Docket: 2004-52(GST)G

BETWEEN:

GRAFTON DEVELOPMENTS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on February 2, 2006 at Halifax, Nova Scotia

Before: The Honourable Justice L.M. Little

Appearances:

Counsel for the Appellant: Raymond G. Adlington

Counsel for the Respondent: John Bodurtha

JUDGMENT

The appeal from assessment no. 01CB-119035251 made under Part IX of the *Excise Tax Act*, notice of which is dated September 23, 2004, is allowed, without costs, for the reasons set out in the attached Reasons for Judgment.

Signed at Vancouver, British Columbia, this 5th day of July 2006.

"L.M. Little"

Little J.

Citation: 2006TCC356
Date: 20060705
Docket: 2004-52(GST)G

BETWEEN:

GRAFTON DEVELOPMENTS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Little J.

A. FACTS

[1] The Appellant is a body corporate incorporated under the Nova Scotia *Companies Act*.

[2] The Appellant is a registrant under the *Excise Tax Act* (the "*Act*") having GST Registration No. R #893689836.

[3] On December 1, 1997 Nasco Consultants Inc. ("Nasco") purchased a property located at 1646 Barrington Street (the "Property") in the City of Halifax, Nova Scotia for a purchase price of $600,000.00.

[4] At the time of the purchase of the Property, it consisted of nine stories including a basement. The Property was used entirely for commercial purposes.

[5] Nasco carried out extensive renovations to the Property and converted four floors of the Property into 19 residential units.

[6] Nasco leased the first residential unit in the Property effective June 1, 2000.

[7] Grafton Developments Inc. ("Grafton") is a body corporate incorporated under the Nova Scotia *Companies Act*. In 2004 Grafton and Nasco were amalgamated and the successor corporation is Grafton.

[8] The Minister of National Revenue (the "Minister") originally determined that the Fair Market Value of the residential portion of the Property on June 1, 2000 was $1,550,000.00. The Minister later determined that the Fair Market Value of the residential portion of the Property on June 1, 2000 was not less than $1,400,000.00.

[9] The Appellant's appraiser determined that the Fair Market Value of the residential portion of the Property on June 1, 1999 was $890,000.00.

[10] On September 23, 2003 the Minister issued a Notice of Reassessment under the *Harmonized Sales Tax Act* ("HST"). The tax assessed under HST with respect to the self-supply of property was calculated by the Minister as follows:

Fair Market Value of Residential Portion of the Property as of May 1, 2000	$1,400,000.00
Multiplied by 15%	x 15%
HST due on Residential Portion	$ 210,000.00

B. ISSUE

[11] The issue to be determined is whether the Appellant was properly assessed by the Minister with respect to HST payable on the conversion of a portion of the non-residential real property to residential apartment units.

C. ANALYSIS

[12] In order to determine if the Reassessment issued by the Minister is correct I must answer the following questions:

A. Whether the Appellant is liable pursuant to subsections 190(1) and 191(3) under Part IX of the *Act* on account of the self-supply rules pertaining to the conversion of the Property from a commercial use property to a mixed use of commercial and residential property.

B. What is the proper date to be applied in this situation?

C. If the Appellant is liable for tax assessed under the "self-supply rules" what was the Fair Market Value of the residential portion of the Property?

A. Self-Supply Rules

[13] The relevant definitions are as follows:

> "multiple unit residential complex" means a residential complex that contains more than one residential unit, but does not include a condominium complex;
>
> "residential complex" means
>
> > (a) that part of a building in which one or more residential units are located, together with
> >
> > > (i) that part of any common areas and other appurtenances to the building and the land immediately contiguous to the building that is reasonably necessary for the use and enjoyment of the building as a place of residence for individuals, and
> >
> > > (ii) that proportion of the land subjacent to the building that that part of the building is of the whole building,
>
> ...
>
> "residential unit" means
> (a) a detached house, semi-detached house, rowhouse unit, condominium unit, mobile home, floating home or apartment.[1]
> ...

Subsection 190(1) of the *Act* provides the following:

> 190. (1) Where at any time a person begins to hold or use real property as a residential complex and
>
> > (a) the property was
> >
> > > (i) last acquired by the person to hold or use as a residential complex, or
> >
> > > (ii) immediately before that time, held for supply, or used or held for use as capital property, in a business or commercial activity.

[1] See subsection 123(1) of the *Act*.

(b) immediately before that time, the property was not a residential complex, and

(c) the person did not engage in the construction or substantial renovation of, and is not, but for this section, a builder of, the complex,

(d) the person shall be deemed to have substantially renovated the complex,

(e) the renovation shall be deemed to have begun at that time and to have been substantially completed at the earlier of the time the complex is occupied by any individual as a place of residence or lodging and the time the person transfers ownership of the complex to another person, and

(f) except where the person is

(i) a particular individual who acquires the property at that time to hold or use exclusively as a place of residence of the particular individual or another individual who is related to the particular individual or who is a former spouse or common-law partner of the particular individual, or

(ii) a personal trust that acquires the property at that time to hold or use exclusively as a place of residence of an individual who is a beneficiary of the trust,

the person shall be deemed to be a builder of the complex.

[14] When a person converts the use of a commercial property to a residential complex and the conditions in paragraphs 190(1)(a), (b) and (c) are met, subsection 190(1) is triggered and the deeming provision contained within the section applies. Three presumptions are contained within the deeming provisions of subsection 190(1):

(a) a presumption that the building was substantially renovated;

(b) that the substantial renovation was completed at the earlier of two events:

(i) when the building was occupied by any individual as a place of residence; or,

(ii) when the person transfers ownership of the building; and

(c) that the person changing the use of the building is the builder for the purposes of the self-supply rules.

Subsection 191(3) of the *Act* provides as follows:

191(3) 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 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 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 is a tenant or licensee of 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 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.

It will be noted that three criteria have to be met to assess tax liability:

(a) the construction or substantial renovation has to be substantially completed;

(b) the taxpayer has to give possession of any of the residential units or occupy it himself; and

(c) the person taking possession of the unit has to be the first to occupy the property following the substantial renovation or construction which is substantially complete.

Once these three criteria are met, the taxpayer is subject to the self-supply rules in the *Act*. If the taxpayer is subject to the self-supply rules the effective date is the later of two times: (1) when the construction or substantial renovation was substantially completed or, (2) when the first tenant occupied one of the units.

Application of these provisions to the case at bar

[15] In 1997, the Appellant acquired the Property.

[16] The Appellant testified that the Property was used for commercial purposes as of October 7, 1998. The Mercury, a restaurant and nightclub in which the Appellant holds a 50% ownership, was the Property's first tenant.

[17] In September 1999 there was also a commercial tenancy entered into with a Tim Horton's restaurant.

[18] The evidence is that the renovation work for the apartments commenced in December 1999.

[19] While the first lease agreement with a tenant in the residential portion is dated May 21, 2000, the date of occupancy specified in the lease is June 1, 2000.

[20] I have concluded that subsection 190(1) was triggered on June 1, 2000 when the first tenant occupied one of the apartments. Furthermore, as the evidence has demonstrated, the Property was used in the Appellant's commercial activity immediately prior to that time.

[21] The substantial renovation was substantially completed since it is so presumed under subsection 190(1). The Appellant gave possession of its first residential unit to its first tenant on June 1, 2000. And finally, this tenant was the first to occupy the residential property. I have concluded that the three requirements of subsection 191(3) were met.

[22] In reaching my conclusion I have considered the statement made by Justice Iacobucci of the Supreme Court of Canada in *Ludmer v. Her Majesty the Queen*[2] where he referred to statutory interpretation and said:

> Today there is only one principle or approach, namely the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament ... .

Iacobucci J. continues at paragraph 38:

> [38] Furthermore, when interpreting the Income Tax Act courts must be mindful of their role as distinct from that of Parliament. In the absence of clear statutory language, judicial innovation is undesirable: ...

[23] I have concluded that the words of subsection 190(1) are clear and I reject the argument proposed by counsel for the Appellant on this issue.

B. Proper Date to be Applied

[24] In my opinion the Appellant was deemed to have made a taxable supply and to have collected the GST/HST on June 1, 2000 calculated on the Fair Market Value of the residential complex at that time.

[25] I have answered Points A and B above. I must now deal with the Fair Market Value question.

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[2] *Ludmer v. Her Majesty the Queen*, [2001] 2 S.C.R. 1082.

C. Fair Market Value

[26] The definition of "fair market value" adopted by the Supreme Court of Canada is:

> "fair market value" is the highest price available estimated in terms of money which a willing seller may obtain for the property in an open and unrestricted market from a willing, knowledgeable purchaser acting at arm's length[3].

[27] The Court heard from two expert witnesses in relation to the Fair Market Value of the residential portion of the Property.

[28] Mr. John Ingram testified on behalf of the Appellant and his Expert Report was entered as Exhibit A-7.

[29] Mr. Paul Hare testified on behalf of the Respondent and his Expert Report was entered as Exhibit R-2.

[30] In his written submission counsel for the Appellant acknowledged that the written opinion of John Ingram bears the incorrect effective date of June 1, 1999 rather than June 1, 2000. During his testimony Mr. Ingram confirmed that if he were presented with the same facts and assumption on June 1, 2000 his opinion of the value of the residential complex would remain unchanged. I recognized that the incorrect date was made in the Expert Report of John Ingram and accept the opinion of John Ingram as if it were dated June 1, 2000.

[31] In his Report Mr. Ingram concluded that the market value of the residential portion of the Property as of June 1, 2000 (rather than June 1, 1999) was $890,000.00.

[32] In his written submission counsel for the Appellant suggested that the residential portion of the Property had the following values:

Cost Approach	$781,722.00 (see page 15)
Income Approach	$500,000.00 (see page 22)

[33] Counsel for the Appellant then said at page 23 of his submission:

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[3] In *Estate of Mann Estate,* [1974] C.T.C. (S.C.C.).

> …the Appellant asks that the appeal be allowed and that the Minister be ordered to reassess the Appellant on the basis that the fair market value of the residential complex contained within the Property was $640,000.00 on June 1, 2000 representing the average of the values indicated by the cost approach and the income approach.

[34] Mr. Hare, the expert retained by the Respondent concluded that the Fair Market Value of the residential portion of the Property on June 1, 2000 was $1,550,000.00.

[35] Counsel for the Appellant and counsel for the Respondent agree that there are three approaches to Fair Market Value that are used in determining the value of property:

1. The Cost Approach
2. The Income Approach, and
3. The Direct Comparison Approach

[36] Both of the expert witnesses agreed that the Cost Approach to value was not appropriate for the subject Property.

[37] At page 20 of his Report (Exhibit A-7) Mr. Ingram referred to the Cost Approach and said:

A. Cost Approach

> The Cost Approach consists of two basic components. Firstly, the valuation of the land as if free and clear of improvements under its highest and best use and secondly, the estimation of the reproduction cost new (*sic*) of the improvements less any loss in value (depreciation) due to deterioration or obsolescence. Given the age and class of property, as well as the initial level of vacancy this approach would not be given consideration by typical buyers and sellers and has not been included for the purposes of this report.

[38] At page 29 of his Report Mr. Hare referred to the Cost Approach and said:

> In this instance, we do not believe a reliable estimate of market value can be obtained by this exercise due to the difficulties and inaccuracies of estimating depreciation on a partially renovated forty year-old building and due to the lack of market data to estimate a profit component.

[39] Based on these comments from the two expert witnesses I have concluded that it is not appropriate in this situation to use the Cost Approach in determining the Fair Market Value of the residential portion of the Property.

B. Income Approach

1. Estimated Revenue

[40] In determining the revenue from the residential complex Mr. Ingram and Mr. Hare adopted different approaches. Mr. Ingram used the estimated rents provided by Mr. Ghosn, the President of the Appellant. Mr. Hare used the actual rents received and comparable market rents.

[41] The rental numbers used by the witnesses were:

Mr. Ingram	$20,885.00 x 12 = $250,620.00
Mr. Hare	$21,730.00 x 12 = $260,760.00

I have concluded that it would be appropriate to use the rental numbers as determined by Mr. Ingram, i.e. $20,885.00 x 12 = $250,620.00.

2. Vacancy Rate

[42] Mr. Ingram and Mr. Hare adopted different views on the vacancy rate for the residential complex. Mr. Hare adopted a vacancy rate of 1% for bad debt and vacancy for the first year stream and a stabilized vacancy and bad debt allowance of 2% thereafter.

[43] Mr. Ingram used a stabilized vacancy rate of 5%. Mr. Ghosn provided detailed evidence as to vacancy problems with the residential complex because of noise from the Mercury Night Club and the lack of parking. In his written submission Appellant's counsel suggested a vacancy rate of 10%, i.e. twice the vacancy rate as determined by Mr. Ingram. I am persuaded by the evidence provided by Mr. Ghosn as to significant vacancy in the building and I will recognize a vacancy rate and bad debt allowance equal to 8%.

Vacancy Allowance	$250,620.00 x .08 = $20,049.00

3. Operating Expenses

[44] In his Report Mr. Ingram determined that the stabilized operating expenses for the residential complex would be $95,870.00. (Note: If we accept counsel for the Appellant's argument that while Mr. Ingram's Report was dated June 1, 1999, the date should really be June 1, 2000, the estimated amount of operating expense for Year 1 according to Mr. Ingram was $88,221.00.) Mr. Hare concluded that the stabilized operating expenses for the residential complex would be $73,858.00.

[45] In his written submission counsel for the Appellant suggested that the stabilized operating expenses should be $130,000.00.

[46] The following numbers are involved in determining operating expenses:

(a) Utilities

In his written submission counsel for the Appellant suggested that the "utilities" for the residential complex may be determined as follows:

Paragraph 70	-	Water	$15,763.00
Paragraph 71	-	Fuel	$34,685.00
Paragraph 72	-	Electricity	$37,901.00
			$88,349.00

Note: The Appellant's Expert Witness, Mr. Ingram, had stated that the utilities according to his calculations for Year 1 were $27,300.00.

I have concluded that the attempt by counsel for the Appellant to increase the utilities for the residential portion from $27,300.00 to $88,349.00 is unreasonable and unsupportable. In the circumstances I will accept the utilities as determined by Mr. Ingram, i.e. $27,300.00. However, based on the evidence of Mr. Ghosn, I am prepared to allow a further $20,000.00 re utilities.

Utilities – $47,300.00

(b) Insurance

In his Report Mr. Ingram determined that the insurance for the residential portion was $2,900.00.

In his Report Mr. Hare indicated that according to his calculation the insurance applicable to the residential portion was $1,900.00.

In his evidence Mr. Ghosn suggested a higher figure.

I will accept the figure as determined by the Appellant's Expert Witness in the amount of $2,900.00.

Insurance – $2,900.00

(c) Professional Fees

I will accept the figure of $2,000.00 as suggested by Counsel for the Respondent.

Professional Fees – $2,000.00

According to my calculation based on the evidence of the Expert Witness the operating expenses of the residential complex from June 1, 2000 to May 31, 2001 were:

Operating Expenses

Property Tax	$16,136.00
Utilities	$47,300.00
Insurance	$2,900.00
Professional Fee	$2,000.00
Advertising	$1,330.00
Repairs and Maintenance	$11,780.00
Office and Management	$10,222.00
Superintendent Fee	$9,500.00
	$101,168.00

4. Capitalization Rate

[47] In his Report Mr. Ingram used a capitalization rate of 12%.

[48] In his Report Mr. Hare used a capitalization rate of 10%.

[49] Based on the evidence that was before me I have concluded that the appropriate capitalization rate that should be used is 10%.

[50] According to the numbers referred to above the net income realized on the residential portion would be:

Gross Annual Rents	$250,620.00
Vacancy and Bad Debts	$20,049.00
Operating Expenses	$101,168.00
	$129,403.00

[51] If we apply a capitalization rate of 10% the value of the residential portion would be $1,294,030.00.

[52] Counsel for the Appellant in his written submission has suggested a Lease Up Period adjustment of $40,000.00. Mr. Hare has proposed a Lease Up Period adjustment of $38,400.00. I will accept the figure of $40,000.00 as proposed by counsel for the Appellant in his written submission.

[53] Counsel for the Appellant has also suggested that the construction costs incurred after June 1, 2000 in the amount of $260,000.00 should be deducted.

[54] Since we are determining the Fair Market Value of the residential portion of the Property on June 1, 2000, and since we are using the Income Approach as suggested by the two Expert Witnesses I am not prepared to allow a deduction for construction costs incurred after June 1, 2000.

[55] According to the Income Approach – the Fair Market Value of the residential portion of the Property will be as follows:

Value Income Approach	$1,294,030.00
Deduct Lease Up Adjustment	40,000.00
Fair Market Value	$1,254,030.00

5. Direct Comparable Approach

[56] At pages 55, 56 and 57 of his Report Mr. Hare refers to a number of comparable sales of residential property. At page 58 of his Report Mr. Hare states that in his opinion based on comparable sales the value of the residential portion of the subject property was $1,662,000.00.

[57] I have determined that the income approach is the appropriate method for valuing the residential portion of the Property and in my opinion the Fair Market Value of the residential portion of the Property on June 1, 2000 was $1,254,030.00. In reaching this decision I agree with the comments made by Justice Walsh in *Bibby v. R.*, 83 DTC 5140 where he said at page 5157:

> While it has frequently been held that a Court should not, after considering all the expert and other evidence merely adopt a figure somewhere between the figure sought by the contending parties, it has also been held that the Court may, when it does not find the evidence of any expert completely satisfying or conclusive, nor any comparable especially apt, form its own opinion of valuation, provided this is always based on the careful consideration of all the conflicting evidence. The figure so arrived at need not be that suggested by any expert or contended for by the parties.[4]

[58] Counsel for the Appellant wrote a letter to the Court dated February 6, 2006. The letter read as follows:

> The Appellant in this matter requests confirmation that the cost award of $1,000 by Justice Campbell in her Order of January 27, 2006 is not payable to the Respondent as a result of the statement on record made by Justice Little on February 2, 2006.

[59] The transcript of the hearing dated February 6, 2006 contains the following comments:

> Mr. Adlington: We would also seek some comments on the cost award that was made by Justice Campbell in relation to this matter.
>
> Justice Little: I will consider this and advise you in the near future.

[60] Since I reached the conclusion and advised the parties that an adjournment created a new hearing, I have determined that the Order of Justice Campbell dated January 27, 2006 should be quashed.

[61] Before concluding my remarks I wish to note that I found it unusual that counsel for the Appellant attempted to discredit the evidence presented by his own Expert Witness. I cite the following examples:

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[4] *Bibby v. R.*, 83 DTC 5140 at 5157.

(1) In his Report Mr. Ingram had stated that the cost approach would not be given consideration by typical buyers and sellers and has not been included for the purposes of this report (see page 20). In his written submissions counsel for the Appellant suggested that by employing the cost approach method, the Fair Market Value of the residential complex on June 1, 2000 was $781,722.00 (see page 15).

(2) In addition, in his written submissions counsel for the Appellant suggested that the Fair Market Value of the residential complex on June 1, 2000 was $640,000.00 (see page 23). However, Mr. Ingram, the Expert Witness, relied upon by counsel for the Appellant, had concluded that the Fair Market Value of the residential complex on June 1, 2000 was $890,000.00.

[62] Since success has been divided by the parties I am not prepared to award costs.

[63] The appeal is allowed, without costs.

Signed at Vancouver, British Columbia, this 5th day of July 2006.

"L.M. Little"

Little J.

CITATION:	2006TCC356
COURT FILE NO.:	2004-52(GST)G
STYLE OF CAUSE:	Grafton Developments Inc. and Her Majesty the Queen
PLACE OF HEARING:	Halifax, Nova Scotia
DATE OF HEARING:	February 2, 2006
REASONS FOR JUDGMENT BY:	The Honourable Justice L.M. Little
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APPEARANCES:

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