

Docket: 2005-2887(IT)G

BETWEEN:

KURT ZAENKER,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on June 18 and 19, 2007, at Vancouver, British Columbia

By: The Honourable Justice Campbell J. Miller

Appearances:

Counsel for the Appellant: Terry S. Gill
Counsel for the Respondent: Linda L. Bell

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 1997 taxation year is allowed, with costs, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to a non-capital loss on the disposition of the Hamburg, Germany property in the amount of \$1,754,068, and any unutilized non-capital losses in 1997 shall be available for carry forward to 1998.

Signed at Ottawa, Canada, this 2nd day of August 2007.

“Campbell J. Miller”

C. Miller J.

Citation: 2007TCC440
Date: 20070802
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REASONS FOR JUDGMENT

Miller J.

[1] Mr. Kurt Zaenker appeals from reassessments of his 1997 and 1998 taxation years. The Minister of National Revenue included interest income in those years from Mr. Zaenker's investments in Germany. Mr. Zaenker claimed he incurred business losses from two loans which went bad, as well as from the disposition of a Hamburg, Germany property in 1997. The Minister denied such business losses.

Facts

[2] Mr. Zaenker grew up in Germany. He had an interest in real estate at a young age. Notwithstanding his father's protestations that his son should maintain a career as a pastry chef in the family business, Mr. Zaenker abandoned that task to pursue his keen interest in real estate. In the late 1960s, in Germany, he took out his first licence as a real estate broker. For several years he carried on that real estate brokerage, relying on advertising and word of mouth to attract clients. He stated that he started making money right from the outset.

[3] After seven or eight years as a broker he realized that the money to be made was not as a broker, but as the owner of properties. He therefore switched real estate strategies in the mid-1970s and started buying and selling properties. He developed a reputation for buying older, cheaper properties. He would then, in common vernacular, flip them. The properties were mainly residential and primarily located in Hamburg, Germany. Occasionally, Mr. Zaenker would take

the time to renovate a property: he gave the example of a property listed for DM 700,000 which he acquired for DM 500,000, he fixed it up over several years and sold it for DM 9,000,000. At the other end of the spectrum was the example he gave of the purchase of a rundown building that he acquired for DM 30,000. The property was painted and a few days later sold for DM 90,000.

[4] Mr. Zaenker would judge the saleability of a property with or without tenants, and if he believed a property was more saleable without tenants, he would attempt to buy them out, though this was not always possible. Mr. Zaenker found buyers by advertising in the Hamburg papers. He was also known by reputation. He normally financed the properties by mortgaging them. He indicated that in Germany a borrower with a good track record, such as his, could obtain a mortgage for greater than the price of the property. He maintained that he used this strategy in finding buyers who would require little or no down payment to acquire his properties. He had a DM 6,000,000 line of credit at the Hamburg Savings Bank.

[5] Between 1975 and 1995, when Mr. Zaenker moved to Canada, he estimated that he had bought and sold approximately 140 properties in his own name. He clearly believed he had a talent for making money on the sale of real estate.

[6] Between December 31, 1994 and August 1995, when Mr. Zaenker moved to Canada, he sold at least six properties. These were townhouses or apartment properties, some of which he had held for 10 years. Monies earned from the sale of these properties went to reducing a mortgage on a certain Hamburg property, the property that Mr. Zaenker maintained has resulted in a business loss in 1997 of CA \$1,754,068. The Hamburg property was the only German property Mr. Zaenker still owned when he immigrated to Canada in August 1995.

[7] The purchase of the Hamburg property was negotiated by Mr. Zaenker in late 1993. The purchase price was DM 8,500,000 financed largely by a DM 8,000,000 mortgage. Mr. Zaenker took possession in early 1994. He described the property as a “beautiful property” in an excellent location. The main floor housed a senior’s meeting place, a coffee shop and a Hi-Fi dealer. On the first floor there was a dental office plus a large office divided into many smaller spaces. The remaining three floors contained apartments. Mr. Zaenker testified that, as was his practice, he tried to sell this “collector’s” property, as he called it, right after he acquired the property. However, as the rental income covered expenses he was in no rush. This situation changed when his primary first floor tenant went bankrupt. He realized he could not rent the space profitably, even if he upgraded the premises. He sold the property in 1997 to a firm of tax consultants for the same

price that he paid, DM 8,500,000. In discharging the balance of the principal on the outstanding mortgage at the time of sale, he was subjected to a prepayment penalty of DM 377,989 from the Hamburg Savings Bank; such penalty was confirmed in correspondence dated March 13, 1997, from the bank.

[8] The parties agree that the exchange rate at the time of Mr. Zaenker's move to Canada in August 1995 was 1 DM = .97950 dollars, and in February 1997, at the time of the sale of the Hamburg property was 1 DM = .80912 dollars. Mr. Zaenker calculated his proceeds from the sale as being DM 8,500,000 less the prepayment penalty of DM 377,989 for a net amount of DM 8,122,011 converted at the rate of .80912, which yields proceeds of disposition of \$6,571,681. Mr. Zaenker subtracts this from the value of the property in 1995, being DM 8,500,000, at rate of .97950 or \$8,325,750, yielding a loss of CA \$1,754,068.

Facts relating to loans

[9] Mr. Zaenker claims to have made 25 to 30 loans while carrying on his real estate practice in Germany between 1975 and 1995. He did not advertise to lend money. People knew he was a man of substance. He would make loans depending on collateral, which he maintained had to be real estate, or he would lend smaller amounts on the basis of an IOU. Some loans (three or four) were what he termed bridge financing in real estate deals. He rarely had to try and realize on his security.

Groth loan

[10] In 1994 Mr. Zaenker was approached by Mr. Wilhelm Groth, a stranger, seeking to borrow funds on the strength of a mortgage on a certain attractive property. Mr. Zaenker reviewed the title to the property he believed was being offered as security. There were numerous charges against the property, which Mr. Groth wanted to have cleared up. Mr. Groth also wanted to do some improvements on the property. Mr. Zaenker felt the property was worth approximately DM 1,000,000.

[11] Mr. Zaenker believed Mr. Groth was hardworking, and proceeded to lend him DM 500,000 in several instalments between May 17, 1994 and December 1995. In July 1995, Mr. Zaenker obtained from Mr. Groth a loan agreement evidencing a loan for the DM 500,000, and also stating that a charge had been registered against the property in Mr. Zaenker's name. As it turned out, Mr. Zaenker's charge was registered against a different property, a property with

little or no value. The property Mr. Zaenker felt he had security against was not owned by Mr. Groth but owned by other members of the Groth family. Mr. Groth made some interest payments towards the loan, then halved the amount of such payments, and then stopped making payments altogether. By the time Mr. Zaenker was living in Canada he was not receiving any further payments from Mr. Groth. He commenced foreclosure proceedings in 1997, but realized that the property charged was worth little. Mr. Groth advised Mr. Zaenker he had nothing. The foreclosure finalized in 1998 did not yield sufficient funds to cover Mr. Zaenker's costs.

Puteick loan

[12] In December 1994, Mr. Zaenker lent Mr. and Mrs. Puteick DM 100,000 at 3% interest for 18 months. Mr. Zaenker knew the Puteicks as neighbours in the small community where Mr. Zaenker had a weekend residence. Mr. Zaenker took no security as he believed Mr. Puteick was "a clean man". For a brief period of time, Mrs. Puteick provided housekeeping services in lieu of paying interest. Following an illness, Mr. Puteick died in 1996. In May 1999, Mrs. Puteick provided a written acknowledgement of the debt to Mr. Zaenker. He bought out the Postal Bank's mortgage on the Puteicks' property to put himself in a position to foreclose on the property, which he did. He then allowed the Puteick family to remain in the home. He recovered none of the DM 100,000 debt owed to him.

Move to Canada

[13] Mr. Zaenker immigrated to Canada in August 1995. He made a couple of trips to Canada prior to this looking for a suitable property, and he opted to buy a property in Nova Scotia. He proceeded to acquire 75 or 80 properties in Nova Scotia, all but one being vacant land. In 1996, he moved to Kamloops, British Columbia, where he acquired a property for development, which ultimately was not developed but sold as vacant land. He bought a couple of other commercial properties in Kamloops in 1997 along with a parking lot. After a serious bout with cancer in 1997 and 1998, he resumed his real estate practice with a couple of single family dwelling purchases in 2000.

Issues

[14] The issues are:

- (i) Are the losses on the Groth and Puteick loans deductible in 1997 and 1998, respectively, pursuant to paragraph 20(1)(p) of *Income Tax Act*?
- (ii) Did the disposition of the Hamburg property result in a non-capital loss in 1997; if so, what was the amount of the loss?
- (iii) If there were non-capital losses incurred by the Appellant in 1997, can he carry forward any of such unutilized losses to be deducted against 1998 income?

Analysis

[15] Paragraph 20(1)(p) of the *Act* reads as follows:

20(1) Notwithstanding paragraphs 18(1)(a), 18(1)(b) and 18(1)(h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto

(p) the total of

- (i) all debts owing to the taxpayer that are established by the taxpayer to have become bad debts in the year and that have been included in computing the taxpayer's income for the year or a preceding taxation year, and
- (ii) all amounts each of which is that part of the amortized cost to the taxpayer at the end of the year of a loan or lending asset (other than a mark-to-market property, as defined in subsection 142.2(1)) that is established in the year by the taxpayer to have become uncollectible and that,
 - (A) where the taxpayer is an insurer or a taxpayer whose ordinary business includes the lending of money, was made or acquired in the ordinary course of the taxpayer's business of insurance or the lending of money, or
 - (B) where the taxpayer is a financial institution (as defined in subsection 142.2(1)) in the year, is a specified debt obligation (as defined in that subsection) of the taxpayer;

[16] As Justice Teskey noted in the case of *Whitland Construction Co. v. Canada*,¹ that for paragraph 20(1)(p) to apply, four conditions must be met:

- (i) there must be a loan;
- (ii) the loan must have been made in the ordinary course of business;
- (iii) the loan must have been made by a taxpayer whose ordinary business included lending of money; and
- (iv) the loan must be established to have become uncollectible in the year.

Chief Justice Bowman, in the case of *Loman Warehousing Ltd. v. Canada*,² further refined the third condition. He stated:

25 The expression "whose ordinary business includes the lending of money" requires a determination of just what the taxpayer's "ordinary business" is. The ordinary business of the appellant is warehousing, not lending money to other companies in the group. Some effect must be given to the word "ordinary". It implies that the business of lending money be one of the ways in which the company as an ordinary part of its business operations earns its income. It also implies that the lending of money be identifiable as a business. I agree that the participation in the MNA, in which a company in the group, depending upon whether on a given day it is in a credit or debit position, may loan or borrow funds is an incident of its business. The appellant's argument equates the words "whose ordinary business includes the lending of money" to the words "in whose business the lending of money is an incident." I do not think the two expressions cover the same territory.

[17] Mr. Zaenker did make loans to Mr. Groth and the Puteicks. However, with respect to the Puteick loan, I find such loan was not made in the ordinary course of business. Mr. Zaenker was helping neighbours. This was evident by his pre-existing relationship with the Puteick family, his attaching a low interest rate to the debt, his acceptance of housekeeping services instead of interest, the lack of security, the sympathy for the family arising from Mr. Puteick's illness and death, which kept him from seeking payments and his ultimate acquisition of the Puteick property so that he could allow the Puteicks to remain resident thereon. This was a

¹ [1999] 1 C.T.C. 2172.

² [1999] T.C.J. No. 341.

personal, not a commercial matter. It was not a loan in the ordinary course of business.

[18] With respect to the Groth loan, I find that it was made in the ordinary course of business, although the lack of documentation until well after the first several loan payments were made to Mr. Zaenker casts some doubt on the loan being in the ordinary course of business. Yet, Mr. Groth was a stranger, Mr. Zaenker did ultimately take a charge against a property (albeit the wrong property) and market interest rates were charged.

[19] The more pertinent question is whether the third condition has been met. Did Mr. Zaenker's ordinary business include the lending of money? Mr. Zaenker's business was real estate – he bought and sold properties. Any loans he made would normally have a real estate element to them. Mr. Zaenker provided little evidence of the 25 or so loans that he indicated he made over a 20-year period. He did not advertise as a lender. The possibility of making loans arose either through his real estate connections or simply because he was known as a man of substance.

[20] I believe Chief Justice Bowman's comments in *Loman* are applicable here. Those loans which were not made on a personal basis (as I have found the Puteick loan was) were incidental to Mr. Zaenker's ordinary business, which was dealing in real estate. His ordinary business did not include the lending of money.

[21] I am further strengthened in this view that Mr. Zaenker's ordinary business did not include the lending of money by the lack of evidence of other loans he had made over the previous 25 years. Given that of the two loans under consideration before me, one I have found is clearly personal, I am not prepared to accept that, without any other evidence, the approximate 20 other loans were all of a commercial nature. The small number over a long period of time, plus this lack of evidence, plus my reading of the circumstances surrounding these loans leads me to the conclusion that the lending of money was not part of Mr. Zaenker's ordinary business.

Hamburg property

[22] Mr. Zaenker was in the business of buying and selling real property. Some of those properties he rented while holding them before sale; others he did not. He certainly did not view his business as being divided between the flipping of properties and the renting of properties.

[23] A number of factors have been developed in the jurisprudence over the years to address the question of income versus capital:

- the nature of the property sold;
- length of the period of ownership;
- frequency and the numbers of transactions;
- the work expended on or in connection with the property;
- the circumstances responsible for the sale itself; and
- the motive or intent of the taxpayer when the property was acquired.

This last factor is considered key in the determination.

Nature of property sold

[24] The Hamburg property was partly residential and partly commercial real estate. This was not dissimilar from other properties held by Mr. Zaenker. The difficulty lies not so much in the nature of the property, real estate, as the purpose for which the property was held. I am influenced by Mr. Zaenker's comments that he had an instinct for determining when a property was more saleable, with or without tenants. It left the impression that rent was incidental to the holding of real property as inventory.

[25] The Respondent suggested that the Hamburg property was dissimilar from the properties held for resale, which were primarily residential, and that the Hamburg property was more similar to the rental properties sold by Mr. Zaenker just before he immigrated. The Respondent's theory was that Mr. Zaenker had two businesses; one being the purchase and sale of single family dwellings; the second being income from rental properties. I do not agree that the evidence suggests this theory. Mr. Zaenker referred to acquiring mainly residential properties, but never equated that to single family houses. Apartment buildings are also residential properties. I do not accept that the business can be split according to the nature of the property. The facts are that some properties, whatever their nature, were rented for longer or shorter periods and some were not rented at all. There was not a great deal of evidence of the nature of the 140 or so properties sold by Mr. Zaenker over the 20 years. The Hamburg property itself was a mixture of residential and

commercial, though three of five floors were residential. I draw no inference from this.

[26] The Respondent referred to the six properties sold in 1994 as rental properties. Apart from the suggestion some might have been held for 10 years, there is not enough detailed evidence on these properties to conclude they were not inventory to Mr. Zaenker. Certainly, to accept Mr. Zaenker's explanation of his *modus operandi*, all real properties were held as inventory; they were not distinguishable on the basis of their nature.

[27] All to say, the nature of the property as partly commercial and partly residential does not inexorably point to a finding of capital or inventory. I must consider the other factors.

Length of period of ownership

[28] There is no magic in the time period. Certainly a property held for 20 years would point to capital while a property turned over in a few months might suggest inventory. But this is a factor that cannot be viewed in isolation. A period of holding for three years in isolation is simply not determinative. It must be considered that Mr. Zaenker had a long history of buying and selling property; he was a real estate broker; he was very successful at reselling properties at a profit; he often mortgaged properties to the maximum extent possible. The length of ownership, viewed in light of all these other factors, is not determinative one way or the other.

Frequency of similar transactions

[29] Mr. Zaenker bought and sold 140 properties over 20 years and became a wealthy man because of it. This clearly points to a finding the Hamburg property was another in his stable of real estate inventory. This is what Mr. Zaenker did. As he put it, he had a basic instinct for turning real estate profitably. The Hamburg property appears to have been his only loss.

Work expended on the property

[30] There is some evidence that Mr. Zaenker expended approximately DM 200,000 on improving the staircases in the property. When he lost his major commercial tenant, he believed the cost to renovate further would not justify continuing to hold the property.

Circumstances responsible for the sale of the property

[31] Mr. Zaenker determined the time was right to sell when the commercial tenant went bankrupt, though his evidence was that he sought to sell the property immediately after acquiring it, but was in no rush as the rent covered the expenses. When that situation changed, he believed he could minimize his losses by selling for what he paid for the property – DM 8,500,000, which he did. Someone in the business of earning rental income would presumably put more effort into finding replacement tenants.

Intention at the time of acquisition of the property

[32] Mr. Zaenker's stated intention was that at the time he acquired the property, he intended to resell it at a profit. He testified that he made it known at that time that the property was available. He indicated it was not necessary to list the property, as it is in Canada. His contacts and reputation were sufficient to search out prospective buyers. He confirmed that he tried to sell in 1994 before leaving the country, but he was in no rush as the cash flow was good. When that cash flow diminished, he sold. I believe Mr. Zaenker. I am satisfied his business was reselling properties at a profit, and the Hamburg property was simply one of those properties, indeed the only property on which he failed to make a profit.

[33] The Respondent argues that the length of ownership (three years), combined with the nature of the property and the fact the sale was triggered by changed circumstances, point away from Mr. Zaenker's stated intention, but point more to an intention of a long-term holding, a holding on capital account. I find that his history of buying and selling properties, the fact such sales included similar properties, the sale of the property rather than seeking a replacement tenant all support Mr. Zaenker's stated intention from the outset. I found Mr. Zaenker an extremely straightforward individual with a passion for real estate and some evident pride in his ability to assess the likelihood of profit on resale. While there are factors that point both ways, I am swayed ultimately by Mr. Zaenker's evidence that the Hamburg property was acquired as inventory and its disposition has led to a loss on income account.

[34] The amount of the loss is determined (relying on subsection 128.1(1) of the *Act*) as the amount of DM 8,500,000, being the value of the property upon arriving in Canada, at the rate at that time, less the proceeds of disposition of DM 8,122,011 at the 1997 exchange rate. This yields a loss in Canadian dollars of \$1,754,068.

This loss reflects the actual loss arising from the prepayment penalty. It also reflects a significant foreign exchange loss. The foreign exchange loss is on income account on the basis that it derives its nature from the nature of the underlying disposition.

[35] The parties addressed the issue of secondary intention, referring to the case of *Regal Heights Ltd. v. M.N.R.*³ It is unnecessary to consider the doctrine of secondary intention, as I am satisfied that Mr. Zaenker had a primary intention to resell the Hamburg property at a profit. If I had to resort to the principle from *Regal Heights*, I would have no difficulty in concluding that, even if Mr. Zaenker's primary intention had been the rental income, he had every intention to obtain profit from the disposition of this valuable, "beautiful" property at the opportune moment.

[36] Before concluding, I will address briefly the parties' reliance on Mr. Zaenker's behaviour upon immigrating to Canada. Both sides suggested Mr. Zaenker's subsequent behaviour supported their respective positions. The Respondent argued that Mr. Zaenker's Canadian real estate dealings were fundamentally different from his German dealings, as in Canada he bought property, mainly vacant land, for a longer term investment, while in Germany he bought and sold single family homes. Notwithstanding my different view of the evidence regarding the nature of the properties sold in Germany, I fail to see how Mr. Zaenker's subsequent real estate dealings bear negatively on a determination of income versus capital nature of the Hamburg property. The Appellant's counsel argues that one of the biggest points in his client's favour is his subsequent speculative Canadian real estate purchases. While I agree his actions are more supportive of a finding that he dealt in real estate, again it is subsequent activity on which I rely marginally.

[37] The appeal is allowed and referred back to the Minister for reconsideration and reassessment on the basis that Mr. Zaenker is entitled to a non-capital loss in 1997 on the disposition of the Hamburg property in the amount of \$1,754,068. Any unutilized non-capital losses in 1997 would be available for carry forward to 1998. The Appellant is entitled to his costs.

Signed at Ottawa, Canada, this 2nd day of August 2007.

³ [1960] S.C.R. 902.

“Campbell J. Miller”

C. Miller J.

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