Docket: 2006-2078(IT)G

BETWEEN:

DALRON CONSTRUCTION LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on February 25, 2008, at Sudbury, Ontario

By: The Honourable Justice M.A. Mogan

Appearances:

Counsel for the Appellant: Gregory Ducharme
Counsel for the Respondent: Ronald MacPhee

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2002 taxation year is dismissed, with costs.

Signed at Ottawa, Canada, this 26th day of August 2008.

"M.A. Mogan"

Mogan D.J.

Citation: 2008 TCC 476
Date: 20080826
Docket: 2006-2078(IT)G

BETWEEN:

DALRON CONSTRUCTION LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

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REASONS FOR JUDGMENT

Mogan D.J.

[1] The Appellant is an Ontario corporation carrying on business in the City of Sudbury. The business of the Appellant is the purchase and development of land through the construction of residential and commercial buildings. Some of the buildings are sold to arm's length purchasers while other buildings are transferred to an associated corporation to retain and lease. The Appellant's fiscal period in each year ends on the 28th day of February. The Appellant's 2002 taxation year (the only year under appeal) includes transactions occurring in the spring and summer of 2001.

[2] On or about August 30, 2001, the Appellant transferred to Prime Property Inc. ("Prime") a parcel of land identified as 1361 Paris Street, Sudbury, For convenience, that parcel of land will herein be referred to as "1361 Paris"; and the adjoining land to the north, 1347 Paris Street, will be referred to as "1347 Paris". At all relevant times, the Appellant owned, directly or indirectly, 80% of the issued shares of Prime. In connection with this transfer, the Appellant and Prime filed a joint election under subsection 85(1) of the *Income Tax Act* (the "*Act*") designating $494,900 as the fair market value of 1361 Paris, and $186,500 as the agreed amount.

[3] As a result of filing the joint election under subsection 85(1) of the *Act*, the Appellant reported for income tax purposes a gain of $79,500 on the disposition of 1361 Paris. The amount of the gain was determined by subtracting the book value of 1361 Paris ($107,000) from the agreed amount ($186,500). Canada Revenue Agency ("CRA") has taken the position that 1361 Paris was inventory in the hands of the Appellant in August 2001 and, therefore, was not "eligible property" as that term is defined in the *Act*.

[4] By reassessment, CRA has regarded the joint election under subsection 85(1) as invalid, and has determined that the Appellant realized a profit of $387,900 on the transfer of 1361 Paris to Prime. The amount of the profit and the additional income actually assessed were computed as follows:

Proceeds of disposition	$494,900
Book value of 1361 Paris	107,000
Profit on disposition	387,900
Gain previously reported	79,500
Additional income assessed	$308,400

[5] The property described in the joint election is in fact 1347 Paris (See Exhibit 1, Tab 4) but the parties are in agreement that the description is a mistake. The Appellant and Prime always intended to make the joint election with respect to 1361 Paris. CRA recognizes the mistake and has reassessed on the basis that the Appellant disposed of 1361 Paris on or about August 30, 2001. In some of the documents filed as exhibits, land described as 1347 Paris should, depending on the context, be read as 1361 Paris.

[6] Before reviewing the evidence, it will be helpful to summarize the relevant parts of section 85 of the *Act*. In tax jargon, a "rollover" is a tax-free transfer of property usually between persons not dealing at arm's length. Subsection 85(1) permits a rollover of "eligible property" from a taxpayer to a taxable Canadian corporation if certain conditions are met. The words "eligible property" are defined in subsection 85(1.1) which states in part:

> 85(1.1) For the purposes of subsection 85(1), "eligible property" means

(*a*) a capital property (other than real property, or an interest in or an option in respect of real property, owned by a non-resident person);

(*b*) …

(*f*) an inventory (other than real property, an interest in real property or an option in respect of real property);

(g) …

[7] The Appellant claims that in August 2001, it held 1361 Paris as capital property. CRA claims that at all relevant times 1361 Paris was inventory in the hands of the Appellant. The basic issue in this appeal is to determine the character of 1361 Paris in the hands of the Appellant as at August 30, 2001. Was it capital or was it inventory?

[8] The only witness who testified at the hearing of this appeal was Ronald Arnold, president of the Appellant corporation. The Appellant was incorporated in 1969. Ronald Arnold holds 51% of the issued shares. The remaining 49% of the issued shares are held by Ronald's three brothers: David, Frank and Phil. A second corporation, Dalron Leasing Ltd. ("DLL)" was incorporation in 1977 and is a wholly owned subsidiary of the Appellant. At the commencement of the hearing, counsel for both parties entered a joint binder of documents identified as Exhibit 1, containing 52 Tabs. Any reference to a "Tab" herein will refer to a document in Exhibit 1. Later, the Appellant entered Exhibits A-1 and A-2; and the Respondent entered Exhibits R-1, R-2 and R-3.

[9] As stated in paragraph 1 above, the Appellant's business is the purchase and development of land through the construction of residential and commercial buildings. Mr. Arnold stated that, if it was the Appellant's intention to retain a particular building as a source of rental income, that building would ordinarily be transferred to DLL. In 1987, the Appellant purchased 1361 Paris at a cost of $135,000. See Tab 10. The agreement of purchase and sale describes the property as 1361 and 1365 Paris Street and as containing two houses each producing rental income. Mr. Arnold stated that the property at 1361 and 1365 Paris Street covered approximately three or four acres. Paris Street is a significant street in the heart of Sudbury running north and south and having not less than four lanes. According to a survey of the relevant land (Exhibit A-2), the property at 1361 and 1365 Paris Street has a frontage of approximately 145 feet on the west side of Paris Street and,

although irregular in shape, has an average depth of approximately 340 feet. The property at 1361 and 1365 Paris Street described in the agreement of purchase and sale (Tab 10) is the same property referred to in these reasons as “1361 Paris”.

[10] Tab 50 is the consolidated financial statements of the Appellant and its subsidiaries as at February 28, 2001. The principal subsidiary was DLL. The consolidated balance sheet shows assets with a book value of $53,199,969. The five assets with the largest book value are as follows:

Inventory of property for sale	$6,589,683
Work in progress	8,262,588
Deferred costs	3,931,884
Mortgages receivable	3,228,779
Capital assets, net	28,809,475

[11] Mr. Arnold reviewed the consolidated balance sheet commenting on certain assets. The inventory of property for sale was acquired over a long period of time. Some parcels of land had been held for 25 years. The work in progress was primarily houses under construction for sale. The capital assets were shown at depreciated values and, according to Note 7 to the financial statements, represented land at $10,120,000 and buildings at $17,657,000.

[12] Tab 48 is the financial statements of DLL as at February 28, 2001. These are the financial statements of DLL alone, not consolidated. The balance sheet of DLL as at February 28, 2001 shows capital assets at a depreciated value of $14,481,247. According to Note 3 to the DLL financial statements, the capital assets included land at $6,076,000 and buildings at $7,853,000. When I compare Note 3 to the DLL financial statements with Note 7 to the Appellant’s financial statements (Tab 48 and Tab 50 both as at February 28, 2001), I am required to reconcile the following amounts:

	Note 3 DLL	Note 7 Appellant
Land	$6,076,000	$10,120,000
Building	7,853,000	17,657,000

[13] Because DLL is included in the Appellant's consolidated financial statements, I conclude that 60% of the land on the Appellant's balance sheet as capital assets is land actually owned by DLL; and 45% of the depreciated value of buildings on the Appellant's balance sheet as capital assets is buildings actually owned by DLL. On the DLL balance sheet, capital assets ($14,481,247) represents 84% of the book value of all assets ($17,140,702) whereas, on the Appellant's consolidated balance sheet, capital asserts ($28,509,475) are only 54% of the book value of all assets ($53,199,969). I therefore conclude that DLL is primarily a holding corporation while the Appellant is primarily an operating corporation. This conclusion is reinforced by the fact that the Appellant's consolidated balance sheet shows significant amounts as "inventory of property for resale" and "work in progress". The DLL balance sheet shows no such assets.

[14] The balance sheets reviewed in paragraphs 10 to 13 above support Mr. Arnold's statement that, if a particular building was to be retained as a source of rental income, it would ordinarily be transferred to DLL.

[15] In March 1997, at the start of its 1998 fiscal period, the Appellant still owned 1361 Paris. The book value had increased from $135,000 (purchase price in 1987; see Tab 10) to $186,481. Mr. Arnold explained the increase in relation to two events. First, the two houses which were on the property producing rental income at the time of purchase had been demolished at some cost. And second, the Appellant was required to pay an amount to the City of Sudbury for access to larger water and sewer lines which had been installed along Paris Street.

[16] At the end of the Appellant's 1998 fiscal period (February 28, 1998), the Appellant wrote down the value of certain lands held in inventory and applied the aggregate write-down to its profit computation. Tab 12 is a page from the Appellant's financial records showing a portion of the write-downs. Tab 12 shows the writing down of 18 lots on Roselawn Street and Sandlewood Court, 42 lots on Donald Street and Jack Street, and 5 other lots including 1361 Paris written down from $186,481 (see paragraph 15 above) to $107,000. The net write-down of 1361 Paris is shown as $79,481. There is no doubt that, at the end of its 1998 fiscal period, the Appellant regarded 1361 Paris as part of its inventory of land for sale.

[17] I turn now to the circumstances in which the Appellant transferred 1361 Paris to Prime in August 2001, and jointly elected a rollover of that land under subsection 85(1) of the *Act*. In the fall of 2000, the Appellant entered into discussions with RBC Dominion Securities Inc. ("RBC-DS") with respect to

leasing 6,500 square feet of a building to be constructed on Paris Street. Tab 21 is an Offer to Lease dated October 2, 2002 in which RBC-DS is referred to as the Tenant and the Appellant is referred to as the Landlord. The Offer to Lease refers to land fronting on Paris Street as Parcel 7935 S.E.S. and Parcel 49415 S.E.S. The second parcel must be mistakenly described because, according to the survey (Exhibit A-2) and the oral testimony of Mr. Arnold, Parcel 49410 S.E.S. contains the land referred to herein as 1361 Paris; the land immediately to the north is Parcel 7935 S.E.S. owned by Prime and identified as 1347 Paris; and the land immediately to the south is Parcel 48415 S.E.S. owned by a stranger. We are concerned only with Parcel 49410 owned by the Appellant (1361 Paris) and the adjoining land to the north, Parcel 7935 owned by Prime (1347 Paris).

[18] As stated in paragraph 2 above, the Appellant owns 80% of the issued shares of Prime. The remaining 20% interest in Prime is owned by Andy Humbert, a man not related to the Arnold brothers. According to Mr. Arnold, Andy Humbert also owned the land immediately west of 1347 Paris and 1361 Paris. Because Andy Humbert ("AH") owned 20% of Prime which owned 1347 Paris, he was interested in any development which might occur at 1361 Paris. Mr. Arnold stated that AH had always wanted to be involved with the Arnold brothers in some kind of real estate development or investment.

[19] The land at 1347 Paris had been purchased by Prime in 1991. It had good frontage on Paris Street, and it provided legal access from Paris Street to AH's land immediately west of 1347 Paris and 1361 Paris. The Appellant did not need 1347 Paris to proceed with the RBC-DS building on 1361 Paris but, by combining 1347 Paris with 1361 Paris, the Appellant could more easily sell or rent a second building on the same site with plenty of parking. Because there was a real commercial advantage in combining the properties, and because AH had always wanted to be involved with the Appellant in a project, the Appellant decided to transfer 1361 Paris to Prime.

[20] Tab 7 is the Asset Transfer Agreement dated August 30, 2001 between the Appellant as vendor and Prime as purchaser. The parties agreed (i) that the fair market value of 1361 Paris was $494,900; (ii) that the purchase price would be the fair market value; (iii) that the purchase price would be paid as to $186,500 by a promissory note from Prime, and as to $308,400 by the issue of 100 common shares of Prime. The parties also agreed (in paragraph 2.6) to make a joint election under subsection 85(1) with respect to 1361 Paris. Tab 8 is the Deed of Land giving effect to the transfer. Tab 4 is the Joint Election under subsection 85(1) as

filed with CRA. In Tab 8 and Tab 4, 1361 Paris is mistakenly described as 1347 Paris.

[21] Tab 9 is a Share-for-Share Exchange between the Appellant and Prime in which the Appellant agrees to exchange 100 common shares of Prime for 308,400 Class B shares of Prime. The Share-for-Share Exchange was necessary to maintain the 80-20 ratio in the equity of Prime as between the Appellant and AH.

[22] Tab 45 is the Final Lease between RBC-DS and Prime dated February 7, 2001. The Appellant must have assigned to Prime its right in the Offer to Lease (Tab 21). I note that Prime is the named landlord in the Final Lease as at February 2001 even though the transfer of 1361 Paris did not occur until August 30, 2001. The Appellant must have informally agreed with AH by February 2001 that the two parcels (1361 Paris and 1347 Paris) would be joined to proceed with the RBC-DS building. In the Final Lease, the RBC-DS leased space is identified as the second floor (6,500 sq. ft.) of a two-storey office building at the Paris Street site.

[23] Tab 22 is a lease proposal from Manulife dated May 31, 2001 addressed to Royal LePage (Sudbury) asking to lease 2,600 sq. ft. on the ground floor of a two-storey office building at 1361 Paris. The proposed landlord is identified as DLL. Tab 24 is the lease between Manulife and DLL (undated) in which Manulife leases 2,600 sq. ft. at 1361 Paris commencing August 31, 2001. Tab 23 is an Assignment of Lease from DLL to Prime dated August 31, 2001 assigning the Manulife lease at 1361 Paris.

[24] As stated in paragraph 7 above, the basic issue is whether the character of the land at 1361 Paris was capital or inventory in the Appellant's hands as at August 30, 2001. This is a question of fact. Having regard to all of the evidence, I have no difficulty in concluding that 1361 Paris was inventory in the hands of the Appellant at all relevant times. 1361 Paris was clearly inventory at February 28, 1998 when the Appellant wrote down the value of many parcels of land at the end of its 1998 fiscal period. See paragraph 16 above.

[25] Exhibit R-3 is a binder containing certain passages from the Examination for Discovery of Andrew Sostarich on behalf of the Appellant, to be taken as "read in" by counsel for the Respondent. Within Exhibit R-3 is confirmation No. 18 in which the Respondent has asked the Appellant to confirm a particular fact, and the Appellant has answered. I will set out confirmation No. 18 as it appears in Exhibit R-3:

> 18. To confirm that the subject property as at February 28, 2001 was held in the books and records of Dalron Construction Limited as inventory.
>
> The lots on hand listing of $5,946,989.38 at February 28, 2001 includes 1361 Paris Street at a book value of $107,000.00.

[26] Confirmation No. 18 proves that 1361 Paris was valued for inventory purposes at $107,000 in February 2001. Tab 12 proves that 1361 Paris was written down in value to $107,000 as inventory in February 1998. Apart from the Offer to Lease (Tab 21), there is no evidence that the Appellant, standing alone, used 1361 Paris for any commercial purpose in the 36-month period from February 1998 to February 2001. I therefore conclude that 1361 Paris was inventory to the Appellant throughout that 36-month period.

[27] Exhibit R-3 contains certain statements made by Mr. Sostarich on Discovery which clearly indicate that the Appellant did not hold properties with long-term leases because such commercial properties always end up in Dalron Leasing Ltd. ("DLL"). I will quote questions 116, 117 and 141 as they appear in Exhibit R-3:

> Q. Is there examples of a deal similar to this where land is transferred to Dalron Leasing after the building went up?
>
> A. I could check and try and give you one, yes.
>
> Q. And more than one. I'd like an idea as to how these transactions typically occur. What you told me at the outset, so I can clarify and understand this - - Dalron Leasing usually holds commercial leases - - properties - - properties that have a long-term lease; is that correct?
>
> A. That's right. If you look at the balance sheet of Dalron Construction versus Dalron Leasing you'll see no commercial property on Construction's balance sheet. They always wind up on leasing.
>
> Q. Why in this instance did the Appellant want to hold this as a commercial property as opposed to doing what it typically did and send it to the leasing company? What was different about this transaction?
>
> A. Actually I don't think anything was different about it. And I can believe that, had Humber not gotten involved the project would have wound up at some point in time in Dalron Leasing Limited.
>
>> MR. DUCHARME: I think it would be our position, counsel, that this particular property followed the model that the witness has laid out in some detail, that Construction wasn't going to hold it. It was

> going to build and at some point Construction doesn't hold commercial rental properties.

The above answers on Discovery confirm Mr. Arnold's testimony that commercial rental properties were ordinarily transferred to DLL. See paragraph 9 above.

[28] Although the original Offer to Lease (Tab 21) was signed October 2, 2000 between RBC-DC and the Appellant, all subsequent documents indicate that the Appellant would not continue to own 1361 Paris as landlord. The final lease (Tab 45) was between Prime and RBC-DS and was dated February 7, 2001. From that document, I infer that Andy Humbert had been brought into the transaction well before February 2001; and that the Appellant had agreed to join 1361 Paris with 1347 Paris by transferring 1361 Paris to Prime.

[29] I cannot find any evidence that the Appellant ever adopted an investment intent with respect to 1361 Paris. The Appellant wrote down the book value of 1361 Paris as inventory at February 28, 1998. See paragraph 16 above. Although the Offer to Lease between the Appellant and RBC-DS is dated October 2, 2000 (Tab 21), the Appellant continues to show 1361 Paris as part of its inventory five months later as at February 28, 2001. See Confirmation No. 18 in Exhibit R-3. Also, the Appellant must have assigned the Offer to Lease to Prime (proving an intention to transfer 1361 Paris to Prime) because the final Lease (Tab 45) is dated February 7, 2001 between Prime and RBC-DS. And finally, the actual conveyance of 1361 Paris from the Appellant to Prime on August 31, 2001 (Tab 8) is the best evidence that the Appellant never intended to hold 1361 Paris as revenue-producing rental property.

[30] Mr. Ducharme, counsel for the Appellant, relied on the decision of the Federal Court of Appeal in *Edmund Peachey Limited v. The Queen*, 79 DTC 5064. In particular, he relied on the following passage from the unanimous reasons of that Court:

> I agree with the learned trial judge that a clear and unequivocal positive act implementing a change of intention would be necessary to change the character of the land in question from a trading asset to a capital asset. …

Mr. Ducharme argued that the Offer to Lease (Tab 21) signed by the Appellant was such a clear and unequivocal positive act because the Appellant was committed to put the tenant in possession by a specific date.

[31] In my opinion, the Offer to Lease (Tab 21) cannot be regarded as evidence of any change of intent on the Appellant's part because the Offer to Lease must be seen in context with the following four unassailable facts:

(i) 1361 Paris was inventory to the Appellant as at February 28, 1998;

(ii) the final lease with RBC-DS is dated February 7, 2001, and was signed by Prime;

(iii) 1361 Paris was still shown as inventory to the Appellant as at February 28, 2001; and

(iv) 1361 Paris was conveyed by the Appellant to Prime on August 31, 2001 (Tab 8).

[32] In addition to the four facts listed above, Exhibit R-3 contains many extracts from the Examination for Discovery of Andrew Sostarich who represented the Appellant. Mr. Sostarich stated consistently that it was not the Appellant's policy to hold rental properties; and that such properties were usually transferred to DLL. Indeed, in Question 141, Mr. Sostarich states that if Andy Humbert had not been involved, the building at 1361 Paris would have wound up in DLL.

[33] The appeal for the 2002 taxation year is dismissed, with costs.

Signed at Ottawa, Canada, this 26th day of August 2008.

"M.A. Mogan"

Mogan D.J.

CITATION:	2008 TCC 476
COURT FILE NO.:	2006-2078(IT)G
STYLE OF CAUSE:	DALRON CONSTRUCTION LIMITED and HER MAJESTY THE QUEEN
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APPEARANCES:

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Counsel for the Respondent:	Ronald MacPhee

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