

Docket: 2005-2177(IT)G

BETWEEN:

GESTION LÉON GAGNON INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on November 9, 2006, at Montreal, Quebec.

Before: The Honourable Justice Louise Lamarre Proulx

Appearances:

Counsel for the Appellant:

Serge Fournier

Counsel for the Respondent:

Marie-Andrée Legault

JUDGMENT

The appeal from the assessment made under the *Income Tax Act* for the 2001 taxation year is allowed, with costs, 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 parties' request that the appeal be classified as a Category B appeal rather than a Category C appeal, given the amount of tax in issue, is granted.

Signed at Ottawa, Canada, this 14th day of December 2006.

“Louise Lamarre Proulx”

Lamarre Proulx J.

Translation certified true
on this 18th day of January 2008.

Erich Klein, Revisor

Citation: 2006TCC682
Date: 20061214
Docket: 2005-2177(IT)G

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GESTION LÉON GAGNON INC.,

Appellant,

and

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Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Lamarre Proulx J.

[1] This is an appeal concerning the 2001 taxation year.

[2] The issue is whether a company, by issuing shares with a redemption value higher than their paid-up capital, conferred on the appellant a benefit under subsection 15(1) of the *Income Tax Act* (the “Act”).

[3] The facts considered by the Minister in making the reassessment are set out in paragraph 12 of the Amended Reply to the Notice of Appeal (the “Reply”) as follows:

[TRANSLATION]

- (a) the appellant’s fiscal year-end is August 31 of each year;
- (b) all of the appellant’s shares are held by Léon Gagnon;
- (c) 55% of the voting and participating shares of the company Centre Financier Iberville/Champlain Inc. (“CFIC”) are held by Léon Gagnon and 45% by Sylvie Turcotte, his spouse;
- (d) on December 19, 2000, CFIC issued 300 Class J shares to the appellant for a consideration of \$300;

- (e) to acquire these shares, the appellant did not have to pay, assign or transfer anything other than their acquisition cost of \$300;
- (f) these non-voting and non-participating shares, of which the paid-up capital was \$1 per share, were retractable for \$1,000 per share;
- (g) by issuing these shares to the appellant, CFIC conferred on him a benefit of \$299,700, i.e. the difference between the shares' paid-up capital of \$300 and their redemption value of \$300,000;
- (h) moreover, CFIC redeemed these shares held by the appellant for \$300,000 on January 16, 2001, i.e. less than one month after they were issued.

[4] All of these paragraphs were admitted by the appellant except for paragraph 12 (g).

[5] I find it useful to cite immediately section 123.54 of the *Companies Act*, which reads as follows:

123.54 [Redemption on demand]

A company may acquire fully paid-up shares it has issued and that, under its articles, it must redeem on demand of a shareholder or on a fixed date or a date that may be fixed, for a price determined in its articles or computed in accordance with the method provided in the articles.

[Exception] In no case, however, may a company pay for the shares where there is reasonable ground to believe that, as a consequence,

- 1) it could not discharge its liabilities when due, or
- 2) the book value of its assets would be less than the aggregate of its liabilities and the sums necessary for the payment, in case of redemption or winding-up, of the shares payable by preference or concurrently.

1979, c. 31, s. 27; 1980, c. 28, s. 14.

[6] It is also useful to know the analogous provisions of the *Canada Business Corporations Act*. I cite the definition of “redeemable share” in subsection 2(1), as well as subsections 36(1) and 36(2), of that Act:

2(1) **[Definitions]** . . .

“**redeemable share**” means a share issued by a corporation

- (a) that the corporation may purchase or redeem on the demand of the corporation, or
- (b) that the corporation is required by its articles to purchase or redeem at a specified time or on the demand of a shareholder;

36(1) **[Redemption of shares]** Notwithstanding subsection 34(2) or 35(3), but subject to subsection (2) and to its articles, a corporation may purchase or redeem any redeemable shares issued by it at prices not exceeding the redemption price thereof stated in the articles or calculated according to a formula stated in the articles.

36(2) **[Limitation]** A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that

- (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
- (b) the realizable value of the corporation’s assets would after the payment be less than the aggregate of
 - (i) its liabilities, and
 - (ii) the amount that would be required to pay the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateably with or before the holders of the shares to be purchased or redeemed, to the extent that the amount has not been included in its liabilities.

[7] Léon Gagnon, president and sole shareholder of the appellant, explained that at the time of the events in question here, the appellant was a company whose main activity was investment management.

[8] Mr. Gagnon was president and director of Centre Financier Iberville-Champlain Inc. (“Centre Financier”). He held 55% of the shares, and his spouse, Sylvie Turcotte, 45%. This company had a franchising agreement with Desjardins, Sécurité financière. Centre Financier managed a team of financial services representatives. Ms. Turcotte looked after the internal administration of Centre Financier.

[9] In 1999 and 2000, Centre Financier received from Desjardins a special bonus totalling \$300,000. Mr. Gagnon stated that this amount was included in Centre Financier’s tax return. This was not questioned by the respondent.

[10] However, neither Mr. Gagnon nor his spouse wished to keep this money in Centre financier. They wanted to put it in safekeeping without triggering any immediate tax consequences. They consulted a tax expert, Mr. Jean-Yves Lepage, who suggested an intercorporate dividend. When the spouses needed the sum or part of it, they would pay the tax due on the amounts withdrawn.

[11] On June 6, 2000, Centre Financier amended its articles under Part IA of the *Companies Act* by adding Class J shares (Exhibit A-2). The description of those shares is as follows:

[TRANSLATION]
CLASS J SHARES

(1) **Dividends**

Subject to section 123.70 of the *Companies Act* and to the rights associated with the shares of Classes E to H, the holders of Class J shares are entitled to receive, at the discretion of the board of directors, an annual non-cumulative dividend. The board of directors will not be required to declare at the same time a dividend on any other class of shares. It is the responsibility of the directors to determine the time and conditions of payment of any dividend that is declared.

(2) **Reimbursement**

If for any reason, including voluntary liquidation, forced liquidation or dissolution, there is a distribution of the corporation's assets, the holders of this class of shares are entitled, with preference over holders of shares of Classes A to D, G and H, but after Class E and F shareholders, to reimbursement of an amount equal to the redemption price determined below in paragraph 5.

(3) **Additional participation**

The shares of this class do not confer any other right of participation in the company's profits or asset surpluses.

(4) **Voting rights**

Subject to the *Business Corporations Act*, holders of this class of shares do not, by the simple fact of holding those shares, have the right to vote at the Company's shareholder meetings, to attend those meetings or to receive notice thereof.

(5) **Redemption by the Company**

Subject to section 123.54 of the *Companies Act* and any shareholder agreement, the holders of this class of shares may require that the Company redeem, within 30 days of a written request to that effect, all or part of the shares of this class that they hold. The redemption price for each share will be \$1,000.

Following the redemption, the Company must reduce its issued and paid-up share capital account with respect to this class pursuant to section 123.51 of the *Companies Act*. For the purposes of this paragraph, the redemption is deemed completed upon surrender and cancellation of the certificates representing the shares redeemed.

[12] On December 19, 2000, the appellant acquired 300 Class J shares issued by Centre Financier for \$1 each. It was because these shares issued for \$1 were retractable for \$1,000 that the Minister of National Revenue (the “Minister”) considered that a benefit had been conferred upon the appellant as a shareholder.

[13] On January 16, 2001, Centre Financier redeemed the 300 Class J shares and issued a cheque for \$300,000. As the redemption was in favour of the appellant, of which Mr. Gagnon was sole shareholder, Ms. Turcotte, as a shareholder of Centre Financier, also signed the redemption resolution and even added the following by hand:

[TRANSLATION]

I declare that I have full knowledge of, and am in agreement with, this redemption of shares by Gestion Léon Gagnon inc.

Sylvie Turcotte

[14] During cross-examination of Mr. Gagnon, counsel for the respondent asked the following questions, which appear on pages 22 to 25 of the transcript:

[TRANSLATION]

[39] Q. Okay. Do you know why, instead of issuing shares and then redeeming the shares, a dividend was not declared on the Class J shares?

R. Can you be more specific: a dividend declared to?

[40] Q. No, but the thing is you said that the purpose of the planning was to . . . well, transfer the money, the profits held in Centre financier, to Gestion Léon Gagnon.

R. Yes.

[41] Q. Okay. Through a dividend.

R. Intercompany.

[42] Q. Intercompany, okay. So to declare a dividend, first of all the company must be a shareholder if there is a share issue. Why wasn't a dividend simply declared on those shares? Do you know?

R. No, what I do know is that I consulted a tax expert. We looked at the situation together and the objective was to protect the capital, to protect the patrimony and to do so without tax consequences, and that's the recommendation that was made to me, and I applied it.

[43] Q. Okay.

R. I . . . that's beyond my abilities.

[44] Q. Okay. So with regard to the resolution providing for the share issue, is it true that the issue price of the Class G shares was \$1 per share?

R. Yes.

[45] Q. It's true?

R. It was \$1.

[46] Q. Okay. How was that decided, that it was \$1 per share?

R. There again, it was decided . . . it was on the recommendation that was made to me.

[47] Q. Okay.

R. I applied the recommendations; I couldn't explain the technicalities.

[48] Q. Okay. Now, the class J shares that were issued, is it true that they have a redemption value of \$1,000 per share?

R. Yes, it's true.

[49] Q. Yes? Okay, how was that amount of \$1,000 per share determined?

R. The same as for the \$1 . . . unfortunately that's beyond me, how it was determined . . .

[50] Q. But the aim was to take the \$300,000 from the operating company and to put it into the management company, is that right?

R. The aim was to protect the capital and to protect the family patrimony and to do so without tax consequences.

[51] Q. Okay.

R. And the recommendation was from company A to company B, the communicating vessels.

[52] Q. Okay. Is it true that when that transaction was made, the share issue, and the redemption value was set at \$1,000 per share, that is, \$300,000 in total, the company had the cash assets to pay that amount?

R. Centre financier?

[53] Q. Yes.

R. Yes indeed, the company had an accumulated surplus of a bit more than \$300,000.

...

[15] Jean-Yves Lepage is a tax consultant. He worked occasionally with the representatives of Centre financier.

[16] Here is his explanation from pages 30 and 32 of the transcript:

[TRANSLATION]

R. Yes, because . . . well, I can say in short that it was Mr. Gagnon's objective from the start. It was to say, that money, we have already . . . the company

has already paid its taxes on it, I don't need it personally, so I don't want to pay any tax immediately, I will pay it when I take the money out. Now, is there a way of transferring or protecting that money without having to pay tax? And the result, in our opinion, was to say: Okay, there will be a non-taxable intercompany dividend.

...

R. Well we . . . Yes, we looked at it and indeed there was no advantage for Mr. Gagnon in that situation because the money went from one company to another. And the tax payable was not reduced because Mr. Gagnon is not in a better position than he was before, in the sense that the money is still in a company and he will have to pay tax on the sums that he takes out of the company. So, whether he takes money from company A or company B, the end result will be the same. Tax will have to be paid. So, the goal was not to defer, to eliminate the tax, on the contrary. It was just to . . . protect the money.

[17] He said that the description of the characteristics of the Class J shares was done with the help of a lawyer.

[18] In cross-examination, counsel for the respondent posed the following questions found at pages 33 to 36 of the transcript:

[TRANSLATION]

[72] Q. Yes? Can you explain to us how the \$1 issue price of the shares was determined and the amount, the redemption value of the shares?

R. Well, basically, what we did was, we said, okay, the amount to be taken out is \$300,000. So, we'll issue shares with a par value of \$1 each and redeem them for \$1,000 each as indicated by the . . . on the certificate, and the difference, that's where the difference, so we considered that the difference would be an intercompany dividend.

[73] Why did you not, as they say, roll over Mr. Gagnon's existing shares instead of issuing new ones?

R. Well, yes. That is something we thought of, it's one of the . . .

[74] That's the normal way of proceeding.

R. Yes, it is in fact one of the possibilities we considered, and we came to the conclusion that, yes, that would have worked. It is, as you say, the normal way of proceeding, but we had . . . of course the costs would have been higher in that

case, whereas this way it was relatively more simple; all there was to do was to modify the capital stock and redeem the shares.

[75] Q. Okay, so it was to avoid money really?

R. Pardon?

[76] Q. It was to avoid . . .

R. It was to avoid costs.

. . .

[19] Sylvie Turcotte confirmed that ever since they have been married (27 years now), she and her husband have always considered themselves as having a single patrimony, and that she was in full agreement that the amount of \$300,000 be included in the appellant's assets.

[20] Ms. Turcotte added that Centre Financier was sold in 2005. This is how she explained the context of the sale at page 41 of the transcript:

[TRANSLATION]

[99] . . .

R. Yes, I can explain, it's very simple. My spouse had cancer and . . . his assistant stood in for him. And there was an agreement with that assistant that the . . . it would be gradually transferred, that he would eventually become the owner. But since, with everything that was happening, it was like . . . it was a bit difficult for us at home as well, and him working a lot but not being the owner. So finally we . . . we sat down, we looked at things, and finally we sold right away.

[21] It would appear that Centre Financier's shareholders wished to sell their business without the \$300,000 remaining in the assets of the company.

Analysis and conclusion

[22] As we have seen from the provisions of the above-cited legislation dealing with companies, corporate law permits the redemption of shares at a value higher than their issue price. The redemption price can be set in the articles of incorporation and the amount be payable on the demand of a shareholder. Certain conditions apply to the redemption.

[23] Paragraph 15(1)(a) of the Act reads as follows:

15(1) **Benefit conferred on shareholder** -- Where at any time in a taxation year a benefit is conferred on a shareholder, or on a person in contemplation of the person becoming a shareholder, by a corporation otherwise than by:

(a) the reduction of the paid-up capital, the redemption, cancellation or acquisition by the corporation of shares of its capital stock or on the winding-up, discontinuance or reorganization of its business, or otherwise by way of a transaction to which section 88 applies;

...

the amount or value thereof shall, except to the extent that it is deemed by section 84 to be a dividend, be included in computing the income of the shareholder for the year.

[24] The Act sets out the tax treatment in the case of a share redemption. Accordingly, if there is a capital gain, subsection 84(3) of the Act provides that the redeeming company is deemed to have paid a dividend equal to the amount, if any, by which the amount paid exceeds the paid-up capital.

[25] It was submitted that it is not the redemption that is in issue here but the share issue. As soon as soon as the shares were issued, a benefit was conferred and I need not be concerned with the redemption.

[26] I disagree. It is the redemption that constitutes the benefit. The redemption is subject to the requirements of corporate law. It is not automatic.

[27] I find it hard to fathom the true reasons that led the Minister's auditors to assess under subsection 15(1) of the Act. They did not testify and their reports were not presented to me.

[28] I do not see on what basis I could declare that the mere issuance of shares whose redemption value is higher than their purchase price constitutes a benefit under subsection 15(1) of the Act when the redemption, although it is initiated by the shareholder, is subject to the provisions of the legislation dealing with companies.

[29] In addition, subsection 15(1) of the Act provides that there is no benefit if the redemption is deemed to constitute a dividend under section 84 of the Act, which it would be under subsection 84(3) of the Act.

[30] It was submitted that rolling over the shares in Centre Financier into management companies would have been the normal procedure. It was not explained to me why it was essential to proceed in this fashion. One might also ask whether a rollover would have served the purposes of Centre Financier's shareholders, who wished to sell, but without including the amount of \$300,000.

[31] What is abhorrent to the underlying policy of the Act is the stripping of the surplus from a corporation without any tax consequences. But this is not what happened here. The redemption of a share at a price higher than the issuing price is deemed to be a corporate dividend.

[32] For these reasons, the appeal is allowed with costs.

[33] The parties asked that the appeal be classified as a Category B appeal rather than a Category C appeal given the amount of tax in issue. This was granted by the Court.

Signed at Ottawa, Canada, this 14th day of December 2006.

“Louise Lamarre Proulx”

Lamarre Proulx J.

Translation certified true
on this 18th day of January 2008.

Erich Klein, Revisor

CITATION: 2006TCC682

COURT FILE NO.: 2005-2177(IT)G

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HER MAJESTY THE QUEEN

PLACE OF HEARING: Montreal, Quebec

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REASONS FOR JUDGMENT BY: The Honourable Justice Louise Lamarre
Proulx

DATE OF JUDGMENT: December 14, 2006

APPEARANCES:

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