Docket: 2010-2234(IT)I

BETWEEN:

JOHN HARE,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on March 31, 2011 at Hamilton, Ontario

Before: The Honourable Justice J.E. Hershfield

Appearances:

Counsel for the Appellant:	James Rhodes
Counsel for the Respondent:	Ernesto Caceres

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2005 taxation year is dismissed, without costs, in accordance with the reasons set out in the attached Reasons for Judgment.

Signed at Ottawa, Canada this 8th day of June 2011.

"J.E. Hershfield"

Hershfield J.

Citation: 2011 TCC 294
Date: 20110608
Docket: 2010-2234(IT)I

BETWEEN:

JOHN HARE,

Appellant,

and

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Respondent.

REASONS FOR JUDGMENT

Hershfield J.

The Issue

[1] The Appellant was reassessed in respect of his 2005 taxation year. The reassessment disallowed $24,000 of a rental loss claimed for the year. The amount disallowed reflects an assessing position that such amount, incurred on two rental properties, was on capital account. The Respondent relies on paragraph 18(1)(*b*) of the *Income Tax Act* (the "*Act*").[1]

[2] Prior to the hearing, having particularized the expenses at issue in respect of each of the two rental properties, the parties narrowed the expenditures at issue. Expenses relating to appliances in the amount of $1,465.25 were agreed to be on capital account. Various miscellaneous expenses totalling $4,402.96 were agreed to be on income account. That left $18,133.60 at issue. Such amounts consisted of

[1] The pleadings also refer to paragraphs 18(3.1)(*a*) and (*b*) of the *Act*. However, no evidence was led that was of particular relevance to such provisions and no argument was made that focused on them.

various expenses incurred on what I will call, for the moment at least, renovations. The renovations consisted of new doors, windows, flooring, kitchen cabinets, siding and the like, which were installed after the properties were acquired in 2005 and prior to any tenancies being in place. Such renovations also required some redoing of existing plumbing and electrical installations.

[3] The renovation work undertaken on each rental property was described in some detail at the hearing and exhibits included a number of before and after pictures. While I will outline the renovations in these Reasons, the issue before me is not about this new window or that new door. It is about the classification of the entirety of the work as either the restoration of a property, which the authorities tend to treat as maintenance and repairs incurred on income account, or the creation of what is essentially a new property, which the authorities more clearly treat as capital improvements. There is also an issue concerning the timing of the work in that it was done, in both cases, immediately after acquisition of the property, before the first tenant was secured.

Background

[4] The two properties are co-owned. The Appellant is one of the co-owners. Another co-owner, Mark Garrett, testified at the hearing. He acknowledged at the outset that he and his wife started out some ten years ago in the renovation business.

[5] They then started buying rental properties and started to seek investment partners. They purchased approximately 57 properties and over a course of years they started a construction company and a property management company based out of Hamilton.

[6] The Appellant was an investor in the two properties that are the subject of this appeal. They have been identified as the Houghton property and the Kensington property. The Appellant's ownership share of the Houghton property was 33.77%. His interest in the Kensington property was 50%. It is my understanding that Mr. Garrett and his wife owned a 50% interest in each of the properties and that they entered into a Joint Venture Agreement with the other co-owner(s) on the basis that the investors (the other co-owners) would put up 100% of the equity required for the purchase of the properties. Initial pre-tenancy renovations were included as part of the purchase price for this purpose. Thereafter, all expenses were shared in accordance with the co-ownership interests.

[7] The investment approach was spoken of by Mr. Garrett to be along the following lines. A realtor would be informed of the type of property sought. The realtor would source a property and identify possible work the property would need. Mr. Garrett would visit the property with a series of trades who could provide on-site estimates to determine what the renovation/repair costs would be. The investor would then be consulted, advised of the purchase price and estimated renovation or repair costs, and a decision would be made as to whether to proceed. If the decision was to proceed, an offer would be made and negotiations would be conducted by Mr. Garrett.

[8] Once an offer was accepted, Mr. Garrett would attend to the closing, line-up the renovations/repairs and begin advertising for and identifying tenants. They would manage the repairs as they were being done and begin interviewing tenants. Once a tenant moved in they would manage the property for the life of the tenancy. When a tenant left they would attend to any needed maintenance or repairs and seek a new tenant.

[9] With respect to the Houghton property, Mr. Garrett provided the following information:

- The property was occupied at the time of the initial inspection.

- It appeared to be a relatively well-maintained and tidy property. It looked like all that was needed was new paint, a cleaning and what Mr. Garrett referred to as the standard “lipstick and rouge” approach.

- After taking possession in March 2005 and doing a closer inspection which was enabled by the removal of all the occupant’s personal effects, they discovered that the windows were in a much worse state of repair than originally anticipated. The positioning of personal effects like a bed or a couch against a windowed wall would make it difficult to have a close inspection of the window. The wood tracks along which panes of glass could slide to open and close the window, had begun to rot due to water seepage. The window sills and window frames were similarly damaged. Repairing the windows would not be feasible as it would require re-milling the entire frame. It was cheaper to replace the windows so that is what was done.

- The replacement windows were a low grade, vinyl-clad window. Mr. Garrett referred to it as an entry level window but admitted that it

would be regarded as being a better quality than the window that was replaced. The cost of the window replacements was $3,027.14.[2]

- The next expenditure that Mr. Garrett addressed was the new siding put on to the exterior of the house. Mr. Garrett referred to the exterior shell of the building as the building envelope. The existing building envelope was pebble stucco that was approximately 80 years old. When the property was first inspected it looked like the building envelope was in acceptable condition as were the soffits. What was later discovered, however, was that the owner had covered up a lot of issues. Between the time of the first inspection and taking possession in March, previous repairs started showing signs of requiring attention. Water from the winter melt must have gotten inside cracks, breaking down the original repairs. There were several examples of this, specifically in the corners and toward the basement.

- Continuing patchwork repairs afforded no guarantee that they would survive over the course of the next winter season. Consequently, re-stuccoing the building needed to be considered. Re-stuccoing required removal of all existing stucco which likely meant dealing with any insulation problems that would be exposed and any other issues that may be revealed by opening the exterior envelope. What was recommended then was to strap the exterior of the building and put on vinyl siding. The cost to re-stucco was uncertain. An estimate to remove the existing stucco, which would have been required to re-stucco had the big unknown of dealing with any exposed insulation. The conservative estimate to re-stucco then was $6,000 - $9,000. The cost of the new siding including soffits and gutters was $3,514.13.[3]

- The next expenditure was to replace the carpet in the property and the vinyl in the kitchen area.

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[2] The invoice for the windows shows a total price of $4,327 and a deposit of $1,400 with a balance of $3,027. The amount in dispute is only the $3,027. It is not open for me to speculate on what happened although it would appear possible that only the after deposit amount was denied as being in the nature of capital expenditure. If that is the case it is not open for me to increase the amount in dispute.

[3] The invoice for the siding shows a total price of $6,914.13 and a deposit of $3,400 with a balance of $3,514.13. The amount in issue is only the $3,514. It seems that the observation in the previous note, can be re-iterated here.

- The plan with the carpet was to remove it and buff the hardwood floors that were originally there. Unfortunately, the carpet had been glued to the floor and on lifting it, the hardwood was basically destroyed. Estimates were received for a new hardwood floor versus putting a new carpet down to replace the old carpet. The cost of a new hardwood floor would be approximately $4,000. The cost of carpeting would be much less. In fact, carpeting plus the new vinyl floors was less than putting in a new hardwood floor.

- In the kitchen, the vinyl was beginning to peel underneath the sink as a result of water leaking. The damage on the floor was hidden at the time of the inspection by a rubber mat. The vinyl could not be repaired without replacing part of the sub-floor as vinyls are now different thicknesses. As well, matching floor materials and patterns would not have been possible. The total cost to re-vinyl together with the carpet was $2,720. It was also pointed out that the new vinyl was of a lower grade with a life of maybe ten years. The old vinyl had likely lasted 30 or 40 years.

[10] With respect to the Kensington property, Mr. Garrett provided the following information:

- The property was occupied at the time of the initial inspection. The individual that was living there had been living there for 60 years and was moving to a retirement home.

- The property was a little more dishevelled and there were lots of personal effects all over the place reflecting the fact that this individual had lived there for so long. Still, the property seemed generally well kept. Painting and a lot of cleaning might only be required once the personal effects were removed.

- Before closing, the individual selling the property passed away and further inspections were apparently made more difficult. Still, it was discovered that a toilet and sink had been installed in the closet of the master bedroom. They were placed right on top of a carpet and they were leaking. It was not up to code and would have to be removed. But for that, it was thought that all the property would

need would be painting, cleaning and a little updating of the hardware to get it ready to have a tenant move in.

- After possession, a bathroom in the basement was discovered. At the time of the inspections it was being used as a storage closet. It was poorly done and leaking and also not up to code. The wall sink was propped up and the faucets did not work. In any event, this bathroom had to be removed, as well.

- Once the plumbing work was started, the plumber by code had to remove galvanized drain piping as well as galvanized supply tubes that were exposed and that led to replacing piping connected through to the kitchen. The piping was replaced with copper piping. The entire plumbing bill was $909.50.

- The next expense relates to the installation of new kitchen cupboards.

    - After taking possession, it was discovered that the stove and range top were not in proper working order and were unsafe. Repairs were not feasible. As well, it was discovered that the floor boards and flooring under the lower kitchen cabinets had suffered extensive water damage. The lower cabinets were unstable. They needed to be repaired or replaced. Removal allowed them to see if there was any further mold or rot issues behind or underneath the cabinets as well.

    - Removal of lower cabinets, replacing the stove at a location in relation to the sink that was to code and addressing plumbing and electrical concerns could most economically be done by what Mr. Garrett described as a slight reorganization of the kitchen. The end result was, in effect, a renovated kitchen. The refrigerator had been moved to a new location, newly configured cupboards were installed and the sink and the new stove were relocated. Unlike the original cabinetry which was wood, the new cabinetry was particle board. The new counter top, like the old counter top, was a particle board with a laminate finish.

  - The entire cost of the kitchen renovation including placing the sub-floor under the cabinets was $2,889.

- The next expenditure of $1,435.83 deals with a number of items.

  - It covers a new exterior door to the back porch door. It was so badly scratched and damaged on the inside that it was virtually unrepairable. A solid wood door was used to replace a solid wood door.

  - Four internal doors also needed to be replaced since once they were removed for painting, it was discovered that the door casings were in such bad condition that the doors could not be re-hung properly. Replacing the doors with casings was the only feasible option. The original doors were solid slab hardwood whereas the new doors were cheap particle board, hollow core, doors.

  - The next item was repairs to the main bathroom. The bathroom had seniors' aid equipment installed. Removal of such hardware caused wall damage and there was water damage around the tub as well. The wall had to be repaired and what was referred to as the "tub surround" had to be replaced and resealed. As well, a shelf unit was replaced; as was the sink. The old wall mounted sink needed support under it and had to be replaced as did the faucets. The old porcelain sink was replaced with a new vinyl sink and a vinyl countertop was installed.

- The last category of expenditure was electrical. As one might understand, as issues with three bathrooms were being addressed and as a kitchen was being renovated, old wiring that was not to code was being exposed and needed to be brought to code. The cost was $3,638.

[11] On cross-examination, Mr Garrett offered additional information.

[12] He looked for long term tenants. It saved advertising costs and did not require more cleaning and painting costs. He viewed the property as habitable when acquired. Even though it was not being lived in when the repairs were started, there were people living there before that. He went in to repair what was

broken and, yes, it benefited the property in the long term. He suggested that he could have moved in tenants without doing all the work and just done the work as required. But the market was slow – they had time to do the work. However, he did say the work had to be done to pursue their business model. Still, he said that in reality, tenants do not stay long suggesting that they could have been rented regardless of that.

[13] He said the repairs prevented deterioration. If you leave exterior cracks and water leaks, the property will deteriorate. He said they kept properties for five to ten years and that it was feasible that the work done had an effect over that period. He said some of the work was required for insurance purposes.

[14] He also confirmed certain assumptions set out in the Reply to the Notice of Appeal (the "Reply"). The Houghton property acquired in December, 2004 for $80,000 was rented by August and the Kensington property acquired in April, 2005 for $122,000 was rented by November. As well, he confirmed that the repairs and renovations were completed between taking possession and the first rentals.

Appellant's Submissions

[15] The Appellant relies on a strong line of cases that support his position that notwithstanding the enduring nature of the repairs and the renovating aspects of some of them, they have not altered the character of the properties or changed them into, or replaced them with, something new. He places emphasis on *Gold Bar Developments Ltd. v R.*.[4]

[16] In that case an entire brick facing of an apartment building had become unsound and was replaced using metal cladding instead of brick veneer. The analysis in that case, in focusing on the purpose of the repair which was not to improve the capital asset or make it different or better, found that the new facing was a deductible outlay. That repairs are expected to and do inevitably improve a property and may even be a "once-in-a-lifetime" incurrence, do not mean they are not "repairs". Further, that new advancements in building techniques give new and better options to repair deteriorating property does not mean that undertaking repairs utilizing those better, more modern, options will condemn a repair to a capital expenditure. In the case at bar the options chosen were largely cheaper options than those that would restore the properties back to anything like their

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[4] 87 DTC 5152 (FCTD).

original condition or even the condition that the Appellant believed they were in when they were acquired.

[17] It is submitted the repairs here were piecemeal repairs dealing with issues as they were discovered on close post-acquisition inspection. They were not part of a design to improve the existing properties or to, in effect, replace them with something other than what they were and when the work was complete, no new assets had come into existence. Like *Gold Bar*, nothing was done more than what was required to repair deteriorating conditions.

[18] Contrasting the current case with one where repairs did constitute capital outlays, the Respondent referred to *Shabro Investments Ltd. v. R.*.[5] In that case the floor of a building had to be reconstructed on top of newly sunken steel piles. A consideration that Jackett C.J. of the Federal Court of Appeal took into account was that the work made the building a long term usable asset – a character it did not previously have due to a serious construction defect. It went from usable to unusable. But for remedying the fabric of the building, replacing the floor using modern technology that incidentally improved the building would not make the repair capital in nature as long as the replacement is not substantially different than what was there before. Urie J. acknowledged that all repairs involve some degree of improvement – the question is whether the improvement brought into existence a different capital asset. Where an integral part of the building has changed in character, that goes beyond a replacement that simply performs the same function of that which is replaced. The purpose in *Shabro*, when examined, was not to restore a functional floor without increasing the value of the building, it was designed to function in a different way as an integral part of the building as a whole.

[19] The Appellant relies as well on *McLaughlin v R.*.[6] In that case Justice Bowman (as he then was) took exception at paragraph 9 to the Minister of National Revenue's (the "Minister") premise that improvements to a habitable rental property made to obtain enhanced rents were capital in nature. He cites the principles in *Shabro* and *Gold Bar* and reiterates that repairs done to put a house back to its original state – not to effect a permanent structural improvement or create something virtually new, as in a case like *Methe v. M.N.R.*[7] - were current

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[5] 79 DTC 5104 (FCA).

[6] 92 DTC 1030 (TCC).

[7] 86 DTC 1360 (TCC).

expenses. In *Methe* a total renovation was found to have resulted into a totally new building making the expenditure on capital account.

[20] Reference is made to *Lewin v R.*.[8] In that case a 20 year old deck with a fibreglass covering was replaced with a new deck with a vinyl covering – a modern equivalent. Other deck changes such as railings, lattice work and vented soffit were not significant and of nominal cost. The replacement was known to be needed when acquired. Again, applying authorities like *Gold Bar* and referring to Justice Lamarre Proulx's decision *Bergeron v. Minister of National Revenue*[9] which allowed that income related expenses included repairs the purpose of which was to make the part of the property repaired suitable for normal use again, it was held the repairs were deductible.

[21] The Appellant's counsel also referred me to *Brunet v. R.,*[10] *Jacques v. R.*,[11] *Janota v. R.*[12] and *Preiss v. R.*.[13]

[22] In a written submission, Appellant's counsel, responded to two questions that I raised at the hearing: what if any bearing does the overall amount of work being done, all at once, have on the issue; and what if any bearing does the work being done right after acquisition, to ready the properties for rental, have on the issue.

[23] Appellant's counsel pointed to his authorities that largely confirmed that aside from excluding individual capital additions, that the timing of the expenditures was not regarded as a factor. Doing a large number of repairs at the same time or doing them to ready a new rental property for rent were not considerations taken into account when considering the purpose and nature of the repairs which were the determinative factors.

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[8] 2008 TCC 618.

[9] 90 DTC 1511 (TCC).

[10] [2003] 2 C.T.C. 2020 (TCC).

[11] [2003] 3 C.T.C. 2673 (TCC).

[12] 2010 TCC 395.

[13] 2009 TCC 488.

[24] For example, he cited *McLaughlin* where a substantial number of repairs were undertaken on a newly acquired property. Justice Bowman (as he then was) applied the tests and principles applied in what he referred to as the leading cases, *Gold Bar* and *Shabro*. Those principles related to the purpose and nature of the work as reflected in paragraph 10 of his reasons:

> A substantial portion of the work that was done was, on the evidence, repairs to put the house back to its original state -- not to effect a lasting permanent structural improvement. Painting and wallpapering, repairs of floors, replacement of drywall, replacing of fixtures is essentially repair. …

[25] As well, the Appellant's counsel pointed out that the Canada Revenue Agency ("CRA") accepts that multiple repairs being done together would not reclassify the nature of repairs. In paragraph 4(d) of Interpretation Bulletin IT-128R it states:

> … where a major repair job is done which is an accumulation of lesser jobs that would have been classified as current expense if each had been done at the time the need for it first arose; the fact that they were not done earlier does not change the nature of the work when it is done, regardless of its total costs.

[26] Appellant's counsel acknowledges an exception to this principle where the effect of multiple repairs is to substantially improve the repaired property to a point past its original condition or to bring into existence an asset different from that which it replaced as was the case in *Shabro* where Justice Urie in the concurring decision for the Federal Court of Appeal stated at paragraph 21:

> … All repairs involve to some degree, renewal and replacement of parts of the subject matter of the repair and, therefore, of necessity an improvement to the repaired structure, machine or whatever the subject matter is.

He then stated:

> That alone, it appears from the jurisprudence, is not sufficient to convert an expenditure for repairs to an income producing property from an income expenditure to a capital expenditure. The crucial question it appears was the outlay such as to bring into existence a capital asset different from that which it replaced?

[27] In *Janota,* Justice McArthur cited Justice Brulé in *Chambers v. R.*,[14] wherein Justice Brulé stated:

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[14] [1998] 1 C.T.C. 3273 (TCC).

> 14 It would seem that if the repairs resulted in virtually the same old building as before the repairs were undertaken then such should be properly expensed, but if on finishing the repairs a virtually new building or at least quite a different building results then the repairs should be on capital account.
>
> 15 One criteria to make such a determination apart form the appearance inside and out of the structure and whether or not the place had to be vacated before repairs were undertaken is the dollar amount of the repairs in relation to the value of the asset. Here these were not extraordinarily large in relation to the building. …

[28] In *Bishop v. R.*[15] Justice François Angers stated at paragraph 10:

> The evidence as presented at trial leads me to the conclusion that the repairs and improvements that were made to the house during the three taxation years at issue were made to materially improve the house beyond its original condition. In fact, the repairs made to the house were substantial enough for one to say that, once they were completed, a totally different house was created ...

[29] A second exception that Appellant's counsel referred to was where a taxpayer has acquired a property that is in very poor condition and requires a total reconstruction or rehabilitation. In such cases the Courts have recharacterized what would otherwise be current expenditures into capital expenditures.

[30] In *Fiore v. R.*[16] (a case relied on by the Respondent) the Federal Court of Appeal had to decide whether expenses totalling $326,648 incurred by the taxpayer to renovate two buildings were current or capital expenditures. Both buildings were bought in poor condition and substantially renovated after purchase. The Court stated at paragraph 5:

> Where, as in the instant case, property is bought for a price ($107,000) below its ordinary capital value at the time of the purchase ($263,380 in 1983) and the expenses are necessary because of the condition of the buildings and are incurred to restore them to their ordinary value, we consider that those expenses are capital in nature.

[31] In *Marklib Investments II-A Ltd. v. R.*[17], Justice Brulé at paragraph 34 states:

> This Court is unable to find the relevance of a number of cases the respondent relied on

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[15] 2009 TCC 323.

[16] 93 DTC 5158 (FCA).

[17] 2000 DTC 1413 (TCC).

> in his argument. The respondent relied on cases involving newly-acquired buildings in poor condition, the need of repairs to get the building operational, and payment of a decreased purchase price because of the building's poor condition. All of the above cases are distinguishable from the case at bar as all involved the taxpayer acquiring or purchasing a deteriorated property. The taxpayers knew the state and condition of the property upon acquisition. I have to wonder whether the respondent is extracting the reasoning out of the cases and erecting it into general principles without taking into consideration the specific facts of the cases. …

[32] In closing, Appellant's counsel made the following submission:

> We submit that the evidence at trial establishes that:
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> - each of the properties in question were habitable, having been lived in prior to the purchase of them by the Appellant and the other individuals;
> - the Appellant would have rented the properties out if tenants were located and, as admitted by the Respondent in the Reply, the Appellant took steps to rent out each property after their purchase;
> - Because the properties were not rented out, repair work was undertaken on each property to fix individual aspects of the property that needed repair or replacement, or would need repair or replacement in subsequent years, in order to put the properties in good operating condition; and
> - The work undertaken to fix aspects of each property did not result in a substantial improvement to either property, as often the work involved a cheaper material or repair technique being used, than originally existed in each property.

Respondent's Submissions

[33] The Respondent essentially urged me to see the repairs as having been made to ready the properties for rental. They were not habitable as rental units of the type that the Appellant wanted to secure would rent. The expenses were incurred to put together a rental property that met his business plan. It was not the mere repair of an income generating property, it was a necessary cost of assembling and readying the capital asset that would generate the rental income.

[34] The Respondent relies on a number of cases. The first case he referred to was *Fiore*. This decision by the Federal Court of Appeal concerned expenses totalling some $326,000 incurred to renovate two buildings intended to be used as rental properties. At the time of acquisition they were in poor condition and the appellants set about renovating them at once. It was held in that case that the expenses were capital in nature and the Respondent argues that the circumstances are similar in the present case, namely that the expenses were necessarily incurred because the condition of the buildings when acquired required them to be restored to their ordinary value. It was further argued that like in *Fiore*, the subject appeal involved renovations that involved a significant improvement to the asset. The improvements in *Fiore* which are asserted to be comparable to those in the instant appeal were summarized in *Fiore* at paragraph 6 as follows:

> … Accordingly, there are now poured concrete foundations that did not exist before. Hardwood floors replaced plywood floors. Ceramic tile took the place of vinyl tile and linoleum. A low-amperage, obsolete electrical system (60 amperes) was replaced by a modern and more powerful system (125 amperes). Walls and ceilings were improved by using gypsum plaster board to replace prefit, plaster and plywood.

[35] The Court of Appeal found that it was not unreasonable for the trial judge to have concluded that the property in question had become new property and that the expenses were capital expenses.

[36] The Respondent takes the position that the purpose of the expense was to confer a lasting benefit to the rental operation. Reliance was placed on *Leclerc v. R.*.[18] In that case, this Court found that if the object of an expenditure was to provide a lasting advantage to the property then it can only be classified as a capital expenditure. Reference was made in *Leclerc* at paragraph 10 to the Federal Court of Appeal decision in *Canadian Reynolds Metals Co. – Société Canadienne de Métaux Reynolds Ltée v. R.*[19] where that court emphasized that it was the purpose of the expense, to confer a lasting benefit, that was the focus of the question. That was the test applied in *Marklib Investments* as well. In *Leclerc* the judge at paragraph 12 concluded that the repairs were on capital account "… because the repairs were not usual repairs on a property in rental condition but repairs to make the property rentable, the purpose of which was to confer a lasting

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[18] [1998] 2 C.T.C. 2578 (TCC).

[19] (1996), 96 DTC 6312 (Fed. C.A.).

benefit on the property." The Respondent submits that the purpose of the repairs in the instant appeal was, similarly, to obtain a lasting benefit.

[37] Focusing on the enduring benefit it was argued that repairs such as eliminating water damage and strapping the building envelope went beyond normal recurring maintenance and repairs. These provided enduring benefits. Similarly to replace cupboards and redesign a kitchen in the process of removing rot went beyond being normal recurring maintenance expenses.

[38] The Respondent argues that the renovations here were in the nature of replacing parts of the building making it something that was essentially different in kind from what it was before so as to constitute an improvement to the building rather than a mere repair of it. Referring to *Shabro*, a case contrasted to the present case by the Appellant, the Respondent submits that that case which found there had been sufficient replacements and substitutions to essentially create a different building was comparable to the one at bar.

[39] Respondent's counsel emphasized that his argument was based, in any event, not so much on the overall improvement of the property but rather on the nature of each of the repairs which if left unattended would cause serious detriment to the buildings. A new kitchen was built because the old kitchen was rotting away. This is not a repair, it is a replacement caused by such degree of deterioration as to underline its enduring benefit as something new.

[40] It was argued that the business model required such capital improvements in order to put the properties in a rentable condition.

[41] In a written submission, Respondent's counsel also referred me to *Brunet*. In that case, Justice Lamarre placed her emphasis on cases that found that the crucial question was whether the outlay was such as to bring into existence a capital asset different from that which it replaced.[20]

[42] Respondent's counsel argued that the subject properties were not up and running income producing assets when acquired and were not part of an existing rental operation. Repairs and renovations were necessary prior to the property

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[20] At paragraph 13 Justice Lamarre relied on the Federal Court of Appeal decision in *Donohue Normick Inc. v. R.*, 96 DTC 6061 (Fed. C.A.) and at paragraph 14 she cites *Canada Steamship Lines Ltd. v. Minister of National Revenue*, 66 DTC 5205 (Ex. CT.).

being available for rental. The fact that the properties were occupied prior to purchase did not mean that the repairs and renovations were necessary to bring the properties into rentable condition. The expenses were incurred to bring the capital asset into use as rental properties.[21]

[43] The Respondent argues that the overall number of repairs and renovations looked at as a whole demonstrate an overall change in character of the asset. That is, an entire renovation project differs from ordinary ongoing maintenance. The Respondent relies on the additional authorities of *Audrey B. Wager v. M.N.R.*[22] and *Charney v. The Queen*.[23]

Analysis

[44] There is no doubt that the cases in this area suggest that the fact that an enduring benefit arises from a repair will not disqualify it from current expense treatment. This, in itself, makes the analysis difficult since it takes the analysis away from a traditional perspective. Replacing a roof or kitchen cupboards can be a repair notwithstanding that they have enduring value. This departure from a traditional analysis seems to stem from the inevitability that all repairs will have some enduring value and from the ongoing and repetitive cycle of repairs due to usage, time and unforeseen issues. Such realities require, or at least have caused, a change in focus and I agree with Appellant's counsel that the primary focus is on the purpose and nature of the work done.

[45] I would not go so far as to say that such focus applies universally with identifiable exceptions as argued by Appellant's counsel. I would say that the analysis of the purpose and nature of the work done incorporates consideration of a number of factors each given different weight in different circumstances. As

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[21] Responding to my request for cases involving or addressing repairs/renovations that were undertaken after acquisition and before rental operations commenced the Respondent referred me to *Fiore*; *Albayate v. The Queen*, 2008 TCC 24; *Nguyen v. The Queen*, 2007 TCC 574; *Methe* and *Martinello v. Canada*, 2010 TCC 432 at para. 20.

[22] 85 DTC 222 (TCC).

[23] [1996] T.C.J. No. 332 at para. 36.

Justice Bowman suggested in *McLaughlin*, a common sense application of the various factors provides the answer.[24]

[46] Nonetheless, it must be recognized that in this area at least, common sense is not particularly "common" to all observers. Is it common sense that replacing a roof is a current expense? I might suggest that it is not – but that would be to ignore an abundance of authorities, including the Minister whose positions on the matter say otherwise. Interpretation Bulletin IT-128R last revised in May, 1985 for example provides as follows in paragraph 4(b):

> (b) Maintenance or Betterment - Where an expenditure made in respect of a property serves only to restore it to its original condition, that fact is one indication that the expenditure is of a current nature. This is often the case where a floor or a roof is replaced. Where, however, the result of the expenditure is to materially improve the property beyond its original condition, such as when a new floor or a new roof clearly is of better quality and greater durability than the replaced one, then the expenditure is regarded as capital in nature. Whether or not the market value of the property is increased as a result of the expenditure is not a major factor in reaching a decision. In the event that the expenditure includes both current and capital elements and these can be identified, an appropriate allocation of the expenditure is necessary. Where only a minor part of the expenditure is of a capital nature, the Department is prepared to treat the whole as being of a current nature.

[47] I cite this to underline that even a new roof can be a current expense. As I will note later in these Reasons, the Minister can point to several cases to support this position. As well, it does reflect a position that regards repairs that restore a property to its original condition to be of greater significance in the determination of the current versus capital issue than repairs that may result in a modest increase in the value of the property.

[48] This might well reflect the way many if not the majority of the authorities view repairs in spite of the Federal Court of Appeal decision in *Fiore*. In *Fiore* the scope of the improvements could be seen from valuation reports that revealed the property, which should have been worth $263,000, was acquired in poor condition for $107,000 and later, after repairs totaling a grand total of $326,000, was valued at $437,000. In finding that the repairs ($174,000 of which were in dispute) were capital in nature, the Court clearly rejected the argument that expenses incurred in that case, to bring a property up to its ordinary value had it been properly

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[24] See *McLaughlin* at para. 17 for references to the requirement of a common sense appreciation of all the guiding features that will provide the ultimate answer.

maintained, were current expenses. That rejection seems to be based on the premise, as noted in paragraph 4 of that decision, that that cannot *always* be true. In some cases, like the case in *Fiore*, restoration expenses, expenses incurred to restore the property to its ordinary value, should be treated as on capital account.

[49] This strikes me, theoretically speaking, as an appropriate result. Capital costs of buildings are, after all, allowed a deduction for wear and tear in the form of capital cost allowance. Allowing a full deduction for the cost of restoring a depreciated property to the starting point in the name of repairs suggests a liberalization of a pretty fundamental aspect of the scheme of the *Income Tax Act*.[25] Still, it must be acknowledged that *Fiore*, on its facts, does present a clear and obvious case of restoration to a new starting point in terms of the appropriateness of capital cost allowance treatment.

[50] Seen in this way, the decision in *Fiore* is not at odds with the authorities that support the Minister's position as reflected in IT-128R. The Bulletin speaks of restoration to a particular condition. *Fiore* speaks of restoration to a value that, but for the deteriorated conditions that made the repairs necessary, would be an ordinary value. Where value is materially enhanced beyond that, by repairs, *Fiore* is authority for finding that such repairs are capital in nature. As well, it should not be overlooked that in *Fiore* the repairs included structural improvements – a poured concrete foundation that did not exist before. This suggests a change in the nature of the property as later found in *Shabro*. Based on such additional facts, the Federal Court of Appeal in *Fiore* was able to rely on the work done as having resulted in a significant improvement to the asset.

[51] Another aspect of *Fiore*, reflected in other cases as well, relates to the relevance of the overall cost of the repairs.[26] Where the extent of the repairs or work done require expenditures that are quantitatively significant relative to the cost of the property to the taxpayer seeking current expense treatment, there is less likelihood that an intention to restore will suffice. The character of *that which was*

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[25] A similar comment was made in *Minister of National Revenue v. Vancouver Tug Boat Company, Limited*, 57 DTC 1126 (Ex. Ct.).

[26] See *Methe* for example and in *Marklib Investments*, Justice Brulé pointed out at paragraph 36 that the magnitude of the expense must be examined in the context of the value of the building. In *Gold Bar* at paragraph 8 it was remarked that the amount in issue represented less than 3% of the value of the asset. That, in itself, was said not to justify the re-classification of the expenditure.

acquired may have changed. Restoration to a former character by a new owner may be a capital project demanding a new starting point in terms of capital cost allowance treatment where the cost and timing of the project undertaken is reflective of an intention to do more than a mere repair. That is, in cases like the case at bar, the issue might be whether the repairs changed the character of the property as purchased as opposed to whether the repairs restored the property to what it was prior to deterioration suffered in the hands of previous owners. While the timing of the repairs in the case at bar may be suggestive of an intention to change the character of the property as purchased, I have not come to that conclusion in this case. As I will note later in these Reasons, timing in this case is of considerable relevance but not because there has been a change in the character of what was acquired.

[52] While the timing of and the relative cost of work done are factors to consider, I note that there is little doubt that, generally speaking, the current treatment of repairs will not be changed simply because a number of repairs are undertaken at the same time.[27] There seems to be no suggestion in the authorities that the courts will second-guess an owner's decision as to the timing of repairs that may, for example, be done at various stages of wear, during vacancies or slow rental markets or when economies present themselves, including a decision to do multiple repairs that may, when done together, appear to be a renovation when they might more properly be considered to be cyclical restorative repairs undertaken with no intention of altering the character of the property.

[53] My reference to a "renovation" does suggest that the extent of the repairs will still be a factor. Intuitively, that seems to align with what common sense might suggest. Still, the authorities on the whole, perhaps recognizing the economic realities of the ongoing and recurrent nature of general maintenance which is largely restorative in nature, suggest that there is room for considerable latitude and tolerance here to allow fairly significant renovations current expense treatment provided they do not go so far as to change the character of the property and that they were undertaken with the purpose to repair the property, in a restorative sense.

[54] The restorative aspect of a repair which is given current expense treatment can readily be seen in the example already mentioned, namely, a new roof. New

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[27] Applying the principles in *Gold Bar* Justice Brulé in *Marklib Investments* at paragraph 47 noted that an appellant should not be penalized simply because a large number of repairs were made in one year.

shingles may last 25 years but they restore a property to its original state from a functional point of view. The shingles may be of better quality, designed to perform and even look better, but if the purpose was primarily to repair a worn or damaged roof, the cost will be deductible.[28]

[55] Perhaps it should go without saying, but the purpose test inevitably must have an objective element. The cost of some materials, the design or even the function of work done, may objectively suggest that mere restoration was not the primary purpose for undertaking it. If a repair becomes an excuse to upgrade a property to appeal to a different class of renter, that might suggest a change in the character of the property as opposed to a consequential improvement incidentally achieved in completing the repair in a restorative sense.

[56] Consider the new kitchen in the Kensington property in the case at bar. Water damage caused rot which led to a variety of required repairs which in turn led to plumbing and electrical code issues. I am satisfied that the new cupboards and flooring were restoration oriented. Reconfiguration of the kitchen, required in large part by building code issues presented by the old configuration, gave rise to an opportunity to improve aspects of the kitchen design. However, this all flowed from the need to repair the damage. Indeed, repairs that involve work on older properties, work required by deterioration, occupant neglect or abuse or intervening events, may never be capable of being restored except in a modern fashion. They are still repairs. Consequential improvements incidentally achieved in completing repairs undertaken in a restorative sense do not change the character of the expenditure. The focus of the work done on the new kitchen in the Kensington property was not to upgrade to modern standards and current residential standards. These became opportunities or requirements that could be or had to be addressed as incidental to the restorative needs of the property. There are no costs here that suggest that the materials, finishings or design changes were indicative of anything but repairs. Indeed, all costs incurred are surprisingly modest. This is most apparent perhaps in the cost of the electrical and plumbing repairs. I am satisfied that the purpose of the work done on each property was to repair damage. That is, it was restorative in nature. There was no intent to change the character of the properties.

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[28] See for example *Marklib Investments* and *Healey v. Minister of National Revenue*, 84 DTC 1017 (TCC). As well in *Brunet*, Justice Lamarre found that re-shingling the property was not a capital expenditure.

[57] Referring to costs, again draws the analysis to consider whether there has been an enhancement of value beyond the ordinary value that these properties might have had but for the need for the repairs. As noted above, that was found to be determinative in *Fiore*. It certainly can speak to intent from an objective perspective. While the Respondent relies on that case, I have no evidence on the point. While there would inevitably be some value enhancement were the problems that needed repair detectable at the time of purchase so as to enable a reduction in price, I have nothing to contradict Mr. Garrett's assertions that that was not the case. They were hidden issues reflecting more deterioration and damage than pre-acquisition inspections revealed. If there was any enhanced value by virtue of the repairs, that could not be seen as indicative of the repairs having crossed over to a renovation in the sense of there having been an intent to effect a fundamental improvement, or change, in the nature of the property. Again then, I accept that the repairs were restorative in nature in this sense.

[58] Accordingly, I have no concerns in the case at bar as to the restorative nature of the expenses incurred by the Appellant even as a new owner of the properties. I have no concerns that the character of the properties were significantly changed or that their value was materially enhanced compared to what was paid. The only troubling aspect of the instant appeal is that the expenses, even as acknowledged in Appellant counsel's written submission, were incurred in order to put the properties in good operating condition. Given the timing of the expenditures, this suggests that although the properties were habitable and, as asserted by Mr. Garrett, could possibly have been rented, they were not really ready to be rented.

[59] While the emphasis of the Respondent's argument, that the expenses were incurred to ready the properties for rental, was on their not being habitable, the crux of that argument does not, in my view, depend on the correctness of that latter assertion. If the properties, on acquisition, are not habitable, that state of affairs points to the conclusion that the rental activity had not commenced. The expenses could not then be found to have been usual operating costs incurred in the normal course of pursuing a rental activity. However, habitable or not, I am not satisfied on the evidence that the properties in this case were ready to be rented when the repairs were undertaken.[29] The expenses strike me as having been incurred, foreseen or not, as part of the process of acquiring the properties.

[29] While Mr. Garrett had a considerable number of rental properties of which these two properties formed part, I have no such evidence in respect of the Appellant. The Appellant was a passive co-owner of the two subject properties. While the Notice of Appeal states that Appellant carried on a rental business, the Reply denies that allegation and the Appellant led no evidence to lead me to conclude that the rental income received by the Appellant was other than income from property. If it

[60] Respondent's counsel referred me to several cases but the one that spoke the loudest was an *obiter dicta* comment made by Justice Boyle of this Court in *Martinello v. Canada*.[30] At paragraph 20, Justice Boyle cites cases that involved expenses incurred to repair a property after it was acquired and before it was used by the taxpayer to produce income. Justice Boyle then said:

> … It is obvious that such expenses should ordinarily form part of the capital cost of the property. The property was being put in rentable condition for the first time.

[61] This comment strikes me as eminently true. However, the cases he relies on, *Fiore*, *Albayate v. The Queen*,[31] and *Nguyen v. The Queen*[32] do not themselves necessarily suggest that the reason the taxpayers lost their appeals was only because they had just acquired the properties and were readying them for rent for the first time. In *Nguyen* for example at paragraph 15 Justice Sarchuk said:

> Clearly, the expenses claimed were for a substantial reconstruction of a portion of the building and were not repairs on a property in rental condition, but repairs to make the property rentable, the purpose of which was to confer a lasting benefit on the property.

[62] On the other hand, a review of the repairs done in that case and their cost suggest that the repairs were no more substantial than the ones I am considering in the case at bar. Further, the evidence in that case was that the taxpayer said the property was in rentable condition before the repairs were done if he found a willing tenant. That testimony is not dissimilar from the testimony of Mr. Garrett who said the properties in the case at bar were rentable before the repairs, intimating that I would be surprised what people would rent.

[63] In *Albayate,* the property was in very bad condition having been used as a "grow-op". The repairs were found to be extensive renovations. In reaching his conclusion that the outlays were capital in nature, Justice Little relied on a comparison with *Fiore* where, as noted above, the scope of the improvements could be seen from valuation reports that revealed the property, which should have been worth $263,000, was acquired for $107,000 and later after the repairs was

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was a business of the Appellant, there is, still, insufficient evidence to permit me to conclude that it had commenced until after the repairs were completed.

[30] 2010 TCC 432.
[31] 2008 TCC 24.

[32] 2007 TCC 574.

valued at $437,000. Nothing in *Fiore* or *Albayate* necessarily suggests that the reason expenses were capitalized was because they were incurred after acquisition, before the first rentals.

[64] Still, Justice Boyle's reasoning in *Martinello* is persuasive and aligns with my views. Aside from concluding that Mr. Garrett's testimony was somewhat disingenuous as it related to the rentability of the properties before the repairs, it is clear that the intentions of the co-owners of the subject properties was, as between themselves, to treat the repairs in the same manner as the purchase price. If that arrangement can be taken as reflecting the nature of the expenditure it would be quite damning. That, however, is not a factor that weighs heavily in my analysis because that aspect of the bargain stuck between the co-owners derives from a tax planning purpose. It does not speak to an intention to repair or renovate and as noted above I accept that the intention here was to repair in a restorative sense. However, as stated, what does weigh heavily is my concurrence with Justice Boyle's general premise which, in this case at least, accords with my earlier remarks concerning the appropriate starting point in the calculation of capital cost allowance.

[65] It is true that a lot more may be done in the name of repairs than lipstick and make-up touch-ups in the course of an active rental program. It is true that repairs of the very nature incurred in the case at bar can be done during a vacancy so as to ready the property for the next tenant, even at a higher rent, without losing current expense treatment. It is true that there might be a fine line between attaching a repair cost to an acquisition where it is incurred before a first rental and not doing so where such cost is incurred during the initial months of a first tenancy; nonetheless, the case at bar is not concerned with those fine lines. Such issues would have to be addressed on a case by case basis.

[66] As well, I might suggest that readying a property for occupancy has more likelihood of being considered on current account where the repairs were undertaken to make the property suitable for normal use *again* by the same owner. Indeed, the concept of "suitable for normal use again" was embraced as part of the principles that Justice Lamarre Proulx formulated in *Bergeron*. I would, as a matter of common sense, read-in "by the same owner" in the case of a newly acquired property.

[67] Similarly, in *Methe*, a certain amount of weight was given to the fact that the buildings in question were always operational and that maintenance costs had to be incurred in order to safeguard and maintain the rental income. Again, as a matter of

common sense, I would read-in “by the same owner” in the case of a newly acquired property.

Conclusion

[68] On the facts, I find that the Respondent’s position that the subject expenses were incurred to ready the property for rental is correct. Given my acceptance in this case, in general at least, of the principle stated by Justice Boyle in *Martinello* and given that the repairs in this case were not just on the heels of the acquisition of the properties and undertaken before a first rental but were expenses incurred, foreseen or not, as part of the process of acquiring the properties, I conclude that the cost of them must be on capital account. Accordingly, the appeal is dismissed, without costs.

Signed at Ottawa, Canada this 8th day of June 2011.

"J.E. Hershfield"

Hershfield J.

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