

Docket: 2008-2593(IT)I

BETWEEN:

CAROLYNNE FIRTH,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on February 25, 2009, at Toronto, Ontario

Before: The Honourable Justice Wyman W. Webb

Appearances:

Agent for the Appellant: Selwyn Firth
Counsel for the Respondent: Eric Luu

JUDGMENT

The appeal from the assessment made under the *Income Tax Act* for the Appellant's 2005 taxation year is dismissed, without costs.

Signed at Ottawa, Ontario, this 5th day of March 2009.

“Wyman W. Webb”

Webb J.

Citation: 2009TCC137
Date: 20090305
Docket: 2008-2593(IT)I

BETWEEN:

CAROLYNNE FIRTH,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Webb J.

[1] The issue in this appeal is whether, in determining the amount of the capital gain realized by the Appellant as result of the disposition of property in 2005, the Appellant is entitled to deduct the amount that she incurred as interest in relation to the mortgage on the property and the amount that she paid as property taxes while she held the property.

[2] The Appellant is a resident of the Cayman Islands. Her mother and father were living in Toronto in a house that they were renting from a third party and which was in need of repair. In 1997 the Appellant's father suffered an injury and he was unable to make the necessary repairs to this house. The Appellant and her brother purchased the property in 1997 so that they could undertake the necessary repairs. The purchase price for the property was \$155,000 and the purchase was fully financed by a vendor take back mortgage. The Appellant's brother sold his half interest in the house to their mother in 2003. The Appellant and her mother sold the house to a third party in 2005.

[3] Throughout the time that the property was owned by the Appellant it was occupied by other members of her family -- by her mother and father until her father

passed away in 1998, then by her mother, and later by her mother and her brother. None of these family members paid rent to her for the use of the property.

[4] When the property was sold in 2005, the Appellant realized a capital gain. The position of the Appellant is that this gain should be reduced by the amount of interest payments that she made since the property was acquired and by the amount of property taxes that she paid during these years.

[5] Subsection 39(1) of *Income Tax Act* (the “Act”) provides, in part, that:

39. (1) For the purposes of this Act,

(a) a taxpayer's capital gain for a taxation year from the disposition of any property is the taxpayer's gain for the year determined under this subdivision ... from the disposition of any property of the taxpayer

[6] Subsection 40(1) of the *Act* provides, in part, as follows:

40. (1) Except as otherwise expressly provided in this Part

(a) a taxpayer's gain for a taxation year from the disposition of any property is the amount, if any, by which

(i) if the property was disposed of in the year, the amount, if any, by which the taxpayer's proceeds of disposition exceed the total of the adjusted cost base to the taxpayer of the property immediately before the disposition and any outlays and expenses to the extent that they were made or incurred by the taxpayer for the purpose of making the disposition, or

[7] The amount paid as interest in relation to the mortgage on the property and the amount paid for the property taxes were not outlays or expenses incurred for the purpose of making the disposition of the property and hence will only reduce the capital gain if they can be added to the adjusted cost base of the property.

[8] “Adjusted cost base” of a property is defined in section 54, in part, as follows:

“adjusted cost base” to a taxpayer of any property at any time means, except as otherwise provided,

...

(b) in any other case, the cost to the taxpayer of the property adjusted, as of that time, in accordance with section 53,

[9] There is nothing in section 53 that provides that the interest paid in relation to the mortgage on the property and the property taxes will be added to the cost to determine the adjusted cost base of the property. The purchase price incurred by the Appellant in acquiring the property (not including the cost of the renovations) was one-half of \$155,000 or \$77,500. Interest paid in relation to the mortgage on the property and the property taxes paid would not, in the absence of a specific provision in the *Act*, providing for the addition of these amounts to the cost of the property, be included in the cost of the property to the Appellant.

[10] The property was renovated and the Respondent acknowledges that \$24,058 was incurred as capital expenditures in relation to the property. Subsection 18(3.1) of the *Act* provides, in part, as follows:

(3.1) Notwithstanding any other provision of this Act, in computing a taxpayer's income for a taxation year,

(a) no deduction shall be made in respect of any outlay or expense made or incurred by the taxpayer (other than an amount deductible under paragraph 20(1)(a), (aa) or (qq) or subsection 20(29)) that can reasonably be regarded as a cost attributable to the period of the construction, renovation or alteration of a building by or on behalf of the taxpayer, a person with whom the taxpayer does not deal at arm's length,... and relating to the construction, renovation or alteration, or a cost attributable to that period and relating to the ownership during that period of land

(i) that is subjacent to the building, or

(ii) that

(A) is immediately contiguous to the land subjacent to the building,

(B) is used, or is intended to be used, for a parking area, driveway, yard, garden or any other similar use, and

(C) is necessary for the use or intended use of the building; and

(b) the amount of such an outlay or expense shall, **to the extent that it would otherwise be deductible in computing the taxpayer's income for the year,** be included in computing the cost or capital cost, as the case may be, of the building to the taxpayer, to the person with whom the taxpayer does not deal at arm's length,

(emphasis added)

[11] This subsection would allow for interest and property taxes attributable to the period of renovations to be added to the cost of the property to the extent that these amounts would otherwise be deductible. This subsection does not apply to the interest and property taxes that are attributable to the other periods of ownership and therefore these amounts that relate to the other periods of ownership cannot, in any event, be added to the cost of the property. The deduction of these amounts that relate to the other periods of ownership is not prohibited by subsection 18(3.1) of the *Act* and therefore if these amounts are otherwise deductible, then they could be deducted in computing the income of the Appellant for these other periods of ownership.

[12] The Appellant's agent had indicated that the renovation to the property had included a basement apartment but this apartment was never rented and never advertised for rent. It seems clear that the renovations were undertaken because the property was in need of repair and to make the property fit for habitation by the Appellant's parents. No rent was paid at any time while the Appellant owned the property. The only possible income earning purpose was the potential capital gain that could arise on a sale of the property. The interest costs would only be deductible if a deduction were permitted for interest incurred in relation to money borrowed to realize a capital gain.

[13] This is also related to the main argument raised by the agent for the Appellant. He argued (without referring to subsection 18(3.1) of the *Act*) that the interest should have been deductible as the Appellant had acquired the property in part for investment purposes and that if the Appellant would have acquired shares of a corporation that did not pay a dividend, that the interest would have been deductible. The argument of the Appellant was that the two investments should be treated the same.

[14] Subsection 18(1)(a) of the *Act* provides as follows:

18. (1) In computing the income of a taxpayer from a business or property 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 the business or property;

[15] This general limitation will apply to the deductibility of the amount paid for property taxes. Unless the amounts paid for property taxes were paid for the purpose of gaining or producing income from the property, such amounts would not be deductible in computing the income of the Appellant.

[16] The deductibility of interest is determined by paragraph 20(1)(c) of the *Act*. This paragraph provides as follows:

20. (1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

(c) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy),

(ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt or property that is an interest in a life insurance policy),

[17] Subsection 9(3) of the *Act* provides as follows:

(3) In this Act, "income from a property" does not include any capital gain from the disposition of that property and "loss from a property" does not include any capital loss from the disposition of that property.

[18] Therefore, if an amount is borrowed only for the purpose of investing in property to realize a capital gain on the disposition of the property, since the capital gain will not be income from property, the interest paid (or payable) on the amount

borrowed to acquire the property will not be deductible. This was confirmed by the Supreme Court of Canada in *The Queen v. Bronfman Trust* [1987] 1 C.T.C. 117, [1987] 1 S.C.R. 32, 87 DTC 5059. Chief Justice Dickson, in that case stated as follows:

28 I agree with Marceau, J. as to the purpose of the interest deduction provision. Parliament created subparagraph 20(1)(c)(i), and made it operate notwithstanding paragraph 18(1)(b), in order to encourage the accumulation of capital which would produce taxable income. Not all borrowing expenses are deductible. Interest on borrowed money used to produce tax exempt income is not deductible. Interest on borrowed money used to buy life insurance policies is not deductible. **Interest on borrowings used for non-income earning purposes, such as personal consumption or the making of capital gains is similarly not deductible.**

(emphasis added)

[19] As well, the Supreme Court of Canada in *Ludco Enterprises Ltd. v. The Queen*, 2001 SCC 62, 2001 DTC 5505 (Eng.), [2002] 1 C.T.C. 95, [2001] 2 S.C.R. 1082, dealt with the issue of whether interest payable in relation to money borrowed to acquire shares in a corporation was deductible in a situation where the amount of interest that was paid exceeded the amount of dividends that were paid on the shares. The Court in that case stated in part as follows:

65 In conclusion, where a taxpayer uses borrowed money for a purpose yielding a reasonable expectation of income from business or property as I have described above, the interest charges incurred will fall within the ambit of s. 20(1)(c)(i) and are deductible.

D. Application of the Foregoing Principles: Are the Interest Charges Incurred by the Appellants Deductible in this Case?

(1) Interest Charges for Initial Investments in Shares of the Companies

66 The question now to be determined is whether, in using borrowed money to purchase shares of the Companies, the appellants had a reasonable expectation of income? If the answer is affirmative, and the amount of interest paid was reasonable within the meaning of the provision, the interest charges are deductible.

67 Here, the objective documentary evidence indicates that the appellants did have a reasonable expectation of income. Owing to the nature of the investments and the Companies' investment strategy, it was reasonable to expect income would be available for distribution. In addition, given the terms of the Dividend Policy, it is clear that the appellants had a reasonable expectation of receiving dividends.

68 Although earning income was not the principal factor that motivated Mr. Ludmer to invest in the Companies, upon reading the relevant documents he did anticipate the receipt of dividend income. In my view, Mr. Ludmer's expectation of dividend income was reasonable. Indeed, the judge at the Federal Court, Trial Division came to the same conclusion at p. 6056.

69 Furthermore, it is notable that income was actually received in the amount of \$600,000 of dividends. Although this amount may be small in comparison to the capital gains realized and the interest charges incurred, absent a sham or window dressing or similar vitiating circumstances (none of which was argued before this Court), we are not concerned with the sufficiency of the income expected or received. There is no sham in this case: the purchase of the shares were genuine investments. Neither can the amount of dividends actually paid be properly be characterized as window dressing. Six hundred thousand dollars is a significant sum and there was some expert evidence indicating that the actual rate of return on the shares of Justinian was within the norm of most of the companies publicly traded on the Toronto and Montreal Stock Exchanges.

70 I conclude that the appellants did have a reasonable expectation of income when they used the borrowed money to purchase shares in the Companies. Therefore, the requisite purpose is present in the circumstances of this case.

[20] In that case the Supreme Court of Canada concluded that there was a reasonable expectation of income when the borrowed money was used to purchase the shares. It also seems clear that if the corporation would not have paid any dividends and if the taxpayer would not have had a reasonable expectation of dividends, then the interest would not have been deductible. Therefore the agent's assumption that interest paid on money borrowed to acquire shares of a corporation will always be deductible is not correct.

[21] In the present case, there was no reasonable expectation of income when the property was acquired as it was to be occupied by members of the Appellant's family for no rent. The potential capital gain that could arise on a sale of property is not "income from a property".

[22] As a result the amounts incurred for interest and the property taxes throughout the period of ownership (including those amounts attributable to the period of renovations) are not deductible in determining the income of the Appellant for the years that she owned the property. Hence those amounts that are attributable to the period of renovations are not otherwise deductible as contemplated by subsection 18(3.1) of the *Act* and cannot be added to the cost of the property pursuant to subsection 18(3.1) of the *Act*. As noted above, those amounts that are attributable to the other periods of ownership also cannot be added to the cost of the property.

[23] As a result, the appeal is dismissed, without costs.

Signed at Ottawa, Ontario, this 5th day of March 2009.

“Wyman W. Webb”

Webb J.

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MAJESTY THE QUEEN
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APPEARANCES:

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