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Memorandum

To: Seminar file
From: George Dube
Date: September 8, 2007
Re: **Capital gains vs. income court case sampling**

Court cases to invigorate the desire for a planning process

Below you will find brief notes of various court cases related to real estate. The descriptions have been copied directly from amongst hundreds listed in CCH Canadian Tax Reporter Commentary's sections 6,075 through 6,200 although we have added bolding in some instances for emphasis. The comments are not meant to be comprehensive nor are they meant to show a fair representation of the cases decided, but rather show a sampling of court cases to stress our major thrusts of be careful, educate yourself and plan appropriately as not all sales are considered capital gains. Further, caution must always be exercised in placing any reliance on commentary without a thorough reading and understanding of the complete court case. However, for our purposes, we are not attempting to argue one side or another on any particular issue but demonstrate the breadth of cases which exist and the commentator's impression as to the significance of the case. You will also see some of the contrasts apparent in the decisions.

As a bit of background to the comments, there are different references in the descriptions to findings where the transaction(s) was considered profit. This is the court's way of saying that the transaction(s) was found to be on account of income as compared to a capital gain. Prior to 1972, capital gains were not taxed in Canada.

You'll note a variety of numbers and initials after the court case names which identify for readers the exact court reference. Without getting into all of the details, generally speaking the higher the court level the more important the decision. Those cases with "S.C.C." (Supreme Court of Canada) and "F.C.A." (Federal Court of Appeal) are the highest levels of court in Canada (ignoring Parliamentary overrides) at this time from a tax perspective. For example, "Regal Heights Ltd. v. M.N.R., 60 DTC 1270 (S.C.C.)" tells us that the tax payer Regal Heights Ltd. is appealing the government's original tax position (represented by M.N.R. Minister of National Revenue or the Queen). (At each level of court beginning with the second level, the taxpayer or government may be the appellant or defendant depending on who didn't like the results of the prior court level. The first court level will have the taxpayer as the appellant since the government will never presumably want to appeal its own Notice of

Assessment or Notice of Reassessment.) The court case was heard in 1960 at the Supreme Court of Canada trial level, and the full details can be found in the Dominion Tax Case records beginning at page 1270.

DO NOT rely upon the materials contained herein for any form of advice whatsoever without consultation with a qualified tax advisor.

- It has been held that the profit realized **from a single transaction** in real estate was taxable when the property was purchased with the intention of reselling it at a profit (Chabot v. M.N.R., 53 DTC 355 (T.A.B.)).
- The intention, of course, will ordinarily be gathered from all the evidence including the taxpayer's **whole course of conduct** and not simply from his statement as to what his intention was (Campbell v. M.N.R., 52 DTC 1187 (S.C.C.)).
- **Eleven years after acquisition**, a block of land in a subdivision upon which a shopping centre was planned, was sold by the developer. The profit was income as the developer admitted that it had not decided whether the proposed shopping centre would be rented or sold. Westport Gardens Ltd. v. M.N.R., 87 DTC 637 (T.C.C.).
- Profit on a sale by the builders of a completed town house and apartment complex was taxable. While the intention of an investment was recognized, there was held to have been a **substantial element of speculation**. Normac Investments Ltd. v. M.N.R., 70 DTC 6234 (S.C.C.), affirming 69 DTC 5326 (Ex. Ct.).
- The real estate gains made by a corporation were characterized as revenue considering that the properties had been **held for three months and their acquisition had been almost entirely financed by loans and mortgages**. 143088 Canada Inc. v. The Queen, 97 DTC 38 (T.C.C.).
- The taxpayer company, which operated hotels, purchased a number of hotels consecutively using the proceeds from the disposition of one to buy the next. Since the sale of each hotel was for the purpose of acquiring a more lucrative hotel, the hotels were acquired as capital assets. Reich Hotels Ltd. v. M.N.R., 82 DTC 1297 (T.R.B.).
- Where the **wife of a real estate agent** purchased three properties on one of which was situated their summer cottage which was destroyed by fire, the profit on the sale of this parcel was a capital gain but the profit on the sale of the other two parcels was income. Wisniewski v. M.N.R., 79 DTC 266 (T.R.B.).
- The profits realized by two taxpayers who bought and resold a commercial property were taxable as income. The taxpayers had rented the property under a **lease-option agreement** and made the profit when the lessee exercised the option to purchase. It was determined on the evidence that, although the taxpayers' intention when the property was acquired was flexible, the transaction had to be considered a trading transaction. Lehrer v. M.N.R., 72 DTC 6224 (F.C.T.D.).

- The profit on a **sale and leaseback** of real estate made by a company engaged in land development was held to be taxable as income. Allarco Developments Ltd. v. M.N.R., 72 DTC 6154 (S.C.C.), reversing 70 DTC 6274 (Ex. Ct.).
- A company controlled by two families, one of which had a **background in real estate development** and the other with a **background in real estate investment**, was held to have realized a capital gain when it accepted an **unsolicited offer** to sell a parcel of land originally acquired with the intention of erecting industrial buildings for rental purposes. The company was able to give a **reasonable and credible explanation** for the eventual sale of the property which tended to negate the possibility of the profitable resale of the property as a secondary intention at the time of its acquisition. Bead Realities Limited v. M.N.R., 71 DTC 5453 (F.C.T.D.). See also C.H.L.M.P. Developments Ltd. v. M.N.R., 79 DTC 599 (T.R.B.).
- However, the profit realized by another construction company on the sale of its office was held to be taxable income. On the evidence, the building had not been designed to meet the requirements of a construction company and there was **no plausible explanation for selling it when it appeared to be satisfactorily and almost completely rented at the time of the sale** Debco Construction Ltd. v. M.N.R., 72 DTC 1032 (T.R.B.).
- A real estate-leasing company **acquired property in excess of immediate requirements for investment purposes**. The sale of the excess property resulted in taxable profit. Edon Development Ltd. v. M.N.R., 66 DTC 609 (T.A.B.). Similarly, where a company engaged in fruit and vegetable business bought land in excess of its needs, the profit was taxable. H. Fine and Sons Ltd. v. M.N.R., 79 DTC 239 (T.R.B.). **However**, in Royal Auto Wreckers Ltd. v. M.N.R., 66 DTC 725 (T.A.B.), **the loss incurred on the sale of excess land was held to be a capital loss and non-deductible**. See also Jarvie Holdings Ltd. v. The Queen, 80 DTC 6395 (F.C.T.D.), reversing 79 DTC 521 (T.R.B.).
- A company incorporated solely for the purpose of making investments, acquired some real property (land, apartment blocks) **but for lack of funds resold it at a profit**. It was held that the profit did not constitute taxable income. Viewing the company's **whole course of conduct** it could be said that by acquiring real property as an investment and selling it when its holding became a risk, the company did not deviate from its purpose and did not engage in the real estate business. Baker Estates Ltd. v. M.N.R., 54 DTC 514 (T.A.B.). Similarly with respect to a shopping centre which had to be sold when a development company and associated construction company faced bankruptcy. Dorwin Shopping Centre Ltd. v. M.N.R., 63 DTC 1258 (Ex. Ct.). See also Kagna v. M.N.R., 65 DTC 385 (T.A.B.) and Gelfand et al. v. M.N.R., 65 DTC 388 (T.A.B.).

Bridgette Cayer v. Her Majesty the Queen, Tax Court of Canada, **March 15, 2007**. Neutral Citation 2007 TCC 136, Court File No. 2005-1351(IT)G

Profits from selling residential properties properly characterized as business income — I.T.A. ss. 9(1), 39(1), and 163(2) (¶4042.28, ¶6210.43, and ¶22,881.40).

The taxpayer was unemployed for some 20 years and reported her primary source of income from 1993 to 2002 as social assistance. **She also held a real estate licence, and bought, built or renovated, and sold properties** valued between \$300,000 and \$400,000, **including three properties** ("Balding", "Stonecroft", and "35 Franklin") **that were purchased and sold between August 2000 and October 2002.** In assessing the taxpayer for 2001 and 2002, **the Minister characterized the profits on the sales of the properties (the "Profits") as income** from business, and imposed penalties for **gross negligence.** The taxpayer appealed to the Tax Court of Canada.

Held: **The taxpayer's appeal was dismissed.** Applying the principles set out in *Happy Valley Farms Ltd. v. The Queen*, 86 DTC 6421 (F.C.T.D.), the Court concluded that the taxpayer was engaged in the business of selling residential properties. Therefore, the Profits were income from that business. **The penalties were also justified. The taxpayer's past conduct evidenced a pattern of avoidance, at best, and deception, at worst. As well, she intentionally attempted to conceal the Profits from the Minister.** The Minister's assessments were affirmed accordingly.

- The **taxpayer claimed a terminal loss** for two condominium units **but the court reduced the amount and treated it as a capital loss.** Although the taxpayer had a business purpose for purchasing the units, the court was unable to allocate the loss between depreciable and non-depreciable property **due to insufficient accounting information.** *Lee v. The Queen*, 2004 DTC 3555 (T.C.C.).
- Since between 1990 and 1994 the **taxpayer had built and resold five houses at a profit, the profit he made was characterized as income from an adventure in the nature of trade** with the exception of the first one which he used as his principal residence as a newly-wed. *Mullin v. The Queen*, 98 DTC 1731 (T.C.C.).
- Profit on the **sale of two houses** was held to be business income considering that the taxpayers were **experienced real estate agents**, construction of the homes was **heavily financed** and they were **listed and sold very quickly.** *Lai et al. v. The Queen*, 98 DTC 1155 (T.C.C.).
- Where a company incorporated to deal in land and buildings constructed some houses with the alleged intention of renting them, but sold them individually at a profit when they proved impossible to rent, the profit was held to be taxable as income from an **adventure in the nature of trade. The intention of the company was to make a profit.** *Norwood Interests Inc. v. M.N.R.*, 64 DTC 211 (T.A.B.). See also *Rubin v. M.N.R.*, 67 DTC 217 (T.A.B.).
- Considering that its shareholders' **original intention had been simply to construct a building**, to rent a portion to a

municipality under a 10-year lease **and to resell it at a profit when it became fully rented, the taxpayer's profit** on the disposition of the building **was business income**. 154135 Canada Inc. v. The Queen, 98 DTC 1828 (T.C.C.).

- **Although a taxpayer was prepared to renovate a rental property** when he bought it, the fact that **the property was located in a speculative area** where resale activity was rampant led to the conclusion that the taxpayer's primary intention was to deal with the property in the most financially advantageous ways, including selling it at a profit. Therefore, such profit was income. Conway v. The Queen, 96 DTC 1282 (T.C.C.).
- **The intentions of the taxpayer's partner, an experienced real estate trader, were not imputed to the taxpayer** where there was no evidence upon which to conclude that R's intentions at the time of acquisition of the property should be attributed to the taxpayer. Grouchy v. The Queen, 90 DTC 6267 (F.C.T.D.).
- **The taxpayer, because of his minority position, was bound by the intentions and actions of the other investors.** Their treatment of income from the sale of a commercial rental building as income was binding on the taxpayer. Wise v. M.N.R., 87 DTC 238 (T.C.C.). See also Stroz v. M.N.R., 90 DTC 1271 (T.C.C.).
- **A research scientist and a real estate trader held an apartment building for four years and a townhouse development for three years. Financing and other facts indicated speculative intention.** The sale of properties produced income. Ramachandran v. M.N.R., 86 DTC 1069 (T.C.C.).
- **Profit on the 1974 sale of 36 acres of land purchased by the taxpayers and two partners in 1960 was income, as one of the motivating factors had been resale at a profit** and the taxpayer's alleged intention to use part of the land personally was at best a contingency plan. Beghin v. M.N.R., 85 DTC 48 (T.C.C.).
- The intention of a taxpayer in buying a parcel of land for \$83,400 was held to be speculative when it was established that after buying the land, the former owner was allowed to remain in possession on a rent-free basis provided he paid the taxes. **The land was in an area subject to some speculation and during the seven years that the taxpayer was in possession there was not "a trace of periodic return or susceptibility to the income-earning process"**. Blackstone v. The Queen, 74 DTC 6020 (F.C.T.D.), affirming 72 DTC 1404 (T.R.B.).
- **An intention to renovate and convert** an older commercial building into desirable, affordable rental space for long-term use by professional tenants desiring tenancy near a new Civic Centre **was frustrated when the Civic Centre plan collapsed**. Hanover Management Ltd et al. v. M.N.R., 89 DTC 355 (T.C.C.).
- A taxpayer purchased land as an investment in 1974 and in 1976 accepted an offer for its sale. The taxpayer's partners repudiated the offer to sell and the land was eventually sold in 1980. **The taxpayer's profit was taxed as a capital gain, calculated on**

the basis of the attempted sale in 1976, and as income thereafter. Hyman v. M.N.R., 88 DTC 1352 (T.C.C.).

- The taxpayer was **in the property management business**. His experience in dealing with commercial property **led to his purchase of a building which he sold after redecorating it**. The profit was treated as income. Jordan v. M.N.R., 85 DTC 482 (T.C.C.).
- The sale of commercial properties yielded capital where the taxpayers' **whole course of conduct confirmed their stated intention to purchase them as investments**. They investigated the rental market, converting existing structures to provide greater rental accommodation, they complied with municipal requirements, they advertised for desirable tenants, they made cash-flow projections and they arranged permanent financing for two of the properties. 600166 Ontario Ltd. et al. v. M.N.R., 93 DTC 910 (T.C.C.).
- However, **despite a taxpayer's stated intention** to acquire a property as an investment, the profit from its resale was income considering that **no detailed business plan or critical path had ever developed and there was strong evidence of a secondary intention**, when the property was acquired, to sell it at a profit if the price were right. Araz Developments Inc. et al. v. The Queen, 93 DTC 922 (T.C.C.).
- **From the outset the taxpayers were willing to sell their property. The profit potential was either from rents or from the sale of the property.** The proceeds from sale were income. Pollock v. M.N.R., 88 DTC 1409 (T.C.C.).
- **Despite the taxpayer's occupation as a real estate broker**, evidence established that the land was purchased with the intention of creating a capital asset. Williams v. M.N.R., 83 DTC 186 (T.R.B.).
- When three corporations controlled by a practicing lawyer each **purchased a residential apartment building, held it for a few years** and then realized a gain on its sale, such **gain was characterized as income because** at the time of purchase of the properties, **their profit potential was marginal** and little was done during **the brief periods during which they were owned** to increase that potential. 3645256 Ontario Ltd et al. v. M.N.R., 93 DTC 787 (T.C.C.).
- On the other hand, the profits from the sale of **two highly leveraged properties were income** where they were so badly undercapitalized that **the taxpayer ought to have known**, from an unfortunate experience with a previously acquired property, **that he would encounter deficits with his highly leveraged methods of financing and could not realistically hope to hold the properties as capital investments**. Campeau v. M.N.R., 93 DTC 92 (T.C.C.).
- **A taxpayer's trading history indicated an intention to sell the property at a profit when the opportunity arose.** Joe's & Company Ltd. v. M.N.R., 86 DTC 1073 (T.C.C.).

- **In an eight-year period the taxpayer had made 17 similar resale transactions which indicated that the profit was in the nature of trade.** Happy Valley Farms Ltd. v. The Queen, 86 DTC 6421 (F.C.T.D.), affirming 82 DTC 1646 (T.R.B.). See also O & M Investments Ltd. v. The Queen, 90 DTC 6150 (F.C.T.D.).
- **Where a taxpayer has engaged in a series of real estate transactions, it is difficult to establish that a particular transaction qualified as an investment rather than an adventure in the nature of trade.** See Regal Heights Ltd. v. M.N.R., 60 DTC 1270 (S.C.C.), affirming 60 DTC 1041 (Ex. Ct.), and 58 DTC 12 (T.A.B.), heard as No. 476 and 477. See also A. & H. Management Ltd. v. M.N.R., 61 DTC 4 (T.A.B.); Jarry v. M.N.R., 64 DTC 5001 (S.C.C.), affirming 61 DTC 1239 (Ex. Ct.); Bernardo v. M.N.R., 65 DTC 759 (T.A.B.); Levenstein v. M.N.R., 70 DTC 1129 (T.A.B.); Western Ltd. v. M.N.R., 71 DTC 421 (T.A.B.); Tilson v. M.N.R., 79 DTC 171 (T.R.B.); Toolsie v. The Queen, 86 DTC 6117 (F.C.T.D.), affirming 80 DTC 1209 (T.R.B.); Matt's Apartment Ltd. v. M.N.R., 89 DTC 441 (T.C.C.).