Docket: 2014-1689(IT)I

BETWEEN:

SHAHRZAD GHAFFARI,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on common evidence with the appeal of *Bernard Tajick* (*2014-1694(IT)I*), on November 25, 2014, in Montréal, Quebec.

Before: The Honourable Rommel G. Masse, Deputy Judge

Appearances:

Agents for the appellant:	Élizabeth Lachance Benoît Larochelle
Counsel for the respondent:	Christina Ham

JUDGMENT

The appeal of the reassessment under the *Income Tax Act* for the 2009 taxation year is allowed in part. Therefore, the matter is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

Signed at Kingston, Ontario, this 8th day of April 2015.

"Rommel G. Masse"

Masse D.J.

Translation certified true
on this 5th day of June 2015
Catherine Jones, Translator

Docket: 2014-1694(IT)I

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Appellant,

and

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BETWEEN:

SHAHRZAD GHAFFARI,
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REASONS FOR JUDGMENT

Masse D.J.

[1] In docket 2014-1689(IT)I, the appellant is Shahrzad Ghaffari (Ghaffari). In docket 2014-1694(IT)I, the appellant is Bernard Tajick (Tajick). The two appellants are spouses. On May 14, 2013, the Minister of National Revenue (Minister) issued reassessments to the two appellants that added to their income $53,100 each for the 2009 taxation year, including $50,550 as rental income.

[2] The appellants appealed their reassessments. Both appeals were heard on common evidence.

[3] The only issue is to determine whether, for the 2009 taxation year, the Minister was justified in adding $50,550 each as rental income to the appellants' income.

Factual background

[4] On May 17, 2010, the Minister issued to the appellants initial assessments for the 2009 taxation year. On May 14, 2013, the Minister issued reassessments, adding to the appellants' income $53,100 each for the 2009 taxation year,

including $50,550 as rental income. On May 31, 2013, the appellants served on the Minister notices of objection to the reassessments. On March 3, 2014, the Minister confirmed the reassessments, hence these appeals.

[5] The appellants are directors and shareholders of a company named "Auberge Manoir Ville-Marie inc." (the Auberge), incorporated on December 23, 2004. They are equal co-owners of a building located at 3130 Sainte-Catherine Street East, Montréal (the building). Further, they are partners in a general partnership doing business as Groupe Best Dev (LLP) (Best Dev). The building is managed by Best Dev and is rented to the Auberge. The Auberge operates a hotel business in this building.

[6] Mr. Tajick explained that the building was hypothecated and the bank required that the business relationships between Best Dev and the Auberge be normalized. The bank required a fixed income and an income statement for each year to comply with the bank's standards. Therefore, a lease was entered into between Best Dev and the Auberge on January 1, 2005 (see Exhibit A-1, Tab 2). In this lease, Best Dev (represented by Tajick and Ghaffari) is described as owner and the Auberge (also represented by Tajick and Ghaffari) is described as renter. The lease was for five years, renewable for five more years. The rent was $9,800 per month, or $117,600 per year, plus applicable taxes. According to the lease, the building is for [TRANSLATION] "*the inn / hotel, for rent: rooms, banquet hall and meeting room.*" The lease provided that the amount of rent could be adjusted at the beginning of each year. The relevant clause stipulates the following:

> [TRANSLATION] There could be an adjustment in rent at the beginning of each year, based on the actual cost of operations and improvements in the building.

[7] It is undisputed that the appellants, Best Dev and the Auberge do not have an arm's length relationship and thus the appellants were effectively renting the building to themselves. Mr. Tajick told us that the appellants had very little knowledge of the neighbourhood where the building was located before buying it. Therefore, the rent was only an estimate based on the value invested in the building and the state of the rental market that Mr. Tajick believed existed at the time in the neighbourhood.

[8] Mr. Tajick testified that he realized from the beginning that it was impossible for the Auberge to continue to pay the amount of rent provided in the lease and, thus, relying on the clause that allowed an adjustment, the rent was adjusted from time to time. For 2005, the appellants reported in their tax returns

the amount of $100,800 as rent instead of $117,600 as provided by the lease. For the 2006 taxation year, they reported $109,200 as rent. For 2007, they again reported $109,200 as rent. The same amount was reported for 2008. However, the amount reported as rent for the 2009 taxation year was reduced significantly to $16,500, which is a great difference in relation to previous years in the circumstances. Mr. Tajick explained that he had already paid back the hypothec, therefore there was less pressure to submit a statement that complied with the bank's standards.

[9] The Auberge never paid the rent provided for in the lease. The rent payments were always late. Mr. Tajick testified that even though Best Dev had billed the amounts indicated above and the appellants had reported these same amounts in their tax returns, Best Dev and, therefore, the appellants had never received the amounts billed and reported. However, the appellants paid the associated taxes. In 2009, the Auberge paid $65,691, which represents the late payments from previous years for which the appellants had already paid taxes. When filing their tax returns for 2009, the appellants each reported rental income for the building of only $8,250 ($16,500 divided by 2) resulting in a rental loss of $47,822 (see Exhibits I-1 and I-2).

[10] In cross-examination, Mr. Tajick agreed that the appellants chose to use the accrual method of accounting instead of the cash method. Therefore, they must pay taxes on the amounts declared even if they did not receive them. He also agreed that the income of Best Dev was included in the appellants' personal income. He told us that Best Dev tolerated such a long delay in payment because it was a lease between them and that their priority was to pay the taxes even on amounts that they had not received in the hope of receiving them the following years. Mr. Tajick agreed that he would not have rented the building at such a low rent to a person with whom he did not have a not an arm's length relationship. In 2009, Best Dev accepted a minimum rent of only $16,500 because the Auberge did not have the means to pay more. I cannot accept this claim because the Auberge's financial statements for the fiscal year ending on December 31, 2009, indicate that it made a profit of $55,651, while the Auberge had allegedly incurred net losses in previous years, i.e. 2006, 2007 and 2008 (see Exhibit A-1, Tab 8). Furthermore, it is undisputed that the Auberge paid Best Dev $65,691 in 2009, which supposedly represents late payments for the previous years, which the Auberge could not have done if the company was facing financial difficulties as described by Mr. Tajick.

[11] Rachid Zaddoug, an auditor working for the Canada Revenue Agency (the Agency), audited the Auberge and then he reviewed the appellants' tax returns. As

part of his review of the Auberge's returns, he conducted a risk analysis for the 2009 taxation year and noted that the Auberge had only reported $16,500 as rent and that the appellants had reported this same amount as income—a very small amount compared to previous years. Then, he reassessed the appellants on the basis that the rent should have been $117,600, as provided in the lease, instead of $16,500. In cross-examination, Mr. Zaddoug indicated that when he had made the reassessments, he was aware that in previous years, the reported rent was approximately $109,000 and never $117,600 as indicated in the lease. He explained that he had only made an assessment based on the amount indicated on the lease and not based on the amounts reported in the past.

[12] It is very important to note that during the taxation year in question, the appellants sold a rental building located at 6366 Chester Street, Montréal, realising a taxable capital gain of $188,050 each. Also, they each recaptured approximately $62,357 as a depreciation recapture. The appellants each achieved a net income of $64,390 for the 2009 taxation year with the sale of this building. Therefore, it is clear that the appellants faced a significant tax liability for the taxation year in question under this sale.

Appellants' position

[13] The appellants argued that the Auberge and Best Dev had the ability to set an amount of rent different from what was indicated in the lease. This is freedom of contract between two contracting parties. The modification of the rent was planned from the beginning by including a clause to this effect in the lease. The common intention of the parties was to allow the rent to be modified based on the circumstances. In civil law, the tax authorities do not have an acquired right to benefit from an error made by the parties to a contract after they have corrected it by mutual consent. The Agency is a third party to the contract and cannot avail itself of a change in contract made by the parties to the contract. The contract must not be interpreted based on the ambitions of the tax authorities, but rather, the common intention of the parties to the contract must be sought. The rent had been adjusted from the beginning based on circumstances and the fact that the parties agreed to adjust the rent for 2009 to a different amount from the previous years reflects the commercial situation that existed in all the circumstances and has nothing to do with the tax authorities.

[14] Therefore, the appellants request that the Court allow the appeals, vacate the reassessments and refer the matter back to the Minister for reconsideration and reassessments.

Respondent's position

[15] The respondent argued that the appellants neglected to report income of $50,550 (($117,600 - $16,500)/2) in their tax returns for the 2009 taxation year. Therefore, the Minister was justified in adding to the appellants' income the amount of $50,550 as rental income under subsection 9(1) and paragraph 12(1)(*b*) of the *Income Tax Act*, R.S.C. (1985), c. 1 (5th supp.), as amended (the Act).

[16] The respondent argued that the clause in the lease, which allowed for the amendment of the rent has very little ambiguity. An amendment to the rent was to be based on the [TRANSLATION] "actual cost of operations and improvements in the building" and not based on the sales figures of the Auberge. In this case, the reduction of rent was based solely on the sales figures of the Auberge and not based on actual costs and improvements made to the building.

[17] The respondent pointed out the fact that during 2009, the appellants sold the rental building located on Chester Street. The result of this sale was a taxable capital gain. There was also a recapture of the depreciation costs, which was added to the calculation of income for this building. By declaring rent of only $16,500 for the building located on Sainte-Catherine Street East, the appellants created a loss that resulted in a significant reduction of their tax liability. It is a basic principle in taxation that all taxpayers may plan their business with the goal of minimizing taxes payable unless it is abusive. Furthermore, the respondent confirms that in this case, the appellants adjusted the rent retroactively after selling the building on Chester Street, which is not allowed.

[18] Therefore, the respondent requests that the appeals be dismissed.

Statutory provisions

[19] The relevant provisions of the Act are the following:

> **9(1) Income** — Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.
>
> **(2) Loss** — Subject to section 31, a taxpayer's loss for a taxation year from a business or property is the amount of the taxpayer's loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require.

(3) Gains and losses not included — In this Act, "income from a property" does not include any capital gain from the disposition of that property and "loss from a property" does not include any capital loss from the disposition of that property.

…

12(1) Income inclusions — There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:

…

(b) **Amounts receivable** — any amount receivable by the taxpayer in respect of property sold or services rendered in the course of a business in the year, notwithstanding that the amount or any part thereof is not due until a subsequent year, unless the method adopted by the taxpayer for computing income from the business and accepted for the purpose of this Part does not require the taxpayer to include any amount receivable in computing the taxpayer's income for a taxation year unless it has been received in the year, and for the purposes of this paragraph, an amount shall be deemed to have become receivable in respect of services rendered in the course of a business on the day that is the earlier of

(i) the day on which the account in respect of the services was rendered, and

(ii) the day on which the account in respect of those services would have been rendered had there been no undue delay in rendering the account in respect of the services;

[20] The relevant provisions of the *Civil Code of Québec*, S.Q. 1991, c. 64 are the following:

1385. A contract is formed by the sole exchange of consents between persons having capacity to contract, unless, in addition, the law requires a particular form to be respected as a necessary condition of its formation, or unless the parties subject the formation of the contract to a solemn form.

It is also of the essence of a contract that it have a cause and an object.

1386. The exchange of consents is accomplished by the express or tacit manifestation of the will of a person to accept an offer to contract made to him by another person.

…

1425. The common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract.

> **1426.** In interpreting a contract, the nature of the contract, the circumstances in which it was formed, the interpretation which has already been given to it by the parties or which it may have received, and usage, are all taken into account.
>
> …
>
> **1429.** Words susceptible of two meanings shall be given the meaning that best conforms to the subject matter of the contract.
>
> …
>
> **1431.** The clauses of a contract cover only what it appears that the parties intended to include, however general the terms used.

Analysis

[21] The appellants rely on the principle of freedom of contract. The civil law of contracts relies on consensus and retains the basic distinction between the exchange of consents and its written expression. The contract belongs to the parties. Between them, but subject to the rights that were acquired by third parties, the parties are free to modify or cancel the contract and the documents that noted them. Nothing prevents them from recognizing the existence of a common error and agreeing to correct it by mutual consent.

[22] It also goes without saying that the parties to a contract may certainly make corrections to a juridical act that is the result of the will of the contracting parties. When they acknowledge errors made in the documents giving effect to their agreement and agree to correct them, the parties may agree on modifications to the contract. Transactions that may have had unexpected tax implications may be corrected by the contracting parties and the tax authorities have no say in the matter. As Justice LeBel of the Supreme Court of Canada stated, "[i]n the civil law, the tax authorities do not have an acquired right to benefit from an error made by the parties to a contract after the parties have corrected the error by mutual consent."[1] However, Justice LeBel acknowledged at paragraph 35 that the validity of consent depends on its integrity. It is not every consensual modification to a contract that can resist judicial review. Justice LeBel at paragraph 45 noted that "[u]nder the civil law itself, the agencies can also prove that simulation existed and

[1] See *Québec (Agence du revenu) v. Services Environnementaux AES inc.*, 2013 SCC 65, [2013] 3 S.C.R. 838 at para. 52.

demonstrate the true nature of transactions they allege to be shams."[2] Justice LeBel advises the following at paragraph 54:

> [54] However, the judicial recognition of the validity of the amendments made by the parties in this case to the writings recording their agreements must be accompanied by certain reservations and a word of warning. Taxpayers should not view this recognition of the primacy of the parties' internal will — or common intention — as an invitation to engage in bold tax planning on the assumption that it will always be possible for them to redo their contracts retroactively should that planning fail. A taxpayer's intention to reduce his or her tax liability would not on its own constitute the object of an obligation within the meaning of art. 1373 C.C.Q., since it would not be sufficiently determinate or determinable. Nor would it even constitute the object of a contract within the meaning of art. 1412 C.C.Q. Absent a more precise and more clearly defined object, no contract would be formed. In such a case, art. 1425 could not be relied on to justify seeking the common intention of the parties in order to give effect to that intention despite the words of the writings prepared to record it. …

[23] It goes without saying that the taxpayers may organize their affairs in such a manner as to reduce the amount of taxes that they would have to pay unless this tax planning is abusive or has a retroactive effect. In *Envision Credit Union v. Canada*, 2013 SCC 48, [2013] 3 S.C.R. 191, Justice Rothstein of the Supreme Court of Canada stated the following well-known principle:

> [1] Every taxpayer is entitled to order his or her affairs so that the tax payable is less than it otherwise would be. Taxpayers often engage in tax planning to achieve that result. Of course, if that tax planning is to achieve the desired result, it must be consistent with the relevant provisions of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) ("ITA"), and other statutes. If the planning runs afoul of such provisions, the sought after tax minimization is not achieved. …

[24] Tax planning that has a retroactive effect is not permitted. In *S. Adam v. M.N.R.*, [1985] 2 C.T.C. 2383, the taxpayer was the majority shareholder of a company from which he received a weekly salary. At the end of the fiscal year for the taxation year, the company decided to retroactively convert the salary already paid to the taxpayer in dividends, which would create for the taxpayer a tax advantage that would enable him to avoid paying certain taxes. Judge Rip of the Tax Court of Canada, as he then was, decided that for tax liability purposes, it was not allowed to convert *ex post facto* a salary that was already paid to dividends. This is not a permitted method of tax planning or optimizing. Tax planning must be prospective and not retroactive. Justice Rip stated the following at paragraph 14:

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[2] *Ibid*.

> [14] However no taxpayer has the right to retroactively alter events when it best suits his purposes although there is no question he may prospectively plan events to suit these purposes: this is sometimes called tax planning. While I may sympathize with Mr. Rabinovitch's desire to minimize his client's taxes and the uncertainty in tax law during 1982, I am of the view that the retroactive adjustments to accounts is not a valid tax planning scheme, and I must therefore dismiss this appeal.

[25] It is possible to lose a tax benefit if an operation is considered incomplete or ineffective because a person neglected to comply with indispensible legal formalities. It is a matter of carefully examining whether the operation that the taxpayer used, e.g. a contract, is a valid operation from the perspective of both formal and substantive conditions. In this respect, the words of Justice Urie, in *Atinco Paper Products Ltd v. The Queen*, [78 D.T.C. 6387], [1978] C.T.C. 566 at pp. 577 and 578 (F.C.A.) (application for leave to appeal before the S.C.C. dismissed (1979) 25 N.R. 603n), are relevant:

> … Nonetheless, it is the duty of the Court to carefully scrutinize everything that a taxpayer has done to ensure that everything which appears to have been done, in fact, has been done in accordance with applicable law. It is not sufficient to employ devices to achieve a desired result without ensuring that those devices are not simply cosmetically correct, that is correct in form, but, in fact, are in all respects legally correct, real transactions. If this Court, or any other Court, were to fail to carry out its elementary duty to examine with care all aspects of the transactions in issue, it would not only be derelict in carrying out its judicial duties, but in its duty to the public at large. It is for this reason that I cannot accede to the suggestion, sometimes expressed, that there can be a strict or liberal view taken of a transaction, or series of transactions which it is hoped by the taxpayer will result in a minimization of tax. The only course for the Court to take is to apply the law as the Court sees it to the facts as found in the particular transaction. If the transaction can withstand that scrutiny, then it will, of course, be supported. If it cannot, it will fall. …

[26] I am not persuaded that this is a case of freedom of contract where two contracting parties wish to correct an error or a misunderstanding in their contractual relationship. It is undisputed that the appellants are the guiding mind of the Auberge and Best Dev. The Auberge and Best Dev are not independent contracting parties; they do not have an arm's length relationship. In reality, the appellants were renting the building to themselves. The fact that the appellants created the Auberge as a legal person and then rented the building to the Auberge constitutes tax planning. Therefore, the actions of the appellants and the Auberge must be carefully examined to ensure that these actions are legally correct and real. It is certainly reasonable to reduce the rent from $117,600 to $109,200 in the

circumstances; but reducing the rent from $117,600 to $16,500 for 2009 is completely unreasonable and would not be tolerated by independent contracting parties. Mr. Tajick told us that in 2009, he had to reduce the rent to $16,500 because the Auberge did not have the means to pay the rent. For the reasons that I have indicated above, I do not agree with this claim.

[27] One also wonders if it is an unexpected coincidence that the rent was so greatly reduced during the same taxation year as that of the sale of the building on Chester Street which resulted in a heavy tax liability for the appellants. I do not believe it. During the taxation years of 2006, 2007 and 2008, the rent was $109,200 per year. The year that the building located on Chester Street was sold, the rent was reduced to $16,500. But the following years, i.e. 2010 and 2011, the rent was again increased to $100,000 and $102,400 respectively. One has to wonder why. I am of the view that the appellants manipulated the rent billed in 2009 for the purpose of avoiding paying taxes as a result of the sale of the building on Chester Street These actions are not legally correct and real as required in *Atinco Paper Products*, *supra*, at para. 25. Therefore, this is opportunistic tax planning as a result of the sale of the Chester Street building, which created a significant tax liability for the appellants and that they wanted to avoid.

[28] It is well established that when taxpayers wish to dispute the validity of an assessment against them, they must establish on a balance of probabilities that the evidence that the assessment is without merit.[3] I am of the view that the appellants have not discharged their burden by showing that the Minister erred in law by alleging that they have a higher rental income than what they reported.

[29] However, I am of the view that Mr. Zaddoug should have considered the historic data in this case. The rent billed and reported by the appellants was never $117,600 in all the previous years. Therefore, Mr. Zaddoug was not justified in insisting that rent be in all cases established at $117,600. Although the contracting parties do not have a not an arm's length relationship, they must be allowed reasonable freedom of contract. The rent varied between $100,000 and $109,200 between 2005 and 2010, without considering the 2009 taxation year. These figures are reasonable. While arbitrary, it seems to be to be reasonable to impute rent of $100,000 for the 2009 taxation year instead of $117,600.

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[3] See *Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336; *Stewart v. M.N.R.*, [2000] T.C.J. No. 53; *Orly Automobiles Inc. v. Canada*, 2005 FCA 425; and *Amiante Spec Inc. v. Canada*, 2009 FCA 139.

Conclusion

[30] For these reasons, the appeals are allowed in part. These matters are referred back to the Minister for reconsideration and reassessment on the basis that the rent for the building is imputed an amount of $100,000 for the 2009 taxation year.

Signed at Kingston, Ontario, this 8th day of April 2015.

"Rommel G. Masse"

Masse J.D.

Translation certified true
on this 5th day of June 2015
Catherine Jones, Translator

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APPEARANCES:

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