

## **Tech Interp (internal) 2001-0104217 -- Leaky condominiums**

**Date: October 12, 2001**

**Reference: 18(1)(a), 18(1)(b)**

**SUMMARY:** Leaky condominiums -- ITA-18(1)(a), 18(1)(b) -- Tax treatment of remediation costs incurred by B.C. homeowners as a result of premature building envelope failure or what is generally referred to as the "leaky condominium" crisis.

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CCRA.

Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ADRC.

**PRINCIPAL ISSUES:** We have been requested to confirm whether expenditures made in respect of "leaky condominiums" in B.C. (rented property) could all be considered deductible as current expenses on account of repairs and maintenance.

**POSITION:** Not possible to confirm the nature of all the expenditures involved.

**REASONS:** It is a question of fact whether outlays are on account of capital or a current expense (IT-128R). No general statement can be made and, in particular, in respect of "leaky condominiums". Moreover, to be eligible for any income tax deduction (as a current expense or as capital cost allowance), the activities of the taxpayer must have a reasonable expectation of profit. Only general comments based on information made available by B.C. government can be provided.

October 12, 2001

Vancouver TSO HEADQUARTERS

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2001-010421

Leaky condominiums

This is in reply to your request regarding the tax treatment of remediation costs incurred by British Columbia homeowners as a result of premature building envelope failure or what is generally referred to as the "leaky condominium" crisis.

Considering the pervasiveness of the "leaky condominium" crisis, the Minister of Municipal Affairs for the province of British Columbia appointed in 1998 a Commission of Inquiry into the Quality of Condominium Construction in British Columbia (the "Commission"). In its report issued in June 1998 (the "Barrett Report"), the Commission reviewed the reasons for and factors contributing to the faulty condominium construction in the province, and issued a number of recommendations to assist the unfortunate

homeowners affected by the crisis. The Commission suggested that the federal government adopt a policy under which specific income tax privileges be allowed to the affected homeowners, such as tax-free withdrawals of RRSP funds to finance the required repairs as well as deductibility from income of the cost of all repairs required in the situation.

Requests for such privileges were forwarded to the Minister of Finance as they would require amendments to the Act. Recently, you have been asked whether the cost of remediation work required in leaky condominium situations should be considered current or capital in nature.

#### Our Comments

As you know, the Canada Customs and Revenue Agency (CCRA) is responsible for administering the *Income Tax Act* ("the Act") and strives to carry out this goal fairly and uniformly for all taxpayers. Tax policy matters are the responsibility of the Minister of Finance.

The issue of whether remediation costs incurred by leaky condominium owners can be allowed a deduction for income tax purposes is relevant only if the property is used for the purpose of earning income from a business or property. Otherwise, the costs are considered personal and living expenses which are not allowed any deduction under the Act. In addition, in order to be entitled to a deduction in respect of capital cost allowance or current repairs and maintenance expenditures, the property must be used in an activity that has a reasonable expectation of profit, which is a question of fact.

As to the nature of the expenditures incurred by leaky condominium owners who use such property for the purpose of earning income, the Act does not define what constitutes a capital expenditure or an expenditure of a current nature. However, the courts have identified a number of factors that should be considered in making such determinations. These factors are explained in detail in Interpretation Bulletin IT-128R, Capital Cost Allowance -- Depreciable Property.

Basically, whether an expenditure is on account of capital or income is a determination that can be made only once all the relevant facts of each particular case have been considered. As a result, we are unable to provide a general statement that could apply to a wide range of expenses which may be incurred on account of remediation work in the "leaky condominium" situation in British Columbia.

However, we can offer the following general comments based on our understanding of the problems involved. Observations made by specialists consulted by the Commission indicate that the "leaky condominium" situation results primarily from a "faulty design" of the "building envelope" (the exterior wall assemblies for example) of condominiums. The premature building envelope failure is intensified in the coastal area of the province where significant rainfall and mild weather increases likelihood of water penetration in the walls, causing damage to the internal components of the buildings.

In reviewing the situation related to the "leaky condominium" crisis, the Barrett Report made the following comments and citations which we believe should be considered relevant in the determination:

In order to estimate the magnitude of the "leaky condo" problem, a definition must be developed.

[...]

In order to understand the Commission's broader definition, it is important to understand what the building envelope is, and what it is intended to do.

The building envelope is composed of several assemblies, each made up of several materials. The most visible envelope elements are the roof and wall assemblies... Building science tells us that three conditions must be present simultaneously for a water problem to occur in a wall:

- (1) there must be water on the wall,
- (2) there must be a hole through which water can enter, and
- (3) a driving force must be acting that will move the water.

Building Envelopes and the *BC Building Code*, Ministry of Municipal Affairs, January 12, 1998

#### (Chapter One: The Problem, Section IV. The Definition of the Problem)

The *BC Building Code* and the Vancouver Building By-Law never explicitly stated that, because of the Lower Mainland's special weather conditions, it may be advisable to take extra care in determining the method of wall construction. They could have done so, and more clearly identified the unique building envelope needs of BC's coastal climate. Design features, brought in during the 1980s and 1990s, such as open walkways, arched windows, complex, intricate and visually-appealing joints and the removal of overhangs, provided more opportunities for water penetration. As well, zoning by-laws relating to floor space ratio (FSR) exacerbated the problem. Roof overhangs are included in the calculation of FSR. As a result, they were often removed from designs. The calculation of FSR from the outside of the building envelope, instead of from the centre or interior side of the wall, tended to promote face seal at the expense of thicker, heavier walls, or rain screen systems. The exclusion of open walkways from FSR prompted their construction on a grander scale, often leading to water ingress problems.

[...]

Face-sealed systems, which relied on the erroneous notion that a building could be sealed with caulking (9.27.4 of the BCBC), also became widely used on condominium projects in the 1980s and 1990s.

... it can be concluded that the face seal systems evaluated in this study are very sensitive to design and construction variables which lead to ingress of water through the cladding, and that in the environment of the Lower Mainland it may not be possible to achieve acceptable performance with face sealed systems. Concealed barrier systems are also very sensitive to water ingress through the exterior cladding and weather barrier. In order for these systems to perform adequately, significant improvement is required in the design and construction of interface details.

Survey of Building Envelope Failures in the Coastal climate of British Columbia, CMHC

In fact, the research literature has been very clear on the inability of face seal methods to be effective.

In the Lower Mainland, the incorrect assumptions of end performance that have resulted in the need for this Commission are reliance on exterior surface treatments of buildings to prevent rain entry under

the conditions of wind driven rain. It is not difficult to find well informed technical opinion suggesting that this is an unreasonable expectation:

Basically there are two possible ways in which one can approach the problem of trying to keep the rain out of a building. One can either attempt to eliminate all the holes through which the water could pass or one can attempt to control the forces which would move the water through these holes. Under practical building conditions, we have seen that the former is more or less doomed to failure and that one can expect better result from the latter method. "From NRC, Walls Window and Roofs for the Canadian Climate, October 1971.

Thomas Morstead, Building Envelope Specialist

(Chapter Two: The Framework of Residential Construction, Section II. *Building Codes*, June 1998)

The Homeowner Protection Office for the province of British Columbia mentions the following in respect of rain penetration in a publication entitled *What is a Building Envelope*:

Face seal refers to a strategy for rain penetration control that relies solely on the elimination of holes in the exposed exterior face of the assembly.

Face sealed walls rely on creating a completely impervious barrier to water at the outer face of the wall.

[...] This surface is frequently wetted, and any imperfections in the face seal will certainly lead to air movement through the holes, which in turn will create the driving force required to bring the water into the wall, or dries slowly, causing deterioration of wood components.

[...]

Rainscreen assemblies refers to a construction strategy for rain penetration control that relies on the deflection of the majority of water at the cladding but also incorporates a cavity which provides a drainage path for water that penetrates past the cladding.

Rainscreen technology recognises that some incidental water may penetrate the exterior cladding, but allows this water to drain through the rainscreen cavity.

Therefore, it seems the owners of condominiums built using the face seal strategy for rain penetration control have the option of continually monitoring the effectiveness of the building envelope of their property and repairing or maintaining it as needed (by sealing any imperfections that may develop), or modifying the existing building envelope structure and design to allow for a more effective strategy for rain penetration control, particularly in light of the unique needs of British Columbia's coastal climate, thereby avoiding future damage to the internal building components (such as a rainscreen strategy).

As outlined in paragraph 4 of Interpretation Bulletin IT-128R, Capital Cost Allowance -- Depreciable Property, one significant factor to consider in the above situation is whether the expenditure only restores the property to its original condition or constitutes a material improvement to the property. Original condition generally refers to the condition of the property when it was acquired.

In the case of *June Earl v. The Queen*, [1993] 1 C.T.C. 2081, 93 D.T.C. 65, the Tax Court of Canada provides a good review of the jurisprudence on issues very similar to the present situation. The owner of a building in that case was also dealing with water penetration problems from a deficient building envelope component, the roof, causing interior damage to the property. The issue was whether the cost of changing the design of the roof (from a flat roof to a pitched roof) to prevent further water penetration should be considered a capital improvement to the building or a current expenditure on account of repairs and maintenance. The taxpayer argued that the market value of the property had not increased as a result of the expenditures, that the appearance of the building had not changed and that the building had merely been restored to its normal condition. After analyzing relevant decisions on similar issues, the court concluded the expenditures were on account of capital. The court states (at page 68):

The new roof did, however, comprise a substantially different integral part of the capital asset. The new roof replaced the existing one just as surely as though the old roof had been totally removed and hauled to a landfill.

In our opinion, whether the market value of the property is increased as a result of the expenditure is not a major factor in reaching a decision. The relative value of the expenditures in relation to the value of the whole property or in relation to previous average maintenance and repair costs must however be considered.

As mentioned in IT-128R, in the event that expenditures include both current and capital elements and these can be identified, an appropriate allocation of the expenditures is necessary. Where only a minor part of the expenditures is of a capital nature, the CCRA is prepared to treat the whole as being of a current nature.

As the above determination requires a review of all facts of each case and involves regional audit issues, we cannot provide a general statement that will apply to all situations. Based on our understanding of the problems related to the leaky condominium situation in general, it would appear that the cost of maintaining and repairing the original building envelope (including the strategy originally used for rain penetration control) of such property could be considered deductible as a current expense. Similarly, the cost of repairing damage to internal components of a building (such as moldy insulation and rotted framing), as a result of water penetration, to restore them to their original condition, using identical or equivalent quality materials (without improving them beyond their original condition) could also generally be considered currently deductible. However, redesigning a building envelope to improve its effectiveness to control water penetration (such as adapting the structure to incorporate a new strategy for rain penetration control) would appear to constitute a material improvement to the property beyond its original condition based on relevant case law, and related costs could be considered on account of capital, subject to capital cost allowance (for greater certainty, in these instances, the cost of repairing damage to internal components would remain currently deductible, to the extent explained above).

We trust that these comments will be of assistance to you.

Milled Azzi, CA

for Director

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