1964

Mar. 23, 24

Nov. 20

BETWEEN:

LOUIS J. HARRIS ..... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

Revenue—Income tax—Lease option agreement—200-year lease with option to purchase—Determination of capital cost allowance—"Price fixed by contract or arrangement", meaning of—Income Tax Act, s. 18(1).

On October 1, 1960, the appellant as lessee entered into a contract to lease a service station in Toronto for 200 years at an annual rental of $3,100.08 and was granted an option to buy the property at the expiration of the term for $19,500. In 1960 appellant claimed a capital cost allowance of $30,425.80, which the respondent disallowed. Section 18(1) of the *Income Tax Act* provides:

> "A lease-option agreement, a hire-purchase agreement or other contract or arrangement for the leasing or hiring of property . . . by which it is agreed that the property may, on the satisfaction of a condition, vest in the lessee . . . shall, for the purpose of computing the income of the lessee, be deemed to be an agreement for the sale of the property to him and rent or other consideration paid or given thereunder shall be deemed to be on account of the price of the property and not for its use; and the lessee shall . . . be deemed to have acquired the property . . . (*b*) . . . at a capital cost equal to the price fixed by the contract or arrangement . . .

Appellant appealed, contending that "the price fixed by the contract" for the purposes of s. 18(1) was the total rent payable during the 200-year term plus $19,500, *viz.* $639,516.

Held: That the capital cost of the service station property as determined by the provisions of s. 18(1) was $19,500.

1. Having regard to the variety of forms which contracts or arrangements falling within the description of s. 18(1) might take, the determination of what is "the price fixed by the contract or arrangement" must depend on the interpretation of the particular contract or arrangement.
2. The words "price fixed by the contract or arrangement" in s. 18(1) were used in contradistinction to the words "rent or other consideration paid or given thereunder" and must be taken to refer to the consideration to be given for the property under the terms of the contract in the event of the transaction resulting in the property vesting in the taxpayer. In the present case the contract clearly fixed the sum of $19,500 as the whole price to be paid for the property at the material time.

(*Partington v. Attorney General* (1869-70) L.R. 4 H.L. 100, per Lord Cairns at p. 122, referred to.)

APPEAL from a decision of the Tax Appeal Board.

The appeal was heard by the Honourable Mr. Justice Thurlow at Toronto.

J. J. Robinette, Q.C. for appellant.

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D. S. Maxwell, Q.C. and *D. G. H. Bowman* for respondent.

The facts and questions of law raised are stated in the reasons for judgment.

THURLOW J. now (November 20, 1964) delivered the following judgment:

This is an appeal from a judgment of the Tax Appeal Board[1] dismissing the appellant's appeal from an assessment of income tax for the year 1960. In his return for that year the appellant claimed a deduction of $30,425.80 as "depreciation" on a service station property on which he had taken a long term lease during the year and the issue in the appeal is whether he was entitled to such a deduction in computing his income for tax purposes. The Minister disallowed the deduction and his action in so doing was upheld by the Tax Appeal Board.

The property in question is situated in Toronto. It was purchased in March 1960 for $31,000 by Douglas Leaseholds Limited who thereupon spent $8,500 on improvements to it and leased it for 25 years to B. P. Canada Limited at a rental of $3,900 per annum on terms *inter alia* requiring the latter to pay the taxes and to keep the buildings on the property insured and in repair. By indenture dated October 1st, 1960 Douglas Leaseholds Limited as lessor leased the same property to the appellant for a term of 200 years commencing on that date at an annual rental of $3,100.08 and agreed that at the expiration of the term the appellant, if not in default under the lease, should have the option of purchasing the property from the lessor for $19,500. In the transaction the appellant covenanted *inter alia* to pay taxes and to keep the premises in repair and he was required to deposit $10,000 with the lessor as security for the performance of his covenants, the lessor agreeing to return the deposit at the expiration of the term if the appellant had observed and performed his covenants. The appellant paid the deposit, received a total of $975 paid by B. P. Canada Limited as rent for October, November and December 1960, and himself paid $775.02 to Douglas Leaseholds Limited for rent under his lease for the same months. In his income tax return the appellant, who is a successful obstetrician and

[1] 31 Tax A.B.C. 113.

gynecologist enjoying a substantial income from his practice, *inter alia* accounted for the $975 as income and against it claimed the sum of $30,425.80 for "depreciation" thus showing a loss with respect to the property for the year of $29,450.80 but he did not claim as an expense the $775.02 which he had paid to Douglas Leaseholds Limited. The reason for this course appears from the somewhat confusing statutory provisions upon which the appellant justifies his computation of his income. In making the assessment the Minister, as previously mentioned, disallowed the deduction of the amount claimed less an amount of $775.02 which he allowed as rental expense.

The basis for the appellant's position is found in ss. 11(1)(*a*) and 18(1) of the *Income Tax Act* R.S.C. 1952, c. 148, the latter subsection as enacted by S. of C. 1958, c. 32, s. 8. These read as follows:

11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year;

(*a*) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation;

18. (1) A lease-option agreement, a hire-purchase agreement or other contract or arrangement for the leasing or hiring of property, except immovable property used in carrying on the business of farming, by which it is agreed that the property may, on the satisfaction of a condition, vest in the lessee or other person to whom the property is leased or hired (hereinafter in this section referred to as the "lessee") or in a person with whom the lessee does not deal at arm's length shall, for the purpose of computing the income of the lessee, be deemed to be an agreement for the sale of the property to him and rent or other consideration paid or given thereunder shall be deemed to be on account of the price of the property and not for its use; and the lessee shall, for the purpose of a deduction under paragraph (*a*) of subsection (1) of section 11 and for the purpose of section 20, be deemed to have acquired the property.

(*a*) in any case where, at the time the contract or arrangement was entered into, the lessee and the person in whom the property was vested at that time (hereinafter referred to as the "lessor") were persons not dealing at arm's length, at a capital cost equal to the capital cost thereof to the lessor, and

(*b*) in any other case, at a capital cost equal to the price fixed by the contract or arrangement minus the aggregate of all amounts paid by the lessee

(i) in the case of a contract or arrangement relating to moveable property, before the 1949 taxation year, and

(ii) in the case of any other contract or arrangement, before the 1950 taxation year,

under the contract or arrangement on account of the rent or other consideration.

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The appellant's case is that the transaction by which Douglas Leaseholds Limited granted to him a 200-year lease with an option to purchase the property at the end of the term was a lease-option agreement or other contract or arrangement for the leasing of property by which it was agreed that the property might on the satisfaction of a condition, that is to say on exercise of the option and payment of the price, vest in him or his successors in title and was thus a transaction of the kind referred to in s. 18(1), that the transaction was not one of those excluded by s. 18(4) from the operation of s. 18(1) and that accordingly the transaction must be treated as an agreement for the sale of the property to him and the rent which he paid must be treated as having been paid on account of the price of the property and not for its use. He was therefore, in his view, entitled, in computing his income for tax purposes, to treat the whole of the rent payable for the 200-year term as well as the $19,500 payable on exercise of the option to purchase, that is to say, a total sum of $639,516.00, as "the price fixed by the contract or arrangement" for the purpose of calculating the deduction to which he was entitled under s. 11(1)(*a*).

Against this view counsel for the Minister raised three grounds upon which he submitted that s. 18(1) did not apply to the transaction at all and three further grounds based on the assumption that s. 18(1) would apply, on the first two of which it was submitted that no deduction whatever could be made and on the third of which it was submitted that the permissible deduction would be reduced to inconsequential size. On the first branch of the argument it was submitted that s. 18(1) did not apply because:

(*a*) it was not established that the transaction in question was not within the excluding provision of s. 18(4) as there was no satisfactory evidence that $19,500 was less than 60 per cent of the value of the property at the material time;

(*b*) the transaction was not really a lease at all and the appellant at the material time was not lessee of the property but merely the holder of an *interesse termini* and s. 18(1) did not apply to such a transaction;

(*c*) that the option offends the rule against perpetuities and, as it is therefore void, s. 18(1) did not apply to the transaction.

Counsel then went on to submit that if, contrary to these contentions s. 18(1) did apply to the transaction the effect of that provision was that the appellant was not entitled to the allowance made by the Minister in respect of the rent paid by the appellant but that he was nevertheless not entitled to the deduction for capital cost allowance claimed because:

(*d*) the transaction was not entered into for the purpose of gaining income but solely or, in the alternative, primmarily for the purpose of reducing the appellant's income tax and thus fell within the prohibition or exception provided by Regulation 1102(1)(c);

(*e*) the deduction claimed represented an expense made or incurred in respect of a transaction which, if allowed would unduly and artificially reduce the appellant's income and its deduction was therefore prohibited by s. 137(1) of the Act;

(*f*) on the correct interpretation of s. 18, as applied to the transaction, the deduction must be based on a capital cost of $19,500 for the property since this is the price fixed for it by the contract. Counsel then submitted that in the event of this contention being upheld the re-assessment should be referred back to the Minister to allow the proper deduction on this basis and to disallow the rental expense item. As an alternative to this point it was submitted that if the price fixed by the contract was indeed to be taken at the appellant's figure of $639,516, s. 18(4) would exclude the transaction from the operation of the section.

As I agree with the first submission in (*f*) above and have further reached the conclusion that on this point the appeal fails it is unnecessary for me to express my views on the submissions outlined in (*a*), (*b*), (*c*), (*d*) or (*e*) or on the alternative submission outlined in (*f*).

On the first submission in (*f*) the matter to be determined is the capital cost to be fictitiously attributed for the purpose of s. 11(1)(*a*) to the property which is the subject matter of the fictitious purchase created by s. 18(1). This is defined in s. 18(1) as "the price fixed by the contract or

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arrangement" and in approaching the interpretation to be put upon these words a few observations of a general nature may be useful.

First, s. 18(1) must in my opinion be taken as meaning neither more nor less than precisely what it says. Its interpretation may be influenced by reading it with the other provisions of s. 18, of which it is a part, but the principle that there is no equity about a tax is well established and there is no basis for the admission of any principle of "equitable construction". *Vide Partington v. Attorney General*[1] where Lord Cairns said at p. 122:

> I am not at all sure that, in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.

The principle so expressed is usually cited in support of a taxpayer's submission but it appears to me to operate both ways.

Secondly, the subsection is plainly divided into two parts. The first is directed to achieve a statutory conversion of the contract or arrangement into an agreement for the sale of the property and to declare that the rent or other consideration which the taxpayer has agreed to pay shall be regarded as having been paid or given on account of the price of the property and not for its use. The consequence of regarding the transaction as an agreement for the sale of the property to the taxpayer is that the property of which he is then in fact only lessee, is regarded as his and in computing his income he is entitled to the deduction provided by s. 11(1)(*a*). The consequence of the declaration that the rent or other consideration paid or given shall be deemed not to have been paid or given for the use of the property is that it cannot be deducted as an expense in computing the taxpayer's income. The statute also declares that the rent or other consideration paid or given is to be regarded as paid or given on account of the price of the property. A consequence of this is that if the money was borrowed the interest on it

[1] (1869-70) L.R. 4 H.L. 100.

would qualify for deduction under s. 11(1)(*c*)(ii). This part of the subsection, however, as I read it is concerned only with the statutory conversion of the transaction into an agreement of sale and with certain stated consequences which are to flow from such conversion. The definition of the capital cost of the property to the taxpayer for the purpose of calculating the deduction under s. 11(1)(*a*) to which the taxpayer is to be entitled is not dealt with in this part of the subsection but is the subject matter of the second part of it. In the second part the subsection declares that the taxpayer shall for the purpose of s. 11(1)(*a*) be deemed to have acquired the property at a capital cost equal to "the price fixed by the contract or arrangement" less, in the case of contracts made before 1950, amounts paid as rent or other consideration prior to certain stated times. Here it is I think of importance to note that the expression used is "the price fixed by the contract or arrangement" and that the expression "contract or arrangement" appeared earlier in the subsection in company with the words "for the leasing or hiring of property . . . by which it is agreed that the property may, on the satisfaction of a condition, vest in the lessee or other person to whom the property is leased or hired". It is thus this contract or arrangement, rather than the "agreement for the sale of the property" fictitiously created by the subsection, which is referred to in the expression "the price fixed by the contract or arrangement".

Thirdly, in the subsection the expression "rent or other consideration paid or given thereunder" is used in contradistinction to the expression "the price fixed by the contract or arrangement" the former being used with reference to rent or consideration for the use of the property during the lease or hiring and for the option itself while the latter includes the word "price" and appears to me to refer to the consideration to be given for the property under the terms of the contract in the event of the transaction resulting in the property vesting in the taxpayer.

Fourthly, it is apparent that contracts or arrangements of the kind with which s. 18(1) deals may take more than one form. One well known variety consists of a leasing or hiring at a rental but contains a provision that at the conclusion of the lease or hiring the owner will at the option of the lessee or hirer sell the property to him for the amounts paid as

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rental, or for parts of such amounts, in some cases with, and in others without some further consideration payable at that time. Another variety provides for payment of either a nominal or substantial payment on acquisition of the property by the lessee or hirer but does not purport to treat any part of the rental payments as part of the price payable for the property. Cases are also readily conceivable wherein no price whatever may be payable at the time of vesting as for example where the vesting might be simply dependent on some extraneous or fortuitous event. In all these cases it appears to me that the determination of what is "the price fixed by the contract or arrangement" must accordingly depend on the interpretation of the particular contract or arrangement.

Next it is to be observed that Parliament in enacting s. 18 appears to have contemplated that "the price fixed by the contract or arrangement" may be less than the total rent or other consideration paid or given under the contract or arrangement since it provides in s-s. (2)(*b*) that on rescission of the contract or arrangement the amount of such rent or consideration paid in excess of the capital cost at which the lessee is deemed to have acquired the property shall be deemed to have been paid for use of the property and not on account of its price and would accordingly be deductible as expense in the year in which rescission occurred.

Finally, neither the remaining clauses of s-s. (1) nor the definitions of s-s. (3) nor the exclusions effected by s-s. (4) appear to me to have any influence one way or the other on the interpretation of the expression "the price fixed by the contract or arrangement" in s. 18(1).

These considerations lead me to conclude that the words "rent or other consideration paid or given thereunder shall be deemed to be on account of the price of the property" do not bear the interpretation which the appellant's contention requires. They do not say that rent or other consideration is deemed to be part of the "price fixed by the contract or arrangement" or of the capital cost of the property for the purpose of s. 11(1)(*a*) but merely that for the purpose of computing the taxpayer's income rent or other consideration paid or given shall be deemed to be "on account of" the price of the property. To find what the capital cost of the

property is to be for the purpose of s. 11(1)(*a*) one must look to the contract or arrangement itself.

In the present case the material provision of the indenture is:

> At the expiration of the term hereby demised, and provided the Lessee is not in default hereunder, said Lessee shall have the option of purchasing the demised premises from the Lessor at the price of NINETEEN THOUSAND FIVE HUNDRED ($19,500.00) DOLLARS.
>
> The Lessee may exercise the said option by giving to the Lessor three (3) months' notice in writing that he intends to purchase the demised premises and upon the exercise of the said option the sale shall be completed within a thirty (30) day period after the option has been exercised.

As a matter of interpretation this to my mind clearly means that $19,500 is the price and the whole of the price to be paid for the property at the material time and as nothing about the nature of the property or in the other provisions of the indenture indicate any other intention $19,500 is in my opinion "the price fixed by the contract" within the meaning of s. 18(1) and the capital cost at which for the purpose of s. 11(1)(*a*) the appellant is deemed to have acquired the property.

Subsection (2) of s. 18 goes on to provide that:

> 18. (2) Where a lessee is deemed by subsection (1) to have acquired property under a contract or arrangement and that property includes property (hereinafter referred to as "depreciable property") in respect of which the lessee has been allowed, or is entitled to, a deduction under paragraph (*a*) of subsection (1) of section 11 in computing his income for a taxation year, the following rules apply:
>
> (*a*) the capital cost at which, for the purpose of a deduction under paragraph (*a*) of subsection (1) of section 11 and for the purpose of section 20, the lessee shall be deemed to have acquired the depreciable property is,
>
> (i) . . .
>
> (ii) . . . the capital cost at which the lessee is deemed by subsection (1) to have acquired the property minus the fair market value, at the time the contract or arrangement was entered into, of the part of the property that is not depreciable property;

As the property includes both land and improvements thereto and the improvements alone are depreciable property within the meaning of this provision and as the evidence indicates that the value of the land alone at the material time was $9,000 it would appear that the basis for the calculation of the deduction to which the appellant is entitled is $10,500. On the basis of the appellant's submission that the property falls within class (iii) of Schedule B

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of the Regulations, the rate of capital cost allowance on which is 5 per cent., the deduction to which he is entitled is $525 and as it is thus not shown that the deduction to which he is entitled under s. 18 exceeds the $775.02 which the Minister, in my opinion wrongly, allowed as rent, the amount of tax assessed against the appellant is not in excess of his liability therefor and it follows that he has no cause to complain and that his appeal fails.

As already mentioned it was suggested by counsel for the Minister that if I reached the conclusion that the appellant was entitled to a deduction of capital cost allowance based on a capital cost of $19,500 for the property the proper course would be to refer the assessment back to the Minister to disallow the rent deduction and to allow a proper deduction for capital cost allowance. As no issue had been raised as to the allowance of $775.02 as rent expense counsel for the Minister also asked leave to amend the reply to raise the question so that the $775.02 deduction might be disallowed when and if capital cost allowance was deducted.

I do not think, however, that this is the correct way to deal with the matter. On a taxpayer's appeal to the Court the matter for determination is basically whether the assessment is too high. This may depend on what deductions are allowable in computing income and what are not but as I see it the determination of these questions is involved only for the purpose of reaching a conclusion on the basic question. No appeal to this Court from the assessment is given by the statute to the Minister and since in the circumstances of this case the disallowance of the $775.02 while allowing $525 would result in an increase in the assessment the effect of referring the matter back to the Minister for that purpose would be to increase the assessment and thus in substance allow an appeal by him to this Court. The application for leave to amend is therefore refused.

The appeal will be dismissed with costs.

Judgment accordingly.