

BETWEEN :

HARMONY INVESTMENTS LIMITED ... APPELLANT,

AND

THE MINISTER OF NATIONAL

REVENUE RESPONDENT.

1964
Dec. 8-9
1965
Jan. 5

Revenue—Income—Income tax—Business—Profit from a business—Adventure or concern in the nature of trade—Investment—Disposition of capital asset—Exclusive intention of taxpayer—Construction and sale of apartment building—Income Tax Act, R.S.C. 1952, c. 148, ss. 3, 4 and 139(1)(e).

The appellant, a company incorporated under the laws of the Province of Ontario by letters patent dated May 20, 1955, undertook the construction of two similar apartment buildings, one on Balhol Street and the other on Keewatin Street, both in the City of Toronto. The construction of both buildings was commenced in March 1956 and the total estimated cost of the projects was \$860,110, including the cost of the land. During the period of construction a strike occurred in the steel industry and delivery of structural steel to the projects was delayed for about three months. When that strike ended a strike occurred in the ready mix concrete business, resulting in a further delay in construction of one month. The actual construction cost was about \$125,000 more than the total estimated cost. In September 1957 the appellant company was without funds to pay about \$90,000 in outstanding and overdue liabilities. At this time the Balliol apartment was fully rented and the Keewatin apartment was partly rented. During and after construction of the two apartment buildings the appellant had received unsolicited offers to purchase them and in September 1957 the appellant's shareholders accepted one of the offers and the purchaser was given the choice of apartment buildings. The purchaser chose to buy the Balliol property because it was fully rented.

On the sale the appellant realized a gain of \$59,627.71, which was assessed by the respondent as income, which assessment was upheld on appeal to the Tax Appeal Board. The question for determination is whether the profit realized by the appellant on the sale of the Balliol property is profit from a business or whether the lands were acquired and the apartment buildings constructed thereon as an investment for the pur-

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pose of receiving rental income therefrom and such plan became impossible of fruition because of the financial difficulties encountered by the appellant which necessitated the sale of the Balliol property.

Held: That if the appellant's exclusive intention was to construct and operate both apartment buildings and derive income therefrom it follows that the profit from the sale of one of the buildings would not be profit from a business or an adventure in the nature of trade, but if such was not its exclusive purpose at the time the enterprise was begun, there can, in such circumstances, be no doubt that the acquisition of the lands and the construction of apartment buildings thereon had for its purpose, or one of its possible purposes, subsequent disposition of one or other of the buildings at a profit, and the resulting profit is taxable.

2. That it is apparent from the evidence that the project was embarked upon with borderline financing and without due regard for the hazards of the construction trade such as difficulties and delays in procuring materials and skilled tradesmen, whether occasioned by strikes or otherwise, and that Mr Stone, a building contractor, and a shareholder and director of the appellant, had estimated the cost of the two apartment buildings at about \$935,000, i.e. slightly more than the actual cost, and the inference naturally follows that the appellant's sole intention was not the retention of both apartment buildings for the purpose of producing rental income.
3. That the possibility of retrenchment by the appellant, by the sale of one of the buildings to secure the retention of the other, must have been present from the outset and the financing, while ample to finance the building and retention of one apartment building, was inadequate for both.
4. That the evidence does not establish that the two apartment buildings had been constructed with the sole intention of retaining and operating them as revenue producing properties, and the appellant contemplated from the outset the possibility of a profit made by disposing of one or other or both of the apartment buildings.
5. That the appeal is dismissed.

APPEAL from a decision of the Tax Appeal Board.

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

S. Thom, Q.C. for appellant.

T. Z. Boles and E. Campbell for respondent.

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

CATTANACH J. now (January 5, 1965) delivered the following judgment:

This is an appeal from a judgment of the Tax Appeal Board,¹ dated July 22, 1963 dismissing the appeal of the appellant from its tax assessments under the *Income Tax*

Act, 1952, R.S.C., c. 148 for the taxation years 1958 and 1959.

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The appellant is a corporation incorporated pursuant to the laws of the Province of Ontario by letters patent dated May 20, 1955, one of its objects being "to purchase, lease, construct or otherwise acquire, hold, enjoy, manage, improve and assist in improving lands, water lots, docks, warehouses, sheds, elevators, offices, apartments, dwellings, restaurants, parks and buildings of every description and to sell, mortgage or otherwise dispose of the same".

The applicants for incorporation and first directors of the appellant were Norman Sky, Samuel Stone and William Lohuara.

The authorized capital is \$40,000 divided into 30,000 preference shares and 10,000 common shares, all of the par value of \$1.00.

Samuel Stone is a building contractor and president of Stone Building Company, Limited, which company together with Norman Sky and William Lohuara had acquired lands and premises municipally known as numbers 161, 167 and 171 Balliol Street, in the City of Toronto (hereinafter referred to as the Balliol property), as trustees for a company to be incorporated, for the purpose of demolishing the existing buildings thereon and erecting a 48-suite apartment building. An application for a building permit, dated February 22, 1955 was made to and approved by the Municipal authorities, the information contained therein being inserted and the application being signed by E. I. Richmond, an architect who had been consulted by Mr. Stone and had prepared the plans for the apartment building. The probable cost of the building, exclusive of land, was therein estimated at \$384,000 which was revised upwards by the Municipal authorities to \$425,000. The figure of \$8,000 per suite was used by the municipality for initial estimation purposes which initial estimate is subject to revision based on a unit cost per cubic foot ranging between 90c. and \$1.25.

A commitment was arranged with the Ontario Loan and Debenture Company to advance by way of first mortgage upon the security of the above land and premises, the sum of \$315,000 for a term of 10 years repayable by

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monthly payments of \$2,725 including principal and interest at 5 $\frac{3}{4}$ percent.

By instrument dated June 27, 1955 and recorded in the Toronto Land Title office on July 21, 1955, Stone Building Company, Limited, Norman Sky and William Lohuara transferred the Balliol property to the appellant.

Before the appellant took any steps to build an apartment building on the Balliol property, and quite independently, four other individuals, Harry Barkin, Jack Barkin, Robert Patton and Percy Singer, over the period between November 1955 to January 1956 acquired three contiguous parcels of land on Keewatin Avenue in the City of Toronto (hereinafter referred to as the Keewatin property) as a site for an apartment building pursuant to an agreement among them dated November 10, 1955. In this agreement it was contemplated that a private company be formed for the purpose of erecting and operating the apartment building when completed and that the four individuals' share holdings in the Company, would be commensurate with their prior respective financial contributions to the enterprise. They envisaged a building with a minimum of 44 suites at a cost not to exceed \$8,000 per suite to be financed by a first mortgage to be arranged on the basis of \$6,500 per suite.

The land was acquired through J. Z. Verina, a real estate broker, with whom Patton was associated in his real estate business and it was also agreed that Verina would supervise the erection of the building and direct its subsequent management.

However the group, particularly Harry Barkin, entertained reservations as to the method of construction contemplated by the plans obtained by Verina and, by coincidence, sought the advice of E. I. Richmond, the architect who had prepared for Stone and his associates, the plans for the building to be erected on the Balliol site. Mr. Richmond agreed with Harry Barkin that the construction method contemplated was novel and might be expensive and suggested that the plans he had prepared for the Balliol property using conventional construction methods, were eminently suitable and could be used for the Keewatin property with slight modification to include 52 suites, being four more suites than proposed for the Balliol property,

because Mr. Barkin and his associates were anxious to include some bachelor suites. It was known to Mr. Richmond that Mr. Stone's two associates, Sky and Lohuara, were doubtful that they could provide the necessary capital and, because economies could be effected by the contemporaneous construction of the two apartment buildings, he arranged a meeting between the two groups.

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As a result of this meeting Messrs. Sky and Lohuara sold the 50 percent interest that they had in the appellant company (Mr. Stone had the remaining 50 percent interest) to Messrs. Harry and Jack Barkin for the sum of \$13,000 by agreement dated December 21, 1955. It was also agreed that the plans which Messrs. Barkin, together with Robert Patton and Percy Singer, had made for erecting an apartment building on the Keewatin property would be merged with the plans for the erection of the apartment building on the Balliol property. The architect's plans prepared for the building on the Balliol property were to be used for the building on the Keewatin property subject to a minor modification to include four bachelor suites. In short the undertaking of the four associates, Harry Barkin, Jack Barkin, Patton and Singer was merged with that of the appellant company and each of them and Mr. Stone acquired four common shares in the capital stock of the appellant and the wife of each man also acquired two common shares making a total of thirty shares which were issued for the total amount of \$30.

On February 12, 1956 the five principals met to consider the cost of the apartment house projects and the manner in which such projects would be financed.

The land had been acquired at a total cost of \$107,050 being \$50,050 for the Balliol site and \$57,000 for the Keewatin site.

A rough estimate of the probable cost of the buildings and appliances was made upon the basis of \$8,000, per suite a total of \$800,000, there being 100 suites.

In the applications for building permits there was inserted, in the case of the Balliol Street apartment, a probable cost of \$384,000, based on 48 suites at \$8,000 per suite which estimate, as mentioned before, was increased by the municipal authorities to \$425,000, and in the case of the Keewatin Street apartment, the probable cost was

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inserted at \$416,000 based on 52 suites at \$8,000 per suite, which estimate was not varied by the Municipality. (The Municipal estimate is fixed at \$8,000 per suite for the purpose of computing the fee upon the issue of a permit and is exclusive of land, and regardless of the type of construction, although that basis of computation may be revised upwards on a cubic content basis, but it is never revised downwards.)

Because of Mr. Stone's experience as a builder, it is obvious that the other principals and shareholders would place great reliance on his knowledge. At the meeting in February 1956 a rough estimate of the cost of the apartment building was prepared by what were then described as "members of the syndicate". This schedule was prepared, in the main, by Mr. Stone and comprised 56 items, some of which were based on firm contract prices and others were estimates. This estimate was in the total amount of \$350,530 per building exclusive of bricks and cement blocks and land. The estimate for both buildings was \$701,060. It subsequently transpired that the cost of the bricks and cement blocks was \$52,000 so that the estimate when increased by that amount would have been \$753,060. The cost of the land added to this figure of \$753,060 would bring the total estimated cost to \$860,110. Mr. Stone in giving evidence stated that the actual costs of construction almost invariably exceed the estimated cost by 10 percent and that it is wise to make provision for such increase. This was not done. If it had been done, the estimated cost would have been approximately \$935,000.

The two projects, which had now become a single project for the erection of two apartment buildings was financed by means of two first mortgages. It will be recalled that before the merger of the two enterprises, the appellant had arranged for a first mortgage from Ontario Loan and Debenture Company in the amount of \$315,000 secured on the Balliol property. A first mortgage in the amount of \$336,000 was arranged with Manufacturers Life Assurance Company secured on the Keewatin property. The two mortgages were assigned to the Bank of Nova Scotia, Spadina and Dundas Branch, Toronto, in order to obtain a loan of \$200,000 which was used for interim construction financing, the loan to be repayable from advances under the mortgages. The loan from the bank was arranged by Harry

Barkin, whose personal business was conducted with this particular bank branch. The difference between the estimated cost which the "members of the syndicate" put at that time at approximately \$800,000 and the total of the two first mortgages of \$651,000 being \$149,000 was, according to the evidence, to be made up by advances of \$30,000 by way of loans to the appellant from each of the five principals.

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By two instruments, both dated March 9, 1956, the five principals, namely, Harry Barkin, Jack Barkin, Stone, Patton and Singer, who held title, as trustees, to the Balliol property (by virtue of a transfer under the merger arrangement) and to the Keewatin property, by virtue of the terms of the original purchase deed, transferred these properties to the appellant.

Construction of the building on the Balliol property was begun on March 18, 1956 and construction of the building on the Keewatin property was begun on March 20, 1956. It was expected that construction would be completed and that the buildings would be ready for occupancy within six months, that is in September 1956.

However, a strike in the steel industry, which resulted in delays in the delivery of steel joists and structural steel, halted construction for approximately three months. Simultaneously with the end of the steel strike, a strike occurred in the ready mix concrete business, which resulted in a further delay of one month in construction. The buildings were completed in January 1957 although some interior work was still required before they would be ready for rental to tenants.

The delays in construction did result in an increase in the cost of construction which the appellant estimated in its pleadings to have been \$125,000, but no adequate evidence was adduced as to the increase in cost attributable to the delay in construction caused by the strikes. The amount of \$125,000 was arrived at by subtracting the estimated cost of construction, i.e. \$800,000, from the actual cost thereof.

Conceivably the cost of steel was increased somewhat and rental income was lost by reason of the apartments not being ready for tenants at the traditional fall moving dates. The appellant was obliged to heat the buildings during the winter months when they were not producing

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revenue and was obliged to employ watchmen during the period when no construction work was being done. The Ontario Loan and Debenture Company cancelled its original mortgage loan commitment on the Balliol property in September 1956 which was renegotiated at an interest rate of 6 percent rather than 5 $\frac{3}{4}$ percent.

The five principal shareholders had each advanced \$30,000 to the appellant by way of loan pursuant to their agreement and in June 1957 each shareholder advanced a further \$8,000 with the exception of Mr. Stone who was able to advance \$4,000 only. The total advances by the shareholders were \$184,000.

Even after this second round of advances, the appellant during September 1957 found itself faced with liabilities, which it was without funds to discharge. The final mortgage advance had been received prior to this time. There was an outstanding liability to the bank of \$68,000, the payment of which the bank was pressing for, as well as approximately \$22,000 in outstanding trade accounts. The principal shareholders were either unwilling or unable to make any further advances.

The Balliol apartment was partially rented as early as February 1957 and was fully rented during the fall of 1957, at which latter time the Keewatin apartment was partly rented. The gross rental revenue from both apartments when fully rented was estimated at \$150,000 which, less an estimated operating cost of \$80,000, would result in an approximate net annual revenue of \$70,000 which, in the opinion of the shareholders of the appellant, was not sufficient to discharge its liabilities.

As mentioned before the loan from the bank was arranged by Harry Barkin who was anxious that this liability should be fully paid forthwith.

During the construction of the buildings and after their completion, the appellant received several unsolicited offers to purchase. At a meeting of the shareholders in August 1957 the possibility of the sale of one of the buildings was discussed.

In September 1957, the shareholders decided to accept one of the offers so received and negotiated the sale. The purchaser was given the choice of which apartment building it wished to purchase and selected the Balliol property

because it was fully rented. The Balliol property was sold on October 1, 1957 at a price of \$525,000 from which sale the appellant realized a gain of \$59,627.71.

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The proceeds of the sale were used to discharge the bank loan and the outstanding trade liabilities. On October 31, 1957 an amount of \$36,000 was divided among the five principal shareholders in partial repayment of their advances, being \$8,000 to each except Mr. Stone who received \$4,000 because his second advance had been \$4,000 less than the others. Between November 1957 and August 1958 further distributions in the approximate amount of \$16,000 were made to each shareholder.

By notices of re-assessment dated May 19, 1961 the Minister added to the net declared income of the appellant for its taxation years 1958 and 1959 the sum of \$59,627.71, which sum was therein described as profit on sale of the Balliol property.

The appellant, by notices dated August 1, 1961, objected to the assessments. The amounts were not disputed but only the taxability thereof. The Minister confirmed the assessments and an appeal was taken to the Tax Appeal Board which dismissed the appeal.

It is from that decision that the appellant now appeals to this Court.

The question for determination on the facts as recited is, therefore, whether the profit realized from the sale of the Balliol property is profit from a business within the meaning of ss. 3 and 4 of the *Income Tax Act* and the extended meaning of "business" as defined by s. 139(1)(e) to include an adventure or concern in the nature of trade or, as submitted by the appellant, the lands were acquired and the apartment buildings constructed thereon as an investment for the purpose of receiving rental income therefrom and that such plan became impossible of fruition because of the financial difficulties encountered by the appellant, which necessitated the sale of the Balliol property giving rise to a profit by way of the disposition of a capital asset and consequently a non-taxable capital gain.

If it was the appellant's exclusive intention to construct and operate both apartment buildings and derive rental income therefrom, it follows that the profit from the sale of one of the buildings would not be profit from a business

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or an adventure in the nature of trade. If that was not its exclusive purpose at the time the enterprise was begun, there can, in such circumstance, be no doubt that the acquisition of the lands and the construction of apartment buildings thereon had for its purpose, or one of its possible purposes, subsequent disposition of one or the other of the buildings at a profit, and the resulting profit is taxable.

One thing that is apparent from the evidence is that the project was embarked upon with borderline financing and without due regard for the hazards of the construction trade such as difficulties and delays in procuring materials and skilled tradesmen, whether occasioned by strikes or otherwise. The appellant could not have been oblivious to such possibilities, since Mr. Stone was an experienced building contractor whose knowledge must have been communicated to his fellow shareholders and directors and thereby to the appellant and who testified that actual costs of construction invariably exceed the estimated costs for which increase provision should be made, normally to the extent of 10 percent, which was not done in the present instance. As previously indicated, a more realistic estimate, according to Mr. Stone's evidence, would have been \$935,000, which would have been slightly higher than the actual cost of the buildings. The inference naturally follows that the appellant's sole intention was not the retention of both apartment buildings for the purpose of producing rental income. The possibility of retrenchment, by the sale of one building to secure the retention of the other building, must have been present from the outset. While the financing was amply adequate to finance the building and retention of one apartment, it was, regarded realistically, inadequate for both.

The evidence does not, in my opinion, establish that the two apartments had been constructed with the sole intention of retaining and operating them as revenue producing properties. Against the background of the facts as established, I am of the view that the appellant contemplated from the outset the possibility of a profit made by disposing of one or other or both of the apartment buildings.

The appeal is, therefore, dismissed with costs.

Judgment accordingly.