Docket: 2001-3596(IT)G

BETWEEN:

RONALD NETOLITZKY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of *Ronald Netolitzky* (2002-1645(IT)G) on January 19, 2006 at Vancouver, British Columbia

Before: The Honourable Justice G. Sheridan

Appearances:

Counsel for the Appellant:	Steven Cook and Richard Wong
Counsel for the Respondent:	Margaret Clare

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 1996 taxation year was withdrawn at the hearing and is dismissed.

The appeal from the reassessment made under the *Income Tax Act* for the 1997 taxation year is allowed, with costs, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to an allowable business investment loss of $1.65 million in 1997 in respect of the debt owed to the Appellant by Chintz and Company Decorative Furnishings Inc., in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 18th day of April, 2006.

"G. Sheridan"

Sheridan J.

Docket: 2002-1645(IT)G

BETWEEN:

RONALD NETOLITZKY,

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Appeals heard on common evidence with the appeals of *Ronald Netolitzky* (2001-3596(IT)G) on January 19, 2006 at Vancouver, British Columbia

Before: The Honourable Justice G. Sheridan

Appearances:

Counsel for the Appellant:	Stephen Cook and Richard Wong
Counsel for the Respondent:	Margaret Clare

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* for the 1998 and 1999 taxation years are allowed, with costs, and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to an allowable business investment loss of:

(1) in 1998, $1.5 million in respect of the debt owed to the Appellant by Chintz and Company Decorative Furnishings Inc.; and

(2) in 1999, $3 million in respect of the debt owed to the Appellant by C.H. Golf Ltd.,

in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 18th day of April, 2006.

"G. Sheridan"

Sheridan J.

Citation: 2006TCC172
Date: 20060418
Dockets: 2001-3596(IT)G
2002-1645(IT)G

BETWEEN:

RONALD NETOLITZKY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Sheridan, J.

[1] The Appellant, Ronald Netolitzky, is appealing the reassessment of allowable business investment losses claimed in 1996, 1997, 1998 and 1999.[1] The 1996 appeal was withdrawn at the hearing and is dismissed. The Minister of National Revenue disallowed the allowable business investment losses ("ABIL") on the ground that in none of these years did the amounts advanced become "bad" debts, and in the case of 1999 only, that the funds were advanced to the debtor company not by Mr. Netolitzky, but by his holding company.

[2] These appeals involve Mr. Netolitzky's investments in two different corporations, Chintz and Company Decorative Furnishings Inc. ("Chintz") and C.H. Golf Ltd. ("Golf"). A third corporation, Keewatin Consultants Inc. ("Keewatin") is Mr. Netolitzky's wholly owned holding company and figures only in the 1999 appeal.

[3] Mr. Netolitzky has the burden of proving wrong the assumptions upon which the Minister based his reassessments under the *Income Tax Act*. He and two of his financial advisors, Mr. John Barclay and Mr. Bob Matthews, testified at the hearing. I was impressed with the straight-forward nature of their testimony, in particular, that of Mr. Netolitzky. All three witnesses were knowledgeable about the events and

[1] These appeals were heard on common evidence. The parties tendered an agreed set of documents marked as Exhibits A-1, A-2 and A-3.

transactions leading to these appeals; all were thoughtful and forthcoming in the presentation of their evidence. I found them thoroughly credible. No witnesses were called by the Crown.

Analysis

The Chintz Loan (1997, 1998)

[4] Mr. Netolitzky is a geologist who started his career in Alberta in the mid-70's preparing geological reports and evaluations. Over time, he expanded his consulting work to include the acquisition and disposition of mineral rights and by the early 1980's, was providing advice to and personally investing in various public sector mining and resource companies. By the end of the decade, some particularly rich mineral strikes in British Columbia made him a "reasonably wealthy" man with, at one point, an RRSP account in excess of $40 million. Around this time, Mr. Netolitzky began seeking opportunities abroad and, between 1996 and 1998, was frequently travelling to Asia and Africa to attend to these new interests. He maintained (albeit on a reduced scale) his geological consulting work and continued to invest in various initiatives and projects.

[5] With his own mining ventures and consulting practice prospering, in 1986 Mr. Netolitzky and his spouse Nicole set up Chintz, an interior design and fabrics business in Calgary where, before meeting Mr. Netolitzky, Nicole had run her own decorating business. Both were shareholders in Chintz. Nicole managed the business; Mr. Netolitzky's role was to finance it. By 1998, Chintz owed some $8 million in shareholders' loans, 90% of which Mr. Netolitzky had advanced to the company. He claimed allowable business investment losses of $1.65 million and $1.5 million[2] for 1997 and 1998, respectively.

[6] The parties agree that these amounts are not in dispute; the Minister takes the position, however, that these amounts are not deductible under paragraph 50(1)(*a*) because the Chintz debts were not "bad" in these years. Paragraph 50(1)(*a*) reads:

> Debts established to be bad debts and shares of bankrupt corporation.
>
> (1) For the purpose of this subdivision, where

[2] Response to Request to Admit, paragraph 1.

> (a) a debt owing to a taxpayer at the end of a taxation year (other than a debt owing to the taxpayer in respect of the disposition of personal-use property) is established by the taxpayer to have become a bad debt in the year, or ...

[7] According to the Crown's argument, Mr. Netolitzky's determination of the debts' unrecoverability was premature: he could have done more to collect the debt and to turn the business around; he should have obtained independent advice on the value of the inventory and of the business itself. The Crown was also of the view that because of his spouse's involvement, Mr. Netolitzky's decision had been influenced by personal rather than purely business considerations. For all of these reasons, the Crown submitted, Mr. Netolitzky had failed to make his determination as "a prudent businessman" as contemplated by the Federal Court of Appeal in *Flexi-Coil Ltd. v. The Queen*, 96 DTC 6350 at page 6351:

> The question of when a debt is to be considered uncollectible is a matter of the taxpayer's own judgment as a prudent businessman. In *Hogan v. M.N.R.*, 56 DTC 183 at page 193, Mr. Fisher described how this determination should be made:
>
> > For the purposes of the *Income Tax Act*, therefore, a bad debt may be designated as the whole or a portion of a debt which the creditor, after having personally considered the relevant factors mentioned above in so far as they are applicable to each particular debt, honestly *and reasonably determines to be uncollectable at the end* of the fiscal year when the determination is required to be made, notwithstanding that subsequent events may transpire under which the debt, or any portion of it, may in fact, be collected. ...

[8] In rejecting the Crown's contentions, counsel for the Appellant referred the Court to *Rich v. The Queen*[3] , a more recent decision of the Federal Court of Appeal in which Rothstein, J.A. (as he then was) also referred to the *Hogan* decision in his consideration of what is required of a taxpayer under paragraph 50(1)(*a*):

> [12] The assessment of whether a debt is bad is one based upon the facts at a particular point in time, i.e. December 31, 1995 [the end of the taxation year in which ABIL is claimed]. The *Income Tax Act* does not prescribe factors to be considered in assessing the collectibility of a debt. However, Tax Appeal Board judgments in *Hogan v. Minister of National Revenue* (1956), 56 DTC 183 and *No. 81 v. The Minister of National Revenue* (1953), 53 DTC 98, suggest some of the factors to be taken into account. After the creditor personally considers the relevant factors, the question is whether the creditor honestly and reasonably determined the debt to be bad.

[3] 2003 DTC 5115, paragraphs 13-15 (Evans, J.A. dissenting).

> [13] I would summarize factors that I think usually should be taken into account in determining whether a debt has become bad as:
>
> 1. the history and age of the debt;
>
> 2. the financial position of the debtor, its revenues and expenses, whether it is earning income or incurring losses, its cash flow and its assets, liabilities and liquidity;
>
> 3. changes in total sales as compared with prior years;
>
> 4. the debtor's cash, accounts receivable and other current assets at the relevant time and as compared with prior years;
>
> 5. the debtor's accounts payable and other current liabilities at the relevant time and as compared with prior years;
>
> 6. the general business conditions in the country, the community of the debtor, and in the debtor's line of business; and
>
> 7. the past experience of the taxpayer with writing off bad debts.
>
> This list is not exhaustive and, in different circumstances, one factor or another may be more important.

[9] In my view, the evidence supports the Appellant's submission that Mr. Netolitzky properly fulfilled the obligations imposed on him by the *Act* and the related jurisprudence. In 1994, 1995, and 1996, the company's balance sheets[4] showed operating losses of $951,000, $447,500 and $31,000[5]; respectively. In 1997, a modest operating income of $109,000 was reported[6]. In 1998, notwithstanding the injection of a $619,000 gain on disposition of market securities[7] (most of which was allocated, in reduction of the bank debt and the shareholder loan), Chintz again

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[4] Exhibit A-3, Tab 1; Reply to the Notice of Appeal, paragraph 6(k).

[5] Figures rounded off.

[6] Exhibit A-3, Tab 1; Reply to the Notice of Appeal, paragraph 6(k).

[7] Exhibit A-3, Tab 1.

showed an operating loss of $103,000[8]. Meanwhile, throughout 1994 to 1998, Chintz's debt to its shareholders increased from $5.9 million to $8.2 million[9]. None of this is consistent with the Crown's characterization of Chintz's financial position as "healthy".

[10] In analyzing his prospects of recovering the amounts advanced, Mr. Netolitzky took into account the company's failure to perform as expected. Rather than showing progressive improvement in its bottom line, Chintz was losing money virtually every year. There were various reasons for this. The expansion of its Calgary-based business to include three other locations (Edmonton, Vancouver and Victoria) and of its business activities to include furniture and soft furnishings turned out to be overly ambitious. In 1994, a fire (for which, it was ultimately discovered, Chintz was under-insured) temporarily sidelined the Edmonton store. The conversion of its computer system soaked up more resources than anticipated, the attendant delay meanwhile exacerbating Chintz's existing inventory management problems. In the fickle market of high-end design, Chintz was being done in by its "trendy" merchandise and its own flawed purchasing practices: bought in container loads from off-shore suppliers months in advance, its inventory was often unmarketable before it hit the salesroom floor. Known as "stale" inventory, it sat, a greedy albatross devouring costly warehouse space. Though aware of the inventory's inflated book value, Chintz hesitated to reduce it (the inventory being the company's only real asset) for fear of jeopardizing its financing agreement with the bank, its other key creditor. In such straitened circumstances, Chintz's modest increase in sales could not keep pace with its escalating operating costs, never mind paying down its debts.

[11] In these difficult times, Mr. Netolitzky turned to his longtime financial advisor, John Barclay. Their professional relationship dates back to the early '70's when, as a Certified General Accountant, Mr. Barclay prepared Mr. Netolitzky's personal and business tax returns. In 1976, he joined Mr. Netolitzky's consulting practice as its Chief Financial Officer, a position he held until Mr. Netolitzky's move to public sector companies. Following Mr. Netolitzky's success with his mining ventures, in 1990 he recruited Mr. Barclay to become the CFO of Keewatin, his newly established consulting company.

[12] Although not officially part of Chintz, Mr. Barclay was well versed in the company's operations: he knew about the lagging inventory from his own observations in the stores and at the warehouses, from discussing the situation with

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[8] Exhibit A-3, Tab 1; Reply to the Notice of Appeal, paragraph 6(k).

[9] Response to Request to Admit, paragraph 1; Reply to the Notice of Appeal, paragraph 6(k).

staff and from examining the company's financial statements prepared by its accountants. He was aware of the various strategies that had been tried without success to improve Chintz's performance - such things as slashing prices on inventory, putting money into renovations, exploring franchise opportunities.

[13] Notwithstanding Mr. Barclay's professional qualifications and long experience with the company, counsel for the Respondent argued that Mr. Netolitzky ought to have obtained an independent assessment of the amount of the loss and of the company's potential resale value. This is an unwarranted expansion of the duty imposed on the taxpayer under paragraph 50(1)(*a*) of the *Act*. In *Flexi-Coil*, MacGuigan, J.A. quoted *Hogan* to hold that "... [T]he person making the determination should be the creditor himself (or his or its employee), who is personally thoroughly conversant with the facts and circumstances surrounding not only each particular debt but also, where possibly, *[sic]* each individual debtor ...". These words were echoed by Mr. Justice Rothstein in *Rich* where he stated it is "the creditor personally"[10] who must consider the factors leading to a bad debt determination.

[14] This is what Mr. Netolitzky did. As an experienced businessman in his own sphere and familiar with Chintz's situation, he made the final determination. Though not obliged to seek third party advice, he took the extra precaution of consulting Mr. Barclay, a knowledgeable professional advisor in whom, at the time, he had quite reasonably reposed his trust. I am satisfied that Mr. Netolitzky "honestly and reasonably" made his determination of the uncollectibility of a portion of the Chintz debt. The case law is clear that under paragraph 50(1)(*a*), either all or a portion of the debt may be considered bad.

[15] As for the Crown's contention that Mr. Netolitzky could have done more to collect the debt before declaring it unrecoverable, it is difficult to see what that might have been. There is a limit to how much the taxpayer is expected to do. The Federal Court of Appeal held that it is not:

> ... necessary for a creditor to exhaust all possible recourses of collection. All that is required is an honest and reasonable assessment. Indeed, should a bad debt subsequently be collected in whole or in part, the amount collected is taken into income in the year it is received. [11]

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[10] *Supra*, at paragraph 8 of Reasons for Judgment.

[11] *Rich*, *supra*.

[16] This latter statement makes clear that even where an ailing enterprise ultimately achieves improved fiscal health, that in itself does not foreclose its creditor, at an earlier and more precarious moment, from legitimately declaring uncollectible amounts advanced during that time. Mr. Justice Rothstein went on to say at paragraph 29, "… there is no obligation on the taxpayer to try to think of every conceivable proactive step and show that none would be productive. It is sufficient that the taxpayer provides evidence as to the condition of the debtor and its inability at the relevant time to repay the loan in whole or in part. That was the evidence in this case."[12] And in my view, that was also the evidence in the present case. The numerous strategies considered were aimed at improving Chintz's performance to make it a profitable business or, if nothing else, attractive to a potential buyer.

[17] Finally, the Crown submitted that Mr. Netolitzky had been overly influenced by what he described as his wife's "passion" for the business, sufficiently swayed by Nicole's wishes so as not to have acted as a "prudent businessman" when he made his "bad debt" determination. In considering the relevance of a non-arm's length relationship between the creditor and the debtor, Mr. Justice Rothstein stated that it "may justify closer scrutiny than in non-arm's length situations. But a non-arm's length relationship alone, without more, cannot lead to a finding that the creditor did not honestly and reasonably determine the debt to be bad."[13] Even on closer scrutiny. the evidence supports the conclusion that the basis for Mr. Netolitzky's determination was the financial analysis he made in consultation with Mr. Barclay.

[18] For the above reasons, I am satisfied that Mr. Netolitzky made an honest and reasonable determination that a portion of the Chintz debts were "bad" and accordingly, he is entitled to an allowable business investment loss $1.65 million and $1.5 million for 1997 and 1998, respectively, in respect of the Chintz loan.

The Golf Loan (1999)

[19] The appeal of the 1999 reassessment pertains only to the debt owed by the second corporation, Golf. Before considering whether that debt became bad, it must be determined whether the advances came from Mr. Netolitzky personally or from his wholly-owned holding company Keewatin.

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[12] *Rich, supra*.

[13] *Rich, supra* at paragraph 16.

Who Advanced the Loan Funds?

[20] Golf was a British Columbia company set up in 1990 for the development and sale of certain lots on Lake Okanagon. Sometime in the 1990's, a former business colleague approached Mr. Netolitzky to solicit his investment in the Golf venture. On the basis of that individual's past successes and the proposal as presented to him, Mr. Netolitzky decided to invest in the project. Mr. Netolitzky did not have any shares in Golf; Keewatin, his holding company, held 35% of the shares. At that time, Mr. Netolitzky was using Keewatin to handle, among other things, his geology consulting work. Mr. Barclay was Keewatin's Chief Financial Officer and it was decided that he would also look after Golf's finances. Mr. Barclay had full signing authority on both the Golf and Keewatin accounts.

[21] The Golf project was initially financed through the Royal Bank but within a year of start-up, the bank withdrew its participation. Mr. Netolitzky suddenly found himself having to help in the scramble for alternate sources of funding.[14] This proved difficult due, in no small part, to his former colleague's inept management and inaccurate portrayal of what the project would involve. Even with Mr. Netolitzky's recruitment of individual investors from his business circles, the company had to resort to short-term institutional funding at ruinous rates. Ultimately, the project floundered. In 1999, Mr. Netolitzky claimed an ABIL of $3 million, a portion of the company's total indebtedness to him.

[22] The Minister's position is that Keewatin, as a separate legal entity, advanced the funds to Golf. The primary basis for the Crown's contention is a description of Keewatin's principal business as "leasing, rental, development and sale of real property". These words appeared in a letter from Smythe Ratcliffe, an accounting firm specializing in tax matters, to the CCRA dated June 5, 2002. By that date, Mr. Netolitzky had retained Smythe Ratcliffe to examine the records and determine what steps, if any, were needed to correct Mr. Barclay's errors and omissions[15]. Their inquiries led to Mr. Netolitzky's filing a voluntary disclosure and paying in full the taxes owing in his amended returns. In doing so, Smythe Ratcliffe prepared certain documents and attached the June 5, 2002 cover letter containing the following passage from which the words quoted above are taken:

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[14] Exhibit A-3, Tab 10.

[15] As discussed in greater detail below.

> "In preparing these schedules, which will be the basis for amended returns, we have taken the position that the company's [Keewatin's] principal business was the leasing, rental, development and sale of real property, as set out in the Regulation of the *Act*."

[23] I am unable to ascribe to the Smythe Ratcliffe description the significance suggested by counsel for the Respondent. First of all, though written on his behalf, these are not Mr. Netolitzky's words. The circumstances in or the care with which they were chosen are not known to the Court; the description was, however, ancillary to Symthe Ratcliffe's primary purpose of providing documentation for the voluntary disclosure. Finally, the Smythe Ratcliffe description is consistent with Mr. Netolitzky's explanation of it, that it reflected Keewatin's own property holdings: in Victoria, the heritage building purchased, extensively renovated and leased to Chintz through its holding company; in Alberta, the buildings for which Keewatin had to take out the mortgage and which were leased to Chintz. Keewatin leased the premises to Chintz for which it paid rent at commercial rates.

[24] Also militating against the Crown's position is the fact that Keewatin simply did not have the fiscal wherewithal to finance the project. I accept Mr. Netolitzky's evidence that the Keewatin account generally maintained a balance not in excess of $200,000. The true source of the payments made to Golf was Mr. Netolitzky's very well-funded RRSP account at RBC Dominion Securities[16]. The evidence shows how the funds in Mr. Netolitzky's RRSP account made their way into Golf's bank account: frequently out of the country, Mr. Netolitzky authorized Mr. Barclay to make withdrawals from his (Mr. Netolitzky's) RRSP account and entrusted to him, RRSP redemption forms signed in blank[17] for this purpose. Mr. Barclay was also authorized to send, under his own signature, letters[18] instructing RBC Dominion Securities to forward the redeemed funds to him for deposit in Mr. Netolitzky's personal account. Finally, he had authorization to instruct the Bank of Montreal to transfer money from Mr. Netolitzky's personal account to the Keewatin account. At no time relevant to these appeals did Mr. Netolitzky authorize Mr. Barclay to transfer funds from the Appellant's personal account to any account other than Keewatin's.

[25] For reasons that are not known to the Court or relevant to this appeal, at some point in 1997 or 1998, Mr. Barclay's formerly impeccable professional competence

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[16] Exhibit A-3, Tab 9.

[17] Exhibit A-1.

[18] Exhibit A-1.

began to deteriorate. It would later[19] be discovered that he had abused his properly delegated authority to transfer funds from Mr. Netolitzky's personal account through Golf to the Keewatin account. At the hearing, he admitted he had used Keewatin as a conduit to make his job easier. While he had always intended to make the necessary adjustments to the respective records of the companies, Mr. Barclay did not manage to do this before succumbing to his personal difficulties.

[26] Finally, I accept the evidence of Mr. Netolitzky and Mr. Barclay that the intention was from the outset that Mr. Netolitzky personally would invest in Golf.

[27] For all of these reasons, I am satisfied on a balance of probabilities that Mr. Netolitzky advanced the funds to Golf and accordingly, the debt was owed to Mr. Netolitzky in 1999.

Was the Debt "Bad"?

[28] Turning now to the question of whether the Golf debt became bad, the Crown has not challenged the *bona fides* of the Golf project or alleged that the Golf - Netolitzky transaction was some sort of sham. Nor is there any suggestion or evidence that Mr. Netolitzky intended anything other than to realize a return on his investment in the land development project.

[29] Applying the same factors from *Rich*[20] as discussed in detail above, the law required Mr. Netolitzky to make his determination at the end of the 1999 taxation year. At that point, he was aware of the mounting chaos at the site. Even though under no obligation to do so, he undertook the task of recruiting private investors or securing affordable institutional financing. He personally experienced the disappointing results. In consultation with Mr. Barclay (at that time, still his trusted advisor), he began to feel he would be lucky to recover even a portion of his investment. When he began losing confidence in Mr. Barclay's judgment, Mr. Netolitzky sought the advice of Mr. Matthews, a former chief financial officer

[19] The extent to which Mr. Barclay's difficulties were affecting Keewatin and Golf did not come fully to light until December 6, 2000.

[20] Paragraph 16 of Reasons for Judgment.

for MacMillan Bloedel and fellow board member in other successful ventures[21]. Mr. Matthews's analysis convinced him that the Golf project was a colossal disaster.

[30] In view of these actions, I am at a loss to see what more Mr. Netolitzky could reasonably have been expected to do. By 1999, it was clear that Golf was without the means to repay all of its indebtedness to him. Indeed, others would later look to Mr. Netolitzky to do exactly that in respect of Golf's indebtedness to them.[22] Although Golf continued in existence after 1999, that in itself does not render invalid the "bad debt" determination. As Mr. Justice Rothstein cautioned in *Rich, supra* at paragraph 14:

> While future prospects of the debtor company may be relevant in some cases, the predominant considerations would normally be past and present. If there is some evidence of an event that will probably occur in the future that would suggest that the debt is collectible on the happening of the event, the future event should be considered. If future considerations are only speculative, they would not be material in an assessment of whether a past due debt is collectible.

In Golf's situation, the likelihood of a future turnaround would have been highly speculative, to the point of being not "material in an assessment of whether a past due debt is collectible."[23]

[31] Considered in light of the principles in *Rich* as discussed above, the evidence satisfies me that Mr. Netolitzky honestly and reasonably determined a portion of the Golf loan to be bad in 1999. It is not open to the Minister, with the benefit of hindsight to second-guess the taxpayer's good faith objective assessment at the relevant time. Mr. Netolitzky is accordingly, entitled to an allowable business investment loss in respect of the Golf loan of $3 million in 1999.

[32] These appeals are allowed, with costs, and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment.

Signed at Ottawa, Canada, this 18th day of April, 2006.

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[21] Mr. Matthew's review would eventually lead to Mr. Netolitzky's seeking additional expert tax accounting advice, making a voluntary disclosure of the reporting inaccuracies and paying in full the additional tax resulting from Mr. Barclay's errors and omissions.

[22] Exhibit A-3, Tabs 2 and 3.

[23] *Rich, supra* at paragraph 14.

"G. Sheridan"

Sheridan J.

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APPEARANCES:

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