1959
Mar. 25
Jun. 23

BETWEEN:

THE MINISTER OF NATIONAL REVENUE .................... APPELLANT;

AND

HADDON HALL REALTY INC. ........RESPONDENT.

*Revenue—Income Tax—Income Tax Act R.S.C. 1952, c. 148, s. 12(1)(a)(b)—Expenditure made on account of income or capital—"An outlay or expense . . . for the purpose of gaining or producing income from property or a business of the taxpayer"—Taxpayer in business of renting apartments—Repairs to and replacements of refrigerators, stoves and blinds for an apartment house are expenditures on account of income.*

Respondent, a real estate holding company, operates a high class apartment building in Montreal, Quebec, which it purchased in 1948, the property consisting of ten connected buildings each one containing apartments making a total of 210 apartments commanding rentals varying from $115 to $350 per month. The leases of these apartments cover *inter alia* the use of frigidaires, stoves and venetian blinds supplied by the owner in each apartment. Respondent deducted from its income for the taxation year 1955 the money paid for replacements of and repairs to refrigerators, stoves and blinds which deduction was disallowed by the Minister of National Revenue. An appeal to the Income Tax Appeal Board by respondent was allowed and from that decision the appellant now appeals to this Court.

*Held:* That the amounts expended were properly deducted by respondent in its income tax return since the apartment building was acquired as a unit composed of land, buildings and equipment which comprised *inter alia* refrigerators, stoves and venetian blinds, these items being inseparable portions of a unit, namely, the apartment building; they were materially and functionally component parts of a whole undertaking and though integral parts they were subsidiary parts, a number of many subsidiary parts of a single profit-making undertaking and the replacement of such parts as refrigerators, stoves and blinds falls within the category of repairs to the building as a whole and the cost was maintenance expenditures.

2. That the maintenance of the apartment building and equipment in a good state of repairs is vital to respondent's business and the expenditures were made by it for the purpose of gaining or producing income from its business.

APPEAL from a decision of the Income Tax Appeal Board.

The appeal was heard before the Honourable Mr. Justice Fournier at Montreal.

*Paul Ollivier* and *Maurice Regnier* for appellant.
*Philip F. Vineberg* for respondent.

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

FOURNIER J. now (June 23, 1959) delivered the following judgment:

This is an appeal from a decision of the Income Tax Appeal Board[1] dated February 13, 1958, allowing the respondent's appeal from an assessment made and confirmed by the appellant in respect of the income tax assessment for the respondent's taxation year 1955.

In its income tax return for 1955 the respondent claimed as a deduction from income an amount of $11,675.95 as an expenditure to earn income from its business. The amount is made up of the following items of expenses:

| Item | Amount |
|---|---|
| Refrigerators | $ 8,817.05 |
| Blinds | 1,888.30 |
| Stoves | 920.60 |
| Total | $11,675.95 |

In his re-assessment the Minister disallowed the amount as a deduction and re-assessed accordingly. The respondent objected but the re-assessment was confirmed by the appellant. The respondent appealed to the Income Tax Appeal Board which allowed the appeal.

The appellant submits that the above expenditure was made for the replacement of capital within the meaning of section 12(1)(*b*) of the *Income Tax Act* and does not constitute an expense made or incurred by the respondent for the purpose of gaining or producing income from a business or property within the meaning of section 12(1)(*a*) of the Act. On the other hand, the respondent contends that the appellant's re-assessment is erroneous in fact and in law on the ground that it disallows as a deduction expenses laid out to earn income from a property or business.

The only question to be determined is whether the amount of $11,675.95 claimed by the respondent as a deduction in computing its income and disallowed by the appellant comes within the ambit of sections 12(1)(*a*) and 12(1)(*b*). These sections read as follows:

12 (1) In computing income, no deduction shall be made in respect of

[1] 18 Tax A.B.C. 421.

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.

I shall summarize the facts established before the Court and which are relevant to the issue. The respondent is a real-estate holding company which operates a high-class apartment building on Sherbrooke Street West, in the city of Montreal. It purchased the Haddon Hall Apartments in 1948. The property consists of ten buildings connected together, each one containing apartments. Altogether, there are 210 apartment units fitted out with first-class equipment. According to size, the rentals vary from $115 to $350 per month. The leases of the apartments cover, amongst other things and services, the use of frigidaires, stoves and venetian blinds supplied by the owner in each apartment. The city assessment of Haddon Hall Apartments is $2,356,000. They are insured for $2,500,000. The building had been erected a number of years before its acquisition by the respondent and had been occupied continuously by tenants. The building and its equipment, as all similar property, needed maintenance, repairs and replacements to be kept in condition for the purposes it was used, otherwise it would have been very difficult or impossible to attract tenants willing to pay rentals commensurate to the investment, the location of the building, the high class of the apartments and the prices of rents. So gradually the respondent attended to the necessary maintenance, repairs and replacements.

The respondent's income tax returns for the years 1950 to 1954 show the amounts disbursed in each of these years for refrigerators, stoves and venetian blinds, viz.:

| | *Refrigerators* | *Stoves* | *Venetian blinds* |
|---|---|---|---|
| 1950 ............ | $ 1,955.67 | $3,649.59 | $1,516.71 |
| 1951 ............ | 6,885.67 | 6,158.64 | 3,370.29 |
| 1952 ............ | 1,561.71 | 787.40 | 1,212.79 |
| 1953 ............ | 1,135.95 | 1,735.69 | 1,398.28 |
| 1954 ............ | 11,208.75 | 231.00 | 1,727.86 |

These expenses were made to keep the apartments in a good state of repairs, to provide necessary replacements and to give the services to which the tenants were entitled

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according to the terms of their leases. In the present dispute, the amounts claimed as deductions, totalling $11,675.15, were for expenditures incurred during the year 1955 for the same purposes as above mentioned.

The evidence is to the effect that the respondent is the owner of a very large apartment building and that its business is the renting of apartments with all necessary equipment, comprising refrigerators, stoves and venetian blinds which it supplies.

The amounts received from the tenants, less the cost of the operations of the business and the expenses for the upkeep of the property and its equipment, was the respondent's income. An important part of the respondent's business is to find tenants for its apartments, keep them satisfied of their homes and obtain a fair return on the leases. It believes that modern services and equipment in good order in each apartment are not only essential but tantamount to the success of its business operations. It is a high-class apartment building, situated in a fashionable district of Montreal and occupied by tenants of means. The prices would indicate that the tenants, in return of the rentals paid, expect services and first-class equipment during their period of occupancy. That is why the respondent repairs or replaces defective equipment in the apartments when needed. The expenses are gradual and recurrent. This is shown by the figures of expenses made by the respondent, every year since 1950, to purchase refrigerators, stoves and blinds. Notwithstanding the fact that the respondent has followed this policy since it became the owner of the apartments, it did not appeal from the assessments disallowing its claims for deduction, because prior to 1955 it did not earn income, and no appeal lies from nil assessments. The policy adhered to by the respondent has resulted in business for it from which income was gained or produced, as is apparent in its income tax returns since operating the business.

These established facts bring me to the consideration of the rules laid down in section 12(1)(*a*). The general principle expressed in section 12(1) is that no deduction is made in respect of an outlay or expense in computing a taxpayer's income. But section 12(1)(*a*) makes an

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exception to the general rule and deals with the computation of income from property or the business of a taxpayer. It allows a deduction in computing income when "an outlay or expense is made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer". Section 4 of the Act defines income from a business or property as "the profit therefrom". The principles for the computation of income or profits or gains are not indicated in the Act but are stated in many judicial decisions.

In the case of *Gresham Life Assurance Society v. Styles*[1], Lord Halsbury L.C. said:

> Profits and gains must be ascertained on ordinary principles of commercial trading,

This rule was approved in *Ushers' Wiltshire Brewery, Limited v. Bruce*[2] by Earl Loreburn when he stated:

> profits and gains must be estimated on ordinary principles of commercial trading by setting against the income earned the cost of earning it,

The President of this Court dealt at length with what he thought should be the right approach to the question whether a disbursement or expense was deductible for income tax purpose under section 6(*a*) of the *Income War Tax Act,* R.S.C. 1927, Chapter 97, in *Imperial Oil Limited v. Minister of National Revenue*[3]; he held

> That if a particular disbursement or expense is not within the express terms of the excluding provisions of section 6(*a*), its deduction ought to be allowed if such deduction would otherwise be in accordance with the ordinary principles of commercial trading or well accepted principles of business and accounting practice.

In another case, but this one dealing with section 12(1)(*a*) of the *Income Tax Act: The Royal Trust Company v. Minister of National Revenue*[4], he said

> that in a case under The Income Tax Act the first matter to be determined in deciding whether an outlay or expense is outside the prohibition of section 12(1)(*a*) of the Act is whether it was made or incurred by the taxpayer in accordance with the ordinary principles of commercial trading or well accepted principles of business practice. If it was not, that is the end of the matter. But if it was, then the outlay or expense is properly deductible unless it falls outside the expressed exception of section 12(1)(*a*) and, therefore, within its prohibition.

[1] [1892] A.C. 309 at 316.
[2] [1915] A.C. 433 at 434.
[3] [1947] Ex.C.R. 527.
[4] [1957] C.T.C. 32.

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The respondent submits that the above test applies to the facts of this case and argues that the expense it claims as a deduction falls within the category of expenditures for maintenance and repairs of the building which it operates as a business, to wit, the renting of apartments.

Before dealing with this point, I shall consider the appellant's contention that the outlay was of the nature of a replacement of capital and comes within the meaning of section 12(1)(*b*) of the Act. The section provides that in computing income no deduction should be made in respect of a replacement of capital and is applicable to all taxpayers. Though it is a general provision, it contains the exception that it will not apply when a deduction is "expressly permitted by this Part of the Act", namely, Part I, Division B, dealing with "Computation of Income". Section 12(1)(*a*), which is a provision of this Part of the Act, provides that an outlay or expense made or incurred by the taxpayer for the purpose of gaining or producing income from a business of the taxpayer is deductible. For convenience, I repeat its wording:

> 12(1)(*a*) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

This section follows immediately the heading "Deductions not allowed in computing income". It lays down the sweeping provision "No deduction shall be made in respect of an outlay or expense". This indicates that it applies to all the subsections and sub-paragraphs of the section and covers (1)(*a*) and (1)(*b*). There are not many general rules of law that do not call for exceptions. Subparagraphs (*a*) and (*b*) contain exceptions. In (*a*) the exception applies not only to outlays and expenses made but also to those incurred; and it is stated when and why a taxpayer is entitled to benefit of the exemption. The amount is deductible when it is made or incurred for the purpose of gaining or producing income from his property or his business. As to (*b*), deductibility will be allowed when it is "expressly permitted by this Part". It seems to me that these words open the door to the exemption of

(1)(*a*). If I am right in so believing, then outlays that are of the nature of income producing expenditures in the operation of a business and which are not replacement of capital or disbursement on account of capital are deductible.

The parties seem to agree on certain facts. The Haddon Hall Apartments were purchased by the respondent as a business project. It acquired the whole undertaking, comprising a structure, a building and its equipment. The respondent did not deny that the expenses incurred and claimed as deductions were expenses incurred to earn income but contended that they were capital expense or replacement of capital.

What really took place is that after purchasing the apartment building, basis of its business operations, the respondent, year in and year out, had to replace certain parts of the equipment of the building and the expenditures to do so were made every year. In this dispute, the replacements consisted of refrigerators, stoves and blinds. When the tenants complained that the equipment was out of order, defective and did not furnish the services to which they were entitled in accordance with the provisions of their lease, the respondent had the equipment repaired or replaced.

Certain tests were suggested to the Court to determine whether the expenses for these replacements were capital or income outlays and references were made to judicial decisions on the subject.

In the case of *Lurcott v. Wakely & Wheeler*[1], Buckley L.J., giving his opinion on repairs, said:

> Repair always involves renewal; renewal of a part; of a subordinate part. A skylight leaks; repair is effected by hacking out the putties, putting in new ones, and renewing the paint. . . . Repair is restoration by renewal or replacement of subsidiary parts of a whole.

In the same judgment, at page 919 Fletcher Moulton L.J. stated:

> For my own part, when the word "repair" is applied to a complex matter like a house, I have no doubt that the repair includes the replacement of parts. . . . Many, and in fact most, repairs imply that some portion of the total fabric is renewed, that new is put in place of old. Therefore you have from time to time as things need repair to put new for old. . . .

[1] [1911] 1 K.B. 905 at 923.

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The test followed in that case was whether the act to be done is one which in substance is the renewal or replacement of defective parts or the renewal or replacement of substantially the whole. The Court was dealing with the restoration of a portion of a wall of 24 feet on the front of a building. The repairing of the wall was made by rebuilding it. They evidently considered that a repair can be a replacement and that the portion of the wall replaced was merely a subsidiary portion of the building.

In the case of *Samuel Jones & Co. (Devonvale) Ltd. v. Commissioners of Inland Revenue*[1], a chimney of a factory was replaced because of its dangerous condition. The cost to do so was claimed as a deduction, which was disallowed. On appeal the Court held "that the whole cost of replacing the chimney was an admissible deduction". The Lord President (Cooper) at page 518 said:

> It is doubtless an indispensable part of the factory, doubtless an integral part; but none the less a subsidiary part, and one of many subsidiary parts, of a single industrial profit-earning undertaking.
>
> So viewing the matter I am unable to see why the expense incurred in relation to this transaction should not be treated as an admissible revenue expenditure on repairs, . . .

Now, can the facts of the present case meet the above test? The Haddon Hall Apartment was acquired as a unit. The whole undertaking was composed of land, buildings and equipment. The equipment, amongst other items, comprised refrigerators, stoves and venetian blinds. It seems clear that these items of equipment were inseparable portions of a unit, to wit, an apartment building. They were materially and functionally component parts of a whole undertaking. Though they were integral parts, they were only subsidiary parts and just a number of many subsidiary parts of a single profit-making undertaking.

Keeping in mind the remarks of the judges in the *Lurcot* case (*supra*) that "repair of a house is restoration by renewal or replacement of parts of the whole and that many, and in fact most, repairs imply that some portion of the total fabric is renewed, that new is put in place of old and that from time to time, as things need repair, to

[1] [1951] 32 T.C. 513.

put new for old becomes necessary", I have come to the conclusion that the replacement of subsidiary parts of equipment of the Haddon Hall Apartments such as refrigerators, stoves and blinds falls within the category of repairs to the building as a whole and that the cost was maintenance expenditures.

I cannot agree with the appellant's contention that pieces of equipment such as refrigerators, stoves and blinds were not parts of the apartment building but were independent and individual units, e.g. capital assets, and that their replacement was a replacement of capital. As stated above, they were inseparable, but subsidiary parts of the building, being materially and functionally portions of a whole undertaking of renting apartments fully equipped to service tenants. The respondent does not rent refrigerators, stoves or blinds—he leases apartments. If the reasoning of counsel were right, it could apply to each and every new item used in the repair of any part of the building or its equipment, whatever small it may be. One can foresee where this would lead us. This, I am sure, is not the meaning of the words of section 12(1)(*b*) that no deduction is made for replacement of capital.

To maintain a building in good condition, replacements, renewals and repairs of parts are needed, and I consider that the amounts thus expended are "maintenance expenditures". The maintenance of the respondent's apartment building and equipment in a good state of repairs is vital to its business. This is according to well accepted principles of business. Without hesitation, I say that the respondent's purpose was to increase its business by maintaining in a good state of repairs its high-class apartment building and to meet its obligations under its leases. I would further add that by doing so it was at times in a position to increase the price of its rentals. It is clear that the expenditures were made by the respondent for the purpose of gaining or producing income from its business. This was the respondent's policy. In my opinion the amounts thus expended were properly deducted in its

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income tax return for the year in question and the Department was in error in disallowing the deduction and adding the amount to the taxable income reported by the respondent.

For the above reasons I find that the respondent, in computing its income for 1955, was entitled to deduct the sum of $11,675.95 and that the Income Tax Appeal Board was correct in deciding that the expenditure should be considered to fall within the exception contained in section 12(1)(*a*) and be held not to come within the provision of section 12(1)(*b*).

Appeal dismissed with costs to respondent following taxation.

*Judgment accordingly.*