Citation: 2004TCC419
Date: 20040629
Docket: 2001-3709(IT)G

BETWEEN:

IRVIN KEW,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Counsel for the Appellant: Kim E. Johnson
Counsel for the Respondent: Victor Caux

REASONS FOR JUDGMENT

**(Delivered orally from the Bench at
Vancouver, British Columbia, on April 8, 2004)**

McArthur J.

[1] This is an appeal from an assessment of tax for the Appellant's 1995 taxation year whereby the Minister of National Revenue disallowed alimony or maintenance deductions of $31,233 and investment interest charges of $16,736. The Appellant transferred his 50% interest in a matrimonial home to his former spouse in consideration of a variety of concessions including arrears of alimony and maintenance. He wishes to deduct the entire amount.

[2] He is a professional architect carrying on business through a corporation, Irvin Kew Architecture Incorporated. The second issue is whether he can deduct $16,736 in interest on operating capital borrowed from the Royal Bank of Canada (RBC), the Hong Kong Bank (HKB) and the Canadian Imperial Bank of Commerce (CIBC).

[3] I will first deal with the child support amount. By written separation agreement dated May 5, 1988, the Appellant and his former spouse Nicola agreed to live separately and apart. They had three children, twin boys born October 1, 1972 and a daughter born February 14, 1979. Nicola had exclusive use of the matrimonial home. The Appellant agreed to pay: (i) $150 monthly per child; (ii) one-half of the private school fees for the two boys; (iii) one-half of the property tax for the matrimonial home; (iv) the mortgage payments on the matrimonial home; and (v) insurance premiums for the children's benefit.

[4] The Appellant's business suffered financially and he fell into arrears of his support obligations almost from the outset. Nicola did not attend the hearing, but her presence was felt from several of her carefully drafted letters to the Appellant and her accounting records of payments made by him. In 1995, RBC called in a substantial loan which eventually resulted in a separation agreement modification which was dated and signed in August 1995 (Exhibits A-5 and R-1, Tab 1) and included the following covenants:

> 2. As of the date of payment to the Husband of the sum of FIFTY ONE THOUSAND DOLLARS ($51,000.00) his obligation to continue with child maintenance is thereby terminated and the payment of FIFTY-ONE THOUSAND DOLLARS ($51,000.00) represents a full and final satisfaction of child maintenance.
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> . . .
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> 4. The Husband and the Wife agree further that the sum of FIFTY-ONE THOUSAND DOLLARS ($51,000.00) in addition to representing full satisfaction of child maintenance obligations shall also represent full satisfaction of the Husband's interest in the property at 1657 Fell Street.

[5] The above terms evolved from an offer made by Nicola to the Appellant in a letter dated July 21, 1995 (Exhibit A-3), which included the following:

> As part of this offer, I will agree to relinquish my legal right to free residence here until Henrietta is 19 years old, which is two and a half years from now. This will save you the sum of $20,085 in mortgage payments over this period of time. I will arrange for my lawyer to draw up a legal revision to the Separation Agreement and Court Order to this effect.
>
> I enclose account sheets setting out the amount of unpaid maintenance and other amounts over the past few years, which total $31,233.17 (interest excluded). . .

Nicola's offer was made after the Appellant requested that he be permitted to mortgage his equity in the matrimonial home to pay creditors. The Appellant accepted Nicola's offer on August 1, 1995 with the following notation set out in a letter from Nicola to him on the same date (Exhibit A-4):

> This is to confirm our telephone conversation and my acceptance of your offer to pay me the total sum of $51,000.00 (net) for my interest on 1657 Fell Street, including the relinquish of all your rights for further claims as itemized in your letter above; it is also agreed that you will confirm receipt of the 1993 and 1994 maintenance arrears the sums of $5,400.00 and $3,600.00 respectively as part of the terms of this agreement.

The Appellant now seeks to deduct, as support payments, the amount of $31,233 which he states was in satisfaction of maintenance arrears.

[6] The Respondent's position is that the amount is not deductible because (i) the second agreement of August 1, 1995 did not provide for satisfaction of maintenance arrears; (ii) the Appellant had been in arrears of child support, private school fees, insurance and property tax for some time; (iii) the portion of the $31,233 which may have been unpaid child maintenance was capital in nature. Counsel refers to the *M.N.R. v. J.J. Armstrong*, (1956) C.T.C. 93 (S.C.C.); and (iv) the Appellant did not actually pay Nicola and she had no discretion over the use of the amount.

[7] For the reasons that follow, I find that the entire amount is not deductible as unpaid child maintenance. The Appellant relies in part on *obiter dicta* of O'Conner J. of this Court in *White v. The Queen*, 97 DTC 1108 at page 1115 where he states:

> With respect to alimony, the amounts paid were not pursuant to a judgment or an order but were rather paid pursuant to a settlement and release agreement which released the Appellant from all obligations past and present. It is true that in certain circumstances a lump sum payment representing payment of alimony arrears may qualify but in this appeal there is absolutely no proof as to whether any portion of the amount paid to the former wife relates to payment of arrears of periodic alimony. Moreover, in my opinion, the $25,000 lump sum payment provided for in the Decree *Nisi* cannot be considered as alimony paid on a periodic basis.

The words from this quotation: "It is true that in certain circumstances a lump sum payment representing payment of alimony arrears may qualify … " are

emphasized by counsel for the Appellant. Unfortunately, those certain circumstances have not been set out, and this comment is of no assistance to the Appellant. The transfer by the Appellant to Nicola of his equity in the home was to satisfy a variety of debts owed by the Appellant to Nicola only part of which may have been maintenance arrears. The Appellant's evidence falls short of establishing that the home equity was transferred: (i) for the maintenance of Nicola or the children; (ii) because it represented unpaid child support; (iii) giving Nicola discretion over the use of the amount.

[8] In addition, I find that the amount was a capital payment. The Respondent's counsel referred to *Armstrong*, where Kellock J. of the Supreme Court of Canada at page 95 stated:

> KELLOCK, J.: - In this case the sum of $4,000 was paid by the respondent "in full settlement" of all payments due or to become due under a decree *nisi* which obligated him to pay to his former wife the sum of $100 a month for maintenance of the infant child of the parties until the latter should attain the age of sixteen years. In consideration of this payment the respondent was released by the wife "from any further liability" under the said judgment.
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> . . .
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> If, for example, the respondent had agreed with his wife that he should purchase for her a house in return for a release of all further liability under the decree, the purchase price could not, by any stretch of language, be brought within the section. The same principle must equally apply to a lump sum paid directly to the wife to purchase the release. Such an outlay made in commutation of the periodic sums payable under the decree is in the nature of a capital payment to which the statute does not extend.

[9] The relevant sections of the *Income Tax Act* have been amended many times since this was written but the basic principle is relevant today. The only breakdown of the lump sum amount is provided by Nicola's July 21, 1995 letter. It includes savings by the Appellant of $16,500 for future child support payments and two $10,000 amounts, which are clearly not maintenance support. I agree with the Minister's position that any outlay made in the computation of periodic sums is a capital payment. The character of the amount changed. In our instance, it is impossible to discern how much of the payment if any, was a computation of periodic sums.

[10] I will briefly deal with the Appellant's remaining submissions. The relevant legislation includes subsection 56(12) of the *Act*, which reads in part:

> 56(12) Subject to subsections 56.1(2) and 60.1(2), for the purposes of paragraphs (1)(*b*), (*c*) and (*c*.1) (in this subsection referred to as the "former paragraphs") and 60(*b*), (*c*) and (*c*.1) (in this subsection referred to as the "latter paragraphs"), "allowance" does not include any amount that is received by a person, referred to in the former paragraphs as "the taxpayer" and in the latter paragraphs as "the recipient", unless that person has discretion as to the use of the amount.

To be an allowance, the recipient must have the discretion as to the use of the amount. Nicola did not have a discretion as to the use of the amount because it was equity in real estate. The Appellant's counsel refers to the words in paragraph 60.1(1)(*b*) which read in part:

> 60.1(1) Where a decree, order, judgment or written agreement described in paragraph 60(*b*) or (*c*), or any variation thereof, provides for the periodic payment of an amount by a taxpayer
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> . . .
>
> (*b*) for the benefit of the person, children in the custody of the person or both the person and those children,
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> the amount or any part thereof, when paid, shall be deemed for the purposes of paragraphs 60(*b*) and (*c*) to have been paid to and received by that person.

The payment was not a periodic payment as required. The equity transferred by the Appellant cannot be considered for the purpose of paragraphs 60(*b*) and (*c*) to be alimony or another allowance payable on a periodic basis. As stated by application of subsection 56(12), it cannot be considered alimony since Nicola had no discretion as to the use of the equity transferred to her.

[11] The Appellant submits that she had discretion in that she became the sole owner of the matrimonial home and had the absolute discretion to deal with the home. This was not the freedom to act as she wished with the $31,000 which is envisaged in the *Act*. She was granted equity in real property. This is not an amount paid for the purposes of paragraphs 56(1)(*b*) and (*c*) or 60(*b*) and (*c*) of the *Act.*

[12] An historical review of the background leading up to the second separation agreement is important. The original separation agreement of 1988 provided for payments as set out earlier. The Appellant made partial payments over the years to

Nicola without any allocation of the amount paid. He was almost always in arrears. She kept careful records; he kept none.

[13] In 1995, his business was in serious financial difficulties and he asked Nicola for permission to mortgage his 50% equity which was agreed to be a net of $83,000 after deducting arrears set out by Nicola in her July 21, 1995 letter, which are not nebulous claims. She offered to pay the Appellant $31,600 for his equity. Finally, they agreed at an amount of $51,000. Nicola had to arrange financing and legal documents. The equity she received was not a discretionary one. It appears to be a hard-fought compromise and commingling of amounts of various natures.

[14] I find that paragraph 60.1(1)(*b*) does not assist the Appellant. Again, Nicola did not have a discretion as to the use of the equity conveyed to her. She did not receive a payment; she received an interest in real estate, not a payment of money that she could use freely. Even accepting the Appellant's argument, only part of the amount is for arrears paid for the maintenance of both Nicola and the children, and no pro rated accounting was, or could be provided with any accuracy.

[15] I now turn to the claimed interest expense in the 1995 taxation year. The issue is whether the Appellant may deduct interest in the amount of $16,736. The question narrows down to whether the interest was on loans between the corporation to various banks or between the Appellant personally and the banks. Who borrowed the money? I have no doubt that the corporation actually made the interest payments in 1995 and expensed it. The Appellant counters this fact by submitting that the payments of interest made by the corporation were in fact his personal drawings which he directed the corporation to be paid directly to the banks. There is no paper trail such as corporate resolutions or directions or other evidence to support this, and I do not accept it.

[16] Carolla Williams, auditor, testified on the Minister's behalf. Her credibility is not in question. She meticulously reviewed both the corporation's and the Appellant's records, including the corporation's contract to borrow the money for its business. The Appellant was the controlling mind of the corporation. The business was substantial, having some 15 employees and monthly carrying costs of $35,000 during the early 1990s. In 1995, the RBC demanded repayment of its loans in excess of $170,000. HKB granted the corporation a line of credit in excess of $200,000. The Appellant personally guaranteed this debt and granted the bank a collateral mortgage on his home. (This is not the same real estate as the matrimonial home that we have referred to above.) The Appellant owed RBC $44,000 personally in 1995 which he paid off with a personal loan from HKB.

[17] In 1994, the Appellant signed a loan agreement with CIBC to purchase a van. The corporation paid the interest and the corporation claimed capital cost allowance in 1995. The van loan and trade-in allowance were credited to the Appellant's shareholder loan in the corporations 1995 fiscal year. The Appellant submits that the $16,700 was interest paid by him on money he borrowed and re-loaned to his corporation for the purposes of producing income. The amount is made up of: (i) RBC - $13,100; (ii) HKB - $2,300; and (iii) car loan - $1,200.

[18] The Appellant had the burden of proving that he borrowed the money and paid the claimed interest for the purposes of earning income. On balance, the documentary evidence does not support the Appellant's position. The greatest portion of the interest was paid to RBC by the corporation. Tab 18 of Exhibit R-1 is a letter dated July 10, 1995 from the RBC to the corporation and the Appellant, clearly identifying the two outstanding loans to the corporation totaling $191,036 and various debts of the Appellant in the amount of $44,642. The bank wrote that it was not prepared to renew the company or personal credit facilities outstanding and demanded payment.

[19] Exhibit A-7 is evidence of a mortgage registered August 1993 against the Appellant's property to RBC for $175,000. This is the best evidence the Appellant produces that it was a personal loan, but given contrary evidence and contradictory evidence, I find this mortgage was collateral security to the corporate loan. Exhibit A-8 is a RBC fax cover sheet addressed to HKB indicating the corporation's $195,000 outstanding debt. In a letter dated July 9, 1999 to Revenue Canada (Exhibit R-1, Tab 3), the Appellant's accountant stated in paragraph 2 on page 2 that the corporation negotiated a line of credit in the amount of $200,000 with HKB to pay out the RBC. I cannot simply ignore this statement as an accountant's error when it is coupled with the evidence: (i) RBC confirmed its $175,000 loan was to the corporation; (ii) the corporation paid the interest and expensed it (about $13,000); and (iii) there is no written evidence that the corporation paid the Appellant a dividend or salary, and he, in turn, had the corporation pay the interest with his money. This is wishful thinking to take tax advantage of transactions between a taxpayer and his corporation. Form matters, and I refer to *The Queen v. Friedberg*, 92 DTC 6031 at page 6032. It has to be documented.

[20] Exhibit R-1, Tab 15 is a receipt for the payment of $13,000 interest by Irvin Kew Architecture to RBC. Tab 16 is a letter from the HKB to the corporation dated September 5, 1995 stating it is pleased to offer the corporation a $200,000

plus loan with an unlimited personal guarantee from the Appellant supported by a $341,000 collateral mortgage on his residence. If RBC and HKB loans were personal and not corporate, I would expect to see a file of documentation including corporate resolutions. The Appellant's evidence falls far short of what is required to meet his burden of proof. With respect to the personal loans with RBC and HKB, there is insufficient evidence to conclude that this money, about $47,000, was used for business purposes.

[21] With respect to the 1994 van loan, the Appellant signed the loan agreement with CIBC and the corporation paid the interest and claimed capital cost allowance. While the trade-in allowance and van loan were credited to the Appellant's shareholder loan, I do not accept the Appellant's evidence that the van was used exclusively for business purposes. It was his only vehicle.

[22] For these reasons the appeal is dismissed, with costs.

Signed at Ottawa, Canada, this 29th day of June 2004.

"C.H. McArthur"

McArthur, J.

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