BETWEEN:

BEN'S LIMITED ..... APPELLANT;

1955
June 20
Oct. 28

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

Revenue—Income—Income tax—The Income Tax Act, S. of C. 1948, c. 52, ss. 11(1)(a), 12(1)(a)(b)—Capital cost of property—Capital outlay—Income Tax Regulations, sections 1100(1)(a), 1102(1)(c) and Schedule B—Deductions in respect of property—Property not acquired for the purpose of gaining or producing income—Appeal from Income Tax Appeal Board dismissed.

Appellant whose expanding business required further accommodation purchased three adjoining properties for $42,832.65, each property consisting of land and a dwelling house. Sometime later the buildings were sold for $1,200 and removed, leaving the land as a site on which a concrete extension was added to the main plant. In its tax return for 1952 appellant claimed a 10% deduction for capital cost allowance in respect of the three buildings. This was disallowed by the Minister on the ground that the entire amount of $42,832.65 was paid for the purpose of acquiring the site on which the extension had been erected and that no portion of the payment was expended for the purpose of acquiring depreciable assets. An appeal from the assessment to the Income Tax Appeal Board was dismissed and on an appeal from the Board's decision this Court

(1) (1907) 24 T. L. R. 16.

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Held: That on the evidence as a whole the sole purpose in making the purchase was to acquire a site for the extension of the factory. There never was any intention to acquire the frame houses for gaining or producing income; the sole intention in regard to the houses was to have them torn down and removed at the earliest possible moment, and that purpose was carried out. The mere fact that certain amounts of rental were obtained from one is attributable to the existing leases and does not affect in any way the real purpose of acquisition. Section 1102(*a*)(*c*) of the Regulations therefore bars the frame houses, under the circumstances, from being property which was subject to capital cost allowance.

2. That although entitled under s. 1100(1) of the Regulations to the actual cost to it of erecting the cement extension appellant cannot here claim the net cost to it of the dwelling houses as part of the capital cost of the cement extension. What is to be ascertained is the capital cost of the "building", namely, the cement extension, and not the capital cost of some other buildings which were previously upon the property.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Cameron at Halifax.

F. D. Smith, Q.C. for appellant.

G. S. Cowan, Q.C. and *E. S. MacLatchy* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

CAMERON J. now (October 28, 1955) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board dated September 7, 1954, whereby the appellant's appeal in respect of its income tax assessment for the taxation year 1952 was dismissed and a re-assessment made upon it and dated January 11, 1954, was affirmed.

The main facts are not in dispute. The appellant owns and operates a bakery on Pepperell Street in Halifax. In January, 1952, it purchased three adjoining residential properties, each consisting of land and a dwelling house; the total cost of acquiring the three properties was $42,832.65. Early in June of the same year it sold the three buildings for $1,200 and shortly thereafter they were removed from the land. The business of the appellant company had increased and it became necessary to provide additional accommodation for its bakery and equipment. The

three properties in question were acquired with the intention that the houses thereon would be removed and the land used as a site for the extension of the main building. At the time of the purchase, however, this scheme could not be carried out as all the properties were located in R2 Zone (Second Density Residential) under the existing by-laws of the city of Halifax and could not be changed from residential use to commercial or business purposes unless and until the property was re-zoned. Accordingly, on May 21, 1952, the appellant lodged a petition (Exhibit 10) with the council of the city of Halifax and the Town Planning Board to re-zone the properties to C2 Zone (General Business Zone). In the result the proposed amendment to the zoning by-law was passed by the City Council on September 11, 1952, and approved by the Minister of Municipal Affairs on September 20, 1952. Shortly thereafter a contract was awarded for the construction of a concrete extension to the main factory and office building and the new extension was completed early in 1953.

In its T2 income tax return for the year 1952, the appellant stated its costs of acquisition of the three properties (after allowing $1,200 for the amount received on the sale of the buildings) to be $41,632.85, which it apportioned as follows: land—$3,000; buildings—$38,632.85. In respect of these buildings it deducted 10 per cent of that amount ($3,863.28)for capital cost allowance, but the full amount thereof (*inter alia*) was disallowed and added to the declared income in the re-assessment dated January 11, 1954. The appellant was advised that the disallowance was made on the ground that the entire amount had been expended for the purpose of acquiring the site on which the plant addition had been erected and that no portion of the payment was expended for the purpose of acquiring depreciable assets.

Subsequently, in its Notice of Objection, the appellant admitted that the value of the land was $6,000 and the appeal to the Income Tax Appeal Board was on the basis of a capital cost allowance of $35,632.85. The appeal to this Court is based on the same amount.

In its Notice of Appeal to this Court the appellant first submits that it is entitled, for capital cost allowance purposes, to amortize the net amount expended by it in

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acquiring the dwelling houses ($35,632.85) at the rate of 10 per cent, that being the maximum amount applicable to frame dwellings under Class 6 of Schedule B of the Income Tax Regulations referable to capital cost allowances. That submission was also made in the appellant's Notice of Objections, but was abandoned in its Notice of Appeal to the Income Tax Appeal Board and was therefore not considered by the Board.

Alternatively, it is submitted that it is entitled to amortize the net cost to it of the dwelling houses as part of the capital cost of the extension to the cement building at the rate of 5 per cent, that being the maximum amount applicable to cement buildings under Class 3 of Schedule B of the Regulations. That was the submission made to and rejected by the Board.

The relevant sections of the 1948 Income Tax Act are:

12. (1) In computing income, no deduction shall be made in respect of

(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part,

.....

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year

(*a*) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation,

In order to succeed in the appeal, the appellant must therefore bring itself squarely within the regulations made by the Governor in Council under the authority of section 106(1) of the Act.

I shall first consider the main submission of the appellant, namely, that it is entitled to the maximum capital cost allowance of 10 per cent provided for "frame buildings" in Class 6 of Schedule B. The inclusion of that type of building in a class, however, is not conclusive of the right to

capital cost allowance in view of the provisions of section 1102 of the Regulations, the relevant parts of which are as follows:

> 1102. (1) The classes of property described in this Part and in Schedule B to these Regulations shall be deemed not to include property
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> .....
>
> (*c*) that was not acquired by the taxpayer for the purpose of gaining or producing income,

(In passing it may be noted that subsection (2) thereof provides that the classes of property described in Schedule B to these Regulations shall be deemed not to include the land on which a property described therein was constructed or is situated.)

For the Minister it is contended that the property in question (namely, the frame houses) was not acquired by the appellant for the purpose of gaining or producing income, but was acquired merely as part of the land on which they stood; and that the entire outlay was incurred solely for the purpose of acquiring a site for the proposed extension of the main building.

If one were to approach the problem without paying strict attention to the precise wording of the Regulations, it might perhaps be said in general language that the whole of the *outlay* was "for the purpose of gaining or producing income". It was undoubtedly the intention of the appellant—as will be found later—to acquire a site for the purpose of extending its building and thereby increasing its business; in order to do so it had to purchase the land with the buildings. That, briefly, was the submission made on behalf of the appellant.

In my opinion, however, the Regulations require a somewhat different approach to the problem. All property which, *prima facie* at least, is entitled to the capital cost allowances, is broken up into "classes" as set out in Schedule B, and the rate of the applicable allowance for each such class is stated in section 1100 of the Regulations. Then, by section 1102(1)(*c*) of the Regulations (*supra*), these "classes of property" are deemed not to include property that was not acquired for the purpose of gaining or producing income. The only applicable item of property in Class 6 is "a building of frame".

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In my view, therefore, the question is not whether the appellant's outlay as a whole was for the purpose of gaining or producing income, but rather this: "Was the property referred to in Class 6 as 'a building of frame' acquired by the appellant for the purpose of gaining or producing income?"

In the case of *Montship Lines Limited* v. *Minister of National Revenue* (1) (later affirmed in the Supreme Court of Canada), I gave consideration to the meaning of the words "for the purpose of gaining or producing income from property or business of the taxpayer" as used in section 12(1)(*a*) of the 1948 Income Tax Act, words which closely parallel those used in section 1102(1)(*c*) of the Regulations. At page 381 I said:

> Section 12(1)(*a*) of the *Income Tax Act* is a positive enactment and excludes deductions which were not made or incurred by the taxpayer *for the purpose* of gaining or producing income from his property or business, subject, of course, to the specific deductions allowed under Section 11. It is not enough to establish that the dilapidations which occasioned the expenditures arose out of or in the course of the business. It must be established that the *purpose* of the taxpayer in making the outlays was that of gaining or producing income from the business. In the present case I am unable to find that that was the purpose of the officers of the appellant.

However difficult it may be in some cases to ascertain the intention or purpose of a transaction, no such problem here exists. It is abundantly clear from the evidence as a whole that the frame buildings located on the lands purchased were not acquired for the purpose of gaining or producing income and that the sole purpose in making the outlays was that of acquiring the land as a site for the extension of the factory. In the Notice of Objections prepared by or with the knowledge of the owner and the appellant company, the following statements appear:

> In the latter part of 1951 the taxpayer, which had for some time found the concrete building too small for its expanding business, decided to extend the building to the west along Pepperell Street as far as the intersection of Preston Street. Between that building and Preston Street, however, stood three dwelling houses. . . . In order to extend its building westward to cope with the needs of its business, the taxpayer therefore found it necessary to purchase from those persons the dwelling houses and the land on which they stood. The taxpayer did not intend to use the dwelling houses but intended to remove them and build an extension to its concrete building on the land on which they had stood.
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> .....

(1) [1954] Ex. C.R. 376.

The taxpayer's motive in buying both of these separate items (the dwelling houses and the land) was to acquire a site for the extension of its factory building—it had a use for the land but no use for the dwelling houses.

.....

The chief assessor was quite right in saying, in the letter of February 16, 1954, referred to above, "that the entire amount of $41,632.85 was expended for the purpose of acquiring the site on which the plant addition was erected", that was, the taxpayer admits, its motive for acquiring the dwelling houses and its motive for acquiring the land on which they stood.

.....

It is quite immaterial that it never used or intended to use the buildings in its business and that from the beginning it intended and did sell them for removal from the land.

.....

The Notice of Appeal to the Income Tax Appeal Board contains similar statements, some of which are as follows:

The taxpayer did not intend to use the dwelling houses in its business but intended to remove them and build the extension to its concrete building on the land on which they stood.

.....

After acquiring the properties, the taxpayer carried out the intention with which it had acquired them, viz, to remove the dwelling houses and build on the land on which they had stood the extension to its concrete factory and office building.

.....

It is true that its motive in purchasing both land and dwelling houses was to acquire the land as a site for the extension of the concrete building, but that does not alter the fact that it intended to and did in fact purchase both land and dwelling houses.

The truth of these statements was not seriously challenged before me at the hearing. An attempt was made, however, to establish that there was also a second purpose, namely, to use the buildings as they were as storage space for the business or as rent-producing property, if the petition to re-zone the property were denied. It was admitted, however, that the houses could not be put to any commercial use, such as warehousing, unless the by-law were changed. It is a fact that the appellant received rentals from one of the properties for a few months after it became the owner, but that was undoubtedly due to the fact that at the time the properties were acquired the tenants in possession held leases expiring May 1. The appellant secured vacant possession of the other properties at the time of purchase. No attempt was made to re-rent any of the properties at any time and it is patent that the appellant was not interested in renting any of them. What it desired

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was vacant possession so that the buildings could be removed at the earliest possible moment in order to secure the site for the proposed extension. It was not anticipated that there would be any serious difficulty in having the area re-zoned; in fact, the buildings were sold and entirely removed some months before the petition was finally granted. No opposition was filed to the petition.

On the evidence as a whole, I am satisfied that the sole purpose in making the purchase was to acquire a site for the extension of the factory. There never was any intention to acquire the frame houses for gaining or producing income; the sole intention in regard to the houses was to have them torn down and removed at the earliest possible moment, and that purpose was carried out. The mere fact that certain amounts of rental were obtained from one is attributable to the existing leases and does not affect in any way the real purpose of acquisition. Section 1102(*a*)(*c*) of the Regulations therefore bars the frame houses, under the circumstances, from being property which was subject to capital cost allowance. The appeal on this point is therefore disallowed.

The alternative claim, as I have stated above, is that the net cost to the appellant of the dwelling houses is part of the capital cost of the extension to the cement building; and that such net cost—as well as the actual outlay for the construction of the extension itself—may be written off by capital cost allowances at the rate of 5 per cent under Class 3 of Schedule B of the Regulations, that being the maximum rate applicable for a building.

I think it may be assumed that if some portion of the frame building had been incorporated in the new extension, the appellant would have been entitled to a capital cost allowance in respect of the ascertained cost to him of such portion, but nothing of that sort took place here; the buildings in their entirety were removed by the purchaser and the appellant was left with nothing but the land itself.

The applicable allowance to a taxpayer in respect of his capital cost is found in section 1100(1) of the Regulations, as follows:

> 1100. (1) Under paragraph (*a*) of subsection (1) of section 11 of the Act, there is hereby allowed to a taxpayer, in computing his income from a business or property, as the case may be, deductions for each taxation year equal to

(a) such amount as he may claim in respect of property of each of the classes numbered 1 to 12 inclusive, in Schedule B to these Regulations not exceeding in respect of property

.....

(iii) of class 3, 5%

.....

(vi) of class 6, 10%

.....

of the amount remaining, if any, after deducting the amount determined in respect of the class under section 1107 from the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) of property of the class;

In this case the appellant is therefore entitled to the capital cost to him of the property of the class; that is, of the building which is the cement extension. I have no doubt that he has been granted an allowance in respect of the actual cost to him of erecting that extension. I am quite unable to agree, however, that under the circumstances of this case any part of the purchase price which might be properly attributable to the buildings can in any sense be considered as a part of the capital cost of the cement extension. What is to be ascertained is the capital cost of the "building", namely, the cement extension, and not the capital cost of some other buildings which were previously upon the property. This alternative claim of the appellant must also be dismissed.

On the whole, I am satisfied that the entire outlay of the appellant in purchasing the three properties—except for such small amount as might be recovered by the sale of the buildings—was for the purpose of acquiring the land alone. That was practically conceded by the evidence of the president of the appellant company, who also added that had he not thought that he could claim capital cost allowances for what he considered to be the value of the frame buildings (even when torn down), he would not have been satisfied to pay the amounts actually expended. I think the whole of such costs—less salvage of the buildings —was attributable to the land, which, unfortunately for the appellant, is not property subject to capital cost allowances.

The findings which I have made seem to me on the evidence before me to be in accordance with sound accounting practices in Canada. Evidence was given on behalf of

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the respondent by Mr. W. Bermin, a chartered accountant and professor of accounting at Dalhousie University. He cited an extract from "The Accountants' Handbook" by Paton, Third Edition, where at p. 597 he states under the heading "Separation of Land and Building Costs", as follows:

Urban land is often purchased with buildings and other structures thereon which must be removed before the site can be utilized for the purpose intended. In such cases care must be taken that no large amount of the purchase price is attached to the improvements subject to removal. In fact the maximum value of the improvements in such conditions is their *net salvage value,* if any, the balance of the purchase price being the cost of the site.

In auditing Theory and Practice, Sixth Edition, by Montgomery, the following statement appears at page 233:

Cost of Demolished Buildings. When land and buildings are purchased with the intention of demolishing the buildings, the original cost, plus cost of (or less salvage from) the demolition of the buildings, represents the true cost of the land. When the intention to demolish is formed subsequent to purchase, the cost of demolition plus the value allocated to the buildings at time of purchase may represent a realized loss or additional cost of land, according to circumstances. When the demolition follows the discovery of unexpected defects in useful value, no part of the cost of removal of the buildings or of the original cost constitutes a benefit to be realized in the future. When land and buildings are purchased and the amount allocated to the land represents the full worth of the land, the book account for the land must not be increased by an expenditure which does not in fact add anything to the worth. Neither should the cost of new buildings, if any are built, be increased by costs which bear no relation to the additions.

And in Principles of Accounting—Intermediate, by Finney, Third Edition, it is stated at page 308:

Buildings. If a building is purchased, cost includes the purchase price plus all repair charges incurred in making good depreciation which occurred before the building was purchased, as well as all costs of alterations and improvements.

If a building is constructed instead of purchased, the cost includes the material, labor and supervision and other expenses, or the contract price, and a great variety of incidentals, some of which are mentioned below:

(1) If land and an old building which is to be razed are purchased at a flat price, the total cost may be charged to the land. The cost of wrecking, minus any proceeds from the sale of materials, should be charged to the land account.

If an old building, formerly occupied by the business, is replaced, the loss on the retirement of the old building should not be capitalized in the cost of the new.

Finally, the appellant submits that it is entitled to capital cost allowance on the net cost to it of the dwelling house at 149-151 Preston Street at the rate of 10 per cent applicable to frame buildings. This property was one of the three referred to above and it was from that property that a small amount of rent, totalling about $140, was received between the date of purchase and the time when the tenants went out of possession, namely, February 28 and April 30. It is submitted that as this property was purchased subject to the existing leases which expired May 1, the appellant acquired it "for the purpose of gaining or producing income". In view of the evidence which I have set out above as to the sole purpose of the appellant in purchasing all three properties, I am unable to conclude that the possibility of receiving rent for a few months from one of them formed any part of its purpose in making the purchases. There was only one purpose, namely, to secure a site for the extension. I regard the receipt of a few months' rent as a merely fortuitous event. The appellant could not eject the tenants until the leases terminated. The receipt of rent was referable to the existing leases and not to any purpose the officials of the company had in mind as to the use to be made of the buildings.

For these reasons, the appeal from the decision of the Income Tax Appeal Board will be dismissed and the assessment affirmed. The respondent is entitled to costs after taxation.

Judgment accordingly.