Tax Court of Canada Cour canadienne de l'impôt

Français

Date: 20010606

Docket: 2000-5110-IT-I

BETWEEN:

PASQUALE CROLA,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Counsel for the Appellant: Howard J. Alpert

Counsel for the Respondent: Lesley King

Reasons for Judgment

(Delivered orally from the Bench at Toronto, Ontario, on May 7, 2001)

Sarchuk J.T.C.C.

[1] These are appeals of Pasquale Crolla from assessments of tax for his 1996, 1997 and 1998 taxation years. In computing his income for those years, the Appellant claimed rental losses with regard to a property located at 1147 Glengrove Avenue, Toronto, Ontario. In reassessing the Appellant for those years, the Minister of National Revenue disallowed the deduction of the aforesaid losses. This appeal followed.

[2] In 1988, the Appellant and his daughter Maria purchased the property in issue. The price was $236,000, $30,000 of which was paid by Maria and $40,000 by the Appellant. The balance of $166,000 was financed by way of mortgage. The property consisted of a bungalow with two living units, one on the main floor and the other in the basement and was acquired by them for rental purposes. The Appellant himself resided at 1145 Glengrove Avenue, the adjoining property. Both the Appellant and his daughter testified that, acting on the advice of their solicitor, title to the property was registered in the daughter's name. Neither could explain in any understandable way why that appeared to have been the lawyer's recommendation; however, at the end of the day, it has no impact on the matter before the Court.

[3] In 1988, the Appellant began reporting the rental of the property in partnership with his daughter and continued to do so in 1989 and 1990. I believe it was in 1990 that Maria was married and, needing to finance the purchase of a home,

sold her interest in the property to the Appellant for $30,000. However, for whatever reason, no steps were taken to re-register the property in his name. In all subsequent years, the Appellant testified that he alone reported all rental income and expenses and claimed losses from the property as follows:

Year	Rental Income	Expenses	Total Loss	Appellant's Share
1988	$4,550	$4,920	$370	$185
1989	15,600	22,282	6,682	3,341
1990	15,600	21,888	6,288	3,144
1991	16,800	24,983	8,183	8,183
1992	15,240	24,835	9,595	9,595
1993	15,720	22,717	6,997	6,997
1994	15,630	17,055	1,425	1,425
1995	11,800	18,446	6,646	6,646
1996	12,000	17,718	5,718	5,718
1997	9,275	17,188	7,913	7,913
1998	9,775	14,945	5,170	5,170

At the hearing of these appeals, returns were produced by the Appellant with respect to the 1999 and 2000 taxation years in which he reported rental income, expenses and net income from the property. The numbers for these years are:

Year	Rental Income	Expenses	Total Income
1999	$18,550	$13,875	$4,675
2000	18,960	14,775	3,885

[4] The Appellant testified that the losses in the years 1996, 1997 and 1998 were larger than expected in good measure as a result of difficult tenants whose rental payments were consistently late, if made at all. According to the Appellant, this difficult situation was not resolved until late 1998. He attributes the favourable results in 1999, 2000 and to date to responsible tenants, higher rent, timely payments, and as of 1999, a new five-year term mortgage at the much better interest rate of 6¼% per annum.

[5] The Respondent's position in this case is essentially predicated on the approach taken by Robertson J.A. who, speaking for the Federal Court of Appeal in *Mohammed v. The Queen*, 97 DTC 5503, observed that:

...there can be no reasonable expectation of profit so long as no significant payments are made against the principal amount of the indebtedness. This inevitably leads to the question of whether a rental loss can be claimed even though no such payment (s) were made in the taxation years under review. I say yes, but not without qualification. The taxpayer must establish to the satisfaction of the Tax Court that he or she had a realistic plan to reduce the principal amount of the borrowed monies. ...

In a nutshell that was the primary position taken by the Respondent. The Appellant's position is that the property was at all relevant times used as a rental property and that the time taken to turn a profit was neither unreasonable nor inappropriate, given the circumstances.

[6] Subsection 9(1) of the *Income Tax Act* defines the concept of income from business or property sources by reference to profit while paragraph 18(1)(*a*) of the *Act* contains specific prescribed statutory limitations and expense deductions. In particular, the latter sets out a general prohibition which denies the deduction unless the amount is paid or incurred for the purpose of gaining or producing income. Further, paragraph 18(1)(*h*) specifically limits the deductibility of personal or living expenses, which are defined in subsection 248(1) of the *Act*, and excludes expenses in connection with a property unless it is maintained in connection with a business

carried on for profit or with a reasonable expectation of profit. It is settled law that where there is no profit in the years in issue, an Appellant must establish that he had a reasonable expectation of profit from the venture.

[7] It is also necessary to observe that since the reasonable expectation of profit test is stricter in its application in the business purpose tests set out in subsection 9(1) and paragraph 18(1)(*a*) of the *Act*, the Minister and the courts are to be guided by the principle that where the facts of a case do not allude to an inappropriate deduction of tax, a personal element or other suspicious circumstances, the test should be applied less assiduously than if any of these factors are present. (See *Mastri v. The Queen*, 97 DTC 5420 (F.C.A.)). In other words, the Minister and the courts must not engage in the practice of second-guessing the business decisions of taxpayers.

[8] It is most evident in this appeal that there was no personal element involved; no inappropriate deductions; nor were there any other suspicious circumstances. The property at all times was held for rental purposes. There is also no suggestion that potential capital gains were a motivating factor in the purchase. Thus the question remains whether the Appellant conducted his rental activity in a commercial or businesslike way giving rise to a reasonable expectation of profit. Counsel for the Respondent says the Appellant did not, again relying on *Mohammed* and the proposition that the mortgage component interest was so large that it was inconsistent with an objectively reasonable profit motive. It was further submitted on behalf of the Respondent that the facts were that it took more than 10 years before any profit whatsoever was shown. I must observe that in *Mohammed*, in discussing the doctrine of reasonable expectation of profit, Robertson J.A. did observe that where the mortgage interest component is so large that a rental loss arises even before other permissible expenses are factored into the profit and loss statement, the reality is that a profit cannot be realized until such time as the interest expense is reduced by paying down the principal amount of the indebtedness. In his words: "these are cases where the taxpayer is unable, *prima facie*, to satisfy the reasonable expectation doctrine". I must emphasize that is not the case here. It cannot be said, in my view, even with respect to the three years in issue when the Appellant was having tenant problems, that the interest component was by itself larger than the gross rental revenues.

[9] Although there is some merit in the Respondent's submission that 10 years is a long period of time, in this particular case it must be taken into account that we are dealing with an unsophisticated investor whose decisions ought not to be assessed on the same basis as that of a commercial real estate developer. I agree that he added to the time it took to show a profit by failing to act more decisively in ridding himself of late-paying tenants, but balanced against that may well have been the cost of any legal action. I note as well that even though he had to acquire his daughter's interest in 1991 for $30,000 thereby limiting his ability to prepay or pay down some of the principal amount of the mortgage, he was nonetheless able to reduce the principal amount from $166,000 to $123,000. As well, the evidence is that the Appellant was gradually reducing expenses even in those years when the property was not fully rented. It is also a fact that he has now managed to increase revenues and is showing, and should be able to continue showing, a net profit on which he no doubt will be taxed. On balance, I am satisfied that this was a commercial operation intended to produce a profit which it did, albeit not without some intervening stumbles.

[10] The appeal will be allowed but not with respect to all of the expenses claimed. I will deal with each year under appeal separately. For 1996, the expenses will be reduced by deleting the amounts of $437 for an item which I believe was snow removal; there was a small amount of $8.37 that was an invalid receipt from 1995, and some $70.42 of unvouchered expenses. The total amount to be deleted is $515.79, which will reduce the net loss, by my calculation to $5,202.97. In 1997, the evidence supports the Appellant's expense claim with the exception of one item, that

being the amount of $2,960, representing the roof repairs. I am not entirely satisfied that an estimate of cost adequately establishes that fact. Second and more importantly, this item, in my view, is not a current expense. Redoing a roof is a capital expenditure which could and should have been added to the undepreciated capital cost of the property. The result is that the net loss in this year will be reduced to $4,953.09. I should also observe that the inclusion of this amount in expenses for that year and the failure of the Minister to deal with it as he should have, i.e., as a capital expenditure, had the collateral effect of strengthening the Respondent's position regarding the commercial viability of the rental property. It artificially increased the loss. I am not saying that was done deliberately. I do not make that assertion, but that is, as I have said before, the collateral effect of permitting an item which was patently a capital expenditure to remain in the expense column. In 1998, the amount of $579.31 representing items of snow removal, personal expenses and unvouchered items, will not be allowed. Thus, the net loss will be $4,590.70 in that year. Subject to the foregoing, the appeals are allowed with costs to be taxed.

Signed at Ottawa, Canada, this 6th day of June, 2001.

"A.A. Sarchuk"

J.T.C.C.