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REFDATE 131126

SUBJECT Change in use

SECTION 13(7), 45(1)

PRINCIPAL ISSUES: Can the CRA provide any guidance or clarification following the comments made by the Federal Court of Appeal on the application of the change in use rules?

POSITION: See letter.

REASONS: See letter.

CRA ROUND TABLE OF NOVEMBER 26, 2013

CTF CONFERENCE 2013

Question 2

C.A.E. Inc. v. Canada ("C.A.E.") - 2013 FCA 92 - The Federal Court of Appeal ("FCA") overturned the hybrid capital/inventory classification of sale-leaseback assets.

2.1 The FCA judgment in C.A.E. showed that everything old can be new again. C.A.E. manufactured flight simulators, but it also earned income by leasing the simulators or using them to sell training services. Some of the flight simulators leased to clients were sold to a bank, leased back to C.A.E., and then sub-leased to the same clients. C.A.E. deducted capital cost allowance ("CCA") and treated the sale-and-leaseback gain as a capital gain. The Tax Court of Canada ("TCC") determined that the sale of four of the flight simulators was on account of income, but allowed the CCA deductions for two of these simulators. This approach introduced a hybrid form of property that was eligible for CCA while used in the taxpayer's business even though gains on sale would be treated on income

account. The FCA rejected this somewhat novel, but practical, approach.

2.2 The FCA held that CCA was available for certain of the flight simulators on the basis that they were capital properties during the time that they were leased or used for training. The FCA reiterated there are only two classes of property: "capital property, the disposition of which gives rise to a capital gain, and property held for sale - i.e. inventory - which when sold gives rise to income". The FCA held that Friesen did not allow for inventory in the year of sale to be treated differently in a prior year (i.e. as other than as inventory) unless it arose from a "change in use" and that depreciable property sold at greater than its original cost must by definition give rise to a capital gain and not income.

2.3 In addition to its conclusions and comments with respect to capital versus income treatment and whether CCA was available to C.A.E. for the simulators during the time periods in question, the FCA expressed the opinion that the change in use rules in subsections 13(7) and 45(1) of the Income Tax Act (the "Act") should apply when property, initially held as inventory, begins to be used as depreciable property (and vice versa). In particular, the FCA commented that it did not agree with the CRA's views on this issue as outlined in Interpretation Bulletins IT-102R2 - Conversion of Property Other than Real Property, from or to Inventory and IT-218R - Profit, Capital Gains and Losses from the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate from Capital Property to Inventory and Vice Versa.

CRA Question

Can the CRA provide any guidance or clarification following the comments made by the Federal Court of Appeal on the application of the change in use rules?

CRA's Response

Subsections 45(1) and 13(7) of the Act provide that where there is a change in the use of property of a taxpayer at any time, from an income-earning purpose to some other purpose (or vice versa), there is a

deemed disposition of the property. That is, the taxpayer is deemed to have disposed of the property at that time for proceeds equal to the fair market value at that time and immediately thereafter to have reacquired it at a cost equal to that fair market value. The specific wording of the Act is: "for the purpose of gaining or producing income" and "some other purpose".

Put broadly, the CRA's view is that subsections 45(1) and 13(7) of the Act (the "change in use rules") apply where the use of property changes, wholly or in part, from a personal use to an income-earning use, or vice versa. This is the view expressed in Interpretation Bulletins IT-102R2 and IT-218R, which explain that the change in use rules do not apply where property is converted from inventory to (income-earning) capital use and vice versa. This position is based on the existing jurisprudence - which we acknowledge is somewhat limited - and is consistent with the Department of Finance Explanatory Notes of March 2001 [S.C. 2001, c. 17 (Bill C-22)]:

"Subsection 45(1) provides for a deemed disposition and reacquisition of property where its use is altered, wholly or in part, from a personal to an income-earning or income-producing use, or vice versa." [Emphasis added.]

With respect, we do not agree with the comments of the FCA regarding the change in use rules. In particular, we are of the view that the FCA's interpretation leads to an untenable result, since it requires the same words to be interpreted differently for business property and personal use property - this problem is acknowledged by the FCA itself. Moreover, it is not clear to us that the FCA's interpretation on this point is consistent with the object, spirit and context of the provisions in question. Finally, it appears to us that it would be challenging for both taxpayers and the CRA to apply the change in use rules in the manner outlined by the FCA. Reporting requirements and potential tax liability for every change from inventory to (income-earning) capital use, and vice versa, could represent a significant compliance and administrative burden.

The CRA acknowledges that the considered comments of the FCA must be taken into account in interpreting the Act. However, for all of the

reasons mentioned previously, and as, on this issue, the comments of the FCA in C.A.E. are obiter dicta, the CRA will not be changing its general position on the change in use rules as currently presented in Interpretation Bulletins IT-102R2 and IT-218R.

The FCA's decision in C.A.E. gives rise to tax questions other than those discussed today, especially for businesses that hold the same type of property as both inventory and income-earning capital property. The CRA will be considering these questions as they arise in particular fact situations that come to our attention.

Maryann Hikspoors

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