Docket: 2015-1539(IT)G

BETWEEN:

DR. DAVID MADY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on April 3, 4, 5, 6 and 7, 2017, at Toronto, Ontario

Before: The Honourable Justice Robert J. Hogan

Appearances:

Counsel for the Appellant:	Vern Krishna, **Q.C.** Alexander Yu Osnat Nemetz (student-at-law)
Counsel for the Respondent:	Suzanie Chua

AMENDED JUDGMENT

The appeal from the reassessments made under the *Income Tax Act* (Canada) for the 2010, 2011, 2012 and 2013 taxation years is allowed in part only and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

The parties will have until June 24, 2017 to agree on costs, failing which they are directed to file their written submissions on costs no later than June 25, 2017. Such submissions are not to exceed 10 pages.

This Judgment is issued in substitution for the Judgment dated June 14th, 2017.

Signed at Ottawa, Canada, this 20th day of June 2017.

"Robert J. Hogan"

Hogan J.

Citation: 2017 TCC 112
Date: 20170614
Docket: 2015-1539(IT)G

BETWEEN:

DR. DAVID MADY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

AMENDED REASONS FOR JUDGMENT

Hogan J.

I. Introduction

[1] The Appellant, Dr. David Mady, has appealed reassessments made in respect of his 2010, 2011, 2012 and 2013 taxation years. This appeal concerns the tax consequences of two distinct series of transactions.

[2] The first series concerns a transfer of shares in a professional corporation from a family trust, to the Appellant's spouse and, immediately thereafter, to the Appellant. Dividends were subsequently declared while the shares were held by the Appellant. However, those dividends were reported and taxed in the hands of the Appellant's spouse on the basis that section 74.1 of the *Income Tax Act* ("ITA") applied.[1] The Minister reassessed the Appellant, adding the dividends received by him to his income on the basis that subsection 74.5(11) applied.

[3] The second series of transactions involved an internal reorganization carried out by the Appellant immediately prior to the sale of his dental practice to an arm's length purchaser. The Minister reassessed the Appellant, alleging that he carried out a reorganization of the share capital of the professional corporation for the purpose of having a significant portion of the capital gains realized on the arm's length sale taxed in the hands of his spouse and two children. The Minister

[1] R.S.C. 1985, c. 1 (5th Supp.). All statutory references are to the ITA unless otherwise stated.

observed that the Appellant's spouse and two children each acquired 85 common shares from the Appellant for $0.85. These shares were immediately thereafter sold to the arm's length purchasers for a capital gain of $734,888. Therefore, the Minister takes the position that the purchase price on the sale of the shares to the Appellant's spouse and children was significantly below the fair market value ("FMV") of those shares under the market approach method of valuation.

II. Facts

A. Contextual Background

[4] Dr. Mady is a dentist. He operated two clinics, one in Windsor and one in Belle River, Ontario. His practice was conducted through Mady Dentistry Professional Corporation ("MDPC"), which was at various times also known by the names JJM Hygiene Corp. or 1352155 Ontario Inc.

(1) The first series of transactions

[5] In 1999, the Appellant's mother settled a family trust, with the Appellant, his spouse Mrs. Judy Mady, and his children as beneficiaries. All issued and outstanding shares of MDPC, then known as JJM Hygiene Corp., were held by the trust. A change in the rules of the Royal College of Dental Surgeons of Ontario required that the Appellant own the voting shares of MDPC. Thereafter, the shares could no longer be held in the trust.

[6] The Appellant, his spouse, and two children were all capital beneficiaries of the trust. As trustee, the Appellant could have transferred the shares directly to himself. The Appellant, however, first distributed the shares to his wife, who immediately thereafter gifted the shares back to the Appellant. In doing so, Dr. Mady was acting on the advice of a partner at BDO Dunwoody LLP. Dr. Mady's current advisor, Mr. Van Essen, was not his advisor at that time.

[7] After this first series of transactions, the Appellant declared dividends from MDPC to himself. However, the dividends were reported in his spouse's income through the operation of the attribution rules in section 74.1. The Minister applied subsection 74.5(11) to prevent the attribution of income to the Appellant's spouse,

alleging that the purpose of the transfers was to reduce the amount of tax payable on the dividend income.

(2) The second series of transactions

[8] The second series has two parts. Part one is the internal share reorganization, commonly known as an estate freeze.

[9] Mr. Van Essen had been advising Dr. Mady to implement an estate freeze for a number of years. The purpose of the freeze was to allow Dr. Mady to income split by declaring dividends to his daughters and to purify MDPC so that gains realized on the sale of its shares would qualify for the capital gains exemption.

[10] Under the plan devised by Mr. Van Essen, the 100 Class A common shares in MDPC (the "old shares") held by Dr. Mady were exchanged for a mix of fixed-value preferred shares and common shares (the "new shares"). The plan called for issuing fixed-value preferred shares equal in value to the FMV of MDPC. This necessitated a valuation, which was performed by a valuator at BDO. The freeze resulted in the following new shares being issued, allegedly on a tax-free basis pursuant to section 86:

No.	Class	FMV
2,071,497	Class A Preferred Shares	$2,071,497
100	Class B Common Shares	$1
100	Class C Common Shares	$1
100	Class D Common Shares	$1
		$2,071,500

[11] In the final step of the freeze, Dr. Mady sold 85 of the Class B, C, and D common shares to each of his spouse and his two children in trust for an amount equal to their paid-up capital ("PUC") and adjusted cost base ("ACB"), being one cent per share.

[12] The freeze was not carried out until January 13, 2012, the same day that all of the issued and outstanding shares of the corporation were sold to an arm's length purchaser for $4.5 million in the circumstances described below. Despite this delay, the freeze reorganization was executed using the FMV as at July 1, 2011.

[13] Part two of the second series is the sale of the shares to the arm's length purchasers.

[14] At the beginning of October 2011, Dr. Mady was approached at a hockey game by Mr. Marco Dolfi. At that time, Mr. Dolfi was acting for Dental Corporation of Canada Inc. and Dental Corporation of Canada Holdings Inc. (jointly referred to as "DCC").

[15] DCC was new to Canada. Its business model, derived from the Australian dental service provider, Dental Corporation, called for acquiring a large number of dental practices and spreading costs over those practices for the purpose of realizing higher earnings.

[16] Mr. Dolfi introduced Dr. Mady to Dr. Andrew Meikle and Graham Rosenberg, co-CEOs of DCC. Negotiations began and, on October 14, 2011, the Heads of Agreement were signed, the purchase price being $4.5 million. On December 15, 2011, the Share Purchase Agreement ("SPA") was executed.

[17] The transaction with DCC included a SPA for the purchase of the outstanding shares in MDPC from Dr. Mady, his spouse, and his two children in trust. The transaction price of $4.5 million was paid with $3.6 million in cash and 900,000 shares in DCC on a tax-free basis pursuant to section 85. The reported FMV of the 900,000 shares in DCC was $900,000.

[18] Dr. Mady and DCC also executed a Professional Services Agreement in conjunction with the SPA. The Professional Services Agreement required Dr. Mady to continue to provide services for 5 years or to arrange for someone else to provide such services. He would be paid a set remuneration. He was required to guarantee a minimum profit level in the form of earnings before interest, tax, depreciation and amortization ("EBITDA"). If the minimum EBITDA was not

met, Dr. Mady would face a clawback from his salary. If he exceeded the EBITDA target, he would receive a bonus.

B. Partial Statement of Agreed Facts[2]

[19] The parties filed a partial statement of agreed facts stating the following:

[20] The Appellant was married to Judith Jamail-Mady and they had two daughters, Alexis and Madison, who were minor children at the relevant time.

[21] The Appellant was a dentist practicing in Ontario.

[22] JJM Hygiene Corp. was incorporated on June 21, 1999.

[23] JJM Hygiene Corp. or Mady Dentistry Professional Corporation ("MDPC") was the Appellant's professional corporation for his dentistry practice.

[24] The paid up capital and adjusted cost base of 100 Class A common shares in JJM Hygiene Corp. were each $100.

[25] Prior to October 18, 2002, the sole shareholder of JJM Hygiene Corp. that owned 100 Class A common shares was The David Charles Mady, Jr. Family Trust.[3]

[26] The Appellant was the sole trustee of The David Charles Mady, Jr. Family Trust.

[27] On October 18, 2002, the Appellant, acting as the sole trustee of The David Charles Mady, Jr. Family Trust, transferred 100 Class A common shares to Mrs. Mady.[4]

[28] On October 18, 2002, Mrs. Mady gifted the same 100 Class A common shares of JJM Hygiene Corp. to the Appellant.[5]

---

[2] The facts set out below are virtually exactly as found in the Partial Statement of Agreed Facts.
[3] Exhibit AR-1, Parties Joint Book of Documents, Tab 22-1, p. 36.
[4] Exhibit AR-1, Parties Joint Book of Documents, Tab 22-1, p. 36.

[29] After the aforesaid transfers, the Appellant became the sole shareholder of MDPC.[6]

[30] The Appellant did not report dividends declared by MDPC in 2010 and 2011 to him.

[31] Mrs. Mady reported the dividends declared by MDPC in 2010 and 2011 in amounts of $659,750 and $110,000 respectively.[7]

[32] On December 6, 2002, JJM Hygiene Corp. was renamed MDPC.

[33] MDPC's Ontario corporation number was 1352155.[8]

[34] 2309712 Ontario Inc. was incorporated in Ontario on December 15, 2011 by the Appellant as the sole shareholder.[9]

[35] On or about January 13, 2012, the following series of transactions were undertaken by the Appellant, Mrs. Mady, the Appellant acting as trustee for Alexis and Madison, and as the sole shareholder of Alexis Dental Ltd. and 2309712 Ontario Inc. (incorporated on December 15, 2011) respectively:

Reorganization of MDPC under s. 86 of the Act

(i) Pursuant to an agreement dated December 15, 2011, Dental Corporation of Canada agreed to purchase the shares of MDPC for $4,500,000 on January 13, 2012;[10]

(ii) The Appellant exchanged 100 Class A common shares of MDPC for 2,071,497 Class A preference shares, 100 Class B common shares,

---

[5] Exhibit AR-1, Parties Joint Book of Documents, Tab 22-1, p. 42.
[6] Exhibit AR-1, Parties Joint Book of Documents, Tab 22-1, p. 36.
[7] Exhibit AR-1, Parties Joint Book of Documents, Tab 17, para. 1.
[8] Exhibit AR-1, Tab 22-1, p. 17.
[9] Exhibit AR-1, Tab 7, p. 8.
[10] Exhibit AR-1, Tab 21-1, p. 1, 19.

100 Class C common shares and 100 Class D common shares on a tax-free basis;[11]

(iii) The purchase price of the share exchange stated in the agreement was $2,071,500;

(iv) This share exchange agreement included a price adjustment clause;[12]

(v) The 2,071,497 Class A preference shares had:

i. Paid-up capital of $97;

ii. An adjusted cost base of $97; and

iii. A redemption value of $2,071,497;[13]

(vi) The paid-up capital and adjusted cost base of the 100 Class B common shares, 100 Class C common shares and 100 Class D common shares was $1 each;[14]

Transfer 800,000 MDPC Class A preference shares to Alexis Dental Ltd.

(vii) The Appellant was the sole shareholder of Alexis Dental Ltd;[15]

(viii) The Appellant sold 800,000 MDPC Class A preference shares to Alexis Dental Ltd. for $800,000 on a tax-deferred basis under s. 85 of the ITA;[16]

(ix) The purchase price was paid by Alexis Dental Ltd. issuing 800,000 Alexis Dental Ltd. Class A preference shares to the Appellant;[17]

---

[11] Exhibit AR-1, Tab 20-1 to 20-9.
[12] Exhibit AR-1, Tab 20-1, p. 3.
[13] Diagram prepared by BDO Dunwoody, Appellant's accountants, Steps #1, #2 and #3 under "Share Reorg".
[14] Diagram prepared by BDO Dunwoody, Appellant's accountants, Steps #1, #2 and #3 under "Share Reorg".
[15] Exhibit AR-1, Tab 6, pp. 32, 37.
[16] Exhibit AR-1, Tab 20-10.
[17] Exhibit AR-1, Tabs 13, 20-1.

(x) The parties reported the transaction under s. 85 of the ITA as follows:[18]

i. Fair market value of 800,000 MDPC Class A preference shares was $800,000;

ii. The adjusted cost base of 800,000 MDPC Class A preference shares was $37.46;

iii. The agreed amount under s. 85(1) of the ITA was $37.46;

(xi) MDPC redeemed 800,000 Class A preference shares for $800,000;[19]

(xii) Alexis Dental Ltd. reported a deemed dividend of $799,962.54 as a tax-free intercorporate dividend;[20]

Class B, Class C and Class D common shares – Mrs. Mady, Alexis and Madison

(xiii) Mrs. Mady, Madison and Alexis (the latter two through the Appellant acting as trustee) purchased 85 Class B, 85 Class C and 85 Class D common shares in MDPC respectively from the Appellant;[21]

(xiv) The purchase price stated in each of the agreements between the Appellant and Mrs. Mady, Alexis and Madison respectively, was $0.85 subject to a price adjustment clause;[22]

Goodwill

(xv) The Appellant purchased the goodwill of the dental practice from MDPC for $900,000;[23]

---

[18] Exhibit AR-1, Tab 13.
[19] Exhibit AR-1, Tab 20-17.
[20] Exhibit AR-1, Tab 6, p. 36.
[21] Exhibit AR-1, Tabs 20-21, 20-22, 20-23.
[22] Exhibit AR-1, Tabs 20-21, 20-22, 20-23.
[23] Exhibit AR-1, Tabs 20-36, p. 2, para. 1.

(xvi) The Appellant paid MDPC with a non-interest bearing promissory note for $900,000;[24]

(xvii) The Appellant sold the goodwill of the dental practice to 2309712 Ontario Inc. for $900,000 on a tax-deferred basis under s. 85 of the ITA, for 100 common shares in 2309712 Ontario Inc. The parties reported the transaction as follows:[25]

i. The fair market value of the goodwill and of the share consideration was $900,000;

ii. The redemption value of 100 common shares was $9,000 per share;

iii. The agreed amount under s. 85(1) of the ITA was $900,000.

[36] On January 13, 2012, the Appellant, Mrs. Mady, and the Appellant acting as trustee for Alexis and Madison sold to third parties shares in MDPC and 2309712 Ontario Inc. for an aggregate sum of $4,500,000 as follows:[26]

(i) Sold by the Appellant to Dr. Meikle Dentistry Professional Corporation ("PC Purchaser"), 100 common shares in 2309712 Ontario Inc. for $900,000;

(ii) Sold by the Appellant to Dental Corporation of Canada Holdings Inc. ("DCCH"), 900,000 Class A preference shares in MDPC for $900,000 on a tax-deferred basis under s. 85 of the ITA for 900,000 common shares of DCCH;

(iii) Sold by the Appellant, Mrs. Mady, and the Appellant acting as trustee for Alexis and Madison, to Dental Corporation of Canada Inc. ("TSC Purchaser"), 371,497 Class A preference shares, 100 Class B, 100 Class C and 100 Class D common shares for the aggregate price of $2,700,000.

[24] Exhibit AR-1, Tabs 20-36, p. 2, paras. 1, 2.
[25] Exhibit AR-1, Tabs 15, 20-39 to 20-44.
[26] Exhibit AR-1, Tab 21-1, p. 19, Section 2.2.

[37] PC Purchaser, DCCH and TSC Purchaser were each at arm's length vis-à-vis the Appellant, Mrs. Mady, Alexis and Madison.

[38] The working capital adjustments added to the fair market value of the shares sold by the Appellant, Mrs. Mady, Alexis and Madison to determine the proceeds of disposition were $39,783, $75,146, $75,146 and $75,146 respectively.[27]

[39] The Appellant reported the transactions above as proceeds of disposition of $1,660,597 that were the aggregate of $900,000 proceeds from the sale of 100 common shares in 2309712[28] and $760,537 proceeds[29] from the sale of 371,497 Class A Preference shares, 15 Class B common shares, 15 Class C common shares and 15 Class D common shares in MDPC combined.

[40] The Appellant reported capital gains of $760,537 in the 2012 taxation year as follows:[30]

371,497 Class A preference shares in MDPC	$371,497
15 Class B common shares in MDPC	$116,425
15 Class C common shares in MDPC	$116,425
15 Class D common shares in MDPC	$116,425
Working capital adjustment	$39,783
100 common shares in 2309712 Ontario Inc.	Nil
	$760,537

And he applied a capital gains deduction of $375,000.

[41] Mrs. Mady, Madison and Alexis each reported proceeds of disposition and capital gains of $734,888 or taxable capital gains of $367,443 on the sale of 85 Class B, 85 Class C and 85 Class D common shares respectively, and applied a

[27] Diagram prepared by BDO Dunwoody, Appellant's accountants, Step #8.
[28] Diagram prepared by BDO Dunwoody, Appellant's accountants, Step #4.
[29] Diagram prepared by BDO Dunwoody, Appellant's accountants, Step #8.
[30] Diagram prepared by BDO Dunwoody, Appellant's accountants, Step #8.

capital gains deduction of $367,443, $367,443 and $356,621 respectively in the 2012 taxation year.[31]

[42] On January 13, 2012, MDPC was renamed 1352155 Ontario Inc.[32]

[43] On March 1, 2012, 1352155 Ontario Inc. was dissolved.[33]

[44] The Minister assessed the Appellant for the 2010 to 2013 taxation years by notices dated May 12, 2011, May, 17, 2012, May 16, 2013 and May 5, 2014 respectively.

[45] The Minister reassessed the Appellant on September 10, 2013 for the 2010, 2011 and 2012 taxation years.

[46] On December 5, 2014, the Minister reassessed the Appellant with respect to the 2010 to 2013 taxation years as follows:

(i) Taxable dividends of $659,750 and $110,000 in the 2010 and 2011 taxation years respectively;

(ii) Taxable capital gains of $1,214,251.50 in the 2012 taxation year;

(iii) Reduction to minimum tax carried over by $10,409.35 in the 2013 taxation year.

[47] With respect to the reassessment of taxable capital gains of $1,214,251 for the 2012 taxation year, that amount was determined on the basis that the fair market value as at January 13, 2012 of 100 Class A common shares the Appellant owned in Mady Dentistry, Professional Corporation ("MDPC", later renamed 1352155 Ontario Inc.) that were exchanged for (i) 2,071,497 Class A preference shares with a redemption value of $1, (ii) 100 Class B common shares, (iii) 100 Class C common share and (iv) 100 Class D common shares of MDPC on a tax-free basis pursuant to section 86 of the ITA, was $4,500,000 which is based on the ultimate sale on the same day to third parties.

---

[31] Diagram prepared by BDO Dunwoody, Appellant's accountants, Step #8; Exhibit AR-1, Tabs 3, 8, 9.
[32] Exhibit AR-1, Tab 21-31, p. 1.
[33] Exhibit AR-1, Tab 22-1, p. 1.

[48] The amount of $4,500,000 was based on the actual transaction sale price to third parties.

C. Review of Evidence

(1) Michael Van Essen

[49] Mr. Michael Van Essen is a chartered accountant with BDO Canada. He has worked full time since 2001 and has been a tax partner since 2010. He is familiar with Mr. Mady's affairs as his advisor.

[50] The evidence shows that Mr. Van Essen had limited involvement with The David Charles Mady, Jr. Family Trust.[34] That was handled by a former partner who was the Appellant's accountant at the time. Mr. Van Essen explained that the Family Trust was wound up in 2002 after a change in the dental hygiene rules in Ontario which mandated that no one other than a licensed dentist could practise dental hygiene unless it was in a professional corporation and that only a licensed dentist could hold shares in such a professional corporation. He further explained that the change in rules resulted in less tax-efficiency than had been the case before, in that, when the trust had been able to hold the shares of the professional corporation, dividends could be declared to any of the trust beneficiaries. Later on cross-examination, Mr. Van Essen testified that there were family law reasons for distributing the shares to Judy first, that it offered some type of protection. However, Mr. Van Essen was not the advisor at the time of the transfer, and this explanation contradicts the earlier explanation that the intent was to rely on the attribution rules in making the transfer. Furthermore, the family law explanation is not borne out by the evidence. Dr. Mady himself was a capital beneficiary of the trust and was able to directly transfer the shares to himself from the trust. The family law explanation appears to have been concocted as an after-the-fact justification for the shares being transferred in a two-step transaction to Dr. Mady.

[51] Mr. Van Essen did prepare the Appellant's tax returns for 2010 and 2011. In those years, the dividend income from MDPC was attributed Mrs. Mady.[35] Mr.

[34] Exhibit AR-1, Volume 2, Tab 11.
[35] Exhibit AR-1, Volume 1, Tab 3, pp. 127-128.

Van Essen testified that Mrs. Mady has not been reassessed to remove the dividend income that the CRA has attributed to the Appellant pursuant to section 74.5(11).

[52] Mr. Van Essen relied on Joanne King, a chartered business valuator in his office, to value the shares of MDPC as at July 1, 2011 which was the date immediately following the par-end of the fiscal year for which its latest financial statements were available. Mr. Van Essen used this valuation in carrying out the freeze. Significantly, Mr. Van Essen did not tell Ms. King about the DCC offer to purchase Dr. Mady's practice. Mrs. King was also unaware of the fact that the freeze was to be carried out on the same day that MDPC was to be sold to an arm's length purchaser.

[53] Step one was the section 86 share-for-share exchange. The 100 Class A common shares held by Mr. Mady in MDPC were exchanged for 2,071,497 preferred shares and 100 each of Class B, C, and D common shares. The preferred shares were assigned a value of $1 per share, and each class of common shares was assigned a value of one cent.

[54] The section 86 share-for-share exchange was done in conjunction with articles of amendment. The articles provide that the preference shares are to be redeemed at fair market value.[36] The share exchange agreement regarding the section 86 share-for-share exchange contained a price adjustment clause ("PAC").[37] The purchase price was stated to be $2,071,500, "being the parties' best estimate of the fair market value."[38]

[55] The second step was to purify MDPC, since it had made loans to Dr. Mady's holding corporation Alexis Dental Ltd., as well as to another corporation called Aesthetica. This was done using a section 85 rollover to transfer 800,000 of the Class A preference shares in MDPC from Dr. Mady to Alexis Dental Ltd. In exchange, Dr. Mady took back 800,000 Class A preference shares in Alexis Dental Ltd. Step three was for Alexis Dental Ltd. to redeem the MDPC shares it held for $800,000, resulting in a deemed dividend, to offset the $798,690 debt that Alexis Dental Ltd. and Aesthetica owed to MDPC. After the purification, the value of

[36] Exhibit AR-1, Volume 4, Tab 22-1, p. 2192, paragraph (iv).
[37] Exhibit AR-1, Volume 3, Tab 20-1, article 3.1.
[38] Exhibit AR-1, Volume 3, Tab 20-1, article 2.2.

MDPC was reduced by $800,000, with 1,271,497 Class A preferred shares in MDPC remaining in Dr. Mady's hands.

[56] Mr. Van Essen also instructed the lawyer to draft the agreement for the transfer of shares under section 85 to purify MDPC.[39] This agreement also has a PAC.[40]

[57] In step four, Dr. Mady sold the Class B, C, and D common shares to his spouse and two children. Mr. Van Essen considered these shares to be worth nothing, so they were sold for a value equal to their paid-up capital (being one cent per share). At this point, Dr. Mady is left with the 1,271,497 Class A preferred shares and 15 each of the Class B, C, and D common shares.

[58] Separate SPA to sell 85 each of the Class B, C, and D common shares to his spouse and two children were drawn up.[41] Each of these has a price adjustment clause.[42] Mr. Van Essen was also involved in providing instructions on these agreements.

[59] Mr. Van Essen testified that Dr. Mady relied on him and BDO in the course of these transactions. Dr. Mady did not provide input on the transactions. Mr. Van Essen thought it was in Dr. Mady's best interests to obtain as high a capital gain as possible in exchange for less salary.

[60] In exchange for the purchase price of $4.5 million, Dr. Mady received $900,000 in DCC shares and $3.6 million in cash, allocated among himself, his spouse, and their two children.

[61] Dr. Mady was required to execute a Professional Services Agreement. Under this agreement, Dr. Mady had to guarantee a minimum EBITDA (the "EBITDA Target") or else face a clawback of his own salary. The clawback was to be effected automatically and according to a formula. There was no opting out. The only way the clawback would not operate was if Dr. Mady died or became disabled.

---

[39] Exhibit AR-1, Volume 3, Tab 20-10, p. 1829.
[40] *Ibid*. article 10, p. 1833.
[41] Exhibit AR-1, Volume 3, Tab 20-21, Tab 20-22, and Tab 20-23.
[42] *Ibid*. article 7.

[62] The earnings projections that were used to set the EBITDA Target were reviewed by Deloitte in performing the due diligence on behalf of the purchaser.

[63] While the projected 2012 EBITDA Target was higher than prior year results, Mr. Van Essen described the target as “realistic” in an email to DCC because it was in line with Dr. Mady’s average revenue growth of 15% per year for the previous four years.[43] The acquisition budget called for total revenue of $2.550 million,[44] which was also the figure used in the Heads of Agreement.[45] Higher EBITDA would also be achieved through savings in overhead costs, which DCC would be able to achieve after the acquisition.[46] Mr. Van Essen admitted on cross-examination that he would not have advised Dr. Mady to accept the figure if it were not within the realm of possibility.

[64] As for the 900,000 DCC preference shares that Dr. Mady received, Mr. Van Essen thought that they might not be worth anything. There are allegations of restrictions on the sale of those shares, although no share restrictions were shown to the Court. As a result, Mr. Van Essen considered them not to be sellable. However, on cross-examination, it was shown through an email that was copied to Mr. Van Essen that Dr. Mady was clearly concerned about the price of those shares going up by the time the purchase was completed.[47] He was clearly worried that the purchaser would require that the shares be issued at a higher price. If this happened he would receive a lesser number of common shares. This indicates that Dr. Mady was satisfied that the shares were worth at least $900,000. The shares issued to Dr. Mady were reported as having an FMV of $900,000 on the section 85 rollover form.[48]

[65] While Mr. Van Essen acknowledged that the freeze was effected on January 13, 2012, he testified that the estate freeze was intended to be completed sooner than that. He blamed the lawyer for not having prepared the documents earlier. Specifically, Mr. Van Essen claimed that the reorganization was meant to have been carried out on October 31, 2011. But in an email dated October 21, 2011, Mr.

---

[43] Exhibit AR-1, Volume 3, Tab 16-4, p. 18.
[44] Exhibit AR-1, Volume 3, Tab 16-6.
[45] Exhibit AR-1, Volume 3, Tab 16-5.
[46] Exhibit AR-1, Volume 5, Tab 24-15.
[47] Exhibit AR-1, Volume 3, Tab 16-10, p. 6.
[48] Exhibit AR-1, Volume 2, Tab 14.

Van Essen advised DCC that a reorganization was currently underway, that he would advise them of the final structure and that he would work with DCC so that the final structure would also meet their criteria.[49] The details of the reorganization remained to be worked out. Therefore, Mr. Van Essen's attempt to blame the lawyer for the delay in implementing the freeze appears unjustified.

[66] The emails between DCC, Dr. Mady, and Mr. Van Essen suggest a first meeting with DCC took place as early as October 5, 2011, when Dr. Meikle for DCC asked Dr. Mady to sign a non-disclosure agreement, and as late as October 12 when it appears the parties were scheduled to meet.[50] On October 14, 2011, Mr. Van Essen emailed Dr. Mady and the DCC representatives, suggesting a purchase price of $4.5 million.[51]

[67] Mr. Van Essen had sent DCC a normalized profit and loss statement showing rent being normalized with a reduction of about 75%.[52] Mr. Van Essen asserted that there had been no overcharging for rent but rather they had decided to reduce the rent to increase the EBITDA and obtain a higher purchase price.

[68] The Heads of Agreement document for the DCC sale was signed on October 14, 2011.[53] The agreement states the proposed purchase price to be $4.5 million, based on an EBITDA of $913,512 and subject to due diligence and the agreement being executed. The final SPA was signed on December 15, 2011 with the same purchase price and EBITDA.[54]

(2) Dr. David Mady

[69] The Appellant, Dr. David Mady, testified that he has relied on BDO to provide tax advice to him since the 1990s. He has worked with Mr. Van Essen and had worked with another partner before him. While Mr. Van Essen spoke to Dr. Mady about the transactions, Dr. Mady testified that he did not understand the transactions and relied on Mr. Van Essen's advice.

---

[49] Exhibit AR-1, Volume 3, Tab 16-10, p. 2.
[50] Exhibit AR-1, Volume 3, Tab 16-4.
[51] Exhibit AR-1, Volume 4, Tab 23-5.
[52] Exhibit AR-1, Volume 5, Tab 24-3, p. 3.
[53] Exhibit AR-1, Volume 3, Tab 16-5.
[54] Exhibit AR-1, Volume 4, Tab 23-4.

[70] As for the transfer of the MDPC shares from the trust to his spouse and then to himself, Dr. Mady testified that he did not remember anything about these transfers.

(3) Joanne King

[71] Ms. Joanne King was presented as an expert witness by the Appellant. She has been an associate with BDO since 2009. She is a chartered business valuator. The Crown objected to her qualification as an expert on the basis of prejudice and a lack of independence. After a voir dire, Ms. King was qualified as an expert witness.

[72] Ms. King used the income approach to value the shares of MDPC. She described such a valuation, which is done on a notional basis, as an art, not a science. It is performed in the absence of a market price. She compared the value so determined with the "rule of thumb" value, which is an industry-specific number used as a reference guide. In this case, Dr. Mady's practice was valued at a figure much higher than the rule of thumb figure, which Ms. King considered reasonable in her report since Dr. Mady had two locations and significantly higher profit margins.

[73] Ms. King determined the value of Dr. Mady's practice by looking at the income of the business. She admitted to making one error in her report by using after-tax income in her cash-flow calculation instead of before-tax income. She corrected this error in her Limited Critique Report.[55] She then normalized expenses that are atypical of a dental practice, which had the effect of increasing the net income used to determine the value. She took the income for the previous three years into account (from 2009 to 2011) and used a weighted average to give more weight to the most recent year. She then multiplied the figure by a capitalization rate which represents the risk of the business. Because the capitalization rate is a judgment call and there is no set number to use, she applied a high and low capitalization rate to come up with a reasonable range. In this case, the value range as at July 1, 2011 was determined to be between $1.939 million and $2.204 million, with a midpoint of $2,071,500. The midpoint number of $2,071,500 was

[55] Exhibit A-2.

ultimately used as the value. The corrected value in the Limited Critique Report, to account for the above noted error, is $2,442,000 as at July 1, 2011.[56]

[74] Ms. King also considered the value of the redundant assets after calculating the value on the income approach. Redundant assets are those which are not required for use in the business. This includes things such as excess cash. Typically, they can be and are easily extracted prior to a sale. Ms. King determined that there were no redundant assets at the time of this valuation. The amounts due from related parties she did not consider to be a redundant asset because of the relationship between those parties. Ms. King also valued the goodwill of the practice by taking her valuation and subtracting the value of the tangible assets. She determined the goodwill to have a value of $1,746,500.

[75] Ms. King also produced a Limited Critique Report of the Richter Report.[57] She stated that the fundamental difference between the two reports is the date of valuation, being, in her report, July 1, 2011, the intended date of the estate freeze, and, in the Richter Report, January 13, 2012. Ms. King's comment that the freeze was intended to be carried out on July 1, 2011 conflicts with the testimony of Mr. Van Essen that the freeze was intended to be carried out in October 2011.

[76] She agreed with the Richter Report that DCC was a special purchaser but asserts that you need to look at the whole transaction and not just the purchase price. In this case, the whole transaction would include the DCC shares that Dr. Mady received as part of his consideration, and the Professional Services Agreement, which included the clawback mechanism. As for the 900,000 DCC shares that Dr. Mady received, Ms. King asserted that, while they were assigned a value of $900,000 by the parties, this does not mean that they were worth $900,000.

[77] On cross-examination, Ms. King acknowledged that she was not aware of the proposed transaction with DCC at the time of issuing her report. In addition, her report was made on the basis of the reorganization's being carried out on July 1, 2011, but the report was issued much later because she needed to wait for the year-end financial statements. Ms. King also admitted that the DCC purchase

---

[56] Exhibit A-2, Schedule 1.
[57] Exhibit A-2.

would have had an impact on her report, had she known about the pending transaction when she issued her report.

(4) Jim Tracey

[78] Mr. James Tracey is a chartered professional accountant and chartered business valuator. Mr. Tracey was called as an expert witness by the Appellant. He was qualified without objection. Mr. Tracey had two expert reports. The first is a review of the BDO report by Ms. King and of the CRA report.[58] The second is a Limited Critique Report on the Richter Report.[59]

[79] My. Tracey's first report is not a traditional report. He does not opine on the value of the shares of MDPC. Rather, he provides comments on the other expert reports, produced by the Appellant and the Respondent.

[80] First, Mr. Tracey examined the proposed 2012 budget. He compared the actual expenses from the first half of the 2012 fiscal year, annualized for the entire year, with the 2012 budget. He found that the actual expenses were higher than the budgeted expenses by 27%. He also did the same calculation for the 2012 income and found that the 2012 budget income was almost double, at 93%, the income for the first half of the 2012 fiscal year, annualized. Therefore, he concluded that the 2012 budget was not justified and not supportive of the determination of a purchase price. Mr. Tracey felt that DCC in this instance was willing to use the 2012 budget because of the clawback in the Professional Services Agreement.

[81] Mr. Tracey also compared the capitalization multiplier used by both BDO and the CRA. The CRA applied the multiplier to the EBITDA, whereas BDO applied it to the earnings. He believes that, once he accounted for this difference, BDO and the CRA were using substantially the same capitalization multiplier.

[82] Mr. Tracey also compared the redundant assets. BDO included no redundant assets. Mr. Tracey's opinion is that the redundant assets as at January 13, 2012 amounted to $281,000.

---

[58] Exhibit A-3.
[59] Exhibit A-4.

[83] Next, Mr. Tracey adjusted Ms. King's valuation to reflect the value as at January 13, 2012 instead of July 1, 2011. He based this on actual expenses and income, on an annualized basis, and included the redundant assets. In the end, he comes up with an updated range and takes the average midpoint between the BDO and CRA valuations, concluding that the fair market value of MDPC as at January 13, 2012 was $2,630,000.

[84] Finally, Mr. Tracey compared the figures with the rule of thumb, which he described as a reasonableness test. He used a rule of thumb of 100% of revenue, which, when applied to the 2012 projected revenue, is $2,442,000. The original CRA estimate of $4.5 million is more than twice that amount. Mr. Tracey could not figure out why. On this basis, Mr. Tracey concluded that the original CRA estimate does not represent the FMV of MDPC, unlike his own figures, which are close to the rule of thumb.

[85] In Mr. Tracey's opinion, the purchase price is greater than the FMV because DCC is a special purchaser and there is a clawback in the Professional Services Agreement. Overall, he considered Ms. King's methods to be appropriate with the one exception of the mistake Ms. King admitted to.

[86] On cross-examination, Mr. Tracey was shown a number of emails between Dr. Mady, Mr. Van Essen and DCC. These emails have Mr. Van Essen stating that the 2012 growth projection was realistic given the 15% increase per year over the past four years,[60] and generally show that the figures used by DCC and Deloitte in their due diligence came from Mr. Van Essen and Dr. Mady. Mr. Tracey had not seen these emails before. Rather, he had relied on Mr. Van Essen's statements that they had claimed a higher EBITDA for the purpose of getting a higher capital gain. Mr. Tracey was not aware of what sort of due diligence had been carried out by the purchaser.

(5) Andrew Michelin

[87] Mr. Andrew Michelin is a chartered business valuator and chartered accountant. He has been with Richter Advisory Group Inc. as a business valuator since 2001. He was called as an expert witness by the Respondent and was

[60] Exhibit AR-1, Volume 3, Tab 16-4, p. 18.

qualified as an expert witness with no objection. He produced a comprehensive valuation report.[61]

[88] Mr. Michelin testified that in this case, because the arm's length purchase and sale was carried out on the same day as the freeze, the market approach should be used to value the shares. The parties, after hard bargaining, agreed that the shares sold were worth $4.5 million. Mr. Michelin also completed a notional valuation of MDPC as a back-up check of the reasonableness of the market approach that had been decided on. In his opinion, one cannot ignore the arm's length purchase price set by the parties given that the freeze was carried out on the same day as the sale.

[89] Mr. Michelin compared the historical revenue and expenses of MDPC going back five years and calculated the adjusted EBITDA for those years. He then compared the 2011 figures and the 2012 budget. He noted that expenses were down in the 2012 budget year on account of synergies, and that revenue was expected to grow by 15%, which was in line with growth in prior years. Overall, he considered the 2012 budget reasonable. Mr. Michelin also noted that Deloitte considered it reasonable as well. However, in determining the enterprise value he did not rely solely on the 2012 budget EBITDA since it relied on the performance of Dr. Mady. To reduce the risk that this represented, he used an average of the 2011 EBITDA and the 2012 budget EBITDA.

[90] Mr. Michelin also stated that in a situation such as this, where there is an imminent transaction, the incremental value resulting from the imminent sale must be considered in the determination of the FMV. This essentially results in use of the market approach to determine the FMV.

[91] Mr. Michelin testified that the Professional Services Agreement is no different from any other business transaction. Such an agreement is the norm in his opinion. He observed that Dr. Mady was not required to work in the practice. He could hire replacements. His only obligation was to ensure that the EBITDA Target was met.

---

[61] Exhibit R-1.

[92] Mr. Michelin also looked at the rules of thumb and found them to be not helpful in this case. This is because Dr. Mady's practice was very profitable. In addition, with DCC's entry into the market in September of 2011, the rules changed, and the old rule of thumb no longer applied.

[93] Mr. Michelin concluded that the FMV of the issued shares of MDPC as at January 13, 2012 was $5.288 million, representing the stand-alone enterprise value, plus redundant assets, minus interest-bearing debt, plus the incremental value of the imminent sale to DCC.

[94] Next, Mr. Michelin considered whether there should be a discount for the clawback in the Professional Services Agreement or for the DCC shares. First, Mr. Michelin noted that the claw back only affects Dr. Mady's future remuneration, not the value of the shares. Second, he considered the risk of a clawback low. The EBITDA Target was reasonable because it accounted for the synergies obtainable by DCC.

[95] In Mr. Michelin's critique of the Tracey report, he comments that Mr. Tracey ignored the DCC transaction. Mr. Michelin also considers Mr. Tracey to have committed two errors: in considering the 2012 budget, he made a mistake with regard to lab fees, and he failed to consider purchaser synergies. He also points out that the Tracey valuation cannot be relied upon because it failed to take into account the DCC transaction that was agreed to prior to the freeze transaction.

(6) Lucia Hutchins

[96] Ms. Lucia Hutchins was the CRA auditor for this file. She has been with the CRA for approximately 21 years.

[97] Ms. Hutchins requested a valuation by a CRA valuator because of the representations being made by Dr. Mady and Mr. Van Essen and because of the transaction price. The CRA valuator valued MDPC at or around $5.1 million. In the end, she used the transaction price as the FMV of the 100 Class A common shares in MDPC as at January 13, 2011. She considered this a fair, realistic number, adopting a conservative approach.

[98] Ms. Hutchins applied gross negligence penalties because she found Dr. Mady to be an educated, astute man who appeared to understand tax matters well enough to know that these plans were devised to achieve tax savings. For example, with regard to the first series of transactions, her impression was that Dr. Mady knew that his wife could not hold the shares of MDPC under the new regulatory regime. Regarding the second series of transactions, there was a history of Mr. Van Essen recommending tax plans to Dr. Mady for income-splitting purposes. In addition, Dr. Mady knew the risk of using the July 1, 2011 valuation because she had advised him of the risk prior to the time his tax returns were filed for the 2012 taxation year.

[99] In regard to the first series of transactions carried out in 2002, the evidence establishes that the 100 Class A common shares in MDPC were transferred out of the family trust, through Mrs. Mady, to Dr. Mady for the purpose of relying on the attribution rules in order to report dividends in Mrs. Mady's income. The parties knew that only Dr. Mady could hold voting shares in MDPC. Mr. Van Essen noted that the change in the dental college rules, which now mandated that Dr. Mady hold the shares, was not tax-efficient and that, following this change there were discussions about how to maintain tax-efficiency. Mr. Van Essen's explanation that there were family law concerns about transferring the shares from the trust to Dr. Mady is not supported by the evidence; it is an after-the-fact explanation. This explanation was never offered to Ms. Hutchins. Furthermore, Mr. Van Essen was not Dr. Mady's advisor at that time.

[100] In regard to the second series of transactions, the evidence establishes that the value of the MDPC shares as at January 13, 2012 was at least $4.5 million.

[101] Ms. King was an honest and credible witness. Her corrected valuation of $2.442 million as at July 1, 2011 might have been acceptable had the reorganization been carried out on July 1, 2011. The problem is that the reorganization was carried out on January 13, 2012 after the sale had been agreed to with DCC. Ms. King did not consider any purchaser synergies because as at July 1, 2011 that would have been entirely speculative. However, by the time she issued her report on October 17, 2011, there was an actual purchaser, with synergies identified and calculated. Ms. King admitted that DCC's purchase would have been relevant to her valuation had she known about the pending transaction.

[102] Mr. Tracey's report is similarly flawed. He fails to consider the identified and calculated purchaser synergies.

[103] The evidence establishes that the EBITDA Target found in the 2012 budget was reasonable and achievable. Both Mr. Van Essen and Dr. Mady considered the figure to be at least within the realm of possibility. Deloitte, in doing the due diligence for DCC, considered the figure reasonable. Mr. Michelin, in analyzing the budget figures, concluded that they were reasonable and could be relied upon.

[104] As for the knowledge and intentions of Dr. Mady, while he had sufficient knowledge of general tax matters and a desire to achieve tax savings, the evidence suggests that at all times he relied on Mr. Van Essen in structuring his affairs.

III. Analysis

A. Does subsection 74.5(11) of the ITA apply so that the taxable dividends received by the Appellant and reported by his wife under subsection 74.1 remain taxable in his hands?

[105] As noted in the agreed statement of facts, prior to October 18, 2002 all of the issued and outstanding shares of MDPC (known at the time as JJM Hygiene Corp.) were owned by The David Charles Mady, Jr. Family Trust (the "Mady Family Trust"). The Appellant's wife and two children were discretionary income beneficiaries. They were also discretionary capital beneficiaries along with the Appellant.

[106] The parties agreed that at some time prior to October 18, 2002, the rules of the Royal College of Dental Surgeons were modified to require that all shares of professional corporations carrying on a dental practice be owned by a licensed dentist.

[107] On October 18, 2002, the Appellant, acting as trustee of the Mady Family Trust, caused the trust to transfer the 100 issued and outstanding shares of MDPC to Mrs. Mady as a capital distribution. Mrs. Mady immediately thereafter gifted those shares to her husband.

[108] MDPC declared and paid dividends to Dr. Mady of $659,750 and $110,000 in the 2010 and 2011 taxation years. Mrs. Mady reported those dividends in her 2010 and 2011 taxation years on the basis that subsection 74.1 deemed the income to be hers and not that of her husband.

[109] The Minister in her Reply assumed that the transfer of shares first to Mrs. Mady and then by way of gift from Mrs. Mady to the Appellant was intended to give rise to the application of section 74.1 and was effected for that purpose. The Minister taxed the Appellant on the dividend income that he received on the basis that subsection 74.5(11) of the Act operated to deny the attribution of the dividend income to Mrs. Mady because one of the main reasons why the transaction was carried out in the manner in which it was implemented was to reduce the amount of tax payable on the dividend income received on those shares.

[110] As noted by Justice Rothstein in *Lipson*,[62] subsection 74.5(11) is a specific anti-avoidance rule that precludes the use of the attribution rules where one of the main reasons for the transfer of property was to reduce the amount of tax that would be payable on the income derived from the property.

[111] The Appellant disagrees with the Minister's application of subsection 74.5(11). The Appellant observes that subsection 74.5(11) does not refer to a "series" of transactions, unlike, for example, the GAAR. The Appellant contends that the Minister, in making her decision to invoke subsection 74.5(11) in order to assess the Appellant on the dividend income, determined the purpose of the transfer of the shares from Mrs. Mady to Dr. Mady by considering the overall "series" of transfers starting with the transfer to Mrs. Mady from the Mady Family Trust and then from Mrs. Mady to Dr. Mady. In other words, according to the Appellant, the Minister applied subsection 74.5(11) because Mrs. Mady was made to be an intermediary transferee/transferor of the shares. The Appellant argues that subsection 74.5(11) dictates that the purpose of the transfer from Mrs. Mady to Dr. Mady must be determined solely by reference to that transaction. The Appellant contends that his interpretation of subsection 74.5(11) is consistent with the decision of the Federal Court of Appeal ("FCA") in *Lehigh Cement Limited*.[63] While that decision involved the interpretation of paragraph 95(6)(b) in the context

[62] *Lipson v. Canada*, 2009 SCC 1, [2009] 1 S.C.R. 3, at para. 105 [*Lipson*].
[63] *Lehigh Cement Limited v. Canada*, 2014 FCA 103, [2015] 3 F.C.R. 117 [*Lehigh Cement*].

of foreign affiliates, it also involved the interpretation of a specific anti-avoidance provision that the Court observed did not employ a "series of transactions" concept for the purpose of discerning a tax avoidance purpose.

[112] According to the Appellant, once Mrs. Mady owned the shares, she would be subject to tax on any dividend income received thereon. Therefore, the transfer of the shares from her to Dr. Mady could not have been intended to reduce tax payable on the dividends received on the shares. She was already the shareholder and the lower income earner. As a result, her tax rate was lower than the Appellant's. If she had retained the shares rather than transfer them to her husband, the amount of tax due on the dividend income would have been less than that payable by Dr. Mady.

[113] In my opinion, the Appellant's analysis of *Lehigh Cement* fails to take into account the FCA's observations in paragraph 69 of that decision which are as follows:

> 69 The principal purpose of the acquisition or disposition of shares in the non-resident corporation is a question of fact to be determined on the basis of all relevant circumstances. An entire series of transactions may form part of the circumstances relevant to discerning the principal purpose of the acquisition or disposition of shares in the non-resident corporation. But it is not open to the Minister to look at an entire series of transactions to discern a tax avoidance purpose that is not the specific target of paragraph 95(6)(*b*).

[114] The FCA accepts that, even in the absence of a "series of transactions" concept, the entire series of transactions may form part of the relevant circumstances in determining the purpose of the transfer of property.

[115] The Appellant's analysis of the underlying circumstances surrounding the transfer of shares to him fails for another reason. The parties agreed that Mrs. Mady could not own the shares of MDPC. The rules of the Royal College of Dental Surgeons prohibited Mrs. Mady from owning the shares. If she could not own the shares she could not receive dividend income thereon. Therefore, dividends could not be subject to tax in her hands at a lower tax rate than that which applied to Dr. Mady. In that context, it is only through the application of section 74.1 that the dividends paid on the shares could be taxed in the hands of

Mrs. Mady. This was achieved by causing Mrs. Mady to transfer the shares that she could not own to Dr. Mady.

[116] As a final observation on the text of subsection 74.5(11), I note that the provision refers to "one of the main reasons" for the transfer of the property being to take advantage of the attribution rules so that the income from property is taxed in the hands of the lower-income earner. Paragraph 95(6)(b) considered in *Lehigh Cement* employs a narrower test, being the "principal purpose" for the acquisition or disposition of shares. In *Groupe Honco*,[64] the FCA concluded that the phrase "one of the main purposes" which is in effect the same test as that employed in subsection 74.5(11), "is unambiguous and implies that a taxpayer may have more than one main motive in acquiring shares". Even if I accept that one of the purposes of the transfer from Mrs. Mady to Dr. Mady was to ensure compliance with the new share ownership restriction discussed above, this does not override the fact that the other main purpose of structuring the transaction as it was in fact structured was to trigger the application of the distribution rules so that dividend income that Mrs. Mady was barred from receiving would be taxed in her hands at a lower rate. The Appellant conceded that his income tax rate was higher than that of his wife in the relevant taxation years. She paid of $180,000 tax on the dividend income attributed to her. The Appellant owes $199,000 of tax according to the Minister's assessment, for a net difference of $19,000.

[117] During his examination in chief, the Appellant offered no explanation as to why his wife acted as an intermediate transferee and transferor of the shares. The Appellant was a discretionary capital beneficiary under the trust and, as trustee, he could have distributed the shares directly to himself. The evidence is clear that Mrs. Mady was precluded from owning those shares under the new ownership restrictions imposed by the Royal College of Dental Surgeons. The evidence shows that the Appellant was aware of this fact before the shares were transferred to him indirectly with his wife acting as intermediary in the transaction.

[118] I did not find Mr. Van Essen to be credible when he denied having knowledge of the tax mitigation reasons for the share transfer being structured as it was. He took this stance in a letter addressed to the CRA dated March 7, 2014. In the letter, he indicated that he and his client had difficulty locating the deed of trust

---

[64] *Groupe Honco Inc. v. The Queen*, 2013 FCA 128, 2013 CarswellNat 4181 at para. 24 [*Groupe Honco*].

and suggested that perhaps the shares were distributed by the trust to Mrs. Mady because it was possible that the Appellant was not a capital beneficiary under the trust. This explanation turned out not to be true.

[119] During his testimony, Mr. Van Essen confirmed that there was an annotation in his client's file to the effect that the rule in subsection 74.1(1) applied so as to attribute the dividend income from the dividend recipient, Dr. Mady, to his wife, Judy Mady. Mr. Van Essen impressed me as a skilled tax planner. I believe he knew why Mrs. Mady was made to act as a transferee and then as transferor of the shares to Dr. Mady.

[120] Later in his testimony, Mr. Van Essen mused that perhaps Dr. Mady was advised to distribute the shares first to his wife because, as a trustee and discretionary capital beneficiary, it would have been imprudent for him to distribute the shares directly to himself. The suggestion was made that perhaps the other capital beneficiaries could have challenged the direct distribution of the shares from Dr. Mady. The witness's explanation appeared to be a pretense to hide the fact that the tax plan was specifically designed to take advantage of the application of the income attribution rule found in subsection 74.1(1) of the ITA. There is not a shred of evidence that allows me to conclude otherwise. For all of these reasons, I conclude that the dividends were properly assessed to Dr. Mady.

[121] I observe that the Minister did not issue a consequential assessment of Mrs. Mady to refund the taxes that had been paid on the understanding that the income was attributed to her under subsection 74.1(1). Needless to say, my finding that subsection 74.5(11) applied to deny the attribution of the dividend income to her under subsection 74.1(1) means that Mrs. Mady was not liable to tax on that income. She paid tax on the dividend income, when none was due. In light of this, I strongly recommend that the Minister reassess Mrs. Mady under subsection 152(4.2) of the ITA to refund the tax that she paid, assuming Mrs. Mady makes an application for a tax refund under that provision within the prescribed 10-year limitation period. If this is not done, the result would be blatantly unfair. The effect of taxing the income in the hands of both Dr. Mady and Mrs. Mady will be that the couple will pay almost double the amount of tax otherwise due on that income.

B. Does subsection 86(2) apply to deny the Appellant a full tax-free rollover in connection with the MDPC capital reorganization?

[122] As noted earlier, the Respondent contends that the Appellant is not entitled to benefit from a full tax-free rollover under section 86 of the ITA in connection with the MDPC capital reorganization because subsection 86(2) of the Act applies to the transaction.

[123] Subsection 86(2) applies where two conditions are satisfied. First, the fair market value of the old shares disposed of by the taxpayer as a result of the share reorganization must exceed the total of the fair market value of the non-share consideration and of the new shares (the difference is referred to as the "Excess") received by the taxpayer as a result of the reorganization. Secondly, it must be reasonable to regard any portion of the Excess as a benefit that the taxpayer desired to have conferred on a person related to the taxpayer.

[124] The object purpose and spirit of subsection 86(2) is to tax the value that is shifted, as the result of the reorganization, from the taxpayer participating in the share reorganization to a person with whom the taxpayer is not dealing at arm's length. This is clear from the words used in paragraph 86(2)(b), which refers to the fair market value of the new shares received by the taxpayer, as a result of the capital reorganization, "immediately after the disposition". Subsection 86(2) is meant to apply to capital reorganizations that result in a shifting of value from one taxpayer to another without an actual transfer of shares from one to the other. In the absence of subsection 86(2), capital gains could be deferred indefinitely.

[125] The CRA auditor who reviewed the transaction and concluded that subsection 86(2) applied appears to have been influenced by the fact that the parties stated that the fair market value of the old shares was $2,071,500 and that they consisted of 2,071,497 Class A preferred shares worth $2,071,497 and 100 Class B, C and D common shares worth $3 in the aggregate. As the old shares were worth $4.5 million, any value that cannot be attributed to the Class A preferred shares accrues automatically to the new Class B, C and D common shares. In other words, the fair market value declared by the parties in the share exchange agreement has no bearing on the determination of the fair market value of the new shares, particularly the common shares, received thereunder.

[126] I pointed out to the Respondent's counsel during her oral submissions that I did not believe that subsection 86(2) applied because the Appellant was the sole shareholder of MDPC (he held all of the old shares) before the transaction and he

remained the sole shareholder of the corporation immediately after disposition (he held all of the new shares after the disposition). In that case, the fair market value of the old and new shares had to be equal. For subsection 86(2) to have applied, the Appellant's wife and children would have to have been shareholders of MDPC prior to the share reorganization or have become shareholders of MDPC as a result of the share reorganization.

[127] While the Respondent acknowledges that Dr. Mady was the sole registered shareholder of MDPC upon completion of the reorganization of capital, the Respondent contends that Judy Mady, Madison and Alexis were the beneficial owners of 85 Class B, C and D common shares respectively immediately upon completion of the share reorganization. On that basis, a benefit was conferred on them by the Appellant because he was the owner of only 15% of the common shares of MDPC as a result of the capital reorganization. The Respondent argues that the Appellant conveyed beneficial ownership of the 85 Class B, C and D common shares on his wife and two daughters when he executed the SPA with Dental Corporation on December 15, 2011. In that agreement Mrs. Mady, Madison and Alexis agreed that they would sell to Dental Corporation the 85 Class B, C and D common shares that they would hold on the closing date.

[128] Respectfully, I conclude that there is no evidence that shows that the Appellant conveyed a beneficial interest in the aforementioned shares prior to the completion of the purchase and sale arrangement with his family members with regard to of those shares on January 13, 2012. I have read the SPA carefully, and my interpretation of that agreement is that Mrs. Mady, Madison and Alexis simply agreed to sell the shares that they would own on the closing date. It is quite common for sophisticated parties, such as Dental Corporation, to enter into transactions that will close at a later date, for example, after a pre-closing reorganization has been carried out to accommodate the tax objectives of the seller.

[129] I agree with the Respondent that when the Appellant signed that SPA he probably intended to sell the 85 Class B, C and D common shares, once issued, to his family members in accordance with the tax plan designed by his tax advisor, Mike Van Essen. However, the Appellant's intention to carry out the pre-closing transaction steps prior to the closing date, in accordance with the tax plan is not equivalent to him being bound to do so. There is nothing in the SPA that suggests that the Appellant had granted to his wife and two daughters the right to acquire

the 85 Class B, C and D common shares for nominal consideration. Therefore, the Appellant owned 100% of the new shares immediately upon completion of the capital reorganization. As a result, the new shares given up by the Appellant and the old shares received by him as a result of the completion of the capital reorganization had equivalent value.

[130] In summary, because the Appellant's wife and daughters did not have an interest in the 85 Class B, C and D common shares prior to the time they purchased them from the Appellant later on the same day, no benefit was conferred on them directly or indirectly as a consequence of the completion of the capital reorganization of MDPC. The Minister's assessment of the Appellant cannot be justified under subsection 86(2).

[131] In the interest of thoroughness, I will examine whether the Minister applied subsection 86(2) correctly to determine the Appellant's revised proceeds of disposition. This analysis is relevant only if I am mistaken on the first point and subsection 86(2) is in fact applicable to the capital reorganization of MDPC on the basis that the Appellant's wife and two daughters were the beneficial owners of 85% of the common shares.

[132] As noted above, it is evident that the old shares and the new shares were of equal value. This is because the old shares and the new shares respectively constituted all of the issued and outstanding shares of the corporation immediately before and immediately after the share reorganization respectively. Any value that is not attributable to the Class A preference shares is attributable to the Class B, C and D common shares.

[133] The Minister's position is that 85% of the Class B, C and D common shares belonged to the Appellant's wife and two daughters immediately upon their issue. The Minister accepts that the Appellant was the registered and beneficial owner of 15 Class B, C and D common shares. These shares were sold by the Appellant to Dental Corporation on the closing date. The Appellant received his prorated share of the $4.5 million purchase price on the basis of the value agreed to by the parties for those shares. According to my calculations, these shares were worth at least

$364,275.[65] Therefore, even if the Minister is correct in contending that the Appellant's wife and children were the beneficial owners of 85% of the Class B, C and D common shares, the Minister overstated the capital gain that the Appellant failed to declare under subsection 86(2) by at least $364,275. As a result, the benefit conferred by the Appellant on his wife and children under subsection 86(2) is at most $2,064,228 if the Minister's position on subsection 86(2) is found to be correct.

C. Does subparagraph 69(1)(b)(i) apply with respect to the disposition of 85 Class B, C and D common shares to Mrs. Mady, Alexis and Madison, respectively for nominal consideration?

[134] The Respondent argued in the alternative that subparagraph 69(1)(b)(i) of the ITA applied in connection with the transfer of 85% of the common shares of MDPC equally to his wife and two daughters. That provision adopts the standard of fair market value for the purpose of determining the taxpayer's proceeds of disposition with respect to the disposition of property to a person with whom the taxpayer is not dealing at arm's length.

[135] The only dispute between the parties with respect to the application of this provision is whether the fair market value of the Class B, C and D common shares sold by the Appellant to his family members was greater than the one cent per share received by the Appellant.

[136] A great deal of evidence was presented by both parties with respect to the fair market value of the Class B, C and D common shares of MDPC. In my opinion, the price paid by Dental Corporation to the Appellant's wife and two daughters for the common shares sold to Dental Corporation is the appropriate benchmark to determine the fair market value of the shares sold by the Appellant to his family members. In coming to my conclusion, I accept the opinion of Andrew Michelin of Richter and Associates Inc., the expert witness for the Crown, for the reasons noted earlier. In summary, he opined that the market price approach should be used to value the shares because the shares were sold by the Appellant and his wife after the parties had agreed to sell those shares to Dental Corporation

---

[65] This value is based on the following calculation: $4.5 million (this is the FMV of the old shares determined by the Minister) – $2,071,497 (redemption price) = $2,428,503 x 0.15 (appellant's ownership percentage of the common shares according to the Minister's position) = $364,275.

for $4.5 million. I have rejected the opinions of the Appellant's expert witnesses for the reasons noted earlier.

[137] Unlike the Appellant, the Appellant's wife and his daughters sold their shares to Dental Corporation solely for cash. They acquired the shares from the Appellant for a purchase price of $0.01 per share and immediately thereafter sold them for a cash purchase price of $8,645 per share. The purchase price paid by Dental Corporation to the Appellant's wife and daughters was final. Unlike the Appellant, they were not parties to the SPA and had no obligations thereunder towards Dental Corporation. If the minimum EBITDA Target set out in the SPA was not met, the Appellant's wife and daughters were still entitled to retain the full cash purchase price that they received.

[138] Mr. Tracey, an expert witness for the Appellant, was asked whether the Appellant would have sold those shares to an unrelated party for one cent per share knowing that they would be sold immediately thereafter for $8,645 per share. I surmise that everyone in the courtroom anticipated that he would respond no. The witness added that the Appellant set the price at a nominal amount because the purchasers were his wife and two daughters. The profit of $734,888 that the Appellant's wife and daughters realized immediately thereafter on the sale of the shares to Dental Corporation remained wealth of the family unit. The advantage was that Mrs. Mady, Alexis and Madison could use their capital gains exemption to shelter the gains shifted to them by Dr. Mady.

[139] In his candid answer, Mr. Tracey recognized that the taxpayer set the price at a nominal amount to achieve a favourable tax result. Subparagraph 69(1)(b)(i) was adopted to prevent that result. It does so by using fair market value as the standard to determine the tax consequences for a taxpayer arising from a disposition to a person with whom the taxpayer was not dealing at arm's length.

[140] In summary, for all of the reasons noted above, the price agreed to by the Appellant's wife and two daughters on the one hand, and Dental Corporation on the other, satisfies the definition of the term "fair market value", which is understood to mean "the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method . . . in a market not exposed to any

undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell".[66]

[141] Therefore, I conclude that the Appellant under-reported taxable capital gains of $1,102,332. The reassessment is incorrect to the extent of $111,919 because the reassessment was issued on the basis that subsection 86(2) applied rather than subparagraph 69(1)(b)(i).

[142] The Appellant's counsel invited me to consider whether the Appellant's wife and two daughters could avail themselves of the purchase price adjustment clause contained in each of the share transfer agreements, assuming the parties decided to give effect to that provision.

[143] The application, or not, of the purchase price adjustment clause has no bearing on the tax consequences to the Appellant under subparagraph 69(1)(b)(i). It is of relevance only for the Appellant's wife and two daughters, assuming that the parties agree to apply the provision and that the provision is effective retroactively in its application. This a complex issue. The Appellant's wife and two daughters are not appellants before me. I have no jurisdiction to decide a matter of consequence to taxpayers that are not appellants before this Court.

[144] The Appellant's counsel also asked me to determine whether the transactions entered into by the Appellant and his wife and two daughters could be characterized as gifts rather than as purchase and sale transactions as they were held out to be in the agreements that the parties signed. The recharacterization requested by the Appellant has no impact on the tax consequences resulting from the disposition of the shares to his family members. In either case, under subsection 69(1) his proceeds are deemed to be equal to the fair market value of the property disposed of. The recharacterization is helpful only for the Appellant's wife and two daughters. In the case of a gift, the recipient is deemed to have acquired the property at fair market value. For the reasons noted above, I will refrain from commenting on this question. Further, I observe that in his Notice of Appeal the Appellant pleaded no facts to establish that the sale could be characterized as a gift and raised no arguments to that effect. It would also be a violation of the rule of procedural fairness for me to comment on this question.

---

[66] *Henderson v. Minister of National Revenue*, 1973 CarswellNat 189 (F.C.T.D.) at para. 21.

D. Is the Appellant liable to gross negligence penalties under subsection 163(2) of the Act?

[145] Counsel for the Respondent, in her written submissions, correctly recognizes that the courts have set a high standard for the Minister to meet in order to prove that a taxpayer's conduct justifies the imposition of gross negligence penalties with respect to that taxpayer's failure to report income. Citing relevant passages from the Supreme Court's decision in *Guindon*,[67] counsel acknowledged that the Respondent must prove, on a balance of probabilities, that the Appellant's conduct amounts to "indifference tantamount to intentional conduct" or an "indifference as to whether the law is complied with and is more than simple carelessness or negligence" with respect to his self-reporting obligation.

[146] It is well established that a taxpayer's general knowledge of business and tax matters must be taken into account in determining whether the taxpayer's conduct crosses this threshold. The complexity of the transactions at issue and of the provisions that give rise to the income tax liability must also be weighed. It is well known that the Minister rarely seeks to apply gross negligence penalties when transactions are considered to violate specific anti-avoidance provisions or the GAAR. Those types of provisions are by their nature difficult to interpret. Skilled tax advisors and the CRA have difficulty identifying where the boundaries of anti-avoidance provisions lie. In the case of transactions found to be shams, gross negligence penalties are often found to apply because of the element of deceit present in those situations.

[147] Courts have generally been reluctant to apply gross negligence penalties where a taxpayer relied in good faith on the advice of tax professionals,[68] or where all relevant amounts were disclosed in tax returns.[69] Although a taxpayer has the primary responsibility for filing tax returns, gross negligence penalties require facts that prove the taxpayer's knowledge of, or concurrence in, the acts of tax

---

[67] *Guindon v. Canada*, 2015 SCC 41, [2015] 3 S.C.R. 3.
[68] See discussion and summary of case law in Colin Campbell, *Administration of Income Tax 2016* (Toronto: Thomson Reuters, 2016), Chapter 11: "Penalties" at pp. 478-492.
[69] The Minister's assessment of penalties was called "aggressive and unwarranted" in *Billingsley v. The Queen*, [1997] 3 C.T.C. 2528, 97 DTC 1436 (T.C.C.). See also *Crown Cork & Seal Canada Inc. v. The Queen*, [1990] 2 C.T.C. 465, 90 DTC 6586 (F.C.T.D.).

preparers.[70] However, wilful blindness to the culpable conduct of tax preparers will not shield a taxpayer from gross negligence penalties.[71]

[148] The Respondent, in her written submissions, justified the imposition of gross negligence penalties as follows (at paragraph 6):

> . . .
>
> Dr. Mady had the requisite business acumen and education to know: (i) dividends were declared to him but reported for tax by Mrs. Mady; (ii) while he solely owned 100% of MDPC, he did not report fully the $4.5m sale price paid for those shares. The appellant participated in, assented to or acquiesced in the making of false statements or omissions in the income tax returns filed for the taxation years in question as a result of which tax that would have been payable as assessed on the information provided in the income tax return filed for those years was less than the tax payable within the meaning of s. 163(2) of the *Act*.
>
> [Emphasis added.]

[149] In my opinion, with respect to the dividend income, the Appellant's knowledge that the dividends were paid to him but were reported by his wife instead is insufficient to justify the imposition of gross negligence penalties. From the evidence, the Appellant relied on tax advice provided by a highly qualified practitioner. He was advised that the dividend income was attributed to his wife under section 74.1. The question as to whether the specific anti-avoidance rule set out in subsection 74.5(11) applies to override the general income attribution rule is highly complex. It had not been previously considered in the case law. Knowledge based on advice obtained from a qualified tax advisor that the income attribution rules apply is certainly not tantamount to knowledge that the beneficial tax consequences that otherwise flow from the transactions are blocked by a specific anti-avoidance provision that uses a complex purpose test to determine its application.

[150] There is no evidence that shows that the Appellant knew that section 74.5(11) applied to override the general attribution rule or that he was wilfully blind to its application. Equally, there is no evidence to show that the Appellant's

---

[70] See discussion in Campbell, op. cit. at p. 481, footnote 54.
[71] *Malleck v. Canada*, [1997] T.C.J. No. 835, (QL).

tax advisor knew, or was grossly negligent in failing to recognize, that subsection 74.5(11) applied to override the income attribution rule. The application of subsection 74.5(11) is not a black or white issue.

[151] For all of the above reasons, the Respondent has failed to show, on a balance of probabilities, that the Appellant's failure to report the dividend income was attributable to conduct that demonstrated "indifference tantamount to intentional conduct" or an "indifference as to whether the law is complied with".

[152] The answer is less obvious with respect to the question whether gross negligence penalties are justified in relation to the additional taxable capital gain resulting from the application of subsection 69(1). On the one hand, there is a large discrepancy between the nominal purchase price set by the Appellant for the shares transferred to his wife and daughters and the price for which they sold them to DCC immediately thereafter. The Appellant knew that the transaction resulted in the shifting to his family members of a large profit realized on the same day that the shares were transferred to them.

[153] The evidence also shows that the CRA had advised Dr. Mady and his tax advisor, prior to the filing of his 2012 tax return, that it had concerns with respect to the circumstances surrounding how he had transferred the shares to his wife and daughters.

[154] A mitigating factor is that the pre-closing reorganization was very complex. It involved steps taken to achieve the Appellant's tax objectives and others taken to accommodate the purchaser's regulatory goals. Non-qualifying assets of MDPC had to be removed from it prior to the third party disposition in order to ensure that the gain realized on the disposition of the shares qualified for the capital gains exemption. The goodwill of the business attributable to Dr. Mady's professional services had to be transferred to a new corporation to satisfy regulatory requirements imposed on the purchaser.

[155] During her testimony, Ms. Hutchins admitted that, notwithstanding her 20 years of practice as a tax professional with the CRA, she found that the series of transactions was quite complex. She issued the reassessment incorrectly on the basis that subsection 86(2) applied so as to deny the Appellant a full tax-free rollover in connection with the capital reorganization of MDPC. The alternative

argument that subparagraph 69(1)(b)(i) was applicable to determine the Appellant's proceeds of disposition was pleaded by the Deputy Attorney General. It was not raised by the Minister during the assessment and confirmation process. In that context, it is difficult to say that the Appellant, knew about, or was wilfully blind to, the application of a provision, i.e. subparagraph 69(1)(b)(i), that the CRA auditor overlooked during the assessment process.

[156] Other aspects of the factual background shed a more favourable light on the Appellant's conduct. The evidence shows that a proposal to implement the freeze was discussed by the Appellant and his tax advisor long before DCC appeared on the scene. On October 2, 2009, Mike Van Essen, in a letter sent to the Appellant, advised his client that it would be beneficial for him to exchange his common shares for fixed-value preferred shares to enable his wife and a trust set up for the benefit of his two daughters to acquire common shares of the corporation for a nominal consideration. The value of MDPC at the time was estimated by Mr. Van Essen to be $750,000. He advised his client that a formal valuation should be performed to avoid a challenge by the CRA. A follow-up letter was sent to the Appellant recommending that the estate freeze be implemented prior to the Appellant's oldest daughter's 18th birthday on February 23, 2012.

[157] In the fall of 2011, Mr. Van Essen, acting on behalf of the Appellant, asked his colleague to undertake a valuation of the shares of MDPC as at July 1, 2011. Mr. Van Essen testified that that date was chosen because it was at about the time of the last financial year-end for which financial statements prepared by BDO were available. From the evidence, I infer that the Appellant honestly believed that the shares of MDPC could be valued under the income approach on the basis of the latest financial statements of MDPC reviewed by BDO because the so-called freeze transaction had been discussed with his advisor well before the date of those statements. The evidence shows that the Appellant did what a reasonable prudent person would be expected to do: he relied on the advice of a reputable tax advisor to structure the share transfer to his wife and two daughters. Mr. Van Essen in turn commissioned a valuation report by a qualified colleague. The Appellant was two steps removed from the valuation process.

[158] While Mr. Van Essen acted imprudently in failing to disclose the pending sale of MDPC to his colleague, I do not believe that the Appellant can be held accountable for his actions. A valuation is a complex undertaking. Different

methods may be used to determine the value of shares. I heard over two days of expert evidence on the determination of the fair market value of the shares. The Appellant and the Respondent felt it was necessary for me to hear that evidence. While I rejected the opinion of the Appellant's experts to the effect that the fair market value of the shares should be based on the income approach, their opinions were not frivolous. It is well established that a taxpayer is responsible for the actions of his agent only where the taxpayer is privy to the gross negligence of that agent or wilfully blind to the fact of that negligence and the taxpayer acquiesces or participates in the false statements or omissions.[72]

[159] Finally, I observe that the transfer agreements between the Appellant and his wife and daughters all contained purchase price adjustments designed to guard against a challenge by the CRA. From the Appellant's testimony, I discerned that he believed that this type of clause allowed for greater leeway in setting the price paid by the related parties.

[160] Against this backdrop, I cannot conclude that the Appellant, knew, or, for that matter, was wilfully blind to the fact, that the valuation performed by Ms. King could not be relied upon to determine the fair market value of MDPC as at January 13, 2012 and be used to set the price for which the 85 Class B, C and D common shares were sold to the Appellant's family members.

[161] Considering all of the above, I conclude that the Respondent has failed to satisfy her legal burden and, as a result, gross negligence penalties were improperly imposed by the Minister on the Appellant.

[162] For all of these reasons, the Appellant's appeal is allowed only in part. The assessments are returned to the Minister for reconsideration and reassessment in accordance with these reasons for judgment.

These Reasons for Judgment are issued in substitution for the Reasons for Judgment dated June 14th, 2017.

Signed at Ottawa, Canada, this 20th day of June 2017.

---

[72] *Udell v. Minister of National Revenue*, [1970] Ex. C.R. 176 at 190 and 192, [1969] C.T.C. 704 at 713-14.

“Robert J. Hogan”

Hogan J.

CITATION:	2017 TCC 112
COURT FILE NO.:	2015-1539(IT)G
STYLE OF CAUSE:	DR. DAVID MADY v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	April 3, 4, 5, 6 and 7, 2017
REASONS FOR JUDGMENT BY:	The Honourable Justice Robert J. Hogan
DATE OF JUDGMENT:	June 14, 2017

APPEARANCES:

Counsel for the Appellant:	Vern Krishna**, Q.C.** Alexander Yu Osnat Nemetz (student-at-law)
Counsel for the Respondent:	Suzanie Chua

COUNSEL OF RECORD:

For the Appellant:

Name:	Vern Krishna**, Q.C.**
Firm:	TaxChambers LLP 155 University Avenue, Suite 1230 Toronto, Ontario
For the Respondent:	William F. Pentney Deputy Attorney General of Canada Ottawa, Canada