

Court File No.: A-350-10

FEDERAL COURT OF APPEAL

BETWEEN:

TRANSALTA CORPORATION

**Appellant
(Respondent on cross-appeal)**

- and -

HER MAJESTY THE QUEEN

**Respondent
(Appellant on cross-appeal)**

FEDERAL COURT OF APPEAL COUR D'APPEL FÉDÉRALE	
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CROWN'S MEMORANDUM OF FACT AND LAW ON APPEAL

AND ON CROSS-APPEAL

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MEMORANDUM OF FACT AND LAW

OVERVIEW

1. This is a purchase price allocation case. TransAlta sold assets and had to allocate the proceeds of disposition of \$818 million to those assets so as to allow for the calculation of recapture and capital gains under the *Income Tax Act*. TransAlta allocated \$190 million, almost 25% of the purchase price to goodwill.
2. TransAlta's allocation was based on an industry practice that the amount paid in excess of the net regulated book value of the assets sold represents goodwill. Such an approach relegates the concept of goodwill to an accounting gap-filler or "plug", ignoring the essence of goodwill as an asset of the vendor which can be sold for value. This approach allows the vendor to avoid recapture and capital gains on the sale. The Minister regarded TransAlta's allocation as unreasonable and, pursuant to section 68 of the *Income Tax Act*, reallocated the entire purchase price to tangible assets.
3. The trial judge correctly recognized that goodwill is an asset created by the vendor and sold for value to the purchaser. Neither the purchaser's characteristics nor its future plans, while they may have prompted it to pay a price in excess of the net regulated book value of the assets sold, constitute goodwill sold by the vendor. As such, certain tax allowances and leverage were properly found not to constitute goodwill.
4. However, the trial judge made palpable and overriding errors in finding that other factors that motivated the purchaser to pay a price in excess of net regulated book value of the assets sold constitute goodwill of the vendor. Accordingly, the Minister's reallocation of the entire purchase price to tangible assets should be restored as none of the factors that motivated the purchaser to pay a higher amount constitute goodwill sold by TransAlta.

PART I

STATEMENT OF FACTS

[A] BACKGROUND FACTS

5. TransAlta operated an electricity transmission business.¹
6. In 2002, TransAlta sold its business by way of a sealed bid auction to a consortium called AltaLink. The final purchase price was \$818 million.²
7. At all material times, AltaLink was owned either directly or indirectly by four limited partners:³
 - (a) SNC Lavalin Transmission Ltd. (50%);
 - (b) OTPPB TEP Inc. (Ontario Teacher's Pension Fund) (25%);
 - (c) Macquarie Transmission Alberta Ltd. (15%); and
 - (d) 3057246 Nova Scotia Company (Trans Elect) (10%).
8. AltaLink, and each partner, dealt at arm's length with TransAlta and its predecessors.⁴

(1) The Alberta Energy and Utilities Board

9. At all material times, the Alberta Energy and Utilities Board, through the regulatory process, set the rates that a transmission business could charge for its services.⁵
10. The owner of a regulated business is entitled to recover a rate of return only on certain assets used in the regulated business. Further, the assets that qualify for a rate of return

¹ Agreed Statement of Facts, paragraph 1.2, Appeal Book Volume 1, Tab 8 at page 00077.

² Agreed Statement of Facts, paragraphs 1.2, 1.3 and 5.2, Appeal Book Volume 1, Tab 8 at pages 00077 and 00081.

³ Agreed Statement of Facts, paragraph 2.5, Appeal Book Volume 1, Tab 8 at page 00078.

⁴ Agreed Statement of Facts, paragraph 2.6, Appeal Book Volume 1, Tab 8 at page 00079.

are depreciated pursuant to the rates set by the regulator. The net regulated book value is that value of the depreciated assets upon which the owner of a regulated business may recover a rate of return.

11. In the existing "cost of service" rate structure, rates are set based on forecasts submitted by the transmission business so as to permit the transmission business to:⁶
- (a) recover the net regulated book value of its assets as they depreciate;
 - (b) recover the estimated expenses of the transmission business, including interest with respect to its debt, taxes and other amounts; and
 - (c) earn a reasonable return on the portion of the net regulated book value the Energy and Utilities Board deemed to be equity for this purpose.

(2) The assets sold and allocation

12. The original cost of the transmission business assets was approximately \$1.4 billion. Asset depreciation for accounting purposes during TransAlta's ownership was approximately \$780 million, resulting in a book value for accounting purposes of approximately \$640 million.⁷
13. Pursuant to the purchase and sale agreement, the purchase price of \$818 million was allocated approximately as follows:⁸
- \$590.6 million to depreciable assets;
 - \$11.9 million to land;
 - \$14.5 million to land rights;
 - \$10.2 million to working capital; and
 - \$190.8 million to goodwill.

⁵ Agreed Statement of Facts, paragraph 7.1, Appeal Book Volume 1, Tab 8 at page 00083.

⁶ Agreed Statement of Facts, paragraph 7.2, Appeal Book Volume 1, Tab 8 at page 00083.

⁷ Agreed Statement of Facts, paragraph 3.2, Appeal Book Volume 1, Tab 8 at page 00080.

⁸ Agreed Statement of Facts, paragraph 5.7, Appeal Book Volume 1, Tab 8 at page 00082.

14. At the time of the sale to AltaLink, the net regulated book value was approximately \$617 million comprised of the depreciable assets, land and land rights. This is the amount on which the owner of the transmission business is entitled to earn a regulated rate of return, on the basis described above.⁹
15. The \$190 million was the approximate amount by which the purchase price exceeded the net regulated book value of the transmission business's assets and the working capital, and was referred to by TransAlta and other parties to the transaction as the "premium".¹⁰

(3) Reasons for paying the premium

16. AltaLink paid the premium at least in part because:¹¹
 - (a) it expected that it would receive, as part of annual revenues permitted by the Alberta Energy and Utilities Board, an allowance for income taxes exceeding the income tax actually paid by its partners (tax allowance);
 - (b) it believed that the return on equity offered by the Alberta Energy and Utilities Board was attractive relative to other investments available to it given the risks it was required to undertake to earn that return; and
 - (c) it expected to be able to arrange its affairs to use more leverage than was assumed by the Alberta Energy and Utilities Board for ratemaking purposes (leverage).
17. TransAlta represented to AltaLink that each of the following opportunities had substantial value:¹²

⁹ Agreed Statement of Facts, paragraph 3.3, Appeal Book Volume 1, Tab 8 at page 00080.

¹⁰ Agreed Statement of Facts, paragraph 1.5, Appeal Book Volume 1, Tab 8 at page 00078.

¹¹ Agreed Statement of Facts, paragraph 8.1, Appeal Book Volume 1, Tab 8 at page 00083.

¹² Agreed Statement of Facts, paragraph 8.5, Appeal Book Volume 1, Tab 8 at page 00084.

- (a) performance based regulation, in the range of \$6 million to \$8 million per year in incremental revenues;¹³
 - (b) potential growth in the regulated aspect of the transmission business, with projected total capital expenditures of between \$655 million and \$955 million projected over the following five-year period; and
 - (c) growth in non-regulated aspects of the transmission business, including telecommunications (wireless and fibre optic), non-regulated or merchant transmission facilities, engineering, procurement, construction management and operations and maintenance services.
18. During the regulatory approval process AltaLink represented to the Alberta Energy and Utilities Board that the premium paid could be justified by AltaLink on the basis that:¹⁴
- (a) a performance based regulation plan could result in a sharing of benefits with customers that would enhance earnings;
 - (b) the possibility of sustained growth in the regulated rate base could dilute the size of the premium; and
 - (c) the existence of competitive merchant transmission projects could provide opportunities to enhance earnings and growth.
19. AltaLink concluded that its ability to earn returns justifying the purchase price, including the premium, was a matter of commercial risk for AltaLink's partners.¹⁵

¹³ Performance based regulation, compared to the existing "cost of service" structure, is a form of regulation that, if implemented, would enable operators of businesses like the transmission business to earn additional returns as a result of creating cost saving efficiencies that would benefit and be shared with their customers.

¹⁴ Agreed Statement of Facts, paragraph 8.3, Appeal Book Volume 1, Tab 8 at page 00084.

¹⁵ Agreed Statement of Facts, paragraph 8.3, Appeal Book Volume 1, Tab 8 at page 00084.

(4) The reassessment

20. The Minister reassessed TransAlta's 2002 taxation year, by applying section 68 of the *Income Tax Act*, to reallocate TransAlta's proceeds of disposition on the sale of its transmission business. The Minister reduced the amounts that TransAlta allocated to goodwill and land rights, and correspondingly increased the amounts allocated to depreciable property and land.¹⁶

[B] THE TAX COURT OF CANADA DECISION

21. The trial judge allowed the appeal in part, finding that \$140.8 million of the purchase price was properly allocated to goodwill. He found that \$50 million of the purchase price had been properly reallocated by the Minister from goodwill to net tangible assets.¹⁷
22. In so holding, the trial judge identified the following issues:¹⁸
- (a) was goodwill one of the assets sold by TransAlta to AltaLink?
 - (b) if goodwill was an asset sold by TransAlta to AltaLink, could the \$190 million reasonably be regarded as consideration for the goodwill? and
 - (c) if not \$190 million, what amount could be reasonably regarded as consideration for goodwill?

(1) Was goodwill one of the assets sold?

23. The trial judge reviewed definitions of goodwill and rejected, for tax purposes, the "residual approach" as being a formula -- goodwill as a "plug" -- and not a definition.¹⁹

¹⁶ Agreed Statement of Facts, paragraph 10.1, Appeal Book Volume 1, Tab 8 at page 00085.

¹⁷ Reasons for Judgment, paragraph 73, Appeal Book Volume 1, Tab 4 at page 00051.

¹⁸ Reasons for Judgment, paragraph 32, Appeal Book Volume 1, Tab 4 at page 00036.

¹⁹ Reasons for Judgment, paragraphs 33, 34 and 39, Appeal Book Volume 1, Tab 4 at pages 00036, 00037 and 00039.

The residual approach views goodwill as the difference between the purchase price and the amount attributed to tangible assets.²⁰ It does not recognize goodwill as an asset to be valued independently.

24. The trial judge concluded that for the purpose of allocation, goodwill must be treated as an asset with a value attached to it. Adopting the definition accepted by the House of Lords in *Commissioners of Inland Revenue v. Muller and Co.'s Margarine Limited*,²¹ he found that goodwill is the “attractive force which brings in custom” and “is worth nothing unless it has power of attraction sufficient to bring customers home to the source from which it emanates”.
25. The trial judge found that although the leverage and tax allowance factors might partly explain why AltaLink paid a premium for the transmission business, they did not constitute the “attractive force which brings in custom” and did not constitute goodwill.²² The court found the other factors constituted goodwill.

(2) Can the \$190 million reasonably be regarded as consideration for goodwill?

26. To determine if the allocation of \$190 million to goodwill was *reasonable*, the trial judge considered the specific wording of section 68 and the associated case law. He noted that section 68 refers to “reasonable”, not “fair market value”, and concluded that what is reasonable is a range – the court was not searching for a specific number.²³
27. The trial judge found that where the parties to a transaction agree to an allocation, the court must determine whether real bargaining occurred with respect to the price allocation. The trial judge made a finding of fact that the parties did not engage in such

²⁰ Reasons for Judgment, paragraph 34, Appeal Book Volume 1, Tab 4 at page 00037.

²¹ House of Lord in *Commissioners of Inland Revenue v. Muller and Co.'s Margarine Limited* [1901] A.C. 217 cited by Justice Miller. Reasons for Judgment, paragraph 33 Appeal Book Volume 1, Tab 4 at page 00036.

²² Reasons for Judgment, paragraphs 59 to 62, Appeal Book Volume 1, Tab 4 at page 00048.

²³ Reasons for Judgment, paragraphs 26 and 47, Appeal Book Volume 1, Tab 4 at pages 00035 and 00042.

real bargaining. TransAlta was motivated to allocate as much as it could to goodwill and AltaLink was indifferent to that allocation as long as the price allocated to the net tangible assets was at least the net regulated book value. The evidence from TransAlta's expert was that the norm in this regulated industry was to allocate the net regulated book value to the tangible assets and the remaining purchase price to goodwill (the "plug"). The trial judge found that this was not real bargaining.²⁴

28. The trial judge determined that a reasonable range for goodwill was between \$115.8 million and \$140.8 million and that TransAlta's allocation of \$190 million to goodwill was not in that reasonable range because:
- (a) the \$190 million was simply a "plug" based on the assumption that the price of the net tangible assets is the net regulated book value,²⁵ and
 - (b) two items (tax allowance and leverage) identified by TransAlta as goodwill were not, in fact, goodwill.²⁶

(3) What amount can be reasonably regarded as consideration for goodwill?

29. In determining the value of the tax allowance and leverage, the trial judge found that the price attributable to the tax allowance was in the range of \$25 million to \$50 million and the price attributable to the leverage was in the range of \$25 million.²⁷ The remaining \$140.8 million was found to constitute goodwill.

²⁴ Reasons for Judgment, paragraphs 47 and 51 to 54, Appeal Book Volume 1, Tab 4 at pages 00043 and 00045 to 00046.

²⁵ Reasons for Judgment, paragraphs 65 and 69, Appeal Book Volume 1, Tab 4 at page 00050.

²⁶ Reasons for Judgment, paragraphs 59 to 62, Appeal Book Volume 1, Tab 4 at page 00048.

²⁷ Reasons for Judgment, paragraphs 70 and 71, Appeal Book Volume 1, Tab 4 at pages 00049 and 00051.

PART II
POINTS IN ISSUE

30. The points in issue on the appeal are whether:
- (a) the trial judge erred in law in defining goodwill as an asset of the vendor with a value attached to it;
 - (b) the trial judge erred in law in interpreting section 68 of the *Income Tax Act*;
 - (c) the trial judge made a palpable and overriding error of fact in finding that the vendor and purchaser did not engage in real bargaining as to the allocation of the proceeds of disposition to the assets sold and therefore section 68 of the *Income Tax Act* applied; and
 - (d) the trial judge made a palpable and overriding error of fact in finding that two of the facts that induced the purchaser to pay a premium, namely the tax allowance and leverage, did not constitute goodwill and that the reasonable range for their value was between \$50 million to \$75 million.
31. The point in issue on the cross-appeal is whether the trial judge made a palpable and overriding error of fact in finding that the other factors that induced the purchaser to pay a purchase price in excess of the net regulated book value of the assets sold constituted goodwill.

PART III

STATEMENT OF ARGUMENT ON APPEAL

[A] THE STANDARD OF REVIEW

32. On an appeal from a decision of the Tax Court of Canada, this court will review questions of law on a standard of correctness. Questions of fact or mixed fact and law, where there is no readily extricable legal principle, are not subject to appellate intervention in the absence of a palpable and overriding error on the part of the trial judge.²⁸
33. The trial judge's interpretation of section 68 of the *Income Tax Act* and its determination that goodwill is an asset of the vendor that can be valued are questions of law reviewable on a standard of correctness.
34. The trial judge's findings as to what constitutes goodwill and what value should be attributed to it are questions of fact reviewable on a standard of palpable and overriding error.

[B] THE TRIAL JUDGE CORRECTLY INTERPRETED SECTION 68

35. The trial judge correctly interpreted section 68 of the *Income Tax Act*. At the material time, the relevant part of section 68 provided:²⁹

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

(a) the part of the amount that can reasonably be regarded as being the consideration for the disposition shall be deemed to be proceeds of

²⁸ *Housen v. Nikolaisen* [2002] 2 SCR 235 at paragraphs 26 to 37.

²⁹ Section 68, *Income Tax Act*, R.S.C. 1985, c. (5th Supp.) as amended.
[Authorities TAB 3]

disposition of the particular property irrespective of the form or legal effect of the contract or agreement, and the person to whom the property was disposed of shall be deemed to have acquired it for an amount equal to that part;...

36. Section 68 provides that only a reasonable amount received as consideration by a vendor for a particular property is deemed to be proceeds of disposition for that property. Where consideration is paid for several different properties, the provision ensures a reasonable allocation of the consideration among the various properties sold. Where the allocation is unreasonable, section 68 applies to deem a reasonable reallocation of the proceeds.
37. In an arm's length transaction, the apportionment of the purchase price among assets must be reasonably gauged on their respective values so as to allow for the calculation of recapture and capital gains. As found by the trial judge, a determination of whether an allocation is reasonable necessarily implies a range rather than a single definitive amount.³⁰
38. The case law relating to allocations under section 68 does not reference an "arm's length safe harbour", to use the appellant's phrase. The trial judge made no error of law in recognizing that, while great weight is to be attached to the arm's length parties' agreement, in certain circumstances, that agreement is not conclusive; other factors must be considered.³¹ This reasoning is consistent with section 68 which states that reasonable consideration will be deemed to be proceeds "irrespective of the form or legal effect of the contract or agreement".
39. As the court noted in *Petersen*, a court may determine that an amount is unreasonable even where there is agreement between parties:³²

Notwithstanding that Mr. Justice Heald considered the finding by the Trial Judge that the agreement in the *Golden* case was not a sham or subterfuge *his decision was based on the specific finding of fact that the amount apportioned by the parties was not an unreasonable amount. Where an*

³⁰ Reasons for Judgment, paragraph 26, Appeal Book Volume 1, Tab 4 at page 00034.

³¹ Reasons for Judgment, paragraph 55, Appeal Book Volume 1, Tab 4 at page 00046.

³² *Petersen v. Minister of National Revenue*, 1987 CarswellNat 577, [1988] 1 C.T.C. 2071, 88 D.T.C. 1040.(T.C.C.) [Authorities TAB 29]

agreement, although evidencing neither sham nor subterfuge, stipulates an amount which is clearly unreasonable in the circumstances, it is still very much open to the court to conclude that section 68 should apply to reallocate the proceeds in a reasonable manner. (all emphasis added)

[C] THE TRIAL JUDGE MADE NO ERROR IN APPLYING SECTION 68

40. The trial judge made no palpable and overriding error of fact in finding that the purchaser and the vendor did not engage in real bargaining with respect to the price allocation and that section 68 of the *Income Tax Act* applied.
41. To determine if the allocation of \$190 million to goodwill was reasonable, the trial judge considered TransAlta's argument that it and the purchaser were arm's length and were sophisticated parties who "hard bargained" the \$818 million purchase price. Specifically the trial judge found that although the parties to the transaction agreed to the price proposed by TransAlta, the court nonetheless needed to determine whether *real bargaining* occurred specifically *with respect to the allocation*.³³
42. The trial judge made no palpable and overriding error of fact in finding that the parties did not engage in real bargaining with respect to the price allocation. There was evidence before him on which he could make such a finding. TransAlta was motivated to allocate as much as it could to goodwill and the purchaser was indifferent to allocating any amount to goodwill as long as the price allocated to the net tangible assets was at least the net regulated book value. The trial judge noted the evidence from TransAlta's expert that **the norm in the regulated industry** was to allocate the net regulated book value to the tangible assets and the remaining purchase price to goodwill (the plug). The trial judge found that this was not real bargaining.³⁴

³³ Reasons for Judgment, paragraphs 47 and 51 to 54, Appeal Book Volume 1, Tab 4 at pages 00043 and 00045 to 00046.

³⁴ Reasons for Judgment, paragraphs 47 and 51 to 54, Appeal Book Volume 1, Tab 4 at pages 00043 and 00045 to 00046.

[D] **THE TRIAL JUDGE CORRECTLY FOUND THAT GOODWILL IS AN ASSET OF THE VENDOR**

43. The trial judge correctly defined goodwill as an asset of the vendor with a value attached to it.
- (1) **Goodwill is an asset**
44. Goodwill is an “unidentifiable intangible” asset.³⁵ In any price allocation exercise, the vendor and purchaser must allocate the purchase price to tangible assets, identifiable intangible assets (if any) and unidentifiable intangible assets (if any).
45. In the purchase and sale agreement, TransAlta and AltaLink recognized goodwill as distinct from the tangible and identifiable intangible assets. “Assets” was defined to include:
- (a) the sites and buildings, equipment, plans and designs, records and current assets (tangible assets);
 - (b) land rights, benefit of the contracts and all other commitments, the warranties, if any, permits, and computers software (identifiable intangible assets); and
 - (c) goodwill of the business which includes the right of AltaLink to represent itself as continuing to carry on the transmission business and to use the TransAlta customer lists and supplier lists (unidentifiable intangible assets).³⁶
46. The trial judge accepted Lord Macnaghten’s definition of goodwill in *Muller* as follows:³⁷

...What is goodwill? It is something very easy to describe, very difficult to define. It is the benefit or advantage of the good name, reputation, and

³⁵ Report of Scott Lawritson, paragraph 5.05, Appeal Book Volume 5, Tab 51 at page 01145.

³⁶ Reasons for Judgment, paragraph 4, Appeal Book Volume 1, Tab 4 at pages 00020 cites the “Appendix A - Glossary” to the purchase and sale agreement.

³⁷ Reasons for Judgment, paragraph 33, Appeal Book Volume 1, Tab 4 at pages 00036.

connection of a business. It is the attractive force that brings in custom... The goodwill of a business must emanate from a particular source or centre... goodwill is worth nothing unless it has the powers of attraction to bring customers home to the source from which it emanates.

47. This definition establishes that goodwill is an existing asset, not an asset yet to be created.³⁸
48. While TransAlta's position is that the entire difference between the net regulated book value and the proceeds of disposition price is goodwill, goodwill cannot be defined with reference to such a regulatory concept. Net regulated book value is the amount deemed to be equity upon which a return will be earned in the cost of service regulatory model. It is unrelated to fair market value, book value, adjusted cost base or any other concept in the *Income Tax Act*.

(2) Goodwill emanates from the vendor

49. Goodwill is an asset of the vendor. Upon questioning by the trial judge, Ms. Glass, TransAlta's expert witness, agreed that goodwill is an asset of the vendor capable of being sold to the purchaser. When questioned as to how leverage or any other circumstance of the purchaser could be an asset of the vendor, Ms. Glass testified that, before the sale, goodwill was something that may not have existed because of the way TransAlta was operating its business. Indeed, once a business is sold, the ability of a purchaser to operate it in a more profitable manner may induce the purchaser to pay a higher price for the business.
50. The appellant's view that the difference between the net regulated book value and the sale price is goodwill, even though the increased price is paid in recognition of an attribute of the purchaser³⁹, does not accord with Lord Macnaghten's definition of

³⁸ *Petersen v. Minister of National Revenue*, 1987 CarswellNat 577, [1988] 1 C.T.C. 2071, 88 D.T.C. 1040. at paragraphs 41 and 56. [Authorities TAB 29]

³⁹ Questions by trial judge of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01482, line 6 to page 01484, line 7.

goodwill, which focuses on goodwill as an asset *of the vendor*.

51. The trial judge correctly rejected TransAlta's definition of goodwill in concluding that goodwill is an asset of the vendor that can be sold and valued.
52. The trial judge recognized that there is a distinction in the case law between goodwill and the factors that may induce a purchaser to pay a premium for a business.
53. In *Jessiman*, the post office paid a premium for a fleet of trucks. The court found that goodwill was not purchased and noted:⁴⁰

It is undisputed that that price was significantly more than the defendant could have obtained from any other purchaser and substantially more than the Post Office could have obtained if it had elected immediately to resell the trucks to any but another postal service. That said, I see no merit in the proposition that the amount over and above their trade-in value was paid for something other than the trucks simply because the Post Office had an immediate need for them "as is" and was prepared to pay that extra amount to satisfy that need.

54. Even if AltaLink was of the view that it could run the transmission business more economically and take advantage of certain savings, its payment of a premium is not goodwill. TransAlta cannot characterize everything that caused the purchaser to pay a price higher than the net regulated book value as goodwill, such as:
 - (a) the "stupidity" of the purchaser/bidder;⁴¹
 - (b) the auction process that encouraged the bidders to put their best offers forward;⁴²
 - (c) the personal attributes of the bidders, which may include their financial structure, their tax structure, and desires to enter the transmission business and to have a

⁴⁰ *R. v. Jessiman Brothers Cartage Ltd.* 1978 CarswellNat 190, [1978] C.T.C. 274, 78 D.T.C. 6205 at paragraph 13. [**Authorities TAB 26**]

⁴¹ Re-examination of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01471, lines 1 to 24.

⁴² Re-examination of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01473, line 10 to page 01474, line 3.

safe investment and a stable income stream;⁴³

- (d) the expectation that a law or regulation will change (such as to performance based regulation);⁴⁴
- (e) the fact that the Ontario Teacher's Pension Fund and Macquarie would each receive \$4.1 million in consulting fees from AltaLink for services provided in connection with the transaction;⁴⁵
- (f) the fact that, if the cost of debt allowed by the regulator is higher than the actual cost of debt to the purchaser, that would yield greater profits for AltaLink (leverage); and⁴⁶
- (g) anything else that drives up the price of the transmission business beyond the net regulated book value.⁴⁷

55. The fallacy in this thinking can be illustrated by an example. A grocery store is listed for sale for \$400,000. Prospective purchaser A has always wanted to run a grocery store, lives close to this store, and has family members who will work for less than arm's-length wages. For these reasons, he is willing to pay \$500,000 for the store. Prospective purchaser B is not willing to pay beyond the list price. The store is sold to A for \$500,000. According to TransAlta's logic, the "thing" sold is a business and therefore \$100,000 can be attributed to goodwill, notwithstanding A's willingness to pay the \$100,000 "premium" has nothing to do with the vendor's efforts to increase the

⁴³ Re-examination of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01473, line 10 to page 01474, line 3.

⁴⁴ Glass Report, paragraphs 197-201 and 204-205, Appeal Book Volume 5, Tab 50 at pages 01086 and 01087.

⁴⁵ Glass Report, paragraph 411, Appeal Book Volume 5, Tab 50, at page 01126.

⁴⁶ Glass Report, paragraphs 244-245, Appeal Book Volume 5, Tab 50, at page 01094.

⁴⁷ Re-examination of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01470, line 25 to page 01472, line 16, page 01473, line 4 to page 01474, line 3; Questions by trial judge of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01478, line 4 to page 01483, line 17.

“attractive force which brings in custom”.⁴⁸ The trial judge was correct to differentiate between goodwill and the factors that induced AltaLink to pay a premium.

[E] THE TRIAL JUDGE MADE NO ERROR IN FINDING THAT TAX INCENTIVES AND LEVERAGE DO NOT CONSTITUTE GOODWILL

56. The trial judge made no palpable and overriding error of fact in concluding that AltaLink’s tax incentives and ability to leverage do not constitute goodwill of TransAlta, but are factors that induced AltaLink to pay a purchase price in excess of the net regulated book value.⁴⁹ They have “nothing to do with anything that TransAlta did or created to maintain or increase its customers”.⁵⁰
57. Goodwill is an asset that can be valued. The Minister assumed on assessing that the fair market value of the goodwill was nil.⁵¹ TransAlta allocated proceeds to goodwill in its purchase and sale agreement with AltaLink but produced no evidence on the value of the asset as identified, preferring to maintain that goodwill was a plug, calculated as the difference between the purchase price and the net regulated book value.
58. The trial judge correctly placed the onus on TransAlta to identify and value the asset called goodwill. Where evidence of the value of the asset is not provided, the Minister’s allocation will stand as reasonable. In *Peterson* Justice Rip stated:

The onus is on the appellant to prove the Minister’s allocation under section 68 is unreasonable; it is incumbent on the appellant to provide the Court with evidence which not only supports a conclusion that the Minister’s allocation is unreasonable, but also to provide evidence to establish, with some degree of certainty, the allocation which the appellant submits is correct.

⁴⁸ The trial judge canvassed a similar example with Ms. Glass, involving the sale of a house. Questions by the trial judge of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01478, line 4 to page 01483, line 17.

⁴⁹ Reasons for Judgment, paragraphs 59 to 62, Appeal Book Volume 1, Tab 4 at page 00048.

⁵⁰ Reasons for Judgment, paragraph 60, Appeal Book Volume 1, Tab 4 at page 00048.

⁵¹ Reply, paragraph 13(r), Appeal Book Volume 1, Tab 7 at page 00066.

While the evidence establishes that goodwill in the business did exist, it does not establish its value and in that respect it is not possible to conclude the Minister's allocation was unreasonable.⁵²

59. The trial judge made no palpable and overriding error in finding TransAlta's allocation was unreasonable because these two items do not constitute goodwill. The trial judge's estimation of the leverage and tax incentives is supportable on the evidence, even though such an estimation is arguably unnecessary given that *none* of the \$190 million allocated by TransAlta to goodwill constitutes goodwill as defined by the courts.
60. While TransAlta argues that the tax incentives and leverage constitute goodwill because they are connected to the licenses and permits sold as part of the transmission business,⁵³ TransAlta and AltaLink explicitly recognized in the purchase and sale agreement that goodwill was distinct from identifiable intangible assets *including the permits and licenses*.⁵⁴ Accordingly, the licenses and permits cannot be used to justify any amount attributed to goodwill.
61. Further, there was evidence upon which the trial judge could find as he did regarding the value attributed to the tax incentives:
- (a) AltaLink expected to receive a \$20 million tax allowance every year from the regulator but only had to pay \$15 million in taxes as the Ontario Teacher's Pension Fund did not have to pay taxes, thus saving \$5 million per annum;⁵⁵ and
 - (b) the ability of AltaLink to create a tax shield by amortizing the premium paid as an

⁵² *Petersen v. Minister of National Revenue*, 1987 CarswellNat 577, [1988] 1 C.T.C. 2071, 88 D.T.C. 1040 at paragraphs 57 and 58. [Authorities TAB 29]

⁵³ Appellant's Memorandum of Fact and Law at paragraphs 75 and 76.

⁵⁴ Reasons for Judgment, paragraph 4, Appeal Book Volume 1, Tab 4 at pages 00020 cites the "Appendix A - Glossary" to the purchase and sale agreement.

⁵⁵ Reasons for Judgment, paragraph 70, Appeal Book Volume 1, Tab 4 at page 00051; Glass Report, paragraphs 174 and 407, Appeal Book Volume 5, Tab 50, at page 01081 and page 01125.

eligible capital expenditure which TransAlta valued at \$28 million.⁵⁶

62. The trial judge also accepted TransAlta's evidence that the leverage would add 2% to the return on investment of AltaLink and estimated the leverage at \$5 million to \$6 million a year.⁵⁷
63. In an attempt to rationalize the allocation of \$190 million to goodwill, Ms. Glass valued the potential for performance based regulation and the strategic benefits⁵⁸ (including engineering, procurement, construction management service, merchant transmission and new markets/growth) at \$50 million. That implies that the two remaining items identified (tax incentives and leverage) are valued at \$140 million, much higher than found by the trial judge.⁵⁹
64. Given these facts the trial judge more than reasonably valued the tax incentives at \$25 million to \$50 million⁶⁰ and leverage at \$25 million.⁶¹

STATEMENT OF ARGUMENT ON THE CROSS-APPEAL

[F] THE TRIAL JUDGE ERRED IN FINDING THAT FACTS THAT INDUCE A PURCHASER TO PAY A PREMIUM CONSTITUTE GOODWILL

65. The trial judge made palpable and overriding errors in concluding that *any* of the factors that induced AltaLink to pay a premium constituted goodwill. The argument that anything that increases the price of the business above the net regulated book value, must be regarded as goodwill [i.e. as not influencing the price of the tangible assets] is unsupportable once goodwill is correctly recognized as a distinct asset of the vendor with

⁵⁶ Glass Report, paragraphs 207 and 406, Appeal Book Volume 5, Tab 50, at page 01087 and page 01125.

⁵⁷ Reasons for Judgment, paragraph 71, Appeal Book Volume 1, Tab 4 at page 00048.

⁵⁸ Referenced in reasons at paragraph 16 page 00026

⁵⁹ Glass Report at paragraphs 407 to 411, Appeal Book Volume 5, Tab 50, at page 01125 to page 01126

⁶⁰ Reasons for Judgment, paragraph 72, Appeal Book Volume 1, Tab 4 at page 00051.

⁶¹ Reasons for Judgment, paragraph 70, Appeal Book Volume 1, Tab 4 at page 00051.

a value.⁶²

66. TransAlta claimed that the following items constituted goodwill:⁶³

- (a) skilled employee base;
- (b) engineering, procurement and construction management;
- (c) potential to take advantage of performance based regulation;
- (d) new markets/growth;
- (e) merchant transmission;
- (f) tax allowance; and
- (g) leverage.

67. Even if the purchase and sale agreement had recognized the above factors as goodwill, the law does not. The trial judge erred in finding that the skilled employee base and the potential of AltaLink to take advantage of engineering, procurement and construction management, performance based regulation, new markets/growth and market transmission constitute goodwill. These items do not emanate from the vendor, they relate to a future event or contingency that is not within the control of the vendor and/or are reliant upon the attributes of the purchaser. They are not an asset sold by the vendor; they are not goodwill.

⁶² Re-examination of Glass, Appeal Book Volume 7, Tab 55, transcripts at page 01471, line 21 to page 01472, line 16.

⁶³ Reasons for Judgement, paragraph 16, Appeal Book Volume 1, Tab 4 at page 00026.

(1) **Skilled employee base**

68. Ms. Glass, the appellant's expert, agreed that, within the confines of a regulated industry, and setting aside the potential profits attributable to engineering, procurement, construction and management services, future growth, and performance based regulation, *no value should be attributed to the skilled employee base*: "The owners will not receive any benefit from the benefits that may be created by employees; consequently, there is no additional value to the firm from this, and, as a result, buyers of this business could not pay the seller for any employee value."⁶⁴ The current cost of service model will adjust cost efficiencies to ultimately benefit the consumers and not the owners in a regulated industry during the rate setting process.
69. Ms. Glass explained that the skilled employee base would be of value only if the performance based regulation model is implemented or if AltaLink can take advantage of the engineering, procurement, construction and management services opportunities.⁶⁵ As a result, no value can be attached to the skilled employee base. The trial judge erred in concluding that the skilled employee base was the source from which AltaLink might take advantage of the potential for engineering, procurement, construction and management services, performance based regulation, new markets/growth opportunities and merchant transmission.⁶⁶
70. If engineering, procurement, construction and management services, performance based regulation, new markets/growth and merchant transmission opportunities do not constitute goodwill, no value can be attached to those items.

⁶⁴ Glass Report, paragraphs 289 to 290, Appeal Book Volume 5, Tab 50, at page 01100.

⁶⁵ Glass Report, paragraphs 289 to 291, Appeal Book Volume 5, Tab 50 at page 01100 and page 01101; Examination in chief of Glass, Appeal Book Volume 6, Tab 54, at page 01338, line 25 to page 01339, line 13.

⁶⁶ Reasons for Judgment, paragraph 63, Appeal Book Volume 1, Tab 4 at page 00049.

(2) **Engineering, procurement, construction and management services**

71. The transfer by TransAlta of 76 skilled employees to SNC Lavalin does not constitute goodwill.
72. At trial, TransAlta argued that AltaLink's plan was to transfer 76 skilled employees to SNC Lavalin and have the employees continue to provide services to AltaLink for a fee. If the fees charged to AltaLink were higher than the wages paid to the employees and recovered by AltaLink from the regulator, then SNC Lavalin would make a profit from that difference. The 76 employees would also be used by SNC Lavalin to provide non-regulated engineering, procurement, construction and management services and thereby increase SNC Lavalin's profits. Overall, the 76 employees would provide training and increase SNC Lavalin's employee skill base.⁶⁷
73. SNC Lavalin's ability to use the stripped asset outside of the business it is buying and thereby make more profit for itself is not goodwill. The 76 employees may indeed increase SNC Lavalin's ability to provide engineering, procurement, construction and management services and add to its skill base, but that is not an attractive force created by TransAlta to attract or maintain and keep the customers of the transmission business. As noted above the skilled employees, *per se*, had no value. It may be a reason why SNC Lavalin was willing to pay a premium, but it has nothing to do with goodwill purchased from TransAlta.
74. TransAlta presented evidence that the engineering, procurement, construction and management services opportunities "resulted in hundreds of millions of dollars in additional revenue over the ensuing 7 years".⁶⁸ The potential of the engineering, procurement, construction and management services does not constitute goodwill and the value allocated to goodwill for that reason must be reduced accordingly.

⁶⁷ Reasons for Judgment, paragraph 63, Appeal Book Volume 1, Tab 4 at page 00049.
⁶⁸ Reasons for Judgment, paragraph 17, Appeal Book Volume 1, Tab 4 at page 00029; Glass Report, paragraph 269, Appeal Book Volume 5, Tab 50, at page 01097 to page 01098.

(3) **Performance based regulation**

75. The trial judge erred in fact in concluding that TransAlta's hope that the government would adopt a performance based regulation model constitutes goodwill.
76. Adopting a performance based regulation model requires changes to the current "cost of service" regulatory system. Under the existing system, the owners of a transmission business recover an approved rate of return and all costs associated with providing the services. During the rate setting process, all cost savings are ultimately passed onto the consumers.⁶⁹ In theory, the performance based regulation model uses a formula whereby the consumers and the owners of the transmission business share in cost savings.⁷⁰
77. At trial, the only evidence put forward by TransAlta that a performance based regulation model was being considered was contained in a settlement negotiated between TransAlta and the intervenors at an Energy and Utilities Board hearing to the effect that TransAlta would "commence discussions... aimed at achieving an agreement on the implementation of a Performance Based Regulation proposal".⁷¹
78. TransAlta's bare assertion that it "expected" the performance based regulation model to be adopted does not constitute goodwill. This expectation has nothing to do with anything that TransAlta did or created to maintain or keep its customers. As noted above, the court in *Peterson*⁷² confirmed that goodwill is an intangible asset that has been created and not an asset yet to be created. The record shows that no shift to performance based regulation has occurred.

⁶⁹ Agreed Statement of Facts, paragraph 7.2, Appeal Book Volume 1, Tab 8 at page 00083.

⁷⁰ Glass Report, paragraph 197, Appeal Book Volume 5, Tab 50 at page 1086.

⁷¹ Examination in chief of Glass, Appeal Book Volume 6, Tab 54, transcripts at page 01316, lines 6-10; Para. 22 of Appendix 4 of the 2001 TFO Tariff and Negotiated Settlement of the Alberta Energy Utilities Board Decision 2001-4 regarding the 2001 General Tariff Application. [Authorities TAB 37]

⁷² *Petersen v. Minister of National Revenue*, 1987 CarswellNat 577, [1988] 1 C.T.C. 2071, 88 D.T.C. 1040 at paragraph 41. [Authorities TAB 29]

79. TransAlta gave evidence that if the performance based regulation model was adopted, the transmission business owner could expect increased profits of \$6 million to \$8 million per annum.⁷³ Thus, the value of goodwill attributed to that reason should be reduced accordingly.

(4) New markets/growth

80. The particular purchaser's financial ability and desire to invest more capital into the transmission business or enter into new markets is not goodwill created or developed by the vendor.

81. TransAlta states that the potential in the future for AltaLink to invest in or construct capital assets thereby increasing its future return on earnings constitutes goodwill. The explanation is that the future growth relates to future assets and not to the current assets and therefore profits relating to future growth form part of goodwill and not an increase in the value of the tangible assets.⁷⁴

82. Whether AltaLink makes the future capital investments is dependent on its financial circumstances and the market's need for the services to be produced by the future capital assets. This has nothing to do with TransAlta and what TransAlta sold to AltaLink.

83. If the "potential" for future capital investment is found to constitute goodwill, then *any vendor of any business* can avoid or limit recapture by allocating a portion of the sale proceeds to goodwill because of the vendor's expectation that the *purchaser* will increase future profits by investing more money into the business.

84. Further, whether or not SNC Lavalin or any other partner can enter the transmission business in new markets such as other regions of Canada or the United States is dependent upon the partners' financial circumstances and the market's need for the

⁷³ Glass Report, paragraph 200, Appeal Book Volume 5, Tab 50, at page 01807.

⁷⁴ Examination in chief of Glass, Appeal Book Volume 6, Tab 54, transcripts at page 01303, lines 3 to 9.

services or products to be provided in that area. This does not constitute goodwill. It is not the attractive force that brings in customers and it does not emanate from a particular source or centre within the vendor.

85. TransAlta's evidence was that they expected future growth in the regulated aspect of the transmission business, with projected total capital expenditures of between \$655 million and \$955 million over the next five years, without quantifying the value of the growth.⁷⁵ Any amount of the \$190 million allocated to goodwill that is attributed to new markets/growth should be reduced accordingly.

(5) Merchant transmission

86. Merchant transmission is an unregulated arrangement whereby a third party constructs and operates an interconnection line on which available transmission capacity is sold.⁷⁶
87. TransAlta provided evidence that the premium was justified, in part, on the basis of the possibility that merchant transmission projects provide opportunities that would enhance earnings and growth.⁷⁷

The potential future benefits would have made the acquisition that much more attractive, and would have influenced the price the Partners were willing to pay.⁷⁸

88. Like new markets/growth, whether AltaLink or any of its partners can enter the merchant transmission business is dependent upon AltaLink's or the partners' financial circumstances and the market's need for the services or products to be provided in that area. This does not constitute goodwill.
89. There was no evidence of the value of the opportunity for merchant transmission. Any amount of the \$190 million allocated to goodwill that related to merchant transmission should be reduced accordingly.

⁷⁵ Agreed Statement of Facts, paragraph 8.5, Appeal Book Volume 1, Tab 8 at page 00084.

⁷⁶ Glass Report, at paragraph 272, Appeal Book Volume 5, Tab 50, at page 01098.

⁷⁷ Glass Report, at paragraph 279, Appeal Book Volume 5, Tab 50, at page 01099.

⁷⁸ Glass Report, at paragraph 283, Appeal Book Volume 5, Tab 50, at page 01100.

[G] CONCLUSION

90. The trial judge correctly determined that goodwill is an asset of the vendor which can be sold to a purchaser for value. This is recognized in the purchase and sale agreement. TransAlta failed to prove that goodwill of any value, as recognized in law or in the purchase and sale agreement, was transferred to AltaLink.
91. Factors that may induce a purchaser to pay a premium do not constitute goodwill. Just as the trial judge properly found that tax allowances and leverage do not constitute goodwill, so too should he have concluded that the other factors that induced AltaLink to pay the premium do not constitute goodwill. These items do not emanate from the vendor, they relate to a future event or contingency that is not within the control of the vendor and/or are reliant upon the attributes of the purchaser. They do not constitute an asset sold by the vendor; they are not goodwill.
92. Without evidence to support a value for goodwill the Minister's assumption that goodwill is valued at nil must be accepted.

PART IV**ORDER SOUGHT**

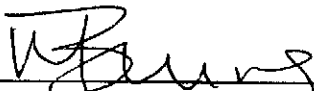
93. The respondent (appellant on cross-appeal) requests that the appeal be dismissed, the cross-appeal allowed, and the original reassessment restored, with costs in this court and in the court below.

DATED at Edmonton, Alberta, this 19th day of April, 2011.

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PART V

LIST OF AUTHORITIES CITED

Provisions of Statutes or Regulations

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2. *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.) as amended (the "*Act*"), section 67.
3. *Act*, section 68.
4. *Act*, subsection 69(2) (now repealed)

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5. Alberta Energy and Utilities Board Decision 2004-052.
6. *167849 Canada Inc. v. The Queen*, 2010 D.T.C. 1208 (T.C.C.).
7. *Dominion Dairies Limited v. The Minister of National Revenue*, 66 D.T.C. 5028 (Ex. Ct.).
8. *Dr. Harold Robbins v. The Minister of National Revenue*, 78 D.T.C. 1669 (Tax Review Board).
9. *Elworthy v. The Queen*, 82 D.T.C. 6067 (F.C.T.D.).
10. *Erawan House Ltd. v. Minister of National Revenue*, 76 D.T.C. 1049 (Tax Review Board).
11. *Fortino et al v. The Queen*, 97 D.T.C. 55 (T.C.C.).
12. *Gabco Ltd. v. The Queen*, 68 D.T.C. 5210 (Ex. Ct.).
13. *Gagnon v. The Queen*, 99 D.T.C. 845 (T.C.C.).
14. *George Golden v. The Queen*, 80 D.T.C. 6378 (F.C.T.D.).
15. *George Golden v. The Queen*, 83 D.T.C. 5138 (F.C.A.).
16. *GlaxoSmithKline v. The Queen*, 2010 F.C.A. 201.
17. *Goldhar Estate v. The Minister of National Revenue*, 88 D.T.C. 1149 (T.C.C.).
18. *H. Baur Investments Ltd. v. The Minister of National Revenue*, 90 D.T.C. 6371 (F.C.T.D.), affg 88 D.T.C. 1024 (T.C.C.).

19. *Northland Properties Corporation v. The Queen*, 2010 B.C.C.A. 177.
20. *Northwestern Utilities Ltd. v. The City of Edmonton et al.*, [1929] SCR 186.
21. *Les Placements A & N Robitaille Inc. v. The Minister of National Revenue*, 96 D.T.C. 1062 (T.C.C.).
22. *Hickman Motors Limited v. The Queen*, 97 D.T.C. 5363 (S.C.C.).
23. *Petro-Canada Ltd. v. The Queen*, 2004 D.T.C. 6329 (F.C.A.).
24. *The Queen v. Canada Trustco Mortgage Co.*, 2005 D.T.C. 5523 (S.C.C.).
25. *The Queen v. Demco Management Limited*, 85 D.T.C. 5603 (F.C.A.).
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27. *The Queen v. Golden*, 86 D.T.C. 6138 (S.C.C.).
28. *The Queen v. Waldorf Hotel (1958) Ltd. et al.*, 75 D.T.C. 5109 (F.C.T.D.) (sub nom. *R v. Shok*).
29. *R.L. Petersen v. The Minister of National Revenue*, 88 D.T.C. 1040 (T.C.C.).
30. *Safety Boss Ltd. v. The Queen*, 2000 D.T.C. 1767 (T.C.C.).
31. *Teleglobe Canada Inc. v. R.*, 2000 D.T.C. 2493 (T.C.C.).
32. *Teleglobe Canada Inc. v. R.*, 2002 D.T.C. 7517 (F.C.A.).
33. *U.S.M. Canada Limited v. The Queen*, 97 D.T.C. 192 (T.C.C.).

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35. John W. Durnford, "Goodwill in the Law of Income Tax" (1981), 29(6) Canadian Tax Journal 759.
36. David C. Nathanson, "The Price-Appportionment Issue" (1992) I:3 Tax Litigation 30.
37. Alberta Energy Utilities Board Decision 2001-4 regarding the 2001 General Tariff Application.