Docket: 2013-1636(IT)G

BETWEEN:

FIDUCIE CLAUDE DERAGON,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on June 17, 2015, at Montréal, Quebec

Before: The Honourable Justice Réal Favreau

Appearances:

Counsels for the Appellant:	Aaron Rodgers Antoine Michaud-Soret
Counsel for the Respondent:	Natalie Goulard

JUDGMENT

The appeal from the new assessment made under the *Income Tax Act* dated May 23, 2008 pertaining to the Appellant's 2004 taxation year is allowed in part without costs given that each party had limited success. The assessment is referred back to the Minister of National Revenue for reconsideration and reassessment in order to give effect to the Respondent's concession to reduce from $16,000,000 to $15,500,000 the total proceeds of disposition of the shares sold by the Appellant and certain other shareholders under the three agreements taking effect on May 1, 2004, for the purpose of calculating the capital gain earned by the Appellant.

Signed at Ottawa, Canada, this 25th day of November 2015.

"Réal Favreau"

Favreau J.

Translation certified true
On this 11th day of October 2016

François Brunet, Revisor

Citation: 2015 TCC 294
Date: 20151125
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BETWEEN:

FIDUCIE CLAUDE DERAGON,

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REASONS FOR JUDGMENT

Justice Favreau

[1] This is an appeal against a new assessment made under the *Income Tax Act*, R.S.C. (1985), c. 1 (5th Suppl.), as amended (the Act), by the Minister of National Revenue (the Minister) dated May 23, 2008 pertaining to the Appellant's 2004 taxation year.

[2] Under the new assessment of May 23, 2008, the Minister rejected the deduction of a capital loss of $7,319,100, which was deemed void in accordance with the provisions of the anti-avoidance rule set out in section 245 of the Act.

[3] The point at issue does not involve the application of the anti-avoidance rule to the reported capital loss, but instead the determination of the proceeds of disposition of shares that the Appellant held in the corporations "Les Investissements Claude Deragon Inc." and "Les Gestions Claude Deragon Inc.". The transactions took place on May 1, 2004, and were part of a transfer of interests that the Appellant held in the Groupe Transpel NJN 1994 to a group known and referred to as "Transforce".

[4] The dispute involves the application of a price adjustment clause set out in two share purchase agreements. The appellant claims that the sellers were unable to earn an amount of $1,500,000 from the agreed-upon sale price.

[5] At the start of hearing, the Respondent conceded that an amount of $500,000 from the agreed-upon sale price had not been earned by the sellers, including the Appellant, up to an amount of $350,000 in the latter's case.

[6] Under an initial share purchase agreement taking effect on May 1, 2004 (hereinafter the "first agreement"), the Appellant, Fiducie Ronald Doutre and Fiducie M.A. Labelle (hereinafter the "sellers") agreed to sell to Gestion TFI Inc. (hereinafter "TFI") all of the issued and outstanding shares of Les Gestions Claude Deragon Inc. (hereinafter "Gestions"), of Transport N.J.N. Inc. (hereinafter "N.J.N."), of Transport F. Audet Inc. (hereinafter "Audet") and of Transport Serge Durivage Inc. (hereinafter "Durivage"). The shares of Audet and Durivage were held directly by Gestions, whereas the N.J.N. shares were held by Gestions and Durivage.

[7] Subject to any adjustment provided for in said agreement, the purchase price of the shares sold was $12,781,475.72, minus the total long-term debts of Gestions, N.J.N., Audet and Durivage on April 30, 2004, but excluding inter-company debts in the amount of $3,515,181.82. The net purchase price of the shares was allocated as follows:

Fiducie Claude Deragon = $6,486,405.73
Fiducie Ronald Doutre = $1,853,258.78
Fiducie M.A. Labelle = $ 926,629.39

[8] The share purchase price adjustment clause was in paragraph 4.3 of the first agreement and read as follows:

> [TRANSLATION]
>
> 4.3 The Share Purchase Price shall be adjusted upwards or downwards by an amount equal to the increase or decrease of the equity of the Companies' Shareholders at the fiscal year end date compared to the equity of the Companies' Shareholders at January 31, 2004.
>
> The adjustment set out above shall be made based on the data in the Companies' audited statements determined by the Companies' auditors as set out in section 5 herein, on the understanding that, on the Close-off Date, the loans or advances of the shareholders, administrators, directors and employees shall be eliminated and that the loans or advances to the shareholders, administrators, officers and employees shall be discharged.

[9] For the purpose of the share purchase price adjustment clause, the fiscal year end date meant the day preceding the actual sale date of the shares, and the equity of the companies' shareholders at January 31, 2004 was based on internal financial statements, i.e. on the balance sheets and income statements of Gestions, N.J.N., Durivage and Audet prepared internally for the period ending January 31, 2004.

[10] Under a second share purchase agreement taking effect on May 1, 2004 (hereinafter the "second agreement"), the Appellant, Fiducie Ronald Doutre and Fiducie M.A. Labelle (hereinafter the "sellers") agreed to sell to Gestion TFI Inc. (hereinafter "TFI") all of the issued and outstanding shares of Les Investissements Claude Deragon Inc. (hereinafter "Investissements"), of Transport Transterm Montréal Inc. (hereinafter "Transterm"), of Groupe Frapar Transports Inc. (hereinafter "Frapar") and of P&W Intermodal Inc. (hereinafter "P&W"). The shares of Frapar, Transterm and P&W were held directly by Investissements.

[11] Subject to any adjustment provided for in said agreement, the purchase price of the shares sold was $2,503,774.42, minus the total long-term debts of Investissements, Transterm, Frapar and P&W at April 30, 2004, but excluding inter-company debts in the amount of $746,489.35. The net purchase price of the shares was allocated as follows:

Fiducie Claude Deragon	=	$1,255,203.62
Fiducie Ronald Doutre	=	$ 338,904.98
Fiducie M.A. Labelle	=	$ 163,176.47

[12] The share purchase price adjustment clause was in paragraph 4.3 of the second agreement and was identical to the one set out in the first agreement, which is reproduced in paragraph 8 herein.

[13] For the purpose of the share purchase price adjustment clause, the fiscal year end date meant the day preceding the actual sale date of the shares, and the net equity of the companies' shareholders at January 31, 2004 was based on internal financial statements, i.e. on the balance sheets and income statements of Investissements, Frapar and P&W prepared internally for the period ending April 30, 2004 and those of Transterm for the period ending January 31, 2004.

[14] Under a third share purchase agreement taking effect on May 1, 2004 (hereinafter the "third agreement"), Mr. Claude Deragon agreed to sell to Gestion TFi II Inc. (hereinafter "TFi II") all of the issued and outstanding shares of A&D Transport Inc. (hereinafter "A&D") that he personally held. A&D was a U.S.

company incorporated under section 402 of the Business Corporation Law of the State of New York (USA).

[15] Subject to any adjustment provided for in said agreement, the purchase price of the shares sold was $714,749.86, minus the total of the company's long-term debts at April 30, 2004, but excluding inter-company debts in the amount of $466,638.86. Therefore, the net purchase price of the shares was $248,111.00.

[16] The share purchase price adjustment clause was in paragraph 4.3 of the third agreement and was identical to the one set out in the first agreement, which is reproduced in paragraph 8 herein.

[17] To summarize, we have here the sale of a company for a total sale price of $16,000,000 minus the balance of long-term debts. Therefore, the net purchase price of the shares, after deducting the debts, was $9,266,293.90 under the first agreement, $1,757,285.07 under the second agreement and $248,411.00 under the third agreement. Since the net purchase price of A&D's shares was not payable to the Appellant, that amount is not at issue in this appeal.

[18] The portion of the total purchase price of the shares that was payable to the Appellant amounted to $7,741,609.35, or $6,486,405.17 under the first agreement and $1,255,203.62 under the second agreement.

[19] Now, at the close of the transactions, the Appellant received a total amount of $8,523,578.90, or $6,766,293.90 under the first agreement and $1,757,285.07 under the second agreement. An additional amount of $500,000 was paid at the close under the first agreement, which was issued in escrow to the purchaser's lawyer.

[20] In addition to those amounts, the Appellant was entitled to receive an amount of $2,000,000 over three years (i.e. $666,666.67 on each anniversary date of the closing of the first agreement) provided that the companies' EBTID (earnings before taxes, interest and depreciation) on the given anniversary date were not below 75% of the EBTID of the 2003 financial statements of the companies sold.

[21] In 2005, the parties to the transactions realized that employee vacation pay and taxes payable had not been discharged or provided for as of the closing date of the transactions, which resulted in the application of the price adjustment clauses set out in paragraphs 4.3 of each share purchase agreement. According to the

closing financial statements, the equity of the purchased companies' shareholders was lower by an amount of roughly $2,428,233.00 than the equity of the purchased companies' shareholders as of January 31, 2004.

[22] After difficult negotiations, the parties signed on or around July 4, 2005 a settlement declaration regarding the establishment of the purchase price for the shares of Gestions, Investissements and A&D, which provided, among other things, that the total share purchase price be set at $15,500,000 minus long-term debts, or a net reduction of $500,000 (hereinafter the "adjustment"). The parties further specified that the adjustment had been established as follows:

a) that the amount of the balance of the conditional sale price be increased by the amount of $1,000,000 up to $3,000,000 and be payable over five years instead of over three years, as initially provided for in the agreements;

b) that an amount of $1,500,000 be reimbursed to TFI by the Appellant and by Fiducie Ronald Doutre from the amounts held back on the amounts due to the Appellant and to Fiducie Ronald Doutre by TFI ($500,000) and from the amounts of the balance of the conditional sale price payable by TFI to the Appellant and to Fiducie Ronald Doutre ($600,000 per year for five years).

[23] The performances of Gestions, Audet, Durivage and N.J.N. proved disastrous for the taxation years ending April 30, 2008 and April 30, 2009, with the result that the expected reimbursements to TFI could not be made by the Appellant and by Fiducie Ronald Doutre for the last two years of the five-year period. The purchasers TFI and TFiII demanded $300,000 from the sellers for the period ending on the date of the fourth anniversary of the transaction and $1,000,000 for the period ending on the date of the fifth anniversary of the transaction. An out-of-court settlement was reached in April 2014 without reimbursement of the amounts demanded.

[24] In its income tax return for the 2004 taxation year, the Appellant reported a capital gain of $7,830,854.00 based on proceeds of disposition of $8,831,414.00 and an adjusted cost base of $1,000,560.00. The capital gain was assessed as reported by the Appellant.

The parties' position

[25] The Appellant maintains that the proceeds of disposition of its shares should have been $6,840,183, calculated on the total purchase price of $16,000,000

reduced by the amount of the purchase price adjustment of $1,500,000, or $14,500,000 minus long-term debts, for total proceeds of disposition of $9,771,690, 70% of which belongs to the Appellant.

[26] The Respondent maintains that the proceeds of disposition of the shares was $15,500,000 after the $500,000 reduction in the purchase price. According to the Respondent, the proceeds of disposition of the shares included the portion of the share purchase price payable in instalments over five years, provided that the companies' EBTID at each anniversary of the close-off date was not below 75% of the EBTID in the 2003 financial statements. The adjustment clause did not increase the share purchase price to an amount exceeding $15,500,000. The Respondent indicated that the Appellant had not claimed the five-year reserve and that the Appellant was able to claim a capital loss for its 2014 taxation year following the out-of-court settlement reached with the purchasers of the shares.

Analysis

[27] The expression "proceeds of disposition" is defined in section 54 of the Act and includes such things as the sale price of property.

[28] In this case, the sales of the shares took place on May 1, 2004, and the total compensation from the sales was $16,000,000, which was brought down to $15,500,000 under the settlement declaration signed on or around July 14, 2005. Moreover, under the settlement declaration, the conditional portion of the sale price of the shares was increased by $1,000,000 and went from $2,000,000 to $3,000,000, which was divided over five years instead of three years, as initially planned. Lastly, the sellers undertook to reimburse $1,500,000 to the purchaser from the amount held in escrow and the amounts of the conditional sale price, all divided over the five-year period. The reimbursement amount was not paid in full because the agreed-upon amounts for the last two years of the agreement were not paid.

[29] Therefore, under the circumstances, the issue is whether the conditional portion of the sale price should have been considered when determining the proceeds of disposition of the shares.

[30] Under the three share purchase agreements taking effect on May 1, 2004, the purchase price of the shares is clearly stated in paragraph 4.1 of each of those agreements, subject to any adjustment provided for in the agreements. In paragraph 4.2 of the first and second agreements, the net purchase price of the shares is

allocated to each seller, whereas in paragraph 4.4 of those same agreements, the terms for payment of the purchase price of the shares are specified with an amount of $500,000 being placed in escrow and the added condition involving the companies' EBTID.

[31] Under these conditions, it appears obvious to me that the conditional portion of the sale price of the shares was part of the proceeds of disposition of the shares.

[32] As written, the adjustment clause provided that the share purchase price could be adjusted upwards or downwards by an amount equal to the increase or decrease of the equity of the companies' shareholders on the end date of the given fiscal year compared to the equity of the companies' shareholders at January 31, 2004. However, the settlement declaration specified that, notwithstanding the adjustment clause, the total purchase price of the shares was $15,500,000 rather than $16,000,000. Therefore, after the adjustment, the total share purchase price of $15,500,000 became the maximum amount obtainable by the sellers following the sale of their shares.

[33] The increase in the balance of the conditional sale price from $2,000,000 to $3,000,000 and the spreading of the balance of the conditional sale price over five years instead of three years had no impact on the total purchase price of the shares since the conditional sale price was part of the total purchase price of the shares, as shown above by the very terms of the share purchase agreements.

[34] The $1,500,000 amount that the Appellant and Fiducie Ronald Doutre had to reimburse under the settlement declaration could not be deducted from the total purchase price of the shares because it was contingent on and dependent on the condition involving the companies' EBTID. Moreover, under the out-of-court transaction between the parties, the expected reimbursements in the last two years of the five-year period were not made.

[35] The Minister's new assessment aligns with the position of the Canada Revenue Agency (the "CRA"), as set out in its interpretation bulletin IT-462 of October 27, 1980, entitled "Payments based on production or use" referring to paragraph 12(1)(*g*) of the Act. Paragraph 9 of that bulletin states the following:

> Paragraph 12(1)(g) does not apply where the sale price of property is originally set at a maximum which is equivalent to the fair market value of the property at the time of the sale and which can be subsequently decreased if certain conditions related to production or use are not met in the future. In such a situation the proceeds will be on account of capital and if there is a reasonable expectation at

> the time of disposition of the property that the conditions will be met, then the disposition is treated in the ordinary manner, and the original maximum amount is considered to be the sale price of the property. If, subsequently, the conditions are not met then an appropriate adjustment will be made in the year in which the amount of the reduction in the sale price is known with certainty and will not vary in the future. Whether there is a reasonable expectation that conditions will be met is a question that is determined on the facts of the particular situation.

[36] The CRA's position has been reproduced in many academic articles, including one by André Paquette entitled "*Clause d'ajustement basée sur la performance* (Earn-out)" [performance-based adjustment clause], which he delivered at the 2006 convention of the *Association de planification fiscale et financière*. The following excerpt from that article is especially relevant for the current issue, since the author explains the concept of a "reverse earn-out clause":

> [TRANSLATION]
>
> ***4.2 – The reverse earn-out clause***
>
> What about the tax considerations for earn-out clauses that are excluded from the operation of paragraph 12(1)(*g*) of the ITA? This is particularly the case when the share purchase price is determined at the closing of the transaction and is a maximum price that may be revised downwards. This is a reverse earn-out clause. In such a case, the entire sale price is treated as proceeds of disposition. If the fiscal projections materialize, it follows that the disposition of the property will be treated in the usual way, and the original amount will be considered as the sale price of the property.
>
> In the event that the seller does not reach its fiscal projections, the adjustment in the income tax will be treated as a capital loss, in the year when the amount of the compensation is known for certain and when there will be no further fluctuations.
>
> A purchaser who receives amounts from the seller, as adjustment and compensation, will have to reduce the indicated purchase costs of the shares, using a method for allocating the amounts on the assets acquired.

[37] Paragraph 12(1)(*g*) of the Act states the following:

> There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
>
> (*g*) any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property, except that an instalment of the sale price of agricultural land is not included by virtue of this paragraph;

[38] When paragraph 12(1)(*g*) applies, the seller must include the initial payment, which corresponds to the minimum purchase price of the company, as proceeds of disposition of the property sold. The payments subsequently received based on the use of the property or the production arising from it are fully included in the income.

[39] In this case, the Appellant clearly wanted to avoid the operation of paragraph 12(1)(*g*) of the Act to avoid having to include in the calculation of its income the entire conditional portion of the sale price of the shares. The Appellant sought to earn a capital gain, which it then attempted to offset with an artificial capital loss.

[40] Counsel for the Appellant made reference to the Supreme Court of Canada decision in *Daishowa-Marubeni International Ltd. v. R.*, [2013] 2 S.C.R. 336 to justify reducing the proceeds of disposition by the amount of $1,500,000 due to the increase in the conditional sale price and to the obligation to reimburse that same amount from the conditional sale price. Unfortunately for the Appellant's counsel, I have difficulty seeing how that decision can support the Appellant's position. In this case, we are clearly not in the presence of an obligation attributable to the nature of the property sold. The Supreme Court of Canada decision involved reforestation obligations taken on by the purchasers. In the current case, the obligation to reimburse a portion of the conditional sale price simply depends on a condition involving EBTID. If the EBTID were not at the anticipated level, no reimbursement was due.

[41] In my opinion, there is no basis for excluding from the proceeds of disposition of the shares, amounts for which reimbursement was conditional and which were not reimbursed for the last two years of the five-year period.

[42] For these reasons, the appeal is allowed with costs in favour of the Appellant. The assessment is referred back to the Minister for reconsideration and reassessment in order to give effect to the Respondent's concession to reduce from $16,000,000 to $15,500,000 the total proceeds of disposition of the shares sold by the Appellant and certain other shareholders under the three agreements taking effect on May 1, 2004, for the purpose of calculating the capital gain earned by the Appellant.

Signed at Ottawa, Canada, this 25th day of November 2015.

"Réal Favreau"

Favreau J.

Translation certified true
On this 11th day of October 2016

François Brunet, Revisor

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STYLE OF CAUSE:	Fiducie Claude Deragon and Her Majesty the Queen
PLACE OF HEARING:	Montréal, Quebec
DATE OF HEARING:	June 17, 2015
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DATE OF JUDGMENT:	November 25, 2015

APPEARANCES:

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Counsel for the Respondent:	Natalie Goulard

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