

BETWEEN:

BEAUDET CLAUDE ET SAUCIER ALAIN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on October 24 and 25, 2013, at Montreal, Quebec.

Before: The Honourable Justice Lucie Lamarre

Appearances:

Counsel for the Appellant: Louis-Frédéric Côté
Counsel for the Respondent: Nadja Chatelois

JUDGMENT

The appeal is allowed and the assessment is referred back to the Minister for reassessment on the basis that the fair market value of each building for which the appellant was to make a self-assessment for the purposes of subsection 191(3) of the *Excise Tax Act* is as follows:

6300 Rue de l' Aster	June 1, 2006	\$4,772,612
6400 Rue de l' Aster	June 1, 2007	\$4,907,324
6305 Rue de l' Aster	June 1, 2008	\$5,309,008
6405 Rue de l' Aster	June 1, 2009	\$5,377,459

The appellant is entitled to its costs under Tariff B of the *Tax Court of Canada Rules (General Procedure)* (Rules), as well as an amount of \$300 per day for services rendered by its expert witness in preparing his report and testifying before the Court, pursuant to subsection 5(2) of Tariff A of the Rules.

Signed at Ottawa, Canada, this 14th day of February 2014.

"Lucie Lamarre"

Lamarre J.

Translation certified true
on this 29th day of July 2014.

Erich Klein, Revisor

Citation: 2014 TCC 52
Date: 20140214
Docket: 2011-3600(GST)G

BETWEEN:

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REASONS FOR JUDGMENT

Lamarre J.

[1] The appellant is an undeclared partnership made up of two partners, Claude Beaudet, chartered appraiser, and Alain Saucier, actuary. This partnership operates a business that builds multiple unit residential complexes for rental purposes. During the period from April 1, 2006, to June 30, 2009, it built four buildings, all located on one lot that it had acquired in 2003, governed by a co-ownership agreement signed in 2008 and having street addresses 6300, 6400, 6305 and 6405 Rue de l' Aster, Québec. This project was known as "Les Jardins de l' Aster" and was built in four phases, one building per year. Since these buildings were constructed by the appellant, which became the owner in the course of its commercial activities (namely renting apartment units), it is deemed to have paid as a recipient and collected as a supplier the tax in respect of the supply of these buildings, calculated on the fair market value (FMV) of each building on the day the work was substantially completed or, if later, the day it gave possession of the apartment building or an apartment in that building to a tenant. This is a self-assessment by the builder for the self-supply of a multiple unit residential complex, pursuant to subsection 191(3) of the *Excise Tax Act* (ETA). This statutory provision states the following:

191(3) Self-supply of multiple unit residential complex — For the purposes of this Part, where

(a) the construction or substantial renovation of a multiple unit residential complex is substantially completed,

(b) the builder of the complex

(i) gives, to a particular person who is not a purchaser under an agreement of purchase and sale of the complex, possession or use of any residential unit in the complex under a lease, licence or similar arrangement entered into for the purpose of the occupancy of the unit by an individual as a place of residence,

(i.1) gives possession or use of any residential unit in the complex to a particular person under an agreement for

(A) the supply by way of sale of the building or part thereof forming part of the complex, and

(B) the supply by way of lease of the land forming part of the complex or the supply of such a lease by way of assignment, or

(ii) where the builder is an individual, occupies any residential unit in the complex as a place of residence, and

(c) the builder, the particular person, or an individual who has entered into a lease, licence or similar arrangement in respect of a residential unit in the complex with the particular person, is the first individual to occupy a residential unit in the complex as a place of residence after substantial completion of the construction or renovation,

the builder shall be deemed

(d) to have made and received, at the later of the time the construction or substantial renovation is substantially completed and the time possession or use of the unit is so given to the particular person or the unit is so occupied by the builder, a taxable supply by way of sale of the complex, and

(e) to have paid as a recipient and to have collected as a supplier, at the later of those times, tax in respect of the supply calculated on the fair market value of the complex at the later of those times.

I Issue

[2] The issue is the market value of each of the buildings on the respective dates the first units were occupied by the first tenants, namely:

6300 Rue de l' Aster

June 1, 2006

6400 Rue de l' Aster

June 1, 2007

6305 Rue de l' Aster
6405 Rue de l' Aster

June 1, 2008
June 1, 2009

(See expert reports, Exhibit A-2, page 3, and Exhibit I-1, page 3.)

[3] The appellant is of the opinion that this market value, in a self-assessment context, corresponds to the construction costs (Exhibit A-2, page 52).

[4] The respondent, on the other hand, favoured the value established using the comparison method (comparable sales) and income method (value based on the income the building can generate) (Exhibit I-1, page 69).

[5] Thus the respective values of the buildings as determined by each of the experts are as follows (Exhibit A-2, page 53, and Exhibit I-1, page 71):

		Value Determined	
		Appellant	Respondent
6300 de l' Aster	June 1, 2006	\$4,450,000	\$5,054,000
6400 de l' Aster	June 1, 2007	\$4,550,000	\$5,524,000
6305 de l' Aster	June 1, 2008	\$4,900,000	\$5,859,000
6405 de l' Aster	June 1, 2009	\$5,150,000	\$6,335,000

II Facts established by the evidence

[6] The two partners call themselves real estate investors. Since 1984, they have been purchasing land on which they build apartment buildings for rental purposes. In 1989, they created their company, Beudet Saucier Inc., which acted as a building contractor. To date, they have built 26 buildings with a total of 1,400 units. Since the goods and services tax (GST) was introduced in 1991, they have always "self-assessed" on the basis of construction costs. This was never questioned by government authorities until July 2010, when the Agence du revenu du Québec (ARQ) adopted a different position for the period at issue. According to the auditor, Alain Tremblay, the ARQ assessment service had never conducted a specific assessment before. This was only done in 2010.

[7] According to Mr. Beudet, who is a chartered appraiser, the value of the consideration for self-assessment purposes is the amount an investor is ready to pay

to acquire the building for the purpose of carrying on a business renting the apartments in that building. He considers that this value corresponds to the construction costs. Included in the construction costs are the builder's profit on labour and the worksite mobilization costs (fixed costs such as trailers, temporary electrical service, and equipment).

[8] In his opinion, subsequent financial success or failure is not an element to be considered. He explained that, for the ARQ, the value for self-assessment purposes is the fair market value of a building that is already in operation in a secondary market (with a history of rental income and operating costs and with financing in place). Mr. Beaudet is of the view that the building should rather be assessed in a primary market (that is, on the basis of the cost of the building, which includes the price of the land and the cost of construction, on day one). He submits that as long as there is no history, future profitability cannot be accurately determined, and this is why, in his view, the building cannot be assessed in a secondary market for self-assessment purposes.

[9] Mr. Beaudet further explained that the appellant had thought it appropriate to make a downward adjustment of the actual costs to take into account unusual problems related to soil tests that had given unfavourable results with regard to bearing capacity, which occasioned exceptional additional excavation costs and a greater use of concrete and steel.

[10] Similarly, there was an unusual cost overrun because the first building had to be built over a condensed period of five months following a default by the business that was to have manufactured the buildings at the factory. There were also unexpected issues with inadequate soundproofing between the rental units and with water leaking through the roof. All this led to unexpected additional costs that, in his opinion, should not be taken into consideration when establishing the value of the buildings for self-assessment purposes. Mr. Beaudet also referred to the fact that a certain percentage of the parking area could not be rented because of its use for building maintenance purposes. Lastly, the swimming pool for the four buildings was only built in 2008 and did not open until 2009.

III Expert testimony

A. Testimony of the appellant's expert

[11] Jérôme Lampron, chartered appraiser, testified as an independent expert for the appellant. He more or less repeated Mr. Beaudet's statements that, in a self-

assessment context, the appraisal should be based on a building that is still empty and not yet in operation (which he, as did Mr. Beaudet, describes as the primary market, as opposed to the secondary market, in which rental buildings are already on the market). In this context, although he analyzed three appraisal methods, he selected the cost method as the most appropriate.

(1) Cost method

[12] Mr. Lampron explained that the most reliable method for appraising a building that has just been constructed and is not yet on the rental market is to establish its value using construction costs. He determines cost using actual production costs, that is, the cost of the land, the physical components of the building, labour and the builder's profit (which corresponds to the total amount the contractor charges the appellant for delivering the building before the appellant begins operating it).

[13] He established these costs using invoices, contracts and accounting records, which had been double-checked in the preparation of his report. Moreover, he added to the construction costs the cost of the project manager hired by the appellant to complete the building finish because this cost had not initially been included in the builder's project cost.

[14] The market value of the land was determined using the actual cost (purchase price of \$245,000, to which were added the various costs incurred, after acquisition, for the development of the site for the overall project: Exhibit A-2, pages 20-21) and verified by the comparison method using transactions on vacant lots, and thus comparing the unit rate per square foot. Since the four buildings were constructed in four phases over four years on a single lot, with each building holding a share of 25% under a declaration of co-ownership, Mr. Lampron allocated 25% of the determined cost of the land to each of the buildings. Mr. Lampron accordingly calculated the actual cost of the land at \$1,391,862, which he divided into four for each phase, thus giving the land a value of \$350,000 per building (Exhibit A-2, pages 21 to 24). He determined that this amounted to \$5.26 per square foot, which accurately reflects the price per square foot of comparable land, in his opinion. He also determined that the price per unit of \$5,374 which he arrived at was in the range of the market rate per unit for a comparable project (between \$5,000 and \$6,000 per unit) (Exhibit A-2, page 23).

[15] With regard to the buildings, as mentioned above, the expert used the actual costs incurred to carry out the project because these were new buildings. Additionally, he concurs with Mr. Beaudet with regard to the downward adjustment

of these costs to take into account extra construction costs that should not, in his opinion, be included when establishing the market value of a building.

[16] In that regard, he noted labour costs that were abnormally high for the construction of the first three buildings. He compared the number of hours per unit generally required in the construction of a residential rental building (around 165 hours/unit) with the hours compiled in this case (256 hours/unit for Phase I, 205 hours/unit for Phase II and 218 hours/unit for Phase III). As Mr. Beaudet had explained, these extra hours are attributable to the fact that, initially, the first building was to have been factory-built but in the end had to be built by a contractor in five months (therefore requiring additional labour). As for the next two buildings, the additional cost is attributable to poor management by the contractor in charge. For Phase IV, the developer changed the team of employees on the worksite and construction was carried out in the standard number of hours (Exhibit A-2, page 27).

[17] The second downward adjustment is for additional costs related to the bearing capacity of the ground. In comparison with a similar construction project, but where there was adequate bearing capacity, the expert considered that there were cost overruns due to a greater use of concrete and steel and to additional costs for laying the foundations. He deducted \$102,000 for obsolescence (depreciation) from the construction cost of each phase (Exhibit A-2, page 28).

[18] The third adjustment is for poor soundproofing between the apartment units and for water leaking from the roof, to which Mr. Beaudet referred. He calculated an amount of \$179,000 per building for functional obsolescence in relation to these problems.

[19] The expert arrived at a depreciated replacement cost, which he used to establish the final value of each building (including the value of the land) according to the cost method, and which he used for the purposes of the appeal before this court, namely the amounts at paragraph 5 of my reasons (see Exhibit A-2, page 30).

(2) Comparison method

[20] Mr. Lampron did not adopt the comparison method because he could not find any comparable sales on the primary market. He felt that taking sales from the secondary market involves too many adjustments, making the result difficult to rely on. These adjustments consist in subtracting from the value of the building on the secondary market the developer's profit (estimated at 5% of the cost of a project) as well as the promotional costs related to launching the project (advertising, office

costs, wages and unit delivery costs, and usual rental losses an investor can anticipate) (Exhibit A-2, pages 35 and 36).

(3) Income method

[21] He did not adopt the income method either because it consists in determining the value of a building using the expected net income adjusted by the application of an overall discount rate (ODR). This rate is established on the basis of comparable sales. As with the comparison method, the expert did not find any comparable sales in the primary market, but had to fall back on sales in the secondary market. The ODR was therefore established on the basis of sales in the secondary market, which, he repeated, is not adequate in a self-assessment context. He concluded that this method was too indirect (transcript, Volume 1, page 134, Exhibit A-2, page 52). However, he went through the exercise of establishing the value using this method nonetheless (Exhibit A-2, page 50). I will come back to his approach in my analysis of the approach used by the respondent's expert, and highlight the differences.

B. Testimony of the respondent's expert

[22] Jacques Flynn, chartered appraiser, was mandated by the ARQ in 2011 to appraise the four buildings in question for self-assessment purposes. He conducted the appraisal using three methods: the cost method, the comparison method and the income method. He stated that he ultimately decided to use the results from the last two methods (Exhibit I-1, page 69).

(1) Cost method

[23] At the outset, Mr. Flynn explained that cost overruns that occur for various reasons in the construction of a building have an impact on the cost for the contractor, but do not necessarily influence the value of the building for a potential buyer (transcript, Volume 1, pages 165-167).

[24] Moreover, he noted that one must be careful to verify what the workers worked on before suggesting that there was an additional labour cost per unit, as the appellant's expert contended. He argues that this additional labour cost could very well have been for the construction of additional parking or the swimming pool or for laying sod on the property. He also stated that even though it was built at the end of the project, the swimming pool was part of the project's overall promotional plan and

it had to be taken into consideration from the start in appraising Phase I (transcript, Volume 1, pages 170-171).

[25] Mr. Flynn first did an analysis using the cost method (adopted by the appellant's expert) to establish the value of the land and the buildings for self-assessment purposes on the various dates mentioned above.

[26] With regard to the land, he noted that the appellant paid \$245,000 for it according to the contract of sale signed August 19, 2003, following an offer to purchase made in 1992 (Exhibit I-2). He calculated that this represented \$1.17 per square foot, which was the value established in 1992.

[27] For self-assessment purposes, Mr. Flynn reappraised the land as at the specific dates noted above, namely June 1, 2006, 2007, 2008 and 2009.

[28] To do this, he analyzed 26 transactions made between 2003 and 2009 and involving vacant lots that were used to build multiple unit residential complexes. The appellant's expert had analyzed 10 sales of similar lots. Mr. Flynn observed that the unit price per square foot had gone up to \$6.75 in 2007.

[29] However, contrary to Mr. Lampron (the appellant's expert), Mr. Flynn preferred to conduct a per-unit appraisal (based on the number of units planned in each project) rather than a per-square foot appraisal. Mr. Lampron explained that he did not use the per-unit value because the density (the number of units, which could be different even for lots having the same area) was too variable. Mr. Flynn simply ignored this factor, assuming that all the lots considered for appraisal purposes were comparable and that the units built on these lots were the same size (transcript, Volume 2, page 40).

[30] Mr. Flynn therefore established the value of the land according to a unit price varying from \$6,500 to \$8,000 from Phase I to Phase IV, for a total land value rising from \$435,500 for Phase I to \$512,000 for Phase IV (Exhibit I-1, pages 20 to 23).

[31] To establish the value of the buildings using the cost method, Mr. Flynn relied on the unit-in-place method rather than actual costs as Mr. Lampron had done. The method Mr. Flynn chose was to estimate the replacement cost of each unit, basing his estimate on a catalogue of unit costs. Mr. Flynn chose the American manual, *Marshall & Swift*, which provides estimated replacement costs with conversion tables for each Canadian province. Mr. Lampron dismissed this approach because the buildings had just been built on the appraisal date and there was no need to turn to

this alternative method. He explained that such a manual was useful for estimating the replacement cost of old buildings, but it was far from accurate. Mr. Flynn noted that, since he, unlike the appellant and Mr. Lampron, did not have the actual costs, he resorted to this manual. In cross-examination, it was demonstrated that the cost estimates in this manual seem far from reflecting actual prices in the province of Quebec, which are apparently much lower than those shown in the manual.

[32] Moreover, Mr. Flynn applied a reduction for obsolescence of 5% of the replacement cost for Phase I, 2% for Phase II and 1% for Phase III to take into account the cost overruns related to the soundproofing and roof issues. He also admitted in cross-examination that he did not perform any soil analysis. He added that the appellant was aware of the soil problem before construction began and should have known that it would result in additional costs. In his opinion, this was not an exceptional cost because the appellant, with full knowledge of the facts, decided to go ahead with construction (transcript, Volume 2, pages 24-26).

[33] He ultimately arrived at a total valuation (including the land) under the cost method by using the unit-in-place method (based on *Marshall & Swift*) (Exhibit I-1, page 32). I have reproduced his valuations below, comparing them with those of the appellant's expert (Exhibit A-2, page 30):

	Appellant	Respondent
6300 de l' Aster	\$4,450,000	\$5,125,657
6400 de l' Aster	\$4,550,000	\$5,469,903
6305 de l' Aster	\$4,900,000	\$5,987,045
6405 de l' Aster	\$5,150,000	\$5,947,701

[34] Mr. Flynn also verified the value of the buildings using the cost method the appellant's expert used (Exhibit I-1, page 34, and Exhibit A-2, page 30). He arrived at a higher valuation for the buildings than the appellant. In so doing, he considered financing costs, promotional costs, and the delivery cost of the units, as well as the salaries of the two partners, which, according to him, were indirect costs that were incurred prior to the self-assessment date and that may be included in the mandatory's cost (transcript, Volume 1, pages 209 to 214). Mr. Lampron (the appellant's expert) did not include these costs in his calculation (Exhibit A-2, pages 25 and 30).

[35] Lastly, Mr. Flynn applied the cost comparison method to verify whether the estimated value using the *Marshall & Swift* method was reasonable. He explained

that, for the first year, the value he arrived at for the building was around \$47 per square foot whereas the value determined by the appellant was \$40 to \$42 per square foot (transcript, Volume 1, page 220). According to the market data he had confidentially traced in other ARQ files (which were therefore not available to the appellant), the indicators varied between \$58 and \$93 per square foot (Exhibit I-1, page 35 and transcript, Volume 2, pages 77 to 82). He therefore concluded that the value at which he arrived using the cost method is closer to the price a buyer would have paid to a general contractor for the buildings in question than is the price at which the appellant's expert arrived, even though he concedes that the market prices he used are not necessarily for identical buildings (transcript, Volume 1, page 221).¹

(2) Comparison method

[36] Mr. Flynn himself admitted that this method is not appropriate in this case, but could be useful for verifying the value obtained through the analysis done using the other two methods. As this method consists in reviewing recent sales of similar – to the extent possible – properties on the market, it provides an indicator of market value.

[37] Most of the comparables used in this case were older buildings, without indoor parking, without an elevator, and without a swimming pool. The indicator derived from these comparables is therefore weak (transcript, Volume 2, page 106).

[38] The values Mr. Flynn arrives at using the comparison method (Exhibit I-1, page 57) show differences of between approximately \$100,000 and \$300,000 as compared with the results obtained using the cost method, which, he said, is not a significant disparity.

(3) Income method

[39] According to the experts, this method requires finding the price an investor would pay for a building, considering the net income and expected rate of return on the capital invested (Exhibit I-1, page 58, Exhibit A-2, page 41).

[40] One must begin by determining the potential gross income from the buildings. The two experts made an estimation thereof based on the lists of pre-rentals provided by the appellant. It corresponds to the projected income before delivery of the units

¹ Since the respondent's expert relied on confidential data not available to the appellant, I will not consider this part of his testimony for the purposes of my analysis.

(Exhibit A-2, pages 41 and 44-47; Exhibit I-1, page 58). Mr. Flynn admitted that he had slightly overestimated the parking income because he did not have the exact data.

[41] A reserve of around 3% for vacancies and bad debts was then calculated by each expert.

[42] Next, the effective gross income (EGI) so established must be reduced by the annual operating costs to establish the net income from the building. According to Mr. Flynn, certain expenses, such as custodial services, maintenance, and repairs, must be standardized using reliable standards (which can be obtained, for example, from the Canada Mortgage and Housing Corporation (CMHC)).

[43] Broadly speaking, it can be seen that the appellant's expert determined an expense amount corresponding to 44% of effective gross income, compared to 37% for the respondent's expert (Exhibit A-2, page 45, and Exhibit I-1, page 66). Mr. Flynn stated that, since he did not have the appellant's income statements, he simply took the 2009 expenses that he had and applied them to the previous years. He stated that the actual expenses from 2009, which he had not standardized or updated, are likely higher than they should for the previous years (transcript, Volume 1, page 250). Moreover, Mr. Flynn explained that the appellant's extra expenses could be attributed to the "salary" item, which, in his view, should not be taken into account for the purposes of this exercise (transcript, Volume 1, pages 252 and 253). In his opinion, the fact that the partners decided to manage their property themselves should not be reflected in the value of the building. In his judgment, it would have cost the appellant less to contract out the building management. That is why this item should be standardized. The appellant's expert, in taking into consideration salaries and management, allocated 10% of the effective gross income to these expenses, whereas Mr. Flynn standardized this item at 5% (transcript, Volume 1, pages 256-259, Exhibit I-1, page 66, and Exhibit A-2, pages 44-47).

[44] In his report, the appellant's expert, Mr. Lampron, explained that this salary expense was standardized [TRANSLATION] "using the difference between the assumed actual expenses for rental costs, administrative support, advertising, management, etc., and the standard management fees (4.5% of the EGI) generally assumed for a comparable building". He added that [TRANSLATION] "this higher expense allows, in particular, the rental of units at higher rates than in comparable buildings" (Exhibit A-2, page 42, Salaries). As for the maintenance and repair expenses, which were greater than the amount used by Mr. Flynn, Mr. Lampron explained that he used the actual costs because the building under consideration offered many more services

that the other rental buildings in the area (Exhibit A-2, page 42, Maintenance and Repairs).

[45] As for the ODR which is applied to the net income from the building in order to capitalize its value, Mr. Flynn used a slightly higher rate than Mr. Lampron, which had the effect of reducing its value (transcript, Volume 1, page 249).

[46] Lastly, the respondent's expert, Mr. Flynn, took into account a shortfall of \$23,000 and \$25,000 for the last two buildings only whereas the appellant's expert took into account lost rent varying between \$131,500 and \$137,000 per year (Exhibit I-1, page 66, and Exhibit A-2, page 50). According to the indications Mr. Flynn obtained, the buildings were almost fully rented on the date of the self-assessment. This is why he did not take into account any shortfall for the first two buildings and why he allowed only a small shortfall amount for the two others. In cross-examination, on looking at the [TRANSLATION] "list of pre-rentals" in Appendix C of his report (Exhibit I-1), he admitted that on June 1, 2006, there were 41 of 67 units that were not rented, 21 of 64 not rented on June 1, 2008, and 23 of 64 not rented on June 1, 2009. He stated that this is why he took into account a shortfall for the last two phases (transcript, Volume 2, pages 131 to 134).

[47] Another significant difference between his report and Mr. Lampron's is that Mr. Flynn did not deduct any amount for the developer's profit. According to him, this profit is earned when the building is full. The promotional work was thus, in his opinion, practically completed at the time of the self-assessment and there is no reason not to consider the developer's profit.

[48] Mr. Flynn believes that the promotional costs (advertising, office costs, salaries and delivery charges) deducted by the appellant should not be handled in this way (Exhibit A-2, page 50). These expenses are already included in the price charged to tenants, in accordance with the principle of anticipation (transcript, Volume 1, page 265). That, according to him, is the main difference between Mr. Lampron's result and his own, that is, the treatment of the promotional expenses (transcript, Volume 1, page 266).

[49] As for the soundproofing and roof expenses, he took them into account in the [TRANSLATION] "building reserve" item in the proportion of 2.5% (Exhibit I-1, page 66).

[50] Mr. Flynn further stated that he had never seen in the literature the distinction Mr. Lampron made between the primary market and the secondary market

(transcript, Volume 1, page 265). He mentions, however, at page 36 of his report (Exhibit I-1), with regard to the comparison method, that [TRANSLATION] "it is rare for an appraiser to find significant sales of new buildings in the primary market". In cross-examination, he also explained that one speaks of a primary market where there is a sale between a builder and a buyer, and that in such cases one seeks to determine the minimum price a contractor would be willing to sell for (transcript, Volume 2, pages 75-76).

(4) Correlation

[51] Mr. Flynn concluded that all three methods gave practically the same indicator, within \$100,000, for the first three buildings. It was only for the fourth building that the appraisal using the income method resulted in a considerable difference of \$300,000 (more) compared to the value established using the cost method (a difference of 5%). The production cost did not really change, but the market shot up following the drop in mortgage rates. He said he used the income method precisely in order to quantify this difference, which represented the developer's profit (transcript, Volume 1, page 268, line 26, and Volume 2, pages 45 and 46). However, in his report, he seems to come to a slightly different valuation for the first two buildings and notes that he used the indications obtained using the comparison method and the income method. The results he ultimately used (Exhibit I-1, page 69) are those found at paragraph 5 of my reasons.

[52] Moreover, Mr. Flynn filed in evidence an appraisal report prepared for the appellant's financial institution in July 2005 for financing purposes (Exhibit I-4). The market value of the building (Phase I) at that time was assessed at \$5,800,000 (Exhibit I-4, page 3) and the appellant obtained a hypothec of \$5,440,000 (Exhibit I-4, tab 2).

IV Analysis

[53] The parties agree that the sole issue is the fair market value of the four buildings on the dates used for the self-assessment, namely June 1, 2006, 2007, 2008 and 2009.

[54] The expression "fair market value" is defined at subsection 123(1) of the ETA as follows:

DIVISION I INTERPRETATION

123. (1) In section 121, this Part and Schedules V to X,

“fair market value” of property or a service supplied to a person means the fair market value of the property or service without reference to any tax excluded by section 154 from the consideration for the supply.

[55] The two experts referred to policy statement P-165R, "Fair Market Value for Purposes of Part IX of the *Excise Tax Act*", published by the Canada Revenue Agency (CRA), in which, under the heading "Fair Market Value", the Minister's position is described as follows: "Generally, the Department's [Revenu Québec's] position is that fair market value represents the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact" (Exhibit A-2, page 5, Exhibit I-1, page 3).

[56] The two experts disagree about the appraisal method for estimating the fair market value in this case. The appellant's expert is of the opinion that the value, in a self-assessment context, corresponds to the value which would be established in a notional contractual agreement with regard to a substantially completed building ready to receive its first occupants. On the appraisal date defined in the ETA, the realization of the project's profitability remains an expectation. Mr. Lampron considers that the fair market value in a self-assessment context corresponds to the price of a property on the primary market, that is, its value established on the basis of production costs, i.e. the cost of the land, the building components, labour and the builder's profit.

[57] Mr. Lampron further states that the developer's profit should not be considered in the appraisal at this stage because what is being appraised is the building (including the land) as such, not the business carried on, namely a residential leasing business, which is subject to secondary market forces (Exhibit A-2, pages 5-6).

[58] As for the respondent's expert, he does not distinguish between the primary and secondary markets. He considers it wrong to say that the cost of production with respect to a property is solely the sum of the property's physical components. In his view, the property to be assessed is a building that has been sold and with which income is associated by virtue of a lease. In his opinion, the leases are part of the sale of the building and all the rental and management activities give added value to the whole of the elements that make up the property (Exhibit I-1, page 70). He therefore includes the developer's profit in his appraisal.

[59] Thus, as has been amply explained, the appellant's expert applied the cost method using the adjusted actual costs. The respondent's expert emphasized that the developer's profit must be determined using the comparison or the income method, and then added to the value established by the cost method. He noted that, for the first three buildings, he arrived at roughly the same result with each of the appraisal methods. It was only for the fourth building that the value estimated on the basis of income was higher, by around 5%, than the value estimated by cost, and this is why he used the income method in the end.

A. Method used by the Court for self-assessment purposes: cost method

[60] In my opinion, since the respondent's expert integrated the developer's profit into his estimated value in any case, regardless of the method used, I believe that the cost method can quite readily be used in this case and that what must now be decided is which components are to be taken into account in using this method to arrive at the value on which the self-assessment will be based. The cost method of appraisal is moreover the one that has generally been used by this court for self-assessment purposes (see *Desjardins v. Canada*, 2010 TCC 521, [2010] T.C.J. No. 401 (QL), [2010] G.S.T.C. 179; *9103-9438 Québec Inc. v. Canada*, 2004 TCC 466, [2004] T.C.J. No. 361 (QL), [2005] G.S.T.C. 95; *Charleswood Legion Non-Profit Housing Inc. v. Canada*, [1998] T.C.J. No. 503 (QL), [1998] G.S.T.C. 65). Moreover, this court may accept or reject, in whole or in part, the opinions offered with regard to the valuation of property to be appraised, and may itself estimate the value, taking into account the admissible evidence available to it (*Petro-Canada v. Canada*, 2004 FCA 158, [2004] F.C.J. No. 734 (QL), 2004 CarswellNat 1163, paragraph 48).

[61] The cost method requires establishing the value of the land on the one hand and the buildings on the other.

(1) Land

[62] The appellant appraised the land using the total cost of the development of the site for the four phases. It arrived at a value of \$1,391,862, for a unit price of \$5.26 per square foot, and a price of \$5,374 per apartment.

[63] This value was allocated equally to each phase, thus giving the land a value of \$350,000 per phase.

[64] The respondent decided to compare sales of vacant lots that were used for the construction of multiple unit residential complexes of various sizes. She arrived at a

total value of close to \$1.9 million, that is, a value between \$6 and \$7.40 per square foot, and a price per unit varying between \$6,500 and \$8,000. The respondent's expert admitted he did not take density into consideration in his comparisons, and that is an element that can cause significant variations in the price per unit (the price per unit will undeniably vary according to the number of units built on the same lot).

[65] I agree with the appellant that it is more accurate to compare on the basis of price per square foot.

[66] On the other hand, I agree with the respondent that the price the appellant paid does not quite correspond to the actual value because it had negotiated the purchase price a number of years earlier. I note, however, that the value assigned to the land by the appraiser who was retained by the financial institution in relation to the granting of a hypothecary loan in 2005 was \$1,463,000, or \$5.50 per square foot (Exhibit I-4, page 3).

[67] I would therefore assign this same value of \$1,463,000 to the land (\$5.50 per square foot), and distribute this value over four years as the appellant did. I therefore arrive at a value for the land of \$365,750 to be included in the cost of the property for each of the phases.

(2) Appraisal of the buildings

(a) *Method used in the appraisal by cost*

[68] For the buildings, the first difference between the experts is the method used in the appraisal by cost. In the appellant's case, actual costs were used. In the respondent's case, a method was used whereby the estimation of costs was based on the *Marshall & Swift* manual. I agree with the appellant that, since the buildings being appraised were new at the appraisal date, it is not necessary to resort to a reference manual that is used for older buildings. In addition, the appellant noted significant differences between the estimated costs of certain building components in the manual and the actual costs.

[69] I will therefore adopt the actual cost method. Each of the experts made adjustments to the actual costs (Exhibit A-2, page 30, and Exhibit I-1, page 34), and I will now analyze these adjustments. This court has accepted the principle that an appraisal by cost can be reduced in cases where there are construction cost overruns, or particular problems with regard to soil contamination, or errors in design or

construction (*Desjardins, supra*, paragraphs 33-34; *Charleswood Legion, supra*, paragraph 47).

(b) *Appellant's adjustments*

(i) Labour

[70] The first adjustment by the appellant was for labour. No such adjustment was made by the respondent. In his report, the respondent's expert assumed that the buildings had been constructed in factory-built sections (Exhibit I-1, page 12). He admitted in court that he was not aware that the appellant had not been able to proceed in this fashion and that it had had to turn to another contractor, resulting in the first building having to be built on an expedited basis over five months. I agree with the appellant that in this context the labour costs were higher than expected and that this must be taken into consideration. With respect to the next two phases, the appellant also made an adjustment based on hours worked in excess of the industry standard. Here, I tend to agree with the respondent: the evidence did not clearly establish the reasons put forward by the appellant. The appellant's expert did not really submit any evidence to support his assertion that 165 is the standard number of hours per unit in the industry. Moreover, the two partners have been involved in the construction of rental buildings for a number of years and I doubt that they would not have maintained control over the hours invoiced during Phases II and III, waiting until Phase IV to correct the situation. Lastly, for appraisal purposes, it would be surprising if the appellant had agreed to sell at a price lower than its actual cost, unless there were particular circumstances as in the first phase.

[71] I therefore accept the adjustment for labour for the first phase only. The appellant took into consideration a difference of 91 hours per unit at the contractor's hourly rate of \$50. The expert calculated this difference on the basis of a standard number of 165 hours per unit. As I am of the opinion that this figure was not proven, I would instead consider a difference determined according to the average number of hours of work in the other phases. A difference of 60 hours at \$50 per hour for Phase I, that is, an adjustment of \$200,000 for 67 units, therefore appears more appropriate to me.

(ii) Bearing capacity

[72] The second adjustment the appellant made was with regard to bearing capacity. In view of the geotechnical study carried out two years after the purchase, which showed very poor soil conditions, the appellant incurred additional costs for

laying the foundations and for unexpected oversizing (Exhibit A-2, page 28). In his report, the respondent's expert indicated that he did not take any soil analysis into account; he thus felt that the quality of the soil and its compaction was adequate (Exhibit I-1, page 6). The respondent therefore did not make any adjustments in this regard.

[73] The appellant's expert compared the expenses in this case with those on a similar-sized project carried out by the same developer in a zone with a better bearing capacity. I agree that the adjustment proposed by the appellant should be made, namely a deduction of \$102,000 from the actual cost for each phase.

(iii) Functional obsolescence: roof and soundproofing

[74] The third adjustment made by the appellant's expert was to reduce the cost by an amount allowed for functional obsolescence for the problems related to the roof and to soundproofing. For the roof, Mr. Lampron used the actual cost of resolving the insulation issue (\$11,000 per building). For the soundproofing, the issues seem to have been caused by the fact that the construction was carried out according to plans drawn up for assembly in factory whereas assembly in fact took place at the actual location of the building. Mr. Lampron therefore calculated the adjustment on the basis of a contractor's tender for the necessary corrective work (\$168,000 per building) (Exhibit A-2, pages 29 and 30). The respondent's expert, not having the actual costs, chose to apply a combined reduction for obsolescence of 5% for the first building (\$243,000), 2% for the second building (\$101,000), 1% for the third building (\$55,000) and nothing for the fourth building, stating that the problems should have been resolved by the time Phase IV began (Exhibit I-1, pages 30 and 32 to 34). Since Mr. Flynn admitted, by allowing for obsolescence, that the problems related to the roof and soundproofing could affect the value and since he did not have the exact amounts while Mr. Lampron based his calculation on the actual figures, I will accept the reduction for functional obsolescence calculated by the appellant for each building.

(c) *Respondent's adjustments*

(i) Financing costs

[75] The respondent added financing costs of 1.5% of the total costs. The appellant did not include any such costs, and provides no explanation for this. At pages 180 to 182 of the *Traité de l'évaluation foncière* by Jean-Guy Desjardins, Éditions Wilson

& Lafleur, Montreal, 1992, which was referred to during the hearing and from which an excerpt was filed in evidence as Exhibit I-3, it is stated that when property is being appraised using the cost method, the costs are made up of three elements: direct costs, indirect costs and the contractor's profit. At page 181, it is stated that the financing costs for the land purchase can be taken into account in the indirect costs. In *Évaluation immobilière, Principes, concepts et pratiques* by Dominique Achour, Éditions Agence d'Arc, Sillery, 1992 (excerpts filed as Exhibit A-3), at page 82, the interest charges on construction financing are also included in indirect costs. A reading of the contract for the purchase of the land (Exhibit I-2) shows no reference to any financing for the purchase of the land, and no evidence was adduced in this regard. Nonetheless, the appellant did secure a \$5,440,000 loan in April 2006, which was related to financing for the first building at issue (Exhibit I-4, tab 2). I therefore agree with the respondent that financing costs should be added. However, I would apply the rate of 1.5% to the total actual costs for the buildings according to the appellant's figures found in the appraisal of the buildings by the cost method, in Exhibit A-2, page 30.

(ii) Promotional, advertising and project management fees and contractor's profit

[76] Finally, the respondent increased the cost of the buildings by an estimated amount of \$30,000 per building for promotion and advertising, as well as an amount corresponding to 5% of the total costs to take into account the project management fees normally charged by the general contractor (in this case, the appellant, which for its part did not calculate any amount for such fees). These additional costs are part of the developer's costs, which the appellant did not see fit to include in the appraisal for self-assessment purposes.

[77] At this point, the respondent's expert considers the cost method to be practically identical to the income method. His opinion is that the value of the buildings, even using the cost method, must take into consideration the rental income from each building and that therefore the cost should be increased by the costs incurred by the appellant as developer to make the project eventually viable. Thus, in his opinion since the partners invested time in the project and incurred promotional costs and costs for signing leases, these indirect costs are part of the cost of the project on the date of the self-assessment. The appellant, however, contends that in a primary market these costs should not be taken into consideration for appraisal purposes as they are related rather to a business in operation. At the time of the self-assessment, according to the appellant, the building was still empty and no judgment

can be made as to rental performance and the amount of the resulting expenses for each building.

[78] The respondent's expert, Mr. Flynn, noted in court that the two partners paid themselves salaries of \$100,000 in the first two years, but a minimal salary in the last two years (transcript, Volume 1, pages 211-12). He himself standardized the expense related to management, indicating management fees varying between \$238,136 and \$263,695 over the four years (Exhibit I-1, page 34).

[79] In the *Traité de l'évaluation foncière* by Jean-Guy Desjardins, cited above, the author seems to distinguish between indirect costs and the contractor's profit. In indirect costs he includes, among other things, advertising costs and those related to leasing and sales, as well as the contractor's administration fees. These can be expressed as a percentage of the direct costs. As for the contractor's profit, he stresses that it varies, depending on, among other things, economic circumstances, and that it is essential that the appraiser first verify the market conditions to be sure that such a contractor's profit exists. On this point, he refers in a footnote to the following from *Real Estate Appraising in Canada*, The Appraisal Institute of Canada, 3rd Edition, 1987, pages 158 and 159:

35. *Real Estate appraisal in Canada*, The Appraisal Institute of Canada, 3rd Edition, 1987, pages 158 and 159.

Entrepreneurial Profit

It is a common mistake to assume that the cost approach sets the upper limit of value as based on the principle of substitution, although sometimes true in the residential market, the cost approach result is often far below the actual market value when applied to other classes of property. This occurs when a sale is made of an income property where the leasing of that property by the developer has created an addition to so-called hard costs which cannot be found by summation of land value and construction costs. Nonetheless, it is quite apparent from the price paid by an informed purchaser that such a phenomenon is a function of the market place. Under conditions of perfect competition, value cannot exceed the cost of producing a product for long. Entrepreneurs would soon enter the market and partake in the large profits produced. The principle of competition dictates that such a flood would result in the lowering of prices. Real estate, however, does not operate under ideal conditions and, hence, value may exceed costs.

There are four primary reasons why real estate fails to conform to perfect competition. First, some sites are unique or limited in number either because of the physical qualities of the area or because other sites cannot be made available. Second, zoning laws may limit the areas of competing uses. Third,

license laws, regulating agencies or clauses in leases may prevent the establishment of competing units. Fourth, the restrictions may temporarily prevent new competing construction. Communities have, for example, declined to issue building permits for home or apartment construction due to crowded schools.

Such barriers to free competition require time and effort to overcome. The ability of a developer to do so, coordinate a parcel of real estate and arrange a proper lease on it, requires a payment which should be recognized as a cost. It is recognized in the market place by purchasers and should logically be considered by appraisers when applying the cost approach.

Over-compensating, however, is not the solution. Care must be taken not to readily accept entrepreneurial profit as inherent in most real property. It can be recognized in cases where the cost approach results in a very low value indication when compared to the results of other approaches. If there is evidence of a possible entrepreneurial profit, it should be listed separately rather than being apportioned between land and building values.

[80] What I draw from this is that in an ideal competitive market, the substitution test enables one to verify that a rational user is not paying more for a building than the price that user should pay for an identical and substitutable building (see also, *Évaluation immobilière, supra*, by Dominique Achour, page 26). However, this ideal competitive market may be affected for various reasons, such as the construction of the building on a unique site or in an area with special zoning or that is regulated by various restrictions limiting the construction of apartments in the area. In that case, the market value could exceed the cost of construction. The appraiser is nevertheless warned to be careful not to integrate the contractor's profit into the cost of the property as being inherent therein.

[81] In my opinion, I was not presented with evidence that the various above-noted elements that could mitigate the conditions of an ideal competitive market were present in this case (there was no evidence of specific zoning regulations or of any restrictions at all). On the contrary, it is the case, rather, that the construction site turned out to be problematic following a soil study conducted after the appellant purchased the land. Moreover, the respondent acknowledged that it was only for the last phase, in 2009, that her expert established a significantly higher value for the building by taking into account the contractor's profit. The expert explained that this was due to the drop in mortgage rates at that time. In my opinion, this estimated profit should not be taken into consideration here for self-assessment purposes since, although the fourth building was constructed in a year in which an increase in building values was possible, this building was part of an overall plan developed at the beginning of the construction of the first building in 2006. It was very difficult at

that time to predict the drop in mortgage rates in 2009. Additionally, the evidence shows that 35% of the units still had not been rented at the time the building was ready to be occupied in 2009.

[82] I therefore conclude that, since what is involved is the construction of an entire four-building complex, the same appraisal method should be applied for each building on the respective self-assessment dates. In the circumstances, I believe that the application of the substitution test mentioned above and doing the appraisal by the cost method without taking the developer's profit into account are justified.

[83] Since I understand from the literature that indirect costs include promotional and advertising costs as well as certain administrative costs, and that these costs appear to be distinct from what is called the contractor's profit, I would take into account a certain amount for indirect costs for the purpose of determining the value of the buildings. The evidence shows that the appellant paid around \$170,000 for advertising, as well as incurring salary and office expenses of approximately \$120,000, for each building (Exhibit A-2, page 50). The respondent added roughly \$270,000 in total for such costs (including the developer's profit) for the first two buildings and \$290,000 for the last two (Exhibit I-1, page 34). The respondent's expert acknowledged that the advertising costs actually incurred by the appellant were too high to be used for the purposes of the appraisal (he himself had allowed \$30,000 per building) (transcript, Volume 1, page 269, Volume 2, page 72). In the end, I consider it fair to increase the total cost of the buildings by \$150,000 each to take into account the indirect costs.

V Conclusion

[84] Taking the appellant's expert's table in Exhibit A-2, page 30, and making the adjustments I have accepted above (underlined in the table), the final value for each of the phases under the cost method, which is the method I have adopted, is modified as follows:

Cost method – Final value determined by the Court

Appraisal date	Phase I June 1, 2006	Phase II June 1, 2007	Phase III June 1, 2008	Phase IV June 1, 2009
Actual cost of buildings	\$4,667,845	\$4,603,522	\$4,999,269	\$5,066,709
<u>Financing costs (1.5%)</u>	<u>\$70,017</u>	<u>\$69,052</u>	<u>\$74,989</u>	<u>\$76,000</u>
<u>Total cost</u>	<u>\$4,737,862</u>	<u>\$4,672,574</u>	<u>\$5,074,258</u>	<u>\$5,142,709</u>

Adjustment of actual cost

<u>Labour</u>	(\$200,000)	\$0	\$0	\$0
Bearing capacity	(\$102,000)	(\$102,000)	(\$102,000)	(\$102,000)
<u>Advertising and management fees</u>	\$150,000	\$150,000	\$150,000	\$150,000
<u>Adjusted actual cost</u>	\$4,585,862	\$4,720,574	\$5,122,258	\$5,190,709
Physical deterioration				
Curable	\$0	\$0	\$0	\$0
Incurable	\$0	\$0	\$0	\$0
<u>Cost after physical depreciation</u>	\$4,585,862	\$4,720,574	\$5,122,258	\$5,190,709
Obsolescence				
Functional				
Roof	(\$11,000)	(\$11,000)	(\$11,000)	(\$11,000)
Soundproofing	(\$168,000)	(\$168,000)	(\$168,000)	(\$168,000)
Economic	\$0	\$0	\$0	\$0
<u>Depreciated replacement cost</u>	\$4,406,862	\$4,541,574	\$4,943,258	\$5,011,709
<u>Market value of land</u>	\$365,750	\$365,750	\$365,750	\$365,750
Final value according to the Court	\$4,772,612	\$4,907,324	\$5,309,008	\$5,377,459

[85] I note that the value of the hypothecary loan the appellant obtained to finance the first building was \$5,440,000. However, this loan was guaranteed to the extent of \$800,000 by another building the appellant owned (Exhibit I-4, tab 2, page 3, article 5.2), which reduces the value attributable to the first building to \$4,640,000. Moreover, the municipal assessment for the first building when the financing for it was obtained was \$4,616,455 (Exhibit I-4, tab 1, page 13). Lastly, the value of \$5,800,000 determined by the financial institution's appraiser in 2005 was based on the assumption that the building was entirely factory-built, that there was no soil contamination problem, that the level of soundproofing was satisfactory and that all the leases were signed (Exhibit I-4, tab 1, pages 3, 4 and 16). The evidence showed that such was not the case. In the circumstances, the final value I have arrived at by reconciling the adjustments made by the two experts seems reasonable to me.

VI Decision

[86] The appeal is allowed and the assessment is referred back to the Minister for reassessment on the basis that the fair market value of each building for which the

appellant was to make a self-assessment for the purposes of subsection 191(3) of the ETA is as follows:

6300 Rue de l' Aster	June 1, 2006	\$4,772,612
6400 Rue de l' Aster	June 1, 2007	\$4,907,324
6305 Rue de l' Aster	June 1, 2008	\$5,309,008
6405 Rue de l' Aster	June 1, 2009	\$5,377,459

[87] The appellant is entitled to its costs under Tariff B of the *Tax Court of Canada Rules (General Procedure)* (Rules), as well as an amount of \$300 per day for services rendered by its expert witness in preparing his report and testifying before the Court, pursuant to subsection 5(2) of Tariff A of the Rules.

Signed at Ottawa, Canada, this 14th day of February 2014.

"Lucie Lamarre"

Lamarre J.

Translation certified true
on this 29th day of July 2014.

Erich Klein, Revisor

CITATION: 2014 TCC 52

COURT FILE NO.: 2011-3600(GST)G

STYLE OF CAUSE: BEAUDET CLAUDE ET SAUCIER ALAIN
v. HER MAJESTY THE QUEEN

PLACE OF HEARING: Montreal, Quebec

DATE OF HEARING: October 24 and 25, 2013

REASONS FOR JUDGMENT BY: The Honourable Justice Lucie Lamarre

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APPEARANCES:

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