[OFFICIAL ENGLISH TRANSLATION]

90-553(IT)O

BETWEEN:

TEREXCAVATION ANTOINE GRANT INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeals heard on June 11, 2002, at Québec, Quebec by
the Honourable Judge Louise Lamarre Proulx

Appearances

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| Counsel for the Appellant: | Jacques Côté |
| Counsel for the Respondent: | Alain Gareau |

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**JUDGMENT**

The appeals from the assessments made under the *Income Tax Act* for the 1983, 1984, 1985 and 1986 taxation years are allowed, with 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 18th day of October 2002.

"Louise Lamarre Proulx"

J.T.C.C.

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Date: 20021018
Docket: 90-553(IT)O

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**REASONS FOR JUDGMENT**

**Lamarre Proulx, J.T.C.C.**

[1] These are appeals for the 1983 to 1986 taxation years.

[2] At issue is an investment tax credit for a tractor, claimed under subsection 127(5) and the relevant definitions set out in subsection 127(9) of the *Income Tax Act* ("the *Act*"), as these subsections applied to the 1986 taxation year.

[3] What must be determined is whether the tractor was acquired on June 10, 1986, when a rental contract with an option to purchase was signed. The appellant has argued that the tractor was acquired within the meaning of the *Act*. The respondent has argued that this property was acquired in January or February 1987, when a leasing contract was signed, at which point this property was not new.

[4] Kenney Grant, who was vice-president of operations for the appellant at the time the facts under review took place, testified for the appellant. He adduced a book of documents with 11 tabs as Exhibit A-1.

[5] The appellant is a business that does work requiring the use of heavy equipment, including forestry work, in particular. This work includes road, culvert

and bridge construction and heavy equipment transportation. The appellant's equipment apparently includes power shovels, bulldozers, truck-trailers, and graders.

[6] Mr. Grant stated that the business's usual operating method was to acquire the equipment it needed, not to rent it.

[7] During the taxation years at issue, the appellant wanted to obtain contracts for forestry work from "Les Bois de l'Est", a corporation that had just begun its operations in the Matane area under a government assistance program.

[8] The appellant obtained such a contract. It did not have the tractor it needed to carry out part of the work, that is, constructing a bush road. According to Mr. Grant, the appellant could have chosen to acquire a used tractor at lower cost but preferred to acquire a new tractor. The appellant knew that acquiring a new tractor would give rise to a tax credit, and this knowledge was an important factor in its decision to acquire a new tractor.

[9] Because the tractor was an expensive piece of equipment costing $267,447, the appellant was unable, in the short term, to arrange the financing needed to acquire it.

[10] On June 10, 1986, the appellant signed a contract with Hewitt Équipement Ltée ("Hewitt") to rent a D7H crawler tractor (Exhibit A-1, Tab 7). The tractor was to be delivered on June 11. The rental period was six months.

[11] Mr. Grant stated that he came to Québec with the Hewitt sales representative on June 9 or 10, 1986. He chose a tractor that was in the yard on condition that Hewitt agree to make certain changes to it. The tractor was not adapted for winter work in the bush. The sales representative agreed to make some changes possibly costing between $20,000 and $25,000. According to Mr. Grant, that agreement indicated that the sales representative knew that the appellant's actual intention was to acquire the tractor.

[12] An option to purchase was signed at the same time as the rental contract (Exhibit A-1, Tab 8). According to this document, the option to purchase had to be exercised on or before December 1, 1986, at the price of $267,447. One special condition of the option to purchase was that the appellant would take out a Plus 3 warranty, and the amount of $2,500 covering this warranty would be payable when the option to purchase was exercised. According to Mr. Grant, negotiating this

warranty also indicated that the appellant's long-term intention was to acquire the tractor. In fact, on the day of the hearing, the business still owned this tractor.

[13] According to one clause in the rental contract, each minimum rental period of one month covered 176 hours of use, and each additional hour of use would be invoiced at $51.14. Mr. Grant stated that, when the rental contract was negotiated, the appellant was not very concerned about this additional hourly rate, which in fact would have increased the monthly rental cost to $9,000, an exorbitant amount for the business if it had not intended to acquire the tractor. Mr. Grant stated that in fact the appellant did not pay the rental amounts for the last two months. When the tractor was acquired, the appellant had paid the interest for those two months. In any case, the option to purchase provided that 100 per cent of rental and interest payments would be deducted from the purchase price.

[14] The rental contract provided that the appellant would pay the costs of insurance and those of maintenance and repair.

[15] The offer to purchase made by the appellant exercising its option to purchase was signed on December 18, 1986 (Exhibit A-1, Tab 9). The offer to purchase was accepted on January 22, 1987. The respondent did not raise the point that the offer to purchase was accepted in January 1987.

[16] The National Bank became a party to the financing of this acquisition under a leasing contract dated December 29, 1986 (Exhibit A-1, Tab 10). The supplier and the lessee were the same entity, that is, the appellant. The supplier was the appellant itself since it had become the owner of the tractor by means of its offer to purchase. The lessor was Le Crédit-Bail Banque Nationale Inc.

[17] Under cross-examination, Mr. Grant confirmed that the contract with Les Bois de l'Est was a one-year contract. The appellant had a better grasp of its financial situation in December than in June. The contract was completed in part, and the appellant was in a position to ascertain whether the contract would be profitable.

Arguments

[18] Counsel for the appellant began by acknowledging that, if the Court were to find that the appellant was entitled to the investment tax credit, the rental expenditures allowed by the Minister of National Revenue ("the Minister") could not be deducted in computing the appellant's income for the 1986 taxation year.

[19] Counsel for the appellant referred to the definition of qualified construction equipment set out in subsection 127(9) of the *Act*:

> "qualified construction equipment" of a taxpayer means prescribed equipment acquired by him after April 19, 1983 that has not been used, or acquired for use or lease, for any purpose whatever before its acquisition by him and that is
>
> ...

[20] Counsel for the appellant told the Court that the only point at issue between the parties was whether the appellant acquired property when the rental contract was signed.

[21] Counsel for the appellant pointed out that the rental contract was a means of readily obtaining bridge financing for the acquisition of the tractor. He noted that the business's policy was to acquire equipment, not to rent it, and that the investment tax credit was an incentive to acquire a new, expensive piece of equipment.

[22] Counsel for the appellant also noted that the business had significant changes made to the tractor, changes that the sales representative had agreed to make. The appellant was careful to take out a Plus 3 warranty, that is, a three-year warranty. As they stood, the clauses in the rental contract would have been financially unacceptable to the business given the number of hours of use of the tractor and the additional rate to be paid.

[23] All these points, according to counsel for the appellant, establish the actual intention of the parties to the rental contract. This was a sales contract transformed into a rental contract with an option to purchase, for the purpose of obtaining quick financing.

[24] Counsel for the appellant pointed out that a leasing contract is also a rental contract with an option to purchase and that, since the decision by the Federal Court of Appeal in *Canada v. Construction Bérou Inc.*, [1999] F.C.J. No. 1761, it was accepted in Quebec that property acquired under a leasing contract is property acquired within the meaning of the federal legislation. Since the present case involves a rental contract with an option to purchase, the reasoning of the Federal Court of Appeal in *Bérou* should be applied.

[25] Counsel for the appellant referred to paragraphs 7 and 14 of that decision, which read as follows:

> 7. In fact, in The Minister of National Revenue and Wardean Drilling Limited [[1969] 2 Ex. C.R. 166], it was held that there was an acquisition of property for purposes of the capital cost allowance when there was a transfer either of title to the property or of all the incidents of the said title, except for legal title which remained in the vendor as security for payment of the purchase price in accordance with accepted commercial practice.
>
> ...
>
> 14. In short, according to these two cases, disposition or acquisition of property for purposes of the capital cost allowance exists under the Act when the normal incidents of title such as possession, use and risk are transferred. I agree with this legal interpretation given for tax purposes to the word "acquired" contained in the definition of "depreciable property". For practical purposes this interpretation has the merit of recognizing, for tax legislation that applies throughout Canada, a business practice that has no boundaries and of avoiding the danger of becoming too embroiled in unnecessary, sectoral and above all sterile and inequitable legalism at a time when the trend in the civil law is to approximate more closely to the common law. In addition, it is significant that Parliament, which annually amends the Act inter alia to alter legislative provisions when they are so interpreted that they do not meet the objectives sought, has not thought it appropriate to overturn this thirty-year-old interpretation. Further, this interpretation is consistent with the legislative intent stated in subsection 248(3) of the Act, which, as I have already mentioned, is intended to treat beneficial ownership of property in the same way as various forms of ownership recognized in the civil law of Quebec.

[26] Counsel for the appellant also referred to Interpretation Bulletin IT-233R, specifically to paragraphs 3 and 5, which read as follows:

> **Lease-Option Agreements**
>
> 3. The Department's principal interest in lease-option agreements is to see that significant sums paid for the purchase of property are not being charged against income as rent, of which no recapture can be made from a lessee who exercises his option and sells the property at a price which reimburses him for all or part of the "rent". Therefore it is necessary to determine whether or not the

> object of the transaction at its inception is to transfer the equity in the property to the lessee. Under conditions similar to those that follow a transaction is considered to be a sale rather than a lease:
>
> (a) the lessee automatically acquires title to the property after payment of a specified amount in the form of rentals,
>
> (b) the lessee is required to buy the property from the lessor during or at the termination of the lease or is required to guarantee that the lessor will receive the full option price from the lessee or a third party (except where such guarantee is given only in respect of excessive wear and tear inflicted by the lessee),
>
> (c) the lessee has the right during or at the expiration of the lease to acquire the property at a price which at the inception of the lease is substantially less than the probable fair market value of the property at the time or times of permitted acquisition by the lessee. An option to purchase of this nature might arise where it is exercisable within a period which is materially less than the useful life of the property with the rental payments in that period amounting to a substantial portion of the fair market value of the property at the date of inception of the lease, or
>
> (d) the lessee has the right during or at the expiration of the lease to acquire the property at a price or under terms or conditions which at the inception of the lease is/are such that no reasonable person would fail to exercise the said option.
>
> 5. The Department is aware that many lease contracts are in the nature of "financial leases" in which the lessor is providing a financial service only. As a result certain costs or obligations that are usually considered incidental to ownership, such as taxes, insurance, maintenance and other obligations become the responsibility of the lessee. In the Department's view the assumption of these obligations by the lessee or any other conditions of the lease that may be indicative of a sale, are not, in and by themselves, conclusive in determining whether the transaction is in substance a sale. Such conditions only add corroborative support where a transaction can be considered to be a sale under the circumstances stated in paragraph 3 above.

[27] In conclusion, counsel for the appellant argued that interpreting the contract as being solely a rental contract would be a limited, strict and literal interpretation that would not represent the economic reality of the transaction that took place and

would be inconsistent with the reasoning of the Federal Court of Appeal in *Bérou* (*supra*).

[28] For his part, counsel for the respondent argued that, since the terms "acquired" and "acquisition" are not defined in the *Act*, in determining the meaning of these terms we must therefore turn to the concepts of "lease", "leasing" and "ownership", as defined in Quebec civil law.

[29] Counsel for the respondent referred to article 1603 of the *Civil Code of Lower Canada*, which, in the chapter on the lease of things, specifically provides that the provisions of a lease shall not apply to a leasing:

> **1603.** This chapter does not apply to a leasing made by a person who carries on the business of lending or granting credit and who, at the request of the lessee, has acquired from a third person ownership of the property forming the object of the contract provided that
>
> 1. the leasing is made for commercial, industrial, professional or handicraft purposes;
> 2. the leasing relates to a moveable;
> 3. the lessee has personally chosen the property;
> 4. the lessor conveys expressly to the lessee the warranty resulting from the sale entered into with the third person; and that
> 5. the conveyance of warranty is accepted without reserve by the third person.

[30] Counsel for the respondent therefore pointed out that "lease" and "leasing" are two separate concepts and that the tax treatment of a leasing is not necessarily the same as the tax treatment of a lease.

[31] Counsel for the respondent explained that a leasing involves a three-party relationship: a supplier of property; a lessor that is a financial institution; and a lessee that asks the financial institution to acquire the property from the supplier for its use, which did not take place in this case.

[32] Counsel for the respondent referred to clause 14 in the rental contract (Exhibit A-1, Tab 7), which stipulates that the lessor, Hewitt, shall remain the owner of the equipment at all times and that nothing in the present rental contract shall be interpreted as giving the lessee a right or title to the equipment other than that of lessee.

[33] Counsel for the respondent argued that the appellant's situation differed from the situation described in *Canada v. Wardean Drilling Ltd.*, [1969] 2 Ex. C.R. 166, at paragraph 26:

> 26. As I have indicated above, it is my opinion that a purchaser has acquired assets of a class in Schedule B when title has passed, assuming that the assets exist at that time, or when the purchaser has all the incidents of title, such as possession, use and risk, although legal title may remain in the vendor as security for the purchase price as is the commercial practice under conditional sales agreements. In my view the foregoing is the proper test to determine the acquisition of property described in Schedule B to the *Income Tax Regulations.*

[34] Counsel for the respondent argued that the appellant was not in the same legal situation as an entity having all the incidents of title. In the instant case, the appellant was only a lessee and was not entitled to the investment tax credit because, in renting the tractor, it did not acquire it.

Conclusion

[35] The Court believes, first, that it is a mistake to see the issue of the interpretation to be given to the term "acquired" as a debate between civil law and common law on the concept of ownership. In the Court's view, *Wardean* interpreted the meaning of the term "acquired" on the basis of the tax legislation. That interpretation may or may not correspond to the common law concept of ownership; that is not the point. The point is that this interpretation was made on the basis of the tax legislation and was accepted by the Minister, as is shown in the Interpretation Bulletin (*supra*).

[36] That interpretation must also be followed in cases subject to Quebec civil law, as was decided by the Federal Court of Appeal in *Bérou* (*supra*).

[37] As counsel for the appellant noted, a leasing contract is a rental contract with an option to purchase. As counsel for the respondent noted, a leasing contract is also not the same thing as a lease.

[38] In both of these legal situations, the lessor retains ownership of the property. The Court therefore sees nothing surprising in clause 14 of the rental contract (Exhibit A-1, Tab 7) on which counsel for the respondent has relied.

[39] The case law has accepted that a leasing contract is a means of acquiring property, a means that takes the form of a lease. In the present case, the evidence as summarized by counsel for the appellant, has established that this was also the situation of the appellant. The rental contract was a financial lease for the purpose of acquiring property.

[40] Like the Federal Court of Appeal in *Bérou* at paragraph 26, the Court considers that the transaction to which the appellant was a party qualifies as an acquisition, under both test (c) and test (d) set out in the Interpretation Bulletin.

[41] In these circumstances, the Court fails to see how it could make a decision other than the one made by the Federal Court of Appeal in *Bérou* (*supra*).

[42] As an aside, the Court notes one aspect of the case that was not raised and that, in the Court's view, would have been worth discussing. According to paragraph 7 of the appellant's Notice of Appeal, Hewitt never claimed the investment tax credit for the tractor sold to the appellant. The Court pointed this out to counsel for the respondent, who stated that, according to paragraph 5 of the Reply to the Notice of Appeal, the respondent was not aware of that fact. The Court would have liked to have more evidence on this aspect of the case, which, in the Court's view, is indicative of the seller's or lessor's intention to divest itself of ownership of the property. In contract matters, the shared intention of the parties is vital.

[43] The seller or lessor, on the one hand, and the lessee, on the other hand, cannot both own the property at the same time and claim the investment tax credit and the capital cost allowance. That was the situation in *Location Gaétan Lévesque Inc. v. M.N.R.*, [1991] T.C.J. No. 406 (Q.L.), a case this Court heard in 1991. A representative of the lessor explained to this Court that the cost of financing the leasing contract was lower than that of a conditional sale or commercial pledge because, under a leasing contract, the financial institution claimed the capital cost allowances. The appellant in fact argued that it too was entitled to claim the capital cost allowance. This Court held in that case that the appellant had not acquired ownership; however, that decision was rendered before the Federal Court of Appeal's decision in *Bérou* (*supra*). As the Court has noted, no evidence on this aspect of the case was adduced, nor did counsel for the respondent raise this point. The Court therefore does not take this aspect of the case into consideration in making its decision and concludes its aside.

[44] In conclusion, the appeal is allowed with costs.

Signed at Ottawa, Canada, this 18th day of October 2002.

"Louise Lamarre Proulx"

J.T.C.C.