Docket: 2013-4440(IT)I

BETWEEN:

ALAN R. MORRIS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on March 7, 2014, at Vancouver, British Columbia

Before: The Honourable Justice Diane Campbell

Appearances:

For the Appellant:	The Appellant himself
Counsel for the Respondent:	Aman Sandhu

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* with respect to the 2009 and 2010 taxation years are allowed, without costs, and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 9th day of May 2014.

"Diane Campbell"

Campbell J.

Citation: 2014 TCC 142
Date: 20140509
Docket: 2013-4440(IT)I

BETWEEN:

ALAN R. MORRIS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Campbell J.

[1] These appeals are from a decision of the Minister of National Revenue (the "Minister") which disallowed rental expenses claimed in both the 2009 and 2010 taxation years.

Facts

[2] The Appellant and his wife, Kit Morris, are chartered accountants. They both worked at Deloitte when they married in December, 2008. The Appellant retired in May, 2009 and started his own tax service business from his home. In 2007, the Appellant agreed to purchase his parents' principal residence located at 1350 Sinclair Street in West Vancouver (the "Sinclair property").

[3] The purchase was made pursuant to a verbal agreement. The agreed purchase price in 2007 was $955,000. The Appellant was to pay monthly instalments of $2,300. He testified that this property was his principal residence commencing on July 1, 2007. However, legal title to the Sinclair property was not transferred to the Appellant until March of 2009. The Appellant introduced a notarized statement (Exhibit A-1) of his mother which confirmed his testimony respecting the Sinclair property. The Respondent objected to the introduction of Exhibit A-1 because the Appellant's mother was not present in Court to be cross-examined. Even without this document, and despite the Minister's assumption of fact that the Appellant did not purchase this property until March,

2009, I accept the Appellant's evidence that he actually purchased the property in 2007, although legal title was not transferred until 2009.

[4] Kit Morris moved into the Sinclair property in December, 2008 after she and the Appellant were married. She testified that this property became her principal residence. She listed her own property located in Coquitlam for sale and it sold in June, 2009.

[5] The Appellant and his wife eventually decided to move to larger premises and purchased a property on Heywood Avenue (the "Heywood property"). They moved from the Sinclair property to this newly-purchased property on August 4, 2009. All of their belongings were relocated to the new property with the exception of some tools, wood and some odds and ends. After August, 2009, both the Appellant and his wife testified that the Sinclair property was no longer their principal residence and was not used for personal purposes. Ms. Morris testified that the insurance on the Sinclair property was changed at this time to reflect that it was a vacant property. The insurance policy at Exhibit A-5 confirms her evidence and it references a vacancy permit in the description of the property.

[6] At the time they relocated, Ms. Morris, after consulting with her realtor, decided to purchase the Sinclair property from the Appellant and to use it as an investment rental property. She purchased the property from the Appellant for $900,000 on August 7, 2009. Exhibit A-4 from the Land Registry Office confirms that the Application for Registration was received on July 20, 2009 and registered on August 7, 2009. The document indicated that the property was subject to a mortgage to the Bank of Montreal. Ms. Morris testified that she obtained a mortgage for 80 percent of the agreed price of $900,000. Exhibits A-8 and A-9 confirm her testimony respecting the mortgage amount and the rate. Both the Appellant and Ms. Morris testified that, contrary to the Respondent's position, the purchase price that Ms. Morris paid to the Appellant was not below fair market value and was based on the market in the prior year plus advice obtained from their realtor.

[7] The Appellant testified that, when the Sinclair property was sold to Ms. Morris, they were both aware that repairs and renovations were necessary prior to renting the property. They undertook to complete the repair work themselves and, according to their testimony, they began working on the property in September, 2009. The Appellant testified that, although he was busy establishing his accounting business at his new residence, he was at the Sinclair property three days per week and on weekends to attend to these repairs. Although

Ms. Morris was pregnant and still working full-time, she also shared in the work, especially on weekends.

[8] The repairs included painting the entire house, replacing the kitchen flooring, fixing and painting the kitchen and bathroom cabinets, replacing closets, repairing light fixtures, repairing a roof leak, hiring a plumber to replace a kitchen faucet and landscaping, which included fence repairs, renovating a bridge over a creek and attending to the gardens. Ms. Morris stated that the work took much longer than they anticipated initially.

[9] Despite Ms. Morris' intention to rent the Sinclair property, it was never listed for rent. While the repairs remained unfinished, the property was rented to a friend of Ms. Morris in December, 2010 for a period of four months, until March, 2011. It was rented for $2,000 monthly, slightly below the fair market value for rentals, because they continued to require access to the property to continue the necessary repairs.

[10] When this four-month tenancy ended, the Sinclair property was listed for sale. Both witnesses testified that, during the four-month rental, there was a change in the market in this area and their realtor approached them about selling this property. It was listed for sale on May 9, 2011 and sold on May 31, 2011. Ms. Morris made a profit of $350,000.

[11] Receipts were not provided for any of the items used in the repairs, although none of those are claimed and they are not in issue before me. A Visa bill belonging to the Appellant shows several purchases at Home Depot between August 23, 2009 and September 22, 2009. However, they do not specifically state what the purchases were for, nor do they support that they related to repairs at the Sinclair property and not their new residence at the Heywood property. The expenses claimed by the Appellant related to mortgage interest, property taxes, insurance and utilities.

The Reassessments

[12] In 2009, there was no rental income in respect to the Sinclair property, but the Appellant claimed rental losses of approximately $13,071, comprised of mortgage interest of $10,872, insurance of $482, utilities of $482 and property taxes of $1,235.

[13] Total rental income in 2010 consisted of the $2,000 paid for the month of December in that year. Claimed total rental losses in this year totalled $26,014 and were comprised of mortgage interest of $25,584 and maintenance of $430, leaving a claimed net rental loss of $24,014.81. In both 2009 and 2010, all claimed expenses were denied with the exception of one-twelfth of the mortgage interest ($2,132) in respect to the December rental.

Issues

[14] The first issue that must be addressed is whether the Appellant had commenced a rental business between August, 2009 and November, 2010. If there was a business, the second issue is whether the Appellant can deduct the claimed rental expenses in 2009 and 2010.

The Position of the Parties

[15] The Respondent's position is that there was no rental operation at the Sinclair property prior to December, 2010 because the hallmarks of such an operation with sufficient commerciality did not exist prior to that date. Therefore, expenses prior to December are not deductible. Despite subjective intention that may have existed, significant activities in this regard were not commenced until they started earning rental income in December, 2010.

[16] The Respondent submitted that it was unlikely that repair work began on the property in 2009 as the Appellant contends. Also, the duration of time that it took to complete the repairs was not reasonable. The Appellant and his wife approached the repairs in a leisurely fashion and there were no reasonable, continuous efforts to complete the repairs and rent the property. Since there was no true intention, no business operation commenced prior to December, 2010 and the expenses should be attributed to basic upkeep rather than for the purpose of earning income from the property. Since there were no receipts relating to the repairs, and no photos evidencing the repairs, the expenses shown on the Appellant's Visa statement (Exhibit A-7) were instead related to their Heywood property.

[17] In the alternative, the Respondent argued that, if there was a finding of a rental operation prior to December, 2010, the expenditures were capital in nature and not deductible.

[18] The Appellant contended that, when his wife purchased the Sinclair property from him, this was the first significant step taken toward establishing a rental

business. Although they did not devote all their time to the repairs, continuous commitment to the work is not essential under the relevant provisions.

Analysis

[19] One of the assumptions of fact included in the Reply to the Notice of Appeal was that from August, 2009 to November 30, 2010, the property was a personal use property of Kit Morris (Assumption 14(i)). Although the Respondent did not directly argue or rely on this assumption of fact during the hearing, the evidence, of both the Appellant and Ms. Morris, was that, after they relocated to their new residence on Heywood in August, 2009, the Sinclair property was essentially empty. Their testimony is supported by Exhibit A-5 which shows that the insurance policy on the Sinclair property was changed to reflect that it was vacant after their move in August, 2009. Based on the testimony and the documentary evidence, this assumption of fact has been demolished and, consequently, I reject the Respondent's contention that the claimed deductions should be denied on the basis they were personal or living expenses pursuant to paragraph 18(l)(*h*) of the *Income Tax Act*, (the "*Act*").

[20] The Respondent conceded in closing submissions that there could be a rental operation as of November, 2010 since the rental agreement that commenced in December, 2010 was signed in that month. The issue is therefore whether there is sufficient evidence to conclude that a rental operation existed between September, 2009 and October, 2010. The Respondent in her submissions seemed to accept that Kit Morris had a subjective intention to create a rental operation at the Sinclair property in 2009:

> In the case at hand it was the evidence of both the appellant and Ms. Morris that there was an intention to utilize the Sinclair property as part of a rental operation.
>
> It's the respondent's position that the mere intention as of the date that they indicate when they made the transfer of the property is not sufficient to begin a rental operation. So we have to look at what was done.
>
> (Transcript, page 121)

[21] The Respondent has therefore focussed her argument on the steps taken to establish a rental operation and argues that there were insufficient steps undertaken to establish such an operation in this period.

[22] The Respondent contends that the work on the Sinclair property did not commence until late 2010. This argument, however, contradicts one of the Minister's own assumptions of fact contained in the Reply to the Notice of Appeal. Paragraph 14(o) of the Reply, assumes the following:

> from August 2009 to November 30, 2010, the Appellant and Mrs. Morris renovated the Property to make the Property suitable to rent;

[23] The Reply contains no other assumptions indicating that the work only commenced in 2010 and if the Reply had in fact contained other such assumptions they would have been potentially contradictory. Other than this one assumption, which agrees with the Appellant's position, the Respondent did not introduce any evidence other than its contention in submissions that the testimony of the Appellant and Ms. Morris was incorrect. As a result, I have no alternative but to accept the evidence of the witnesses and conclude that the work on the Sinclair property began in September, 2009.

[24] The Respondent relied on the decision in *Gartry v. Canada*, [1994] 2 CTC 2021, where J. Bowman (as he was then) concluded that when a business operation commences is a question of fact and that it begins somewhere between the time when the intention to start the business forms and when it starts to earn income. In *Gartry*, the court concluded that the fishing business had started because the taxpayer had arranged to purchase a boat, make modifications on the boat, obtain licences, arrange insurance, borrow money, arrange for a crew and make arrangements with other boat owners to utilize his services. In the present appeal, Kit Morris purchased the Sinclair property from the Appellant, arranged a mortgage of $720,000 to finance the purchase and personally completed various repairs. According to the evidence, the substantial repair work consisted of the painting of the entire premises. The work spanned a period of September, 2009 to March, 2011 and, according to the Appellant and his wife, they were working at the property several days per week and on weekends. Only one contractor, a plumber, was hired to replace a kitchen faucet. I have difficulty accepting that the work conducted at the property took this length of time in light of the evidence respecting the type of repairs completed and the alleged amount of time spent at the property. It is also unlikely that two chartered accountants would neglect to retain the receipts that would support the actual repair work and instead claim the obvious larger amounts that could easily be proved. I also have difficulty believing that the Appellant's wife exposed herself to the potential harmful effects of paint and so forth during this period when she was pregnant, having difficulties with the

pregnancy due to her age and having concerns over the health of her baby. The steps taken in these appeals are in no way comparable to the steps taken in *Gartry*.

[25] While repairs may take a longer period of time to complete than anticipated, findings on the reasonableness of the delays will be dependent upon the facts in each case. In the case of *Preiss v. Canada*, 2009 TCC 488, [2010] 1 CTC 2164, J. D'Arcy did not find that a four-year delay affected the taxpayer's intention to produce rental income. However, in that case, there was evidence of legitimate delays relating to zoning delays and health issues. Nevertheless, the testimony of the Appellant and his wife was not impinged on cross-examination and I have no evidence to support my suspicion that actual work may not have commenced until sometime in late 2010. I also have the glaring assumption of fact at paragraph 14(o) stating that the Respondent acknowledges that the Appellant and his wife were renovating the property between August, 2009 and December, 2009. Consequently, I have no alternative but to conclude that a rental operation was in existence between August, 2009 and November, 2010.

[26] In respect to the plumber's fee of $430 for replacing a kitchen faucet, the Respondent conceded that, although the amount would be non-deductible since it was a capital expense, it was a small expense and could be allowed as a current expenditure (Transcript, page 136). I accept the Respondent's concession and I will allow the plumbing expense, one of the few actual receipts relating to repair work that the Appellant did retain, which brought the sink back to its original functioning form.

[27] Finally, in respect to the Respondent's alternative argument, I conclude that the deductibility of claimed so called "soft costs" is not precluded by subsection 18(3.1) of the *Act*. The Respondent submitted that the deductibility of those expenses should be disallowed on the basis that they were related to the construction, renovation or alteration of the property. If the repairs do constitute construction, renovation or alteration within the meaning of the *Act*, then it must be determined whether the mortgage on the Sinclair property should be capitalized pursuant to subsection 18(3.1). That is, if the mortgage proceeds are found to be used to purchase the Sinclair property and not to finance its construction, renovation or alteration, then the interest payable on the mortgage will remain deductible pursuant to paragraph 20(1)(*c*) as a current expense. J. Margeson in *Magnowski v The Queen*, 2000 DTC 2244, at paragraph 71, explained the purpose of limiting the deductibility of soft costs under subsection 18(3.1) as follows:

> … to prevent taxpayers from using construction costs to create a loss which would shelter income from other sources. The rules also appear to assume that "soft costs" represent a disguised portion of the cost of land and buildings.

[28] The terms "construction, renovation or alteration" are not expressly defined in the *Act*. However, J. D'Arcy in *Preiss* indicates that the terms require more than simply general repairs and cosmetic touch-ups. Although the expenses were allowed in *Preiss*, the facts unfortunately did not outline the details of the repairs in that case. I am, however, inclined to believe that, the tasks completed on the Sinclair property, including painting, landscaping, minor plumbing and cleaning, which constituted the majority of the work, are cosmetic touch-ups rather than construction, renovation or alteration of the property.

[29] Even if I had not concluded that the repairs at the Sinclair property were merely cosmetic in nature, I had no evidence before me that the mortgage proceeds were used to finance any of the repair work. The Respondent on cross-examination of the witnesses did not ask any questions respecting the use of the mortgage proceeds. In addition, there were no assumptions of fact made in this regard. Therefore, even if the Appellant did engage in construction within the meaning of subsection 18(3.1) of the *Act*, he would not necessarily be precluded from the deduction of the mortgage interest since the Respondent did not establish that the funds were used to pay for the construction. Consequently, the Respondent's alternative argument must also fail.

[30] In conclusion, based on the evidence, a rental operation existed in 2009 and 2010 and the deductibility of the claimed costs are not precluded by any of the relevant provisions in section 18 of the *Act*. The appeals are allowed, without costs.

Signed at Ottawa, Canada, this 9th day of May 2014.

"Diane Campbell"

Campbell J.

CITATION:	2014 TCC 142
COURT FILE NO.:	2013-4440(IT)I
STYLE OF CAUSE:	ALAN R. MORRIS and HER MAJESTY THE QUEEN
PLACE OF HEARING:	Vancouver, British Columbia
DATE OF HEARING:	March 7, 2014
REASONS FOR JUDGMENT BY:	The Honourable Justice Diane Campbell
DATE OF JUDGMENT:	May 9, 2014

APPEARANCES:

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Counsel for the Respondent:	Aman Sandhu

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