Montreal 1967 Apr. 14 June 2

BETWEEN:

NATHAN COHEN .....APPELLANT;

AND

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

AND

BETWEEN:

HYMAN ZALKIND .....APPELLANT;

AND

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

Income tax—Capital cost allowances—Emphyteutic lease in Quebec—Transfer of lessee's rights in land and building—Leaseholder owner of building—Whether capital cost allowances for building or for leasehold interest—Income Tax Regulations, s. 1102(5)—Construction of.

In 1952 appellants acquired the lessee's rights under a 99 year emphyteutic lease of property in Montreal which had 58 years to run. The deed specifically transferred to appellants (1) the lessee's interest in the lease and (2) a building erected on the land. The original lease executed in 1910 required the lessee to demolish existing buildings on the land and erect a new building thereon, and a 10 storey building was erected in 1912. The original lease contained a number of clauses unusual for an emphyteutic lease, amongst them that the lessee might demolish the building provided he erected another, that on the lessee's failure to remedy defaults in payment of rent or taxes after notice all buildings, etc. should become the lessor's property, and that on the expiration of the lease the lessor should be entitled to purchase the building.

Held, having regard to the terms of the deed of transfer and the special clauses in the lease appellants became owners of the building erected on the leased land and as such were entitled to capital cost allowances in respect of the building under class 3 of Schedule B of the *Income Tax Regulations* and not, as contended by respondent, at a lower rate for leasehold interests under class 13.

While s 1102(5) of the *Income Tax Regulations* permits a Leaseholder who constructs a building on the leased land to claim capital cost allowances on the building under class 3 it does not follow that a leaseholder who acquires absolute ownership of a building on the leased land is disentitled to the normal capital cost allowances allowed the owner of a building under class 3.

INCOME TAX APPEAL.

Phillip F. Vineberg, Q.C. for appellants.

A. Garon and *P. F. Cumyn* for respondent.

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NOËL J.:—These are appeals from the decision of the Tax Appeal Board[1] whereby a building belonging to the appellants was held to be properly relegated for the purpose of capital cost allowances from class 3 as a building to class 13 as a leasehold interest with reference to the years 1956, 1957, 1958, 1959 and 1960.

The rights of the appellants as lessees under a 99 year emphyteutic lease were acquired from The Transportation Building Company at a time when the lease still had 58 years to run. The lease of the property fronting on St. James, Notre-Dame and St-François-Xavier Streets, in the City of Montreal, was transferred to the above corporation by the owners, the Ecclesiastics of the Seminary of St-Sulpice of Montreal, in the circumstances described in an agreed statement of facts signed by the solicitors for both parties and hereunder reproduced:

AGREED STATEMENT OF FACTS

1. On the 2nd of June, 1910, the Ecclesiastics of the Seminary of St. Sulpice of Montreal, owners of a property fronting on St. James, Notre-Dame and St. François Xavier Streets in the City of Montreal, entered into a deed of lease and agreement with respect to the aforesaid property with The Transportation Building Company, Limited; a copy of that deed is annexed hereto and produced by consent of the parties as Exhibit A-1.

2. In 1912, pursuant to clause VI of the aforementioned deed, the building now standing on the aforementioned property was constructed by the then lessee, The Transportation Building Company Limited.

3. On the 4th of July, 1952, The Transportation Building Company Limited, sold, conveyed, transferred and made over to Hyman Zalkind and to Nathan Cohen all its right, title and interest in and to the aforementioned Lease and Agreement and in and to the building referred to in paragraph 2 above; a copy of that deed of sale is annexed hereto and produced by consent of the parties as Exhibit A-2.

DATED at OTTAWA this 4th day of April 1967.

The sole issue in these appeals is whether the appellants can depreciate the building situated on the leased land on a basis of 5% under class 3 of Schedule B to the *Regulations* as a building, as the appellants contend, or on a basis of one-fortieth (1/40th) per annum pursuant to Regulation 1100(7) of the Act under class 13 as a leasehold interest, as contended by the respondent.

[1] 38 T.A.B.C. 417 and 420.

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In order to properly deal with this issue, it will be necessary to examine the various sections and regulations of the *Income Tax Act* which deal with capital cost allowances on buildings and on leasehold interests.

Capital cost allowances are granted under section 11(1)(*a*) of the *Income Tax Act*. This section states that a taxpayer is entitled to whatever is allowed under the *Regulations*. Section 1100(1) of the *Regulations* states that a taxpayer is allowed "in computing his income from a business or property...deductions for each taxation year equal to

> (*a*) such amounts as he may claim in respect of property of each of the following classes in Schedule B not exceeding in respect of property" (the rates for particular classes of property set down in the above section).

It therefore appears that the entire economy of the *Regulations* with respect to capital cost allowances is to categorize objects, place them in particular classes and then allow them particular rates. For instance, class 3 of Schedule B of the *Regulations* which covers

> Property not included in any other class that is
>
> (*a*) a building or other structure, including component parts such as electric wiring, plumbing, sprinkler systems, air-conditioning equipment, heating equipment, lighting fixtures, elevators and escalators.

allows amortization of such a building on the reducing balance method at a rate of 5%.

On the other hand, a special class of assets, class 13, is established under Schedule B of the *Regulations* which covers leasehold property. Capital cost allowance with regard to this property is computed on the basis that the yearly deduction allowable to the tenant is the lesser of (a) one-fifth ($\frac{1}{5}$th) of its cost or (b) the amount obtained by dividing the capital cost of the leasehold improvement by that number of years which the lease has to run not exceeding 40. Where a tenant has a lease with the option to renew, the term of the lease for the purpose of calculating the number of years over which the capital cost allowance is to be prorated is taken to be the original term of the lease together with the first renewal option. I should point out here that whereas in the case of the building in class 3, the amortization is effected by the reducing balance

method, the amortization of the capital cost here is by the straight line method applied to each item, i.e., to each lease.

Section 1102(2) states that a taxpayer is not entitled to capital cost allowance on land.

Section 1102(4) of the *Regulations* gives directions as to what is to be included in the capital cost of a leasehold interest when it states that:

> (4) For the purpose of paragraph (*b*) of subsection (1) of section 1100, capital cost includes an amount expended on an improvement or alteration to a leased property, other than an amount expended on
>
> (*a*) the construction of a building or other structure,
>
> (*b*) an addition to a building or other structure, or
>
> (*c*) alterations to buildings which substantially change the nature or character of the leased property.

The above appears to include in the cost of a leasehold interest only those amounts expended for improvement or alteration relative to small things (which, however, in some cases may run into thousands of dollars), such as walls, partitions, panelling, store fronts, etc., and excludes relatively large amounts expended on things such as the construction of a building, an addition thereto or an alteration which changes the nature or character of the leased property.

The taxpayer in the exclusion may still have a leasehold interest in those buildings but the section says that he will not be able to apply the faster straight line cost allowance of a leasehold interest to their cost and may only apply the slower reducing balance method of the rates applicable to a building.

I now come to section 1102(5) of the *Regulations* which states that

> (5) . . . reference in Schedule B to a property that is a building or other structure shall be deemed to include a reference to that part of the leasehold interest acquired by reason of the fact that the taxpayer has
>
> (*a*) erected a building or structure on leased land,
>
> (*b*) made an alteration to a leased building or structure, or
>
> (*c*) made alterations to a leased property which substantially change the nature of the property,
>
> unless the property is included in class 23 in Schedule B. (which deals with a leasehold interest or concession in respect of land granted under or pursuant to an agreement . . . for the 1967 World Exhibit . . .).

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The above Regulation which deals with buildings on leased properties, says that if the taxpayer puts up a building, or makes an alteration to a leased building or an alteration to a leased property which substantially changes the nature of the property, even though the interest of the taxpayer in the building is only a leasehold interest, he can amortize the cost of the building, or alteration thereto, only as class 3 property and not as class 13 property.

It is upon the above section that the respondent relies to relegate the appellant's building from class 3 as a building to class 13 as a leasehold interest on the basis that although under section 1102(5) of the *Regulations* the first holder of the lease who constructed or altered the building can amortize the building under class 3, his successor (and this is somewhat of an extraordinary result) cannot. It was on this reasoning that Mr. Fordham, Q.C., of the Tax Appeal Board held that the appellants herein could amortize the building as class 13 property only on the basis that unless a leaseholder is the person who erected the building standing on leased land, he cannot claim capital cost allowance under any class other than class 13. He then concluded that it was, therefore, not necessary "to make a minute inquiry into the precise position of the lessee named in an emphyteutic lease". I must say that the above section does seem to achieve the extraordinary result of permitting a leaseholder who is the constructor to amortize the building as class 3 property whereas, if he sold his right the day after he constructed the building, or if he died and his rights passed to his heirs, his successor or successors could only amortize the building as class 13 property under those rules which apply to one holding a leasehold interest.

This, however, in my view, does not end the matter as, although the above section seems to achieve the above described result in all cases where the interest of the taxpayer in the land and building is purely a leasehold interest, it would, in my view, not apply in the event that, while the taxpayer is the lessee of the land, his interest in the building is not that of a leaseholder but is that of an absolute owner. I would, indeed, think that section 1102(5) of the *Regulations* must be read with section 1102(4) and if this is done, it means only that generally speaking one does not include in the capital cost of a leasehold interest the cost of buildings or alterations put

up by the taxpayer. It does not mean, however, that in all cases where a taxpayer has a leasehold interest in land, his right to capital cost allowance on whatever building or construction is erected thereon will be governed by section 1102(5) of the *Regulations* and if not included in the categories therein mentioned will be automatically excluded and subject to the amortization rate which applies to leasehold interests, even if the taxpayer's interest in the building he purchased is that of a proprietor. It does not, in my view, do away with the general scheme which allows capital cost allowance on buildings owned by a taxpayer, and the above section, as drafted, cannot be interpreted to give it that effect.

It indeed appears clear to me that the very language of the section as well as paragraph (b) of class 13 of Schedule B which reads as follows:

Class 13

Property that is a leasehold interest except
(*a*) . . .
(*b*) that part of the leasehold interest that is included in another class by reason of subsection (5) of section 1102, . . .

indicate that the interest dealt with in the section must be a leasehold interest.

If this is the proper way to interpret these *Regulations*, it then becomes important to inquire into the precise position of the appellants under the lease and agreement between the Ecclesiastics of the Seminary of St-Sulpice of Montreal and The Transportation Building Company Limited, dated June 2nd, 1910, and produced as Exhibit A-1, as well as in regard to a few clauses of the deed of sale, dated July 4th, 1952, and produced as Exhibit A-2, whereby The Transportation Building Company Limited sold, conveyed, transferred and made over to the appellants all its rights, title and interest in the original lease and agreement and in the building constructed on the property.

I should, however, before doing this, point out that we are dealing here with an emphyteutic lease under the civil law of Quebec (art. 567 to 582 inclusive of the *Quebec Civil Code*) where, under art. 569 of the *Civil Code* an emphyteutic lessee enjoys "all the rights attached to the quality of a proprietor", under art. 570 C.C. he "may alien-

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ate, transfer and hypothecate the immoveable so leased", under art. 571 "the immoveables held under emphyteusis may be seized as real property, under execution against the lessee by his creditors . . ." and, finally, under art. 572 C.C. where "the lessee is entitled to bring a possessory action against all those who disturb him in his enjoyment and even against the lessor".

From the above it appears that the emphyteutic lessee in Quebec has not only a right *"in personam"* in the immoveable leased (as an ordinary lessee has) but a real right although this real right is a partial one only (*un droit réel demembré)*. This right does not, however, make him the owner of the land or give him complete ownership even of the plantations or constructions erected thereon. It will not, however, be necessary to determine here whether such an interest is proprietary or leasehold because, although clause IV of the lease states that the lease shall be an emphyteutic lease and that generally the emphyteutic lease rules will apply, it also says that such rules will apply only unless ". . . specifically derogated therefrom" and there have been some important derogations in this case.

An examination of the deed of lease and agreement between the Ecclesiastics of the Seminary of St-Sulpice of Montreal and The Transportation Building Company Limited as well as of the deed of sale to the appellants of the rights in the original lease and agreement and in the building constructed on the property reveals that some of the clauses of the deed of lease and agreement are standard emphyteutic clauses whereas others are not and are unusual.

I shall now consider only those clauses pertinent to the present case and which may be helpful in determining the nature of the rights the appellants purchased from The Transportation Building Company Limited.

Clause I of the lease (Exhibit A-1) indicates that when this lease was granted in 1910, there were buildings on the property. Clause II sets out its term for 99 years and mentions "the present lease of the said land" with no reference to the buildings. Clause III deals with the rental "for the said land" and indicates that the rent is a fixed amount for a number of years, a higher amount after that

and from 1933 onward, the amount of the rental is fixed periodically by a review of the value of the land. The greater the value of the land, the greater the rental. There is no indication in this lease that the owner of the land, the Seminary, is entitled to greater or lesser rent because of the value of the building erected on the land.

Under clause VI the lessee or his assigns are obliged to demolish the old buildings but the lessee is entitled to the materials of the old building. He must put up a new building at a cost of at least $500,000 which, of course, corresponds to the obligation of an emphyteutic lessee to make improvements on the land (*cf.* art. 577 C.C.). Under paragraph *d*) of the above clause, if the new building is destroyed by fire, the lessee must replace it in which event, however, it is stated that the lessee receives the insurance money required to replace it. Under paragraph *f*) of clause VI the lessee, if it so wants to, can demolish the building providing he erects another. I should point out here that this is exceptional in that an ordinary emphyteutic lessee has no right to destroy the immoveable.

Clause VII gives the lessee the right to issue bonds upon the security of the building and, of course, an emphyteutic lessee in Quebec can hypothecate the immoveables leased under art. 570 C.C. This, however, indicates that an emphyteusis in Quebec conveys a right *"in rem"* whereas an ordinary lessee would only have a right *"in personam"* and cannot form the subject of a fixed charge under a bond issue.

In clause VIII (second page) it is stated that in the case of non-payment of the rent or taxes, etc., after the defaults of the lessee have run their course and have not been rectified after the notices ". . . all buildings and improvements on the land shall become and be the property of the Seminary . . ." which, of course, indicates that until then, the Seminary is not the owner of the building. I should point out here that it is unusual to find this situation in an emphyteutic lease in Quebec as an emphyteote is not ordinarily the owner of the buildings erected on the land but merely has a partial real right (un droit réel demembré) in them. This, I should think, is an acknowledgement by the Seminary that the lessee or its assigns, the present appellants, are not lessees of the

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building but its owners as successors to The Transportation Building Company.

Clause X states that if during the lease the Seminary is made a party to any suit affecting the land (no mention is made of the building) then the company shall defend such suit and indemnify the Seminary against any damages resulting therefrom.

Clause XIII states (and this is a most important derogation from an emphyteutic lease) that "at the expiration of the present lease, the Seminary shall have the right to purchase the building then erected on the land".

Ordinarily, in an emphyteutic lease, the owner of the land usually gets the building (and this, of course, is one of the great advantages of such a lease) in accordance with art. 581 C.C. which states that "at the end of the lease . . . the lessee must give up . . . the property received from the lessor, as well as the buildings he obliged himself to construct, . . .".

The above clause also provides that in the event the Seminary does not wish to buy the building, the lessee can take it away or insist upon an extension of the lease.

In the event of expropriation, clause XV provides that the money corresponding to the value of the land goes to the Seminary but the money for the value of the building goes to the lessee.

Clause XVIII allows the Seminary to assign the lease or alienate the land but there is no right given to alienate the building.

An examination of Exhibit A-2, the deed of sale whereby The Transportation Building Company Limited sold, conveyed, transferred and made over to the appellants all its rights, title and interest in the original lease and agreement and in the building on the property, shows that there is nothing therein inconsistent with the lease. Furthermore, The Transportation Building Company, in the above deed, is called the vendor and Messrs. Cohen and Zalkind, the appellants, are referred to as the purchasers and the said deed transfers two distinct things:

1. All their right, title and interest in and to that certain Lease and Agreement between The Ecclesiastics of the Seminary of St. Sulpice of Montreal and the Transportation Building Company Limited . . .
and

2. The ten storey stone and brick building erected on the above mentioned lot known as the "Transportation Building" . . .

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I should also mention that the above sale and transfer was made for the not inconsiderable amount of $1,072,000.

It therefore appears to me that whatever are the rights of an ordinary emphyteutic lessee in Quebec or whatever difficulties there may be in the common law provinces because ownership of the land carries with it whatever is built thereon, I cannot, on the documents as they stand herein, reach any other conclusion but that the appellants were the proprietors of the building erected on the land owned by the Seminary.

The lease indeed clearly asserts that the Seminary is not the owner in stating that after the defaults for non-payment of the rent, taxes, etc., have run out and the notices have not resulted in a rectification of same, the Seminary only then becomes the owner of the building. Furthermore, the right to purchase the building, which is given to the Seminary at the expiration of the lease is a further clear and complete assertion not only that the Seminary does not own the building at this stage, but that The Transportation Building and its successors do. This, of course, is not mere payment of compensation for its value, as provided for in art. 582 C.C. for improvements voluntarily made, but a real purchase of the building and may I reiterate a further clear assertion of proprietary interest in the building. Furthermore, the price is arrived at by way of a procedure of evaluation set down in the lease whereby experts are appointed to determine the value of the building which is paid to the lessee. The fact that the owner of the land does not obtain the buildings at the expiry of the lease (which is usually one of the advantages of an emphyteutic lease) unless he purchases the building, clearly shows, in my view, that the appellants here are not mere emphyteutic lessees with respect to the building erected on the land but seem to have something similar to what is called in Quebec a right of superficies (which appears to be unknown in the common law provinces) with respect thereto. Indeed, they have not merely a partial real right therein (*un droit réel demembré*) but are the veritable owners of the building.

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Having reached the conclusion that they have a right of proprietorship in this building and not a leasehold interest, they should and are entitled to depreciate their property as a building.

The appeals are, therefore, allowed. The appellants will be entitled to the costs to be taxed in the usual way in both appeals but as the latter were heard on the same evidence and at the same time, counsel for the appellants will be entitled to one set of counsel fees at trial only. The assessments for the taxation years of both appellants for the years 1956, 1957, 1958, 1959 and 1960 are therefore vacated and the matter referred back to the Minister for him to reassess the appellants on the basis that the building involved in these appeals is property of class 3 of Schedule B to the *Income Tax Regulations*.