMENT: September 16, 2011

APPEARANCES:

Agents for the Appellant: Douglas Cageorge
Douglas Porter

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COUNSEL OF RECORD:

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