July 7, 2022

***Godcharles v. Québec Revenue Authority* [1]**

Case Study

In the following case, the Québec Court of Appeal determined that the interests of 8 unrelated taxpayers were so closely aligned that they were considered to be dealing with each other on a non-arm's length basis, thus upsetting the planned tax relief.

Normand Godcharles ("**NG**") and 7 other individuals acquired a retirement home in Québec, through direct co-ownership of land and building (as Co-Owners), and through shareholdings in 9118-9837 Québec Inc. ("**9118**"), which provided management services to the retirement home business and held some business assets, including goodwill associated with the business. On January 18, 2006, the 7 shareholders of 9118 sold their shares to a holding company owned by NG for a pre-determined price. On January 20, 2006 the 7 Co-Owners of the land and building, along with 9118, sold their assets, including goodwill from 9118, to an arm's length purchaser, "**SECA**", for CAD$11,550,000.

On Sale 1, the sale of shares of 9118, the 7 shareholders claimed the *lifetime capital gains exemption.* In 2006, an individual could realize a tax-free capital gain of $500,000 on the disposition of "qualified small business corporation shares".[2] On Sale 2, the sale of assets to SECA, an unreported portion of the sale price was allocated to the building (to generate a capital gain) and another, presumably larger unreported portion of the sale price was allocated to the goodwill and other business assets sold by 9118, which resulted in a capital gain to the Co-Owners, and another larger capital gain and a credit to the "capital dividend account" of 9118. [3]

The Québec Revenue Authority ("**QRA**") revised the sale price deemed to be received by the vending shareholders of 9118, on the basis that if the vendors and the purchaser did not deal at arm's length, the price could be no greater than its fair market value. In this case, the price exceeded its fair market value. In addition, the QRA revised the allocation of sale proceeds received from SECA, to increase the allocation to building (thus increasing recapture of depreciation, taxable as ordinary income) and reduce the allocation to the assets of 9118 (thus reducing the capital gain subject to inclusion of only 50% in income).

The Court reviewed the appraisal of the land and building, and determined that the most reliable valuation fixed the land and building value at CAD$9,385,000, thus reducing the amount allocable to the assets sold by 9118 to CAD$2,165,000- hence reducing the amount credited to the capital dividend account of 9118

1 2021 QCCA 1843 (Québec Court of Appeal)
2 In 2022, the amount is now CAD$913,630.
3 When a private corporation resident in Canada realizes a capital gain, one-half is taxable and the other half is credited to an account, the capital dividend account, from which tax-free dividends can be paid to Canadian residents.

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(and making capital dividend distributions in the years after the sale as exceeding the amount in the capital dividend account, thus resulting in penalty taxes applying).

In a noteworthy finding of fact, the Court determined that NG and the 7 shareholders/Co-Owners did not deal at arm's length, as evidenced by NG's dominance in all the negotiations for the transactions, the documents and the testimony in court. There was "a bond between NG and the other appellants which, in fact, would have made them dependent on him". They were, in effect, acting in concert through NG's actions. As a final comment, the Court noted that what the appellants engaged in was not legalistic deceit, or a form of duplicity, nor an attempt at tax evasion- far from it..."It is simply a question of tight tax planning which pushed too far as to what a self-assessment system seems to allow to be done, and to be of benefit to the taxpayer who arranges his affairs by thinking of the tax consequences which will result from it. An attempt was made to transform taxable proceeds into non-taxable or taxable at a lesser amount but not in accordance with the law which the appellants did not anticipate."