Docket: 2010-3192(IT)I

BETWEEN:

LISE PERREAULT,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeals heard on February 15, 2011, at Québec, Quebec

Before: The Honourable Justice Réal Favreau

Appearances:

Agent for the appellant:	David Sicard-Payant
Counsel for the respondent:	Marie-France Dompierre

JUDGMENT

The appeals from reassessments made under the *Income Tax Act* in respect of 2006 and 2007 taxation years are allowed in part and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment to allow 50% of the expenses claimed to be deducted for each of the taxation years.

Signed at Ottawa, Canada, this 19th day of May 2011.

"Réal Favreau"

Favreau, J.

Translation certified true
on this 30th day of June 2011
Margarita Gorbounova, Translator

Citation: 2011 TCC 270
Date: 20110519
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REASONS FOR JUDGMENT

Favreau, J.

[1] These are appeals under the informal procedure from reassessments made on April 23, 2009, pursuant to the *Income Tax Act*, R.S.C. (1985) c. 1 (5th Supp.), as amended (the Act), for the 2006 and 2007 taxation years.

[2] The issue is limited to disallowed business losses of $23,640 for 2006 and of $1,076 for 2007.

[3] In making and confirming the reassessments, the Minister of National Revenue (the Minister) based himself on the following findings and assumptions of fact, stated in paragraph 7 of the Reply to the Notice of Appeal:

> [TRANSLATION]
> (a) Between June 2006 and September 2007, the appellant incurred expenses of $24,900 for the 2006 taxation year and $1,077 for the 2007 taxation year with respect to starting up an Internet business; (**admitted**)
> (b) She was involved with an entity called Advantage Conference, which recruited representatives by inviting Internet users to become independent associates via its Web site, prosperinfaith.com; (**admitted**)
> (c) Advantage Conference is allegedly a multi-level American entity whose goal is to help future representatives, whom it recruits through religious principles, become financially successful. The company offered online tutoring through the

use of conferences on financial planning and marketing, among other things, promising future representatives financial success; (**admitted**)

(d) The appellant chose the highest level of entry, namely, level 3 [*sic*], which enabled her to obtain a Web site, which explained to her how to sell products online and included an integrated auto-reply system, which made it possible to pre-qualify potential clients, generally found in the religious population; (**admitted**)

(e) The start-up costs were US$10,054, that is, $59 for membership and $9,995 for level 3 [*sic*]; (**admitted**)

(f) The appellant's work consisted in contacting potential clients by telephone, once they had been selected, in order to recruit them as representatives; (**denied as worded**)

(g) Between her telephone calls to clients, she had to manage the Web site in order to maximize its performance because there was a fee for each visit; (**denied as worded**)

(h) The appellant got involved with that business because she was expecting to make money by adding conference sales and through residuals from the associates she recruited; (**denied as worded**)

(i) In filing her income tax returns for the years at issue, the appellant reported a gross business income of $1,260 for the 2006 taxation year and no business income for 2007; (**admitted**)

(j) During those same years, the appellant claimed 100% of her business expenses while her agent and spouse, David Sicard-Payant, stated that he was an equal-share owner of the business with the appellant; (**admitted**)

(k) During the 2006 and 2007 taxation years, the appellant worked full time for the Hudson's Bay Company and received wages of $63,475 in 2006 and $65,283 in 2007 from it; (**admitted**)

(l) The appellant had no specific business plan and was unable to demonstrate that she had made serious or reasonably sustained efforts that could show that the activity she was engaged in was undertaken in a sufficiently commercial manner; (**denied**)

[4] Paragraphs 7(f), (g) and (h) of the Reply to the Notice of Appeal were denied because it was the appellant's spouse, not the appellant herself, who managed the business, contacted clients in order to recruit them and managed the Web site. The appellant's involvement in the business consisted only in contributing funds for starting up and developing the business from the beginning to the end of activities.

[5] Paragraph 7(l) of the Reply to the Notice of Appeal was also denied, and the appellant's spouse, David Sicard-Payant, provided explanations regarding the following in his testimony:

(i) the market research he had done in order to start an e-business;

(ii) the business plan and marketing efforts;
(iii) the advertising campaigns; and
(iv) the time spent on operating the business.

[6] Mr. Payant explained that he had had no regular employment since 2004 and that the appellant was the only one who supported the family financially. Mr. Payant explained that he had researched online for three months to find businesses that offer the possibility of operating a home-based e-business. He stated that he had considered several businesses specializing in e-commerce including Advantage Conferences. He stated that he had spent approximately a month thoroughly examining all aspects of the way Advantage Conferences worked. His spouse and he decided to join Advantage Conferences because the organization's goal was to contribute to its representatives' financial success through biblical business principles.

[7] Advantage Conferences was a multi-level business (pyramid sales system): representatives had to recruit new independent representatives in order to benefit from recurring monthly profits on the sales they made. The other way to earn income was by selling conferences (Millionaire Mindset Conferences – MMC) such as the one called [TRANSLATION] "management and leadership training for entrepreneurs".

[8] On May 30, 2006, the appellant and her spouse signed a membership form to become co-representatives of Advantage Conferences and paid US$59 as an entry fee at that time and US$9,995 to became members at the MMC-IV level. In his testimony, Mr. Payant explained that they had opted for level IV in order to avoid having to share commissions with higher-level representatives. For US$9,975, the appellant and her spouse obtained the following:

- participation in a two-day conference, which included 6 mentorship sessions with multi-millionaires;
- over 100 hours of training via telephone on such subjects as marketing, advertisement and business development;
- 52 hours of tele-mentorship calls distributed on a weekly basis;
- 10 hours of training on financial health and knowledge of finance on CD;
- a 90% discount for future conferences;
- a fully operational personalized Web site for professional promotion;
- access to an online support centre to access archived training;

- a system that automatically replies to and follows up on messages on a weekly basis for visitors to the Web site who have passed the three qualification tests of the system.

[9] The Web site included a function for filtering interested persons by making them pass three qualification steps. Step one consisted in browsing the corporate Web site, downloading and perusing an electronic kit containing a presentation on e-commerce and/or listening to an audio version of that presentation, and downloading the compensation plan offered by Advantage Conferences. Step two included participation in a tele-conference on such subjects as taking charge of personal finances and managing a family business or listening to an audio recording on these topics. Step three was a telephone interview with the president of the organization to provide additional information and to ensure that the candidate possessed the qualifications needed to become a good representative.

[10] When an interested person reached the third step, Mr. Payant was informed of it and had to contact the person to answer any other questions and to convince him or her to buy the product and to become a representative. After being contacted twice, the interested person usually signed the membership form.

[11] A level-IV representative could make US$7,000 from each level-IV sale and US$500 from level-I or -II sales, except that commissions made from the first two sales had to be given to his or her level-IV mentor (i.e. the person who had recruited him or her). In 2006, the appellant and her spouse earned $1,260 in commissions following the sale of one level-IV membership, one level-I membership and one level-II membership, while in 2007 they earned no commissions.

[12] Concerning the date of the start of operations, Mr. Payant specified that operations had started on May 19, 2006, that is, the date on which he had reserved the domain name for his Web site, openwindowsofheaven.com, not on June 1, as he had indicated at first. From May 19 to 30, he continued reading the documents provided by Advantage Conferences. In the last week of May, he had his interview with the president. That same week, he received confirmation that he had been accepted and that he could send off his membership form and payment orders. Everything was sent on May 30, 2006. In the three weeks that followed, he finished the layout of the Web site and familiarized himself with the use of Google Adwords and other online advertizing techniques. The Web site became operational around the end of June 2006.

[13] Mr. Payant stated that he had spent 4 to 5 hour per day, 6 days per week, during the last 4 months of 2006 on the activities of Advantage Conferences: managing the Web site, participating in training tele-conferences, calling potential clients (about a hundred calls per week), determining the best times and places to put up ads on Google Adwords and identifying other ways to advertise. He specified that he had followed the business plan of Advantage Conferences and that, in 2006, he had incurred about $11,000 in advertising costs, including (a) US$10,195.94 for an intense four-month marketing campaign with Google Adwords, (b) US$212 for putting a direct link on the American site "Moms of Faith" and (c) $225 for advertisements in the "2007 Community Connection" in the publication *Voice of English-speaking Quebec* in 2007.

[14] Mr. Payant also testified that the target market was Evangelical Christians, who make up about 40% of the population of the United States. Based on his estimates, sales of about $2,500 per month were needed to pay his costs. Following the opening of his Web site in the summer of 2006, he sent over 300 e-mails to his contacts and those of the appellant to encourage them to visit their new Web site. It was the only Web site of its kind in Quebec, but there were others in Ontario.

[15] The intensive advertising campaign on Google Adwords did not have the expected results, and so the appellant and her spouse decided to limit their spending on advertising in 2007 and to limit themselves to the prepaid advertising costs. The Web site stopped operating in September 2007, that is, 14 months after it had started.

Discussion

[16] It is quite evident that the appellant and her spouse's Internet activities were not profitable at all. The 14 months of operations resulted in a meagre gross income of $1,260. However, the issue is whether those activities could constitute a source of income for the purposes of sections 3 and 9 of the Act. The Supreme Court of Canada decided on this issue in *Stewart v. Canada*, [2002] 2 S.C.R. 645 and developed the following principles at paragraphs 50 to 55 and 60:

> 50 It is clear that in order to apply s. 9, the taxpayer must first determine whether he or she has a source of either business or property income. As has been pointed out, a commercial activity which falls short of being a business, may nevertheless be a source of property income. As well, it is clear that some taxpayer endeavours are neither businesses, nor sources of property income, but are mere personal activities. As such, the following two-stage approach with respect to the source question can be employed:

(i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?
(ii) If it is not a personal endeavour, is the source of the income a business or property?

The first stage of the test assesses the general question of whether or not a source of income exists; the second stage categorizes the source as either business or property.

51 Equating "source of income" with an activity undertaken "in pursuit of profit" accords with the traditional common law definition of "business", i.e., "anything which occupies the time and attention and labour of a man for the purpose of profit": *Smith*, *supra*, at p. 258; *Terminal Dock*, *supra*. As well, business income is generally distinguished from property income on the basis that a business requires an additional level of taxpayer activity: see *Krishna*, *supra*, at p. 240. As such, it is logical to conclude that an activity undertaken in pursuit of profit, regardless of the level of taxpayer activity, will be either a business or property source of income.

52 The purpose of this first stage of the test is simply to distinguish between commercial and personal activities, and, as discussed above, it has been pointed out that this may well have been the original intention of Dickson J.'s reference to "reasonable expectation of profit" in *Moldowan*. Viewed in this light, the criteria listed by Dickson J. are an attempt to provide an objective list of factors for determining whether the activity in question is of a commercial or personal nature. These factors are what Bowman J.T.C.C. has referred to as "indicia of commerciality" or "badges of trade": *Nichol*, *supra*, at p. 1218. Thus, where the nature of a taxpayer's venture contains elements which suggest that it could be considered a hobby or other personal pursuit, but the venture is undertaken in a sufficiently commercial manner, the venture will be considered a source of income for the purposes of the Act.

53 We emphasize that this "pursuit of profit" source test will only require analysis in situations where there is some personal or hobby element to the activity in question. With respect, in our view, courts have erred in the past in applying the REOP test to activities such as law practices and restaurants where there exists no such personal element: see, for example, *Landry*, *supra*; *Sirois*, *supra*; *Engler v. The Queen*, 94 D.T.C. 6280 (F.C.T.D.). Where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer's business decisions. Such endeavours necessarily involve the pursuit of profit. As such, a source of income by definition exists, and there is no need to take the inquiry any further.

54 It should also be noted that the source of income assessment is not a purely subjective inquiry. Although in order for an activity to be classified as commercial in nature, the taxpayer must have the subjective intention to profit, in addition, as stated in *Moldowan*, this determination should be made by looking at a variety of objective factors. Thus, in expanded form, the first stage of the above test can be restated as follows: "Does the taxpayer intend to carry on an activity for profit and is there

> evidence to support that intention?" This requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour.
>
> 55 The objective factors listed by Dickson J. in *Moldowan*, at p. 486, were: (1) the profit and loss experience in past years; (2) the taxpayer's training; (3) the taxpayer's intended course of action; and (4) the capability of the venture to show a profit. As we conclude below, it is not necessary for the purposes of this appeal to expand on this list of factors. As such, we decline to do so; however, we would reiterate Dickson J.'s caution that this list is not intended to be exhaustive, and that the factors will differ with the nature and extent of the undertaking. We would also emphasize that although the reasonable expectation of profit is a factor to be considered at this stage, it is not the only factor, nor is it conclusive. The overall assessment to be made is whether or not the taxpayer is carrying on the activity in a commercial manner. However, this assessment should not be used to second-guess the business judgment of the taxpayer. It is the commercial nature of the taxpayer's activity which must be evaluated, not his or her business acumen.
>
> . . .
>
> 60 In summary, the issue of whether or not a taxpayer has a source of income is to be determined by looking at the commerciality of the activity in question. Where the activity contains no personal element and is clearly commercial, no further inquiry is necessary. Where the activity could be classified as a personal pursuit, then it must be determined whether or not the activity is being carried on in a sufficiently commercial manner to constitute a source of income. However, to deny the deduction of losses on the simple ground that the losses signify that no business (or property) source exists is contrary to the words and scheme of the Act. Whether or not a business exists is a separate question from the deductibility of expenses. As suggested by the appellant, to disallow deductions based on a reasonable expectation of profit analysis would amount to a case law stop-loss rule which would be contrary to established principles of interpretation, mentioned above, which are applicable to the Act. As well, unlike many statutory stop-loss rules, once deductions are disallowed under the REOP test, the taxpayer cannot carry forward such losses to apply to future income in the event the activity becomes profitable. As stated by Bowman J.T.C.C. in *Bélec*, *supra*, at p. 123: "It would be ... unacceptable to permit the Minister [to say] to the taxpayer 'The fact that you lost money ... proves that you did not have a reasonable expectation of profit, but as soon as you earn some money, it proves that you now have such an expectation.'"

[17] I have no doubt that the appellant and her spouse had a subjective intention to profit from their Internet activities and I consider that the requirement to demonstrate that their activities were carried out in accordance with objective standards of businesslike behaviour was met.

[18] Mr. Payant did research on the Internet in order to identify organizations offering the possibility for investors to start their own home-based e-business. Several business were analyzed. The appellant and her spouse opted for Advantage Conferences, a serious organization that had existed for several years. The values promoted by Advantage Conferences matched their own values. Advantage Conferences also offered very interesting training and mentorship products on leadership and business management. The auto-reply system integrated into the Web site provided an undeniable advantage with respect to competition because it made it possible to contact only those interested in the products for sale, resulting in higher chances of sale. A fully operational Web site was published and a significant sum of money was invested in advertising at the start of commercial activity. Mr. Payant spent the hours needed to manage the Web site and to contact potential clients while continuing his training with the help of the products offered by Advantage Conferences.

[19] Unfortunately for the appellant and her spouse, the expectations of profit did not materialize and the Web site had to be closed after only 14 months of operation. The fact that the e-business did not succeed does not necessarily mean that a source of income or a business did not exist.

[20] Counsel for the respondent tried to convince the Court that Mr. Payant was a computer geek and that the activities related to Advantage Conferences were simply a pastime or a personal activity for him. I do not believe that that is the case. Mr. Payant appeared to me to be an articulate person, who is very methodical in his analysis of business proposals. The appellant and her spouse would certainly not have invested over $20,000 in activities related to Advantage Conferences if they had not believed that they could make a profit from them. The appellant and her spouse dedicated the money, time and energy necessary to operate their e-business.

[21] The objective factors listed by Dickson J. in *Moldovan v. The Minister of National Revenue*, [1997] 1 R.C.S. 480, at page 486, to which the Supreme Court of Canada referred at paragraph 55 of *Stewart*, *supra*, namely,

(a) the profit and loss experience in past years;
(b) the taxpayer's training;
(c) the taxpayer's intended course of action; and
(d) the capability of the venture to show a profit.

are not determinative in this case. Counsel for the respondent did not put in evidence the state of the losses claimed by the appellant and by her spouse in previous years.

There is no doubt about the appellant's spouse's information technology training. The path on which the appellant and her spouse had embarked was promising and the business had the capacity to show a profit. The absence of a business plan specific to the business activities of the appellant and her spouse is also not determinative because they were following the plan proposed or imposed by Advantage Conferences to the letter. The absence of accounting records and proper financial statements is not a determinative factor in the circumstances given the short duration of business operations (only 14 months in total).

[22] For these reasons, the appeals are allowed, in part, and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment, in order to allow the deduction of 50% of the expenses claimed by the appellant in each of the taxation years in question.

Signed at Ottawa, Canada, this 19th day of May 2011.

"Réal Favreau"

Favreau J.

Translation certified true
on this 30th day of June 2011
Margarita Gorbounova, Translator

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APPEARANCES:

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