Date: 20080715

Docket: A-545-06

Citation: 2008 FCA 238

CORAM: **LINDEN J.A.**
SHARLOW J.A.
TRUDEL J.A.

BETWEEN:

KEVIN WEAVER and JENNIFER WEAVER

Appellants

and

HER MAJESTY THE QUEEN

Respondent

Heard at Vancouver, British Columbia, on June 19, 2008.

Judgment delivered at Ottawa, Ontario, on July 15, 2008.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: LINDEN J.A.
TRUDEL J.A.

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REASONS FOR JUDGMENT

SHARLOW J.A.

[1] The issue in this appeal is whether the appellants Kevin Weaver and Jennifer Weaver are entitled to the "enhanced" capital gain deduction under subsection 110.6(2.1) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as it read in 1998, in respect of the capital gain they realized on the sale of shares of Songhees Retirement Park Ltd. ("SRP"). The Weavers are entitled to that deduction if, at the time of the disposition of the shares, all or substantially all of the fair market value of the assets of SRP was attributable to assets used principally in an active business carried on by SRP. Justice Beaubier of the Tax Court of Canada concluded that this condition was not met (2006 TCC 566). The issue in this appeal is whether Justice Beaubier's conclusion is correct.

Facts

[2] SRP is a Canadian controlled private corporation with a fiscal year ending on October 31. Until sometime in 1998, Kevin Weaver and Jennifer Weaver each owned 25% of the shares of SRP The remainder of the shares of SRP were owned by Bob Malcolm. In 1993, SRP commenced the development of certain land as a retirement community consisting of manufactured homes on leased lots. As the land was located on the New Songhees Indian Reserve, SRP could not obtain title to the land. Instead, it entered into a lease (the "headlease") with the Government of Canada, acting on behalf of the members of the Songhees Band who were in lawful possession of the land.

[3] The term of the headlease was 49 years, commencing on November 1, 1993 and ending on October 31, 2042. The rent payable under the headlease was $90,000 per year for the first five years of the term, and "fair market rent", as determined by the Minister, for each succeeding five year period during the term. The fair market rent for the second five year period of the headlease (November 1, 1998 to October 31, 2003) was approximately $99,000 per year.

[4] The terms of the headlease permitted the creation of lots on the leased land which could be sublet for a term ending one day before the end of the term of the headlease. Rent payable under each sublease consisted of "basic rent", plus an additional amount reflecting the sublessee's proportionate share of the operating costs of the community. The basic rent was set initially at an amount that would ensure a spread between SRP's expected rental revenues and the rent it was required to pay under the headlease for the first five years, assuming all of the lots were sublet. In addition, the sublease provided that the basic rent would increase by the same percentage as the

increase in the rent payable under the headlease. That provision ensured that SRP's expected rental revenue would increase as its rent expense increased. It also ensured that the spread between SRP's expected rental revenue and its rental expense would grow with each rental increase.

[5] SRP developed 95 lots on the leased land, of which 93 were leased to individuals who purchased manufactured homes from SRP for the lots. The last lot was leased and the last home sold at some point in the first three months of 1998. The evidence of Mr. Weaver is that, for each manufactured home sold, SRP provided a one year warranty for finishes and materials, and a five year structural warranty. Until Mr. Weaver ceased being actively involved with SRP in November of 1998, he coordinated the activities of SRP in connection with the warranties. From his evidence, it appears that the one year warranty was the most time consuming.

[6] SRP purchased two other land development properties, referred to as "Selwyn" and "Grafton". The Grafton property was sold in October of 1998 for approximately $315,000, and the Selwyn property was sold in November of 1998 for $500,000. SRP also acquired some publicly traded securities, the value of which is not enough to be of concern in this appeal.

[7] At some point, disagreements arose between the Weavers and Mr. Malcolm. In November of 1998, Mr. Weaver withdrew from active participation in the company. SRP engaged Equitex Management as its agent to provide maintenance and other services for the retirement community for a fee.

[8] On an unspecified date in September of 1998, Mr. Malcolm agreed to buy from the Weavers their shares of SRP for a price equal to one half of the value of the property of SRP. That agreement was not put into writing. When the agreement was reached, SRP owned Selwyn and Grafton, as well as its interests in the headlease and the subleases.

[9] The terms of the agreement governing the sale of the shares of SRP to Mr. Malcolm are set out in a document that was apparently signed on December 10, 1998. The purchase price of the shares is stated as $400,000 plus one-half of the value of the publicly traded securities owned by SRP on December 10, 1998. By that date, SRP had sold Selwyn and Grafton, so that the value of SRP at that time would have been based primarily on the value of SRP's interest in the headlease and the subleases. According to an expert report submitted to the Tax Court, the fair market value of SRP's interests in the headlease and the subleases was $902,000 (based on the anticipated rents and assuming a capitalization factor of 14%).

[10] The proceeds of disposition received by each of the Weavers for their shares of SRP, as reported in their income tax returns for 1998, was approximately $214,500. For each of them, the adjusted cost base of the shares was $100,000 and the costs of disposition were $500. As a result, for each of the Weavers, the capital gain on the disposition of the shares was approximately $114,000. The inclusion rate in 1998 was 75%, so the taxable capital gain for each of them was approximately $85,500, before taking into account any deduction under paragraph 110.6 (2.1) of the *Income Tax Act*. If they were eligible for that deduction, their taxable capital gain would be zero.

Discussion

[11] The entitlement of the Weavers to the enhanced capital gains deduction in respect of the disposition of their shares of SRP depends on the combined operation of a number of complex provisions of the *Income Tax Act*. As this case does not involve a disputed point of statutory interpretation, it is not necessary to quote those provisions at length. A summary of the effect of each of the relevant provisions will suffice.

Date of disposition

[12] First it is necessary to resolve the threshold issue, the date of the disposition of the shares of SRP, because the correct application of the statutory provisions depends on that determination. Justice Beaubier, agreeing with the Minister, concluded that the date of the disposition of the shares was December 10, 1998. The Weavers argue that the disposition occurred in September of 1998, when they reached an oral agreement to sell the shares to Mr. Malcolm for an agreed price.

[13] It is possible, as a matter of law, for the beneficial ownership of property to be transferred by means of an oral agreement, and it is also possible for the transfer of the beneficial ownership of property to precede the transfer of legal title (see, for example, *Lysaght v. Edwards* (1876), 2 Ch. D. 499, *Martin Commercial Fueling Inc. v. Virtanen* (1997), 144 D.L.R. (4th) 290 (B.C.C.A.)). When that occurs, the disposition of the property for income tax purposes is generally the earlier date.

[14] The issue in this case is whether there is evidence of an agreement in September of 1998 that had the effect of passing beneficial ownership of the shares of SRP at that time. The Weavers

rely on the oral evidence of Kevin Weaver and Mr. Malcolm, who both say that they agreed in September of 1998 that the shares would be sold for a price determined as one-half of the value of the assets of SRP. However, there is no evidence that they agreed on a date for the valuation.

[15] The evidence contradicting the position of the Weavers is the written agreement dated December 10, 1998, which states that the sale occurred on December 10, 1998, and also contains a representation by the Weavers that they were the beneficial owners of the shares on December 10, 1998. In addition, the statement of agreed facts submitted to the Tax Court states that the shares were sold on December 10, 1998, and that the Weavers were the beneficial owners of the shares for the 24 month period prior to December 10, 1998. In my view, given this record, Justice Beaubier made no error in concluding that the disposition of the shares occurred on December 10, 1998.

Entitlement to deduction claimed

[16] I turn now to the statutory provisions that must be applied to determine the entitlement of the Weavers to the deduction claimed. Subsection 110.6(2.1) of the *Income Tax Act* permits a reduction in the capital gain realized by the Weavers if the shares met the definition of "qualified small business corporation share" on the date of their disposition. The question is whether the shares of SRP met that definition on December 10, 1998.

[17] The phrase "qualified small business corporation share" is defined in subsection 110.6(1) of the *Income Tax Act*. The definition contains a number of tests that must be met, but for the purposes of this appeal, only one of those conditions is relevant. The key condition is that, "at the

determination time", SRP must have met the definition of "small business corporation". In the context of this case, the determination time is the date of the disposition of the shares of SRP, which is December 10, 1998.

[18] The phrase "small business corporation" is defined in subsection 248(1) of the *Income Tax Act*. The definition is complex. For the purposes of this case it is sufficient to say that SRP would meet that definition if, on December 10, 1998, all or substantially all of the fair market value of the assets of SRP was attributable to assets that were used principally in an "active business" carried on by SRP. I note parenthetically that the Minister generally accepts, as a rule of thumb, that the word "principally" signifies more than 50%, and that the phrase "all or substantially all" signifies 90% or more. In this case, all parties were content to use these guidelines.

[19] The characterization of a business as "active" has long been used as a means of providing preferential tax treatment of various kinds. As a result there is a great deal of jurisprudence on the meaning of the phrase "active business". In *Canada v. Rockmore Investments Ltd.*, [1976] 2 F.C. 428, this Court held that the question of whether a business was "active" was a question of fact, to be determined by the nature and degree of the activity required to generate the revenue of the business. In that case, a business incorporated to invest in mortgages was held to be carrying on an active business. Similarly, in *Canadian Marconi v. R.*, [1986] 2 S.C.R. 522, the Supreme Court of Canada held that the active management of a portfolio of securities obtained with the proceeds of sale of a division of the corporation was an active business. These cases and others adopted a

meaning of “active business” that was so broad that there was very little a corporation might do that would not comprise the carrying on of an active business.

[20] Parliament apparently was concerned that the broad interpretation of “active business” adopted by this Court and the Supreme Court of Canada could mean that corporations earning passive investment income would obtain the tax advantages intended for businesses whose income was the result of a higher level of activity. To meet that concern, the *Income Tax Act* was amended to add the definition of the phrase “active business” in subsection 248(1) and subsection 125(7) of the *Income Tax Act* to mean, *inter alia*, any business carried on by a taxpayer except a business falling within the definition of “specified investment business” (see *Lerric Investments Corp. v. Canada (C.A.)*, [2001] 2 F.C. 608, and *Baker v. Canada*, 2005 FCA 185). At the same time, the phrase “specified investment business” was defined to mean a business, the principal purpose of which is to derive income from property, including interest, dividends, rents and royalties (subject to a number of exceptions that are not relevant to this case).

[21] The Minister argues that the business of SRP at the relevant time (that is, on December 10, 1998) met the definition of “specified investment business” and therefore was not an active business. I summarize the Minister’s reasoning as follows. On December 10, 1998, the assets of SRP consisted of its interests in the headlease and the subleases, a small amount of cash and a few publicly traded securities. Given the relative value of those assets as summarized above, SRP’s interests in the headlease and the subleases comprised all or substantially all of the fair market value of the assets of SRP. On December 10, 1998, those assets were used to derive rental income, and

only rental income. Therefore the business of SRP met the definition of “specified investment business”.

[22] The Weavers do not dispute the facts asserted by the Minister, but they dispute the conclusion. I summarize their argument as follows. The interest of SRP in the headlease and the subleases are the foundational assets from which SRP derived income from its land development business for its 1993 to 1998 fiscal years, which was an active business. By December 10, 1998, that active business was not completely at an end because SRP had continuing obligations under the warranties given to purchasers of the manufactured homes. The continued existence of those warranties on the manufactured homes is enough to establish that the purpose of the business of SRP, as of December 10, 1998, was still that of a land developer rather than an investor in rental properties. Therefore, on that date the business of SRP was still an active business and had not become a specified investment business.

[23] Justice Beaubier noted that, by December 10, 1998, the obligations of SRP under the subleases were the responsibility of Equitex Management, which was retained as the agent of SRP to manage the retirement community on SRP’s behalf. It is not clear whether he intended that observation to be a reason for rejecting the Weavers’ argument. In my view, that would not be a sound basis for concluding that the business of SRP was not an active business. An active business is no less active merely because it is carried on by an agent: *E.S.G. Holdings Ltd. v. Canada*, [1976] C.T.C. 295, 76 D.T.C. 6158 (F.C.A.).

[24] However, Justice Beaubier also noted that, by December 10, 1998, the income of SRP consisted entirely of rent. As I understand his reasons, that was the principal basis for rejecting the Weavers' argument. In my view, Justice Beaubier reached the correct conclusion on this point.

[25] The definition of "specified investment business" does not ask about the general nature of the business of a corporation, or the degree of activity or passivity actually required by that business. Rather, it asks about the legal character of the income that the business is intended principally to earn. If on the relevant date the legal character of that income is rent, for example, then the business meets the definition unless once of the statutory exceptions applies (none of those exceptions is relevant in this case).

[26] As explained above, in determining whether the business of SRP met the definition of "specified investment business" on December 10, 1998, the key question is whether the principal purpose of that business at that time was to derive income from property (such as rent). It is not relevant that SRP carried on an active business before that time. The fact is that on December 10, 1998, almost all of the income of SRP was rent, and almost all of the property of SRP was property that generated and could generate only rental income. Indeed, the terms of the headlease and sublease, which had terms running to October 31, 2042, were structured to result in a steady, and steadily growing, stream of rental income. Except for minor amounts of cash and securities, SRP had no property that was capable of resulting in any kind of income other than rent. The warranties existed, but they were obligations of SRP. They could produce only costs, not income. There is no

evidence of any plans or prospects for SRP that could possibly cause SRP to earn any kind of income other than rent.

[27] In my view, it would not be reasonable on these facts to conclude that the principal purpose of the business of SRP, on December 10, 1998, was to derive anything other than rental income. It follows that the business of SRP on that date was a "specified investment business", and therefore it was not an active business. The inescapable conclusion is that the Weavers are not entitled to the capital gains deduction in respect of the capital gain on the disposition of their shares of SRP.

[28] I have not ignored the argument of the Weavers based on the definition in subsection 129(4) of the *Income Tax Act* which states that the income or loss of a corporation for a taxation year from a source that is a property "does not include the income or loss from any property that is incident to or pertains to an active business carried on by it". I agree with the Minister that this definition applies only for the purposes of section 129 (dividend refunds to private corporations). More importantly, however, it does not address the issue in this case. Perhaps there was a time when it could be said that SRP's interests in the headlease and subleases were properties that were incidental to or that pertained to an active business carried on by SRP. However, that was no longer the case on December 10, 1998.

Conclusion

[29] I would dismiss this appeal with costs.

J.A.

"I agree.
A.M. Linden J.A."

"I agree.
Johanne Trudel J.A.

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-545-06
STYLE OF CAUSE:	Kevin Weaver and Jennirer Weaver v. Her Majesty The Queen
PLACE OF HEARING:	Vancouver, British Columbia
DATE OF HEARING:	June 19, 2008
REASONS FOR JUDGMENT BY:	SHARLOW J.A.
CONCURRED IN BY:	LINDEN J.A. TRUDEL J.A.
DATED:	July 15, 2008

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