REVENU QUÉBEC

INTERPRETATION AND ADMINISTRATIVE BULLETIN CONCERNING THE LAWS AND REGULATIONS

Income Tax

IMP. 128-4/R3 — **Current Expenses and Capital Expenditures With Respect to a Capital Property**

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Reference(s): *Taxation Act* (CQLR, c. I-3), sections 80, 128, 129, 130 and 135.4

> *This version of interpretation bulletin IMP. 128-4 supersedes the version of December 30, 2009. The bulletin was revised to broaden its scope in order to clarify Revenu Québec's position on the elements to be considered when classifying expenses incurred to earn income from a business or property, as part of a rental activity or another activity.*

This bulletin sets out the main elements considered by Revenu Québec in determining whether an expense incurred by a taxpayer with respect to a capital property constitutes a current expense or a capital expenditure.

APPLICATION OF THE ACT

GENERAL

1. According to section 80 of the *Taxation Act* (TA), a taxpayer's income from a business or property is the taxpayer's profit therefrom, subject to Part I of the TA.

2. In *Canderel Ltd.* v. *Canada*, [1998] 1 S.C.R. 147, the Supreme Court of Canada found that, to compute his or her income from a business or property, the taxpayer is free to adopt any method that is not inconsistent with

a) legislative provisions;

b) established case law principles or "rules of law"; and

c) well-accepted business principles (generally accepted accounting principles (GAAP), in particular).

3. Section 128 of the TA provides that, in computing a taxpayer's income from a business or property for a taxation year, only the outlays or expenses made or incurred by the taxpayer during that year or payable in respect of that year may be deducted, to the extent that they may

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reasonably be regarded as related to the business or property and that they were made or incurred to gain such income, unless otherwise provided in Part I of the TA.

4. In that regard, section 129 of the TA specifies that the outlays or expenses referred to in section 128 of the TA must not include any replacement of capital, or any payment or amount disbursed on account of capital.

5. However, where any replacement of capital or any payment or amount disbursed on account of capital is involved, the taxpayer may, under paragraph (a) of section 130 of the TA, deduct the prescribed part or amount of the capital cost of the property.

6. Notwithstanding the foregoing, the amount of a current expense must be included in the cost or capital cost of a building, provided the expense can reasonably be regarded as having been incurred during the construction, renovation or alteration of the building (section 135.4 of the TA). For more information, see the current version of interpretation bulletin IMP. 128-13.

DETERMINATION OF THE NATURE OF AN EXPENSE

7. Generally, an expense incurred to repair or maintain capital property is considered a current expense that may be deducted in computing the income from the business or property.

8. An expense incurred in order to acquire capital property, or to make an addition or improvement thereto, is considered a capital expenditure that cannot be deducted in computing the income of the business for which the capital property is used, or in computing the income from the capital property. Instead, it must be added to the capital cost of the capital property.

9. The computation of a taxpayer's income from a business or property must be consistent with GAAP in order to determine whether an expense is a current expense or a capital expenditure. However, the TA provides for exceptions for certain expenses (e.g., section 135.4, paragraphs (h), (h.1) and (h.1.1) of section 157).

10. According to GAAP—the main source of which in Canada is the frequently amended handbook of the Canadian Institute of Chartered Accountants (CICA)—a repair serves to maintain the service potential of a corporeal capital property, while a betterment increases this potential. The *Dictionnaire de la comptabilité et de la gestion financière* defines service potential as the capacity of a property to provide future benefit to the entity that possesses it. This potential is increased where

— the physical output capacity or the service capacity of the capital property is increased in relation to its capacity prior to the expense being incurred;

— the associated operating costs are reduced;

— the life or useful life of the capital property is extended;

— the quality of output is enhanced (output being the goods or services produced by or with the capital property).

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11. Fiscal case law has provided no generally applicable rule of law in this regard. Instead, the courts use a number of tests to determine the nature of an expense, with no one test being predominant, decisive or infallible. In doing so, the courts aim to tailor their approach to each situation.

12. Without referring specifically to GAAP, the tendency in case law is to develop tests that define a repair or betterment in a manner similar to these principles. Both GAAP and case law hold the concepts of repair and betterment in opposition.

13. Thus, in *Québec (Sous-ministre du Revenu)* c. *Goyer*, [1987] R.D.F.Q. 159, the Court of Appeal of Québec found as follows:

[TRANSLATION]

> Maintenance and repair are actions taken to preserve the capital property. In general, it matters little whether one replaces a few deck boards or a few lengths of pipe each year—which would undoubtedly be considered maintenance expenses—or, having allowed the property to fall into disrepair, one is obliged to make major and enduring repairs. As long as new capital property is not created, the normal value of the property is not enhanced, [...] and property that has ceased to exist is not replaced by other property, then the work done amounts to repairs and maintenance carried out in an effort to restore the property to its normal value.
>
> In this case, as decrepit as the balconies, plumbing, windows and doors were when they had to be replaced, they do not constitute [...] the capital property but only integral components of such property, so that replacing them is not replacing the capital property but simply repairing it. [...]

14. The Court of Appeal of Québec found that the work done did not create a new capital property and that the related expenses were therefore deductible in computing the taxpayer's rental income.

15. In plain terms, maintenance means keeping a property in good condition, whereas betterment improves the property or enhances its value.

16. In *Goyer*, the Court of Appeal of Québec found that an expense does not become a capital expenditure solely because it was incurred in lieu of carrying out regular maintenance work over the years.

17. To determine whether an expense is incurred to repair or maintain capital property or instead to improve it, the property's condition immediately after the expense is incurred must be compared with its previous condition in order to determine whether its service potential has increased, within the meaning of GAAP.

18. This is undoubtedly what the Court of Appeal of Québec sought to elucidate in *Goyer* since the concept of the "normal value of a property" is not found in the TA or in GAAP.

19. This being said, as the Court of Appeal stressed in *Goyer*, where an expense is incurred to repair or maintain a capital property, it matters little whether it provides any enduring, long-term benefit to the taxpayer, whether it is likely to be repeated during the useful life of the property, whether it is incurred once and for all, whether it prevents the deterioration of the property or whether the amount of the expense is substantial in relation to the value of the property.

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20. In *Shabro Investments Ltd.* v. *R.*, 79 D.T.C. 5104, to which the Court of Appeal of Québec referred in *Goyer*, the Federal Court of Appeal found that any repair improves a capital property to a certain extent, but that such an improvement is not sufficient in order to classify as a capital expenditure an expense that is otherwise current. Thus, according to the majority judges, the fundamental problem is determining whether, from the owner's viewpoint, the capital property that exists after work is done is different in kind from the property that existed before the work was done.

21. The Federal Court of Appeal concluded that replacing a building's concrete floor that was cracked and broken because of a construction defect unknown to the purchaser constitutes a capital expenditure since, compared with the previous floor, the new floor's structure was better suited to the soil base. Key features of the floor had therefore changed. In addition, the work counted as a significant repair to the capital property since it allowed the building's lower level to be used.

22. To use the accepted term in GAAP, in *Shabro* there was an increase in the capital property's service potential, which bettered the property.

23. To determine the nature of an expense, it can help to compare the amount of an expense to the capital property's value or to the average maintenance or repair expenses already incurred. Accordingly, a replacement that costs as much as the acquisition cost of the capital property, or as much as its undepreciated cost, tends strongly to establish that a new capital property has been created and acquired. This element is often associated with the betterment of a capital property.

24. Examples:

— In *Thompson Construction (Chemong)* v. *M.N.R.*, 57 D.T.C. 1114 (Exchequer Court of Canada), a new engine was acquired for a price equivalent to the undepreciated capital cost of the power shovel in which it was to be used.

— In *Minister of National Revenue* v. *Vancouver Tug Boat Company Limited*, 57 D.T.C. 1126 (Exchequer Court of Canada), new tugboat engines were acquired for a cost greater than the undepreciated capital cost of the tugboats concerned.

25. The rulings in these examples are in accordance with GAAP since the service potential of the capital properties concerned was increased.

26. However, an expense incurred to replace all the windows of a rental property, or to redo its dilapidated roof or plumbing, may be deducted in computing the income from the property, provided it is not attributable to a period in which renovations or alterations to the property were made and provided it is incurred only to restore that part of the property to good condition, using materials of a quality comparable to those used previously. In other words, any expense incurred only to maintain the capital property's service potential counts as a deductible current expense.

27. If, at the time of acquisition, work is already required to restore a capital property to good condition, the expenses incurred by the purchaser after the acquisition to carry out such work are then capital expenditures and their amount is added to the capital property's capital cost. In fact, the fair market value of the property takes into account the extent of its deterioration.

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28. Such was the conclusion reached by the courts in *Fiore* v. *R.*, 93 D.T.C. 5158 (Federal Court of Appeal) and *Guilbault* c. *S.M.R.Q.*, 2010 QCCQ 3067. Where work is required because of a hidden defect, how the related expenses are classified depends on their nature. If they increase the service potential of the property, as was the case in *Shabro*, they are considered a capital expenditure.

29. What emerges from GAAP and case law is that, where an expense serves to maintain a capital property in good condition, it can be deducted as a current expense in computing the income from a business or property. However, an expense is considered a non-deductible capital expenditure where it increases the service potential of a capital property in relation to its previous condition, which is normally the case if an expense

— enhances the physical output capacity or the service capacity of the capital property;

— reduces the capital property's operating costs;

— extends the life or useful life of the capital property;

— increases the fair market value of the capital property or its municipal assessment;

— replaces a capital property that is rundown, dilapidated or outdated, or that has ceased to exist;

— creates a new capital property.

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