Docket: 2011-5(IT)G

BETWEEN:

ANDRÉ DROUIN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on January 23, 24, 25, 26, 27, 30 and 31;
February 1, 2, 6, 7, 8, 9, 13, 27, 28 and 29;
March 1, 5 (teleconference), 13, 14,
15, 16, 19, 21 and 23;
April 3; and May 8, 9 and 10, 2012,
at Montréal, Quebec

Before: The Honourable Justice Paul Bédard

Appearances:

Counsel for the appellant:	Guy Du Pont Michael H. Lubetsky Jack J. Fattal
Counsel for the respondent:	Michel Lamarre Alain Gareau Vlad Zolia Sara Jahanbakhsh

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JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2008 taxation year, notice of which is dated August 27, 2009, is allowed, with costs, and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 3rd day of May 2013.

"Paul Bédard"

Bédard J.

Translation certified true
on this 9th day of October 2013.

François Brunet, Revisor

Citation: 2013 TCC 139
Date: 20130503
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REASONS FOR JUDGMENT

Bédard J.

[1] This is an appeal from a reassessment, notice of which is dated August 27, 2009, for the 2008 taxation year (the reassessment), whereby the Canada Revenue Agency (the CRA) denied $85,875.33 in deductions that the appellant had claimed as capital cost allowance, eligible capital property and interest in respect of the purchase of a franchise authorizing him to market computer software.

Background

[2] Prospector Networks International Inc. (PIN) was a company based in Barbados. The appellant submits that PIN carried on a business that developed software for business markets in North America and elsewhere ("the software").

[3] The software consists of the following:

(i) Solutions Prospector: a software package designed to help salespeople identify prospective clients;

(ii) Mail it Safe: software designed to secure and track e-mail to help lawyers, health care professionals, public agencies and others who regularly send and receive confidential information;

(iii) CashOnTime: a software package designed to help financial officers and collection agents track accounts receivable and payments.

[4] PIN granted licences (in 2003 and 2004) and franchises (from 2005 to 2008) that, according to the appellant, allowed the licensees and franchisees (collectively, "the franchisees") to use and market the software and any products derived from the software.

[5] According to the appellant, PIN also offered to market the software on the franchisees' behalf under contracts of mandate with PIN's subsidiaries and associated businesses.

[6] The appellant is a software engineer.

[7] In 2007, the appellant bought a franchise and signed an agency agreement with a subsidiary of PIN. Under the terms of this mandate, the subsidiary undertook to operate the appellant's franchise. I should immediately note that the respondent submits that this agency agreement is a sham. The appellant bought the franchise on the advice of his financial planner.

[8] The purchase price of the franchise in 2007 was $200,000: $10,000 for the franchise rights and $190,000 for the Solutions Prospector and Mail it Safe software. The appellant gave the franchisor a five-year full recourse promissory note bearing interest at a rate of 7.5% per annum. The respondent submits that this promissory note is a sham.

[9] The contracts signed in 2007 (i.e., the franchise agreement and the agency agreement) were replaced with new contracts in 2008. The cost of the franchise was raised by $30,000 in 2008. When he bought his franchise in 2008, the appellant gave the franchisor a ten-year full recourse promissory note bearing interest at the rate of 4% per annum. The respondent submits that the 2008 agency agreement and promissory note, too, are shams.

[10] Any dealings that the appellant had with PIN, the agent or any of PIN's affiliated companies were at arm's length.

[11] The respondent's position: The CRA's position is that the appellant bought the franchise solely for the purpose of obtaining tax deductions. This position is based on the following arguments.

(A) Argument I – There was no business

[12] First, the CRA submits that the deductions were not made for the purpose of gaining or producing income, because at no time during the relevant period did the appellant intend to carry on a business or in fact carry on a business, nor for that matter did Network Prospector or MarketX Services Inc. intend to carry on a business or in fact carry on a business on behalf of the appellant. See the Reply to the Notice of Appeal (the Reply) at subparagraph 26(l). See also the Reply at paragraphs 28, 29 and 36 to 38. See also the Reply at subparagraphs 25(o), (p) and (r), where the CRA alleges that the appellant never intended to draw income from his business.

(B) Argument II – The sham

[13] Second, the CRA submits that the full recourse promissory note and the agency agreement constituted [TRANSLATION] "shams" (see the Reply at subparagraphs 26(l), (m), (p), (x), (y), (z), (aa) and (bb) and at paragraphs 32 and 34).

(C) Argument III – The unreasonable price

[14] Finally, the CRA submits that the [TRANSLATION] "fair market value of the franchise and the rights attached to it was nil" (see the Reply, subparagraph 25(s)). The CRA further submits that [TRANSLATION] "the fair market value of a franchise of Prospector International Networks Inc. was very low, if not nil" (see the Reply, subparagraph 26(cc)).

Issue

[15] The issue in this case is the following: Was the appellant carrying on a business in the year 2008? This issue also raises the following questions:

(a) Did the full recourse promissory note and the agency and management agreement constitute shams?

(b) Did the appellant pay a reasonable price for his franchise?

Procedural history

[16] On December 21, 2010, the appellant filed in this Court an appeal against the reassessment; the CRA filed its Reply on March 14, 2011.

[17] After two case management conferences held on May 19 and September 6, 2011, the Court set a tight, expedited schedule requiring the parties to disclose a considerable volume of documents and to hold examinations for discovery.

[18] On September 14, 2011, the Court rendered a confidentiality order in respect of the exhibits filed by the appellant (see *Drouin v. The Queen*, 2011 TCC 425, 2012 DTC 1020).

[19] On October 21, 2011, the CRA filed a [TRANSLATION] "Motion to Amend the Reply to the Notice of Appeal" alleging that the appellant's franchise was a [TRANSLATION] "tax shelter" and that the software that he marketed constituted [TRANSLATION] "computer tax shelter property", such that the deductions claimed by the appellant were prohibited under the applicable provisions. On November 10, 2011, the Court dismissed the motion (see *Drouin c. The Queen*, 2011 CCI 519, 2012 DTC 1012).

[20] The hearing lasted a total of 30 days, from January 23, 2012, to May 10, 2012. The appellant filed approximately 785 exhibits, totalling around 13,000 pages. The respondent filed 161 exhibits.

[21] During the hearing, the Court rendered a decision dismissing *inter alia* an objection by the appellant to the testimonies of five other franchisees and two financial planners whom the CRA wanted to call as similar fact witnesses:

> [TRANSLATION]
> [44] It is appropriate to reproduce paragraphs 22 to 24 of the written submissions of the respondent, which read as follows:
>
> > [TRANSLATION]
> > 22. The respondent submits that the testimonies of the franchisees and the financial planners are entirely relevant according to the criteria of the Supreme Court because these people were involved in transactions identical to those involving the appellant and thus will give evidence that may increase the

> likelihood that the contracts signed by the appellant and the promissory note allegedly given to him are in fact shams.
>
> 23. The testimonies of the franchisees and the financial planners will also increase the likelihood that representations were made to the Prospector franchise buyers to the effect that buying a franchise would give them a tax benefit in excess of the amount paid by them.
>
> 24. The testimonies of the franchisees and the financial planners will also increase the likelihood that no businesses were actually carried on through Prospector franchises.

(*Drouin c. La Reine*, 2012 CCI 94 [not translated], para. 44)

[22] In that same judgment, the Court also ruled on the qualifications of the expert witnesses that each of the parties planned to call after a motion on February 9 and 13, 2012. The Court thus accepted Jean-François Ouellet (Mr. Ouellet) as an expert in management and in innovation marketing. However, the Court refused to accept Denys Goulet as an expert in appraisal, deeming his report to be of no probative value because his opinion was inextricably based on the opinions of an unidentified person who had not been presented to the Court as an expert.

Proceedings

[23] At the trial, the appellant presented an overview of the history of PIN from its beginnings to the present day through the testimonies of Thomas L. Jones (Mr. Jones), Michel Vincent (Mr. Vincent), Claude Duhamel (Mr. Duhamel), Paul-André Mathieu (Mr. Mathieu) and Stéphane Teasdale (Mr. Teasdale).

[24] The testimonies of Mr. Jones and Mr. Duhamel reveal that PIN is the successor to Stratsite Inc. (Stratsite), an information technology company founded in 1998 by two young entrepreneurs, Mr. Jones and Carl Phoenix (Mr. Phoenix). Stratsite was initially involved in providing Web site development, PowerPoint presentation and electronic communications services for companies in the financial sector. Stratsite's clients included Valeurs mobilières Internat, a brokerage firm where Mr. Duhamel worked as a stockbroker. Mr. Duhamel had clients who wanted to invest in new high-tech companies. Being satisfied with Stratsite's work, he decided to approach Mr. Jones and Mr. Phoenix to learn more about their future projects. One of the projects that Mr. Jones and Mr. Phoenix discussed with him was C-Local, an electronic data bank, similar to the Yellow Pages, that incorporated advanced search

engines. However, this project required considerable financing. Mr. Duhamel managed to raise several million dollars in financing from various investors, which allowed Stratsite to go forward with the development of C-Local.

[25] Near the end of 2000 and in early 2001, when the technology bubble burst, C-Local's Web site was online and accessible to the general public, but the product was not being marketed. The financing needed to roll out C-Local was impossible to come by, and an initial public offering had to be cancelled. The company was soon short of funds and had to reduce its staff considerably.

Solutions Prospector

[26] In spite of everything, Stratsite managed to finalize the tracking and notification system it had been working on. In 2002, Stratsite decided to breathe new life into the company by focusing on this tracking system. Building on their Web site design know-how, their database and the tracking system, Mr. Jones and his associate created a new computer program: Solutions Prospector. This software was designed to allow users to send an e-mail to a select list of recipients, inviting them to visit a Web site. The software would then track what action the recipients took, if any, after receiving the invitation.

[27] Mr. Duhamel testified that when he was seeking funds for Stratsite, he was referred to Andrew Murray (Mr. Murray), a businessman residing in Barbados who knew people with access to capital around the world. According to Mr. Duhamel, Mr. Murray had expressed an interest in Stratsite and had joined with him in preparing the financing plan and the following business plan with him. Canaventure, a company owned by Mr. Murray and incorporated in the British Virgin Islands, would ask Stratsite to develop Solutions Prospector on its behalf. Canaventure, which would hold the intellectual property rights for the software to be developed, would sell investors marketing licences for the products developed by Stratsite, and the licensees would in turn ask Stratsite to market the software on their behalf. The money paid to Canaventure would be given to Stratsite to finance the software's development.

[28] Licences were initially priced at $75,000 each. To maintain a stable cash flow for Canaventure and Stratsite, the licences had to be paid partly in cash and partly by means of a limited recourse promissory note. Mr. Duhamel explained that structuring the licences in this way had the added advantage of significantly reducing their risks

by allowing them to claim a capital cost allowance on their licences while still receiving royalties.

[29] In 2002, only a handful of licences were sold. In 2003, the initial price of $75,000 was increased to $100,000, and the initial 30% down payment had to be paid in instalments over two years. The balance, paid by a limited recourse promissory note, was due 10 years later. Interest was paid out of the income earned. According to Mr. Duhamel, they sold approximately 140 licences in 2003 and 250 in 2004, under the same terms.

[30] In 2003, Canaventure began using the business name Prospector International and then officially changed its corporate name to PIN. On August 1, 2003, PIN incorporated Prospector Network Inc. (Network) to take over Stratsite's activities, and Stratsite was wound up. Mr. Duhamel explained that from then on, Network played two distinct roles: first, developing software for PIN; and second, marketing this software for the licensees. According to Mr. Duhamel, a third company, Prospector USA, wholly owned by Network, was incorporated in the United States to facilitate marketing efforts in that country.

[31] Development of Solutions Prospector was completed in November 2003. The company's business activities also began to pick up in 2003. For example, Network tried to do business with resellers of modified products, that is, businesses that were already selling information technology products and could distribute Solutions Prospector through their own networks. The attempt failed: Mr. Duhamel and Mr. Jones explained that the resellers refused to distribute Solutions Prospector because it was still unproven on the market. Network opened offices in Miami and Montréal to try to sell the software. A business plan identifying target markets was drawn up, and numerous presentations, personalized proposals and competitive analyses of competing products were done. Network made efforts to identify clients, efforts which included using Solutions Prospector. A few paying or prospective clients were using Solutions Prospector. Twelve of them were designated as [TRANSLATION] "strategic accounts", that is, well-known businesses that, if encouraged to use Solutions Prospector, could foster market uptake and thus increase sales. Network offered these businesses free or discounted user rights. In addition, to target more niche clients, Network launched two derivative programs based on Solutions Prospector: "Prospector Finance" and "Prospector Trade Show". Licensees were informed of new releases and upcoming projects through updates.

[32] Despite all this, Network's efforts did not translate into sales. Mr. Jones and Mr. Duhamel attribute these disappointing results to the laborious nature of designing

and developing microsites that meet high standards of professionalism. Clients also expected Network to provide the databases, which are very expensive, while Prospector's business model assumed that clients would provide their own lists.

Mail it Safe

[33] In April 2005, new software was announced. Prospect Mail, later renamed Mail it Safe, is described as a productivity and security tool. Basically, it allows senders to know when their messages have been read, how long the messages were looked at, and whether the attachments were downloaded. It also gives senders' messages added security by using encrypted networks on the Mail it Safe central server and by offering additional options, such as password protection. Initially, Mail it Safe could only be used via the Web as a module of Solutions Prospector, but it was later adapted to make it compatible with Outlook, and eventually with Lotus and BlackBerry, which increased the client base. Mail it Safe is offered either under a perpetual licence or through the purchase of a limited-time right known as "SaaS" (software as a service). Mr. Vincent described the difference between the two arrangements in the following terms (see Examination of Mr. Vincent, Transcript, January 25, 2012, Question 340):

> [TRANSLATION]
> Generally, an SaaS solution is hosted. That means that the hardware isn't at the client's offices but is taken care of by the solution provider. So, for example, with Mail it Safe, the clients who are in SaaS mode use the solution via a server hosted by us, actually, by our partner, who has the specialized infrastructure. As to why we offer two modes, it's because it leaves us—it's a question of business flexibility. There are businesses that don't want to do what in industry jargon is called "capex", capital expenditures, and that prefer to have an operating expense in the budget. Because under their internal procurement approval procedures, it's easier to justify incurring an operational expense than a capital expense. In other businesses, it's the opposite. So we give ourselves the flexibility to align with the clients' interests.
>
> What's more, there are businesses where technology is almost like a religion. There are some that think one thing is the best in the world and another thing is worthless, while others say the opposite. Everyone has their own beliefs. So there are businesses that say there's no way we can have the information from the applications we use be hosted outside our infrastructure. So these companies object to the SaaS mode because they can't accept having their data stored elsewhere. Other business will tell you the opposite. They don't want anything to do with managing that in house because they don't have the resources in place.

[34] In 2005 and 2006, Network devoted considerable effort and money to marketing Mail it Safe. Marketing consultants were hired to develop Mail it Safe's market image. Specific sectors were identified: legal services, financial services and health services. Network also decided to close the Miami office and open offices with sales teams in New York, Chicago, Los Angeles and Boston. It hired additional staff through the Montréal office. A “virtual office” was set up in London for about six months, and there were plans to open an office in Paris, according to Mr. Duhamel. There were also discussions with a Mexican associate, according to Mr. Duhamel.

[35] A significant amount of documentation was prepared for prospective clients: presentations, brochures, guides, user manuals, webinars and technical documents. Network created a Web site for Mail it Safe. It did strategic planning and trained in-house salespeople using reports, presentations and analytical documents. It also attended a number of trade fairs, including the LegalTech Trade Show in New York, and took part in various events attended by its target clientele. It also conducted a survey of selected members of its clientele to better understand clients' perceptions of the software.

[36] Network also entered into agreements with certain organizations, including the Greater Montréal Real Estate Board, the Corporation de services du Barreau du Québec and the New York County Bar Association. It donated 250 user licences to the Blythedale Children's Hospital, where the software was used. There were negotiations with Pitney Bowes and the Massachusetts Vietnam Veteran Association towards entering into a business agreement. Network also made IBM its technical associate, meaning that IBM took care of the security reports for Mail it Safe. Moreover, like Microsoft and BlackBerry, IBM allowed its logo to be used for advertising purposes.

[37] Network also tried to find resellers that could sell Mail it Safe to their clients. According to Mr. Duhamel, this solution could have led to sales but would have had the added advantage of raising the product's profile with a view to a possible acquisition by a major company. According to Mr. Duhamel, there were talks with Cablevision, Openface, Reach Everywhere, Merrill and BBDO, but nothing came of them.

[38] In 2005, Revenu Québec, which viewed the licensing system more as an investment than a business, threatened to disallow the capital cost allowances claimed. In response, Network and PIN offered the licensees the opportunity to convert the licences into franchises. According to Mr. Duhamel, approximately

40 licensees, or 20% of them, refused to convert their licences. Two hundred new franchises were sold in 2005. In addition, Mr. Duhamel explained that a special agreement, consisting primarily of a partial interest holiday, was concluded with 14 franchisees who had already invested in another of its business projects that had not turned out well.

[39] Mr. Duhamel explained that under the terms of the 2005 franchise agreements, the franchisees acquired [TRANSLATION] "an operating franchise" giving them [TRANSLATION] "the non-exclusive right to distribute, within the territory and to authorized clients, . . . Solutions Prospector and MIS™ software for a term of 25 years beginning January 15, 2005". Under the contract, each of the franchisees was assigned a specific territory and had access to a data bank on the businesses located in that territory (see also the Solution Prospector and Mail it Safe franchise agreement between Prospector International Network Inc. and Annie Fortin dated December 30, 2005, Exhibit A-55 (1-97), Volume 27, page 10893, at page 10897, paragraphs 2.1 and 3).

[40] Another clause in that contract stipulated that if 75% of the franchisees agreed at a special meeting to sell their franchises to a third party, a franchisee could be required to sell its franchise, on condition that the sale be made under the same terms as for all the franchises.

[41] In response to a question from the franchisees regarding the number of franchises that PIN intended to grant, Mr. Duhamel answered that PIN had capped the number of franchisees at 1,500 and had divided the United States into 1,500 territories accordingly, by postal code. According to Mr. Duhamel, each territory was supposed to have between 10,000 and 20,000 potential clients entered in the Dun & Bradstreet data bank for businesses and professionals. According to Mr. Duhamel, the franchisees were told several times how the territories were divided up.

[42] Furthermore, the price of a franchise was raised to $160,000 (including $10,000 in franchise fees to take into account the launch of Mail it Safe), with an interest rate of 7% per annum. The term of the promissory note was four years.

[43] New franchises were sold in 2006 under similar terms.

[44] According to Mr. Duhamel, the money from the franchisees was used for development and marketing. Moreover, the evidence showed that Network was in regular contact with franchisees, usually by e-mail, but sometimes by regular mail.

Most often, these contacts took the form of updates. There were also annual and special meetings, well attended by franchisees, during which presentations on the business situation and development were given. A [TRANSLATION] "franchisees' manual" with periodic updates was sent to franchisees by mail and e-mail. A [TRANSLATION] "VIP night" was organized to mark the launch of Mail it Safe, an intranet site was made available to franchisees, and franchisees were invited to refer people they knew to Network.

The 2006 appraisal by Wise, Blackman

[45] Mr. Duhamel explained that well after the technology bubble had burst, some financial groups renewed their interest in Mail it Safe and started negotiations. According to Mr. Duhamel, Mr. Murray considered the possibility of taking the company public. Mr. Duhamel also explained that it had become important to have a valuation of the company done (see Examination of Mr. Duhamel regarding the announcement to franchisees that the company might be taken public, Transcript, February 2, 2012, Questions 519-531; Update (in a bundle), Exhibit A-23.1.16.5, Volume 18, page 7852, at pages 7862-7865,) (announcement to franchisees that the company might be taken public).

[46] In addition, according to Mr. Duhamel, the franchisees started asking whether the franchisor and the agent had the financial capacity to continue developing and marketing the products (Examination of Mr. Duhamel, Transcript, February 2, 2012, Questions 293, 299 and 302.)

[47] To answer these questions, PIN hired renowned appraiser Richard M. Wise, FCA, FCBV, FASA, MCBA, of the firm Wise, Blackman LLP, which merged with MNP LLP on June 1, 2011 (Examination of Mr. Duhamel, Transcript, February 6, 2012, Question 88; Valuation of the business of Prospector International Network Inc. as at Sept. 30, 2006, by Wise, Blackman LLP, Exhibit A-21.1, Volume 16, page 6939).

[48] In its report (the 2006 valuation), Wise Blackman concluded as follows:

> [TRANSLATION]
>
> In our opinion, according to the information and documents that we have reviewed and the explanations that were given to us, and subject to the assumptions and restrictions herein, the fair market value of the business on or about the valuation date was from $147,000,000 to $164,000,000 (rounded).

[49] The franchisees were notified of the conclusions of the 2006 valuation (Mail it Safe 2006 Overview and Forecast for 2007, Exhibit A-22.1.27, Volume 17, page 7298, at page 7301; PIN – Update – July 2009, Exhibit A-22.1.36, Volume 17, page 7419, at page 7421).

[50] Despite all efforts, sales of Mail it Safe were weak. Mr. Jones and Mr. Duhamel attributed the failure of Mail it Safe to the managers of potential client's information technology departments, who failed to understand the added value of the tracking function and tended to take a lot of time to ensure that Mail it Safe was compliant with their own networks, such that sales became a very long process. Mr. Ouellet, whom I recognized as an expert, explained that the market had a poor awareness of the problem of the lack of security in electronic communications and was therefore less inclined to invest substantial amounts of money in security (Examination of Mr. Ouellet, Transcript, March 1, 2012, Question 47). Furthermore, according to Mr. Jones and Mr. Duhamel, given the disputes with the tax authorities, Network had to devote more resources to legal fees and liaison activities with franchisees. Finally, according to Mr. Jones, and especially according to Mr. Duhamel, the tax dispute negated the benefits of the partnerships that Network had entered into.

[51] Mr. Duhamel and Mr. Jones testified that Network took a number of steps to deal with these disappointing sales, including creating a [TRANSLATION] "strategic sales committee", conducting surveys and seeking new partnerships. It also changed its human resources policy and required its salespeople to prepare reports when they lost potential sales. The price of Mail it Safe was changed, and new brochures and presentations were developed. In reaction to comments from certain clients, Network added a [TRANSLATION] "secure Reply" function to Mail it Safe.

[52] Mr. Duhamel stated that in 2007, since results were still minimal, Network changed its business plan. He testified that Network decided to close its offices in the United States and focus its efforts on Quebec, a territory that had not been assigned to franchisees, in order to create a virtual storefront that could then be used to gain sales in the United States. Network was able to recruit two key employees: Mohammed Yacoub (Mr. Yacoub), the former president of a company with 1,200 employees and a turnover of $120 million; and Michel Lamontagne, a member of the ethics board of the Autorité des marchés financiers (AMF) and chairman of the board of the Régie de l'assurance maladie du Québec. Mr. Yacoub commissioned market studies targeting larger businesses. Intensive negotiations were held with IBM's

Montréal office with a view to turning a technical partnership into a reseller partnership and to encouraging the use and adoption of Mail it Safe. IBM took steps in this direction with Royal Bank, Bombardier and Desjardins. Network also entered into an agreement with the Ordre des conseillers en ressources humaines et en relations industrielles du Québec and continued to create new software.

[53] According to Mr. Duhamel, in 2007, Network nevertheless continued its sales efforts in the United States, but from its Montréal office.

[54] Network made several sales in Quebec in 2007.

[55] Mr. Duhamel explained that in August 2007, Mr. Yacoub offered to take over the development and marketing business. According to Mr. Duhamel, Mr. Yacoub, however, wanted to operate that business through a separate company because he wanted to steer clear of trouble with the tax authorities. MIS International (MIS) was created for this purpose in December 2007. Mr. Yacoub and Mr. Lamontagne became chief executive officer and chairman of the board of MIS, respectively. PIN, which held 70% of the company's shares, tasked him with developing products and creating a virtual storefront for the franchisees (Examination of Mr. Duhamel, Transcript, February 29, 2012, Questions 575 and 577).

[56] According to Mr. Duhamel, the franchisees were informed of the planned creation of MIS at the annual general meeting in November 2007.

[57] To develop the software, MIS took charge of the technology team and the software's intellectual property. The relationship between MIS and PIN was governed by a series of contracts, some of which were filed in evidence (Exhibits A-132, A-133, A-134 and A-135). Under the terms of these contracts, PIN transferred the intellectual property to MIS for a royalty equal to 12% of the sales. The contracts also included clauses to ensure that PIN would be able to meet its obligations to the franchisees (see clause 2.1 of the contract entitled "Intellectual Property Licence Agreement", Exhibit A-134).

[58] The following emerged from the credible testimony of Mr. Vincent. In fall 2007, Mr. Vincent was appointed vice-president of sales of MIS and was instructed [TRANSLATION] "to design and rethink the marketing strategy for the Mail it Safe solution". He came up with a new business strategy and restructured the sales team. In addition to capitalizing on its existing partnerships, MIS established new technology partnerships with Microsoft, the seller of Outlook, and RIM, the seller of BlackBerry. Mr. Vincent also implemented a [TRANSLATION] "government

strategy" aimed at having the product adopted by public and parapublic agencies that often deal with confidential data and communications. Significant resources were also devoted to training staff and preparing presentations. Some client prospecting was done by telephone. Mr. Vincent's efforts bore fruit, and Mail it Safe started to acquire some prestigious clients, including Revenu Québec. The proceeds from these sales were not shared with the franchisees, whose territories did not include Canada, but were used, according to Mr. Duhamel, to develop a virtual storefront for the international marketing of Mail it Safe in the franchisees' territories.

[59] Although MIS focused most of its efforts on Quebec and made most of its sales there, there were also some meetings and presentations in the United States, Toronto and abroad, even though no offices had been opened there. The contracts between PIN and MIS were amended in 2009 to make it clear that MIS's marketing rights were limited to Canada.

[60] The following also emerged from Mr. Duhamel's testimony. In late 2007, further discussions were held with Revenu Québec, this time regarding the promissory notes. Revenu Québec rejected the capital cost allowance claimed for the franchises acquired with limited recourse promissory notes. To rectify this problem, PIN proposed to the franchisees that the notes be converted into full recourse promissory notes. This meant that franchisees would promise to pay the amounts due upon maturity and would no longer be able to simply give back their franchises. The franchisees' initial reaction to this proposal was mixed, but in the end, after the meeting on November 27, 2007, about two thirds of the franchisees acquired new franchises with full recourse promissory notes.

[61] The main features of the 2007 contract are similar to those of the 2005 and 2006 contracts, with the exception of some significant differences regarding the price and the payment terms: the promissory note became a full recourse promissory note, the interest rate was reduced to 7.5%, and the term was extended to five years. Mr. Duhamel stated that the amount of the principal was raised to $200,000 to account for the improvements made to Mail it Safe and for the new partnerships.

[62] Mr. Duhamel explained that the territories were precisely defined: each franchisee would be given 20,000 businesses selected from the database according to a unique combination of postal codes and SICs (Standard Industrial Classification numbers). Mr. Duhamel also explained that territories in Florida and France, as well as Zurich, were expressly excluded from the assigned territories because they had been sold by PIN in 2005 and 2006. Canada was not expressly excluded, but as Mr. Duhamel stated, it was clear that Canada was reserved for the virtual storefront.

According to Mr. Duhamel, approximately 1,100 new franchises were sold in 2007, including those assigned to new franchisees (such as the appellant) and those assigned to franchisees as a replacement for others.

[63] Mr. Teasdale, a lawyer who specializes in franchise law, explained that PIN hired him in 2008 to analyze the contracts and propose changes that would, on the one hand, better [TRANSLATION] "reflect the business and operational reality" and, on the other hand, put the contract [TRANSLATION] "on the cutting edge of what is being done in contracting in many industries". The 2008 version of the contract, prepared by Mr. Teasdale, included numerous changes and clarifications:

> (1) the preamble was changed considerably;
>
> (2) an express definition of [TRANSLATION] "franchised business" was added (section 1.1.3);
>
> (3) a manual was expressly provided for (section 1.1.4);
>
> (4) a 10-year time limit was added to the renewal terms, as 10 years was considered to be [TRANSLATION] "pretty much the industry standard";
>
> (5) clarifications were added to explain how the exclusive lists work, and to provide for [TRANSLATION] "a mechanism whereby if a franchisee sold to a client on someone else's list, compensation would have to be paid" (section 6.2);
>
> (6) [TRANSLATION] "additional services provided by Prospector, the franchisor" were spelled out (section 9);
>
> (7) clarifications regarding the level of personal participation required of a franchisee were added (section 10);
>
> (8) financing terms were largely moved into an appendix, since the financing terms can vary and it is [TRANSLATION] "easier to deal with an appendix than to deal with a contract each time" (section 12 and appendix);
>
> (9) the franchisee's right to his or her own agent was expressly confirmed, subject to the franchisor's approval (section 13);
>
> (10) model clauses were added, as were an arbitration clause and a clause stating that the applicable law would be Quebec law (sections 16-17).

> (Examination of Mr. Teasdale, Transcript, January 26, 2012, Questions 408, 409, 413 and 414; Prospector World E & T Network International franchise agreement (comparative version), Exhibit A-36, Volume 26, page 10179.)

Furthermore, the franchise price was increased to $230,000, the interest rate on the promissory note was reduced to 4%, and the term was extended to 10 years. As suggested by Mr. Teasdale, who felt the expression "Prospector" was confusing, the expression [TRANSLATION] "Prospector World franchisee" was replaced with [TRANSLATION] "E&T Network International franchisee" ("E&T" stands for "Encryption and Tracking").

[64] According to Mr. Duhamel, the list of possible exclusive clients for each franchisee was reduced to 10,000 more carefully selected businesses. Self-employed workers were removed from the list, for example. Also, Canada was expressly excluded from the definition of the franchisees' [TRANSLATION] "territory".

[65] As regards the mandate, MarketX Services Inc. (MarketX) became the agent. According to Mr. Duhamel, the law firm Fraser Milner Casgrain recommended that the agent should be a company other than Network, so as to maintain [TRANSLATION] "a certain distance between the franchisor and the agent" (see court reporter's notes, March 21, 2012, paras. 79 to 81). The evidence showed that MarketX was never incorporated. It was not until March 2009 that Mr. Bernier (who had bought Prospector) realized that MarketX had not yet been created. I also note that under a resolution dated March 25, 2009, filed in evidence as Exhibit A-80, PIN assumed all of the rights and obligations of MarketX. It also emerged from Mr. Duhamel's testimony that he learned that MarketX did not exist around the same time that Mr. Bernier did. The evidence on this point shows that the appellant did not find out that MarketX did not exist until April 30, 2009 (that is, at the meeting of franchisees). The appellant explained that at the time, he had assumed that Network was still his agent under the 2007 agency agreement because MarketX was supposed to replace Network. The appellant also testified that Network had been his agent until March 26, 2010, when the franchisees' association replaced Network.

[66] I reiterate that in the 2008 contracts, as compared against the 2007 contracts, the franchise purchase price was increased to $230,000, the interest rate of the promissory note was reduced from 7.5% to 4%, and the term was extended from 5 years to 10 years. Mr. Duhamel explained that the term was extended in response to pressure from the franchisees and their financial advisers, who were unhappy with the sales of Mail it Safe (Examination of Mr. Duhamel, Transcript, February 6, 2012,

Questions 220, 222, 231, 244, 253, 283 and 285). Finally, the combined effect of the 2008 agency agreement and the 2008 franchise agreement increased the royalties payable to franchisees from 6% in 2007 to 12%.

[67] The following also emerged from Mr. Vincent's testimony. Although MIS succeeded in selling Mail it Safe to credible clients, sales revenues were never as high as hoped because the sales cycle was longer than expected and clients were not prepared to spend considerable sums of money to make electronic communications more secure because they could not measure the benefits in dollar terms. Mr. Vincent stated the following about Mail it Safe and its potential: [TRANSLATION] "We have a good thing in Mail it Safe, but it's not clear that it can be turned into a viable business" (Examination of Mr. Vincent, Transcript, January 26, 2012, Questions 39 to 41).

CashOnTime

[68] The decision was, therefore, made in 2008 to develop a new business solution that was based on the tracking technology but [TRANSLATION] "would allow us to quantify the benefits and calculate a quick return on investment" (see Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 351 and 516; MIS International Inc. – Management Meeting, August 26, 2008, Exhibit A-22.1.29, Volume 17, page 7314, at page 7326). MIS, inspired by Mr. Mathieu's idea of using Mail it Safe to send invoices to his clients and reduce collection time, created CashOnTime (see Examination of Mr. Mathieu, Transcript, February 28, 2012, Questions 578 to 581; Examination of Mr. Duhamel, Transcript, February 6, 2012, Questions 177 and 184). According to Mr. Vincent, this program used the tracking technology to automate invoicing and track accounts receivable effectively. A team of specialists was hired in mid-2008 to create the program as quickly as possible. Like Mail it Safe, CashOnTime is offered under one of two arrangements: a perpetual licence or a limited-time right (software as a service).

[69] Mr. Ouellet testified that CashOnTime is definitely much easier to sell than Mail it Safe because it meets an easily measured need, although because of the nature of software as a service, this takes time:

[TRANSLATION]
JUDGE: . . .

[44] Q. In that sense, CashOnTime is easier to sell.

A. In that sense, CashOnTime, in fact, the large part . . . there are two, to answer the question directly, two components of CashOnTime that make it perhaps more difficult. There is a component that really stands out, in my mind, and as I was starting to tell you yesterday, the reason why I personally, if I were to invest in this business, would be very interested in CashOnTime, it's because it meets a need that is, I think, not difficult to promote, to stimulate. It's based on something that is . . .

[45] Q. That is easily measured.

A. That is measurable, that can be defined, you see, in terms of the return on investment from the standpoint of the buyer, the client, that is.

But the trade-off, again, is that it's "Software as a Service". If I had a business with accounts receivable, I'm not sure that I would want to send that information out onto the Web to be held by someone I know but I don't know, being vulnerable to that business being hacked by malicious individuals who then have access to my data, which are pretty secret and important for my business. So "Software as a Service" makes that more complicated.

The other dimension that's probably just as important is that, again, if you are an SME that has always had some kind of paper record with your accounts in it, moving from that to a computerized notice system, from "Don't forget collect X from Y," well, that's something that isn't compatible with their current way of doing things. It's less critical than in the case of the SAX than for the SaaS dimension of that product. But that can explain why it takes a lot more time anyway.

In the case of Mail it Safe, in the case of Prospector, well, in fact, what slows things down, the main factor slowing things down, once again, is this incompatibility with. . . with the current way of doing things. And the main factor speeding things up, usually, is the perceived relative advantage.

In the case of CashOnTime, you can see the advantage. In the case of Mail it Safe, you can see it, but it's less obvious because it's not just a more roundabout way than exiting and going. . . There's more hands-on work involved in sending an e-mail by Mail it Safe, but the relative advantage is hard to see because there hasn't really been a scandal. I think that was already raised, when I was here at the beginning.

[46] Q. Disaster.

A. There wasn't any. . . That's it. There's nothing that makes. . . It's a bit like fire insurance, if you've never experienced. . . Everyone has fire insurance, but every

> time I pay for it, I ask myself why I have it. Because nobody in my circle or close to them has had a fire, you know, but as long as you haven't experienced it. But when it happens to you, however, then it becomes essential. I didn't have any insurance for my hot tub because I told myself, at the cottage, no one can steal a hot tub; it's always full. Well, son of a gun! One weekend, I get there, and guess what had disappeared? My hot tub. I bought a new one, and it's been insured ever since. But I had to get robbed before taking out the insurance, the rider. Who steals a hot tub? So there you go! So there's that.
>
> And as for Prospector, well, there, the relative benefit or advantage is less obvious. So there are even more disadvantages than advantages from the consumer's point of view, probably. I've gone a bit off topic.
>
> Examination of Mr. Ouellet, Transcript, March 1, 2012, Questions 44 to 46.

[70] In the end, four [TRANSLATION] "sectors" were targeted for marketing CashOnTime: the manufacturing sector, the distribution sector, the transportation sector and the professional services sector. The sales efforts for CashOnTime began in 2008, when the program was still "vapourware" (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 526 and 537 to 539; Exhibit A-22.1.30, Volume 17, page 7347; and Exhibit A-22.1.31, Volume 17, page 7358). The first sale was made on October 31, 2008, to Client B (Exhibit A-31, Volume 25 (confidential), page 9993). Again, a vast array of presentations, brochures and Web sites, in English and French, was prepared. Mr. Vincent made adjustments to the sales team, took charge of training the salespeople and used the services of external consultants that specialize in presenting software. He prepared a [TRANSLATION] "sales manual" and kept it up to date. According to Mr. Vincent, the sales cycle lasted from 6 to 12 weeks, sometimes longer.

[71] Twelve sales of CashOnTime were made from 2008 to 2011. In addition, from 2009 to 2011, there were four new sales of Mail it Safe.

[72] In December 2008, Mr. Yacoub, on behalf of MIS, sent the franchisees an update announcing the creation of Mail it Safe (MIS update by Mr. Yacoub, December 10, 2008, Appellant's Undertaking, Appendix 60.B, Exhibit A-109, page 11508, at page 11509).

[73] On February 16, 2009, Mr. Yacoub and Mr. Vincent sent the franchisees notice of a general meeting to be held on April 30, 2009. At the annual general meeting, the CashOnTime software was unveiled, and the franchisees were given financial statements detailing the various expenses incurred over the years. There was

also some discussion of the marketing efforts for Mail it Safe and of the decision to focus on CashOnTime. Finally, the franchisees were told that MarketX had not been incorporated and that Network would continue to act as agent (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 262 to 267 and 643; Examination of Mr. Duhamel, Transcript, February 6, 2012, Question 318; Examination of the Appellant on January 30, 2012, Questions 264, 265, 371 and 372; Examination of Mr. Duhamel, Transcript, February 6, 2012, Questions 15, 357, 362 and 363).

[74] The franchisees received the minutes of the meeting in July 2009. The minutes state: [TRANSLATION] "The current objective is to create a virtual storefront for the CashOnTime service by the end of 2009 by having MIS enter into contracts with major Canadian businesses" (Examination of Mr. Duhamel, Transcript, February 7, 2012, Questions 289 to 296; PIN – Update, July 2009, Exhibit A-22.1.36, Volume 17, page 7419).

[75] According to Mr. Duhamel, Mr. Murray's interest and participation in Prospector and MIS waned after 2007 because of his wife's illness. Mr. Duhamel discussed this situation with Richard Lange, a long-time family friend, who in 2007 introduced him to Marc Bernier (Mr. Bernier), a senior manager. Mr. Duhamel told Mr. Bernier all about Mr. Murray's lack of interest and the difficulties they were having in marketing the software. Mr. Bernier told him that he wanted to buy PIN. In March 2009, following discussions between Mr. Duhamel and Mr. Bernier, and several months after having external experts conduct an audit first, Mr. Bernier bought PIN. Mr. Duhamel stepped down as Network's president and became a consultant.

[76] According to Mr. Duhamel, Mr. Bernier chose not to go ahead with the incorporation of MarketX, and on March 15, 2009, PIN adopted a resolution whereby it assumed all the obligations entered into by MarketX (see Examination of Mr. Duhamel, Transcript, March 21, 2012, Question 85; resolutions of Prospector International Networks Inc. of March 15, 2009, regarding MarketX Services Inc., Exhibit A-80, Volume 29, page 11139).

[77] According to Kevin Klein (Mr. Klein), a South African lawyer living in Cyprus, Mr. Bernier asked him in June 2009 to review PIN's contracts. Mr. Klein testified that he had a lot of experience in franchising, having been a member of the board of directors of the Franchise Association of South Africa, which belongs to the International Franchise Association (Examination of Mr. Klein, Transcript, April 3, 2012, pages 57, 58 and 139).

[78] Mr. Klein explained that he was also asked to improve the contracts governing the relationship between MIS and PIN, a task which was completed on December 14, 2009, with the signing of the following clarification agreements:

(1) Clarification to the Option to Acquire Certain Intellectual Property Rights (Exhibit A-136, Volume 33)

(2) Clarification to the Assignment of Intellectual Property (Exhibit A-137, Volume 33)

(3) Clarification to the Intellectual Property Licence Agreement (Exhibit A-138, Volume 33).

[79] Mr. Klein also testified that he found [TRANSLATION] "confusion over roles" and that he thought it necessary to clarify that MIS's role had always been to develop and market the software in Canada alone, whereas PIN's role was to market the software abroad through its network of franchisees (Examination of Mr. Klein, Transcript, April 3, 2012, pages 65 to 68).

[80] Accordingly, Mr. Klein proposed changes to clear up some issues, particularly the following:

> (1) The marketing rights that MIS granted to PIN in countries other than Canada were <u>exclusive</u>, in that MIS could not sell abroad. These changes were designed to [TRANSLATION] "counteract a possible irregularity apparently stemming from the interpretation, be it accurate or not, or from the previous agreement, that MIS had a joint right, which could compete with the franchisees and their rights" (page 73).
>
> Examination of Mr. Klein, Transcript, April 3, 2012, pages 73, 75, 76, 80 to 82 and 87.
>
> (2) The marketing rights that MIS granted to PIN in countries other than Canada were <u>transferable</u>, [TRANSLATION] "which they had to be so that the network of franchisees could take advantage of them" (page 73). These changes reflected the fact that [TRANSLATION] "in the case of a business operated by franchise, franchisees come and go".
>
> Examination of Mr. Klein, Transcript, April 3, 2012, pages 73, 75, 77, 82, 83 and 87.

(3) The marketing rights that MIS granted to PIN covered [TRANSLATION] "everything that had been developed by MIS", so [TRANSLATION] "that it would be clear that the franchisees expected everything that had been developed by MIS . . . . In the world of IT, software isn't set in stone. It evolves. You'll have to take advantage of changes and version upgrades, and the intention was that everything that was produced would benefit the franchisees".

Examination of Mr. Klein, Transcript, April 3, 2012, pages 70 and 71.

(4) The contracts between PIN and MIS did not derogate from the franchisees' rights, since the changes expressly recognized that PIN and MIS [TRANSLATION] "did not at any time intend to withdraw or restrict the rights of Prospector franchisees or licence holders". As Mr. Klein explained, [TRANSLATION] "the reason for this was that we wanted to emphasize the fact that we wanted to maintain the franchisor-franchisee relationship, that we wanted the franchisees to be able to turn a profit on their investment".

Examination of Mr. Klein, Transcript, April 3, 2012, pages 74 and 78 to 80.

Clarification to the Assignment of Intellectual Property entered into by Prospector International Networks Inc., Prospector Network Inc. and Mail it Safe International Inc., December 14, 2009, Exhibit A-137, Volume 33, page 12015

The CRA search

[81] In October 2009, the CRA carried out a vast search at the offices of Network, MIS and Mr. Duhamel, among others.

[82] According to Mr. Klein and Mr. Duhamel, the search threw the files and records of Network and MIS into disarray; two servers were corrupted while under the CRA's control, which caused a significant number of files to be lost. The CRA also seized some cheques, and Mr. Klein had to travel to Montréal to get them back (Examination of Mr. Duhamel, Transcript, February 27, 2012, Questions 176 and 182; Examination of Mr. Klein, Transcript, April 3, 2012, pages 89 and 90).

[83] The search was very upsetting for the employees and senior management. On December 11, 2009, Mr. Yacoub resigned, and Mr. Klein was appointed director in his place. On December 14, 2009, Mr. Vincent became the interim head of operations at MIS (Examination of Mr. Vincent, Transcript, January 25, 2012, Question 233. See also the Examination of Mr. Vincent, Transcript, January 26, 2012,

Question 100; Examination of Mr. Klein, Transcript, April 3, 2012, pages 63, 64 and 100; Examination of Mr. Vincent, Transcript, January 26, 2012, Question 97).

The Association period (2009–2010)

The 2010 reorganization

[84] After the search, Mr. Bernier decided to reorganize the business to give it [TRANSLATION] "a fresh start" with a view to [TRANSLATION] "maximizing business potential" on a global scale. The firms Gowlings and Raymond Chabot Grant Thornton recommended a new structure, which was implemented in March 2010 (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 233 and 241 to 246; Examination of Mr. Vincent, Transcript, January 26, 2012, Question 100).

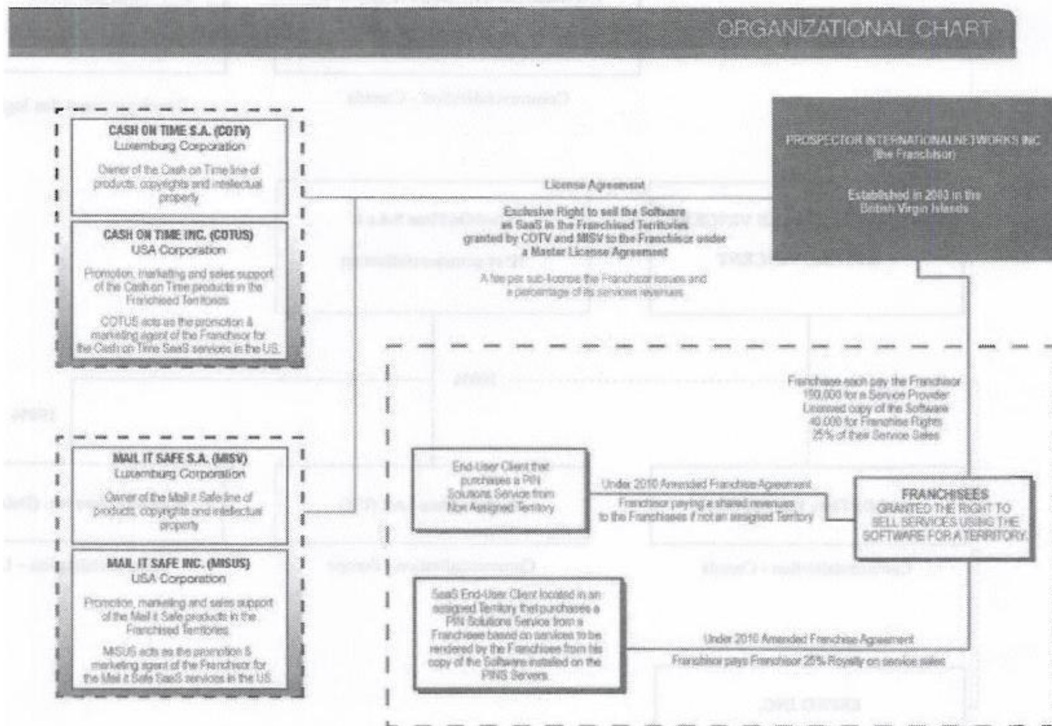
[85] Under the new structure, the intellectual property rights were held by Luxemburg-based companies, namely CashOnTime S.A.R.L. and Mail it Safe (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 248, 249 and 253; Examination of Mr. Vincent, Transcript, January 26, 2012, Questions 11 and 25).

[86] Marketing was done by subsidiaries or associates in the countries where the business activities took place: CashOnTime Inc. (Delaware), CashOnTime Ltd. (England), CashOnTime Inc. (Quebec) and Courriel Sécuritaire Inc. (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 249 and 254; Examination of Mr. Vincent, Transcript, January 26, 2012, Questions 11, 12, 19, 25 and 26).

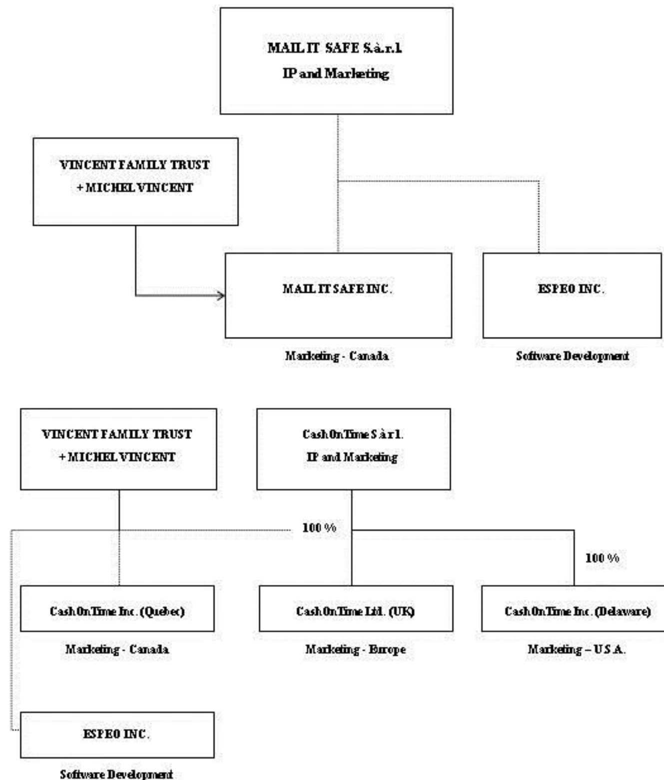
[87] Separate structures were created for Mail it Safe and CashOnTime, on the one hand, because each type of software was aimed at a distinct market, and on the other, because this made it easier to sell one or the other separately to a potential buyer (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 250 to 252).

[88] Espeo Inc. carried on with the development of the software. Espeo is a distinct company belonging to Mr. Vincent (Examination of Mr. Vincent, Transcript, January 26, 2012, Questions 12, 13 and 26).

[89] After the reorganization, the organization chart for the Prospector group of companies looked like this:



Organization chart downloaded from the intranet site of Prospector International Networks Inc., Exhibit A-42, Volume 26, page 10306.



Organization chart prepared by Mr. Vincent, Exhibit A-35, Volume 26, page 10177.

The intranet

[90] The Association des franchisés Network Prospector (the Association) was founded on March 26, 2010, to [TRANSLATION] "find sellers and buyers and to market the latest solutions . . . that have been developed". The Association was established at Mr. Bernier's request, and PIN saw to its financing through another company, Gestion Viso Inc. The Association was a non-share capital corporation incorporated under Part II of the *Companies Act*, RSQ, c. C-38. Its founders consisted of Mr. Duhamel and a number of financial planners. PIN played no part in the Association's management (Examination of Mr. Duhamel, Transcript, February 6, 2012, Question 406; Examination of Mr. Duhamel, Transcript, February 27, 2012, Questions 87, 88, 91, 95 and 96; Examination of Mr. Duhamel, Transcript, March 21, 2012, Question 125).

[91] Starting in April 2010, the franchisees were notified of the Association's creation and the fact that it would be replacing Network, and membership

applications began arriving in May 2010 (Examination of Mr. Duhamel, Transcript, February 7, 2012, Questions 85 and 86; Examination of Mr. Duhamel, Transcript, April 3, 2012, pages 164 and 166; letter from Mr. Bobby Doyon dated May 18, 2010, regarding membership in the Association, Exhibit A-111, Volume 31, page 11563).

[92] Since the Association was a non-profit corporation, it could not carry on business activities. Consequently, it tried to enter into agreements with resellers who could take care of the marketing for the franchisees. It thus entered into a contract with Onix to do marketing in the United States, beginning in New York City (Examination of Mr. Jones, Transcript, January 24, 2012, Questions 415 *et seq.*; Examination of Mr. Jones, Transcript, January 25, 2012, Question 107 (back in 2010); Examination of the Appellant, Transcript, January 30, 2012, Questions 488 to 491; Examination of Mr. Duhamel, Transcript, February 7, 2012, Questions 47, 48, 57, 69, 70, 71, 73, 83, 87, 88 and 90; Examination of Mr. Duhamel, Transcript, February 27, 2012, Questions 93 and 107; Examination of Mr. Duhamel, Transcript, April 3, 2012, pages 167 and 173; Authorized Reseller (VAR) Agreement between Association Franchise Prospector and Onix Service Inc., May 15, 2011 (Appellant's Undertakings, Appendix 58), Exhibit A-44, Volume 27, page 10652; [TRANSLATION] "List of potential clients currently being prospected by Onix Services Inc." (Appellant's Undertakings, Appendix 66), Exhibit A-45, Volume 27, pages 10653 to 10658).

[93] Onix was founded by Jeff Dana, one of Network's salespeople in Miami at the time Solutions Prospector was being marketed. He made a presentation to the Association in March 2011 to explain a marketing strategy for Mail it Safe and CashOnTime ("Onix Go to Market Strategy", March 28, 2011, Exhibit A-141, Volume 33, page 12026; Examination of Mr. Duhamel, Transcript, April 3, 2012, page 161).

[94] The franchisees were notified of the agreement with Onix by mass e-mail on April 15, 2011, and the final contract was signed on May 5, 2011 (Examination of Mr. Duhamel, Transcript, April 3, 2012, pages 158 and 159; contract between Association Franchise Prospector and Onix Services Inc., May 15, 2011 (Appellant's Undertakings, Appendix 58), Exhibit A-44, Volume 27, page 10652; e-mail from the Association des Franchisés Network Prospector to the appellant regarding [TRANSLATION] "News from the agent", April 15, 2011, Exhibit A-139, Volume 33, page 12020).

[95] The Association instructed Mr. Jones to assist Jeff Dana in his consulting work. More specifically, he helped the Association to prepare [TRANSLATION] "a

business plan on the distribution and sale of these products, particularly in New York. He also took part in efforts already under way to recruit salespeople (Examination of Mr. Jones, Transcript, January 23, 2012, Questions 414 to 427).

The 2010 general meeting

[96] The 2010 annual general meeting was held on June 15, 2010, at the Sofitel Hotel in Montréal (Examination of Dr. Ngô, Transcript, March 14, 2012, Question 548).

[97] The incorporation of the Association was announced at that meeting, and the franchisees were invited to join it online by visiting the "Franchise Information Centre" Web site. The franchisees were also given an update on the tax dispute, after which there was discussion of the marketing efforts and of the market study that had been prepared by "D". There was also a presentation on the latest version of CashOnTime, which, in the opinion of the appellant, who attended the meeting, [TRANSLATION] "had been improved . . . to target large companies" (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 629, 646 and 648; Examination of the Appellant, Transcript, January 30, 2012, Questions 388, 392 to 395, 726 and 727; Examination of Dr. Ngô, Transcript, March 14, 2012, Question 550; Examination of Mr. Duhamel, Transcript, April 3, 2012, page 162).

[98] The franchisees' committee, the formation of which had also been announced at the 2010 general meeting, consisted of seven franchisees and was responsible for following up on all general information regarding the marketing efforts and the disputes with the tax authorities (Examination of the Appellant, Transcript, January 30, 2012, Questions 396 to 410 and 420).

The new contracts

[99] In 2010, Mr. Teasdale was asked to revise the franchise agreements again. Mr. Teasdale explained that he was instructed to [TRANSLATION] "once again change the contract to reflect the reality of what was going on between the franchisor and the franchisees" (Examination of Mr. Teasdale, Transcript, January 26, 2012, Questions 427 and 449).

[100] The 2010 revisions were much broader in scope than the 2008 revisions, and the final contract was much more detailed than the previous ones. For example, appendices were added regarding franchisee territories, the list of trade marks, the

software concerned and prices (Examination of Mr. Teasdale, Transcript, January 26, 2012, Questions 434 and 444; Contract entitled PIN Franchise 2010 Version Franchise Agreement (comparative version), Exhibit A-37, Volume 26, page 10222).

[101] The new contract also added clauses regarding user licence contracts and the "Franchise Information Centre (FIC)", an intranet site hosting the operations manual and other communications between the franchisor and franchisees. In addition, the new contract contained [TRANSLATION] "rather substantial additions regarding additional obligations or services that would be provided by the franchisor, particularly in terms of promotion and advertising and the assistance that the franchisor would give the franchisees" (Examination of Mr. Teasdale, Transcript, January 26, 2012, Question 444).

[102] The 1,500 territories in the United States were redefined (Examination of Mr. Duhamel, Transcript, February 6, 2012, Questions 606 and 607; Examination of Mr. Duhamel, Transcript, February 7, 2012, Question 11).

[103] The new contracts were announced at the 2010 annual general meeting, and the franchisees were invited to approve them online through the FIC Web site. The vast majority of franchisees agreed to the proposed new contracts (Examination of the Appellant, Transcript, January 30, 2012, Questions 485 and 486; Examination of Mr. Duhamel, Transcript, February 7, 2012, Questions 3, 4 and 105).

<u>Changes to the promissory notes</u>

[104] According to Mr. Duhamel, because of the disappointing sales and the increasingly bitter dispute between the tax authorities and the franchisees, and after discussions with Mr. Duhamel and the financial planners, PIN agreed to make significant changes to the terms of the promissory notes, including the following:

(1) the interest rate was reduced to 1.75%, retroactively to 2007;

(2) the annual payments were set at $3,500, retroactively to 2007;

(3) any amount paid in a given year (that is, a period of 12 consecutive months from the date the promissory note was signed) that exceeded the interest and the amount of the principal (in this case, $1,500) due would constitute an advance payment of interest and capital that the franchisees could apply against interest and capital in a subsequent year.

As a result of these changes, each franchisee had to pay $3,500 in 2010 and 2011, including $1,500 in capital and $2,000 in interest. After 2011, they would owe nothing before the maturity date, when a final lump-sum payment became due (Examination of Mr. Duhamel, Transcript, February 7, 2012, Questions 12, 29 to 33; see also the Examination of the Appellant, Transcript, January 30, 2012, Question 516; Examination of the Appellant, Transcript, January 31, 2012, Questions 107, 109 and 110; Examination of Mr. Duhamel, Transcript, February 27, 2012, Questions 124, 133 and 139 *et seq.*).

The appellant's testimony

A. The appellant's background

[105] The appellant is an engineer and a member in good standing of the Ordre des ingénieurs du Québec. After completing a university degree in electrical engineering with a specialization in automation in 1991, he founded his own consulting business. He went on to develop software for a company called Softec. Later, he worked for Noranda, where he worked primarily in mining automation. In 2000, he accepted a position at Nortel, where he worked to ensure that all equipment was ISO 9001 compliant. In 2001, Nortel laid him off. After his layoff, he worked for CAE checking software provided by the United States Navy. In 2002–2003, he founded a business that marketed an anti-moss agent to farmers. He wound up that business in 2005.

B. The purchase of the franchise

[106] The following also emerges from the appellant's testimony.

(a) He first heard of Prospector from Claude Legault (Mr. Legault), his financial planner since the mid-1990s. Mr. Legault looked after his investments, such as his RRSP and his life insurance policy. The appellant trusted him and still does business with him.

(b) He met with Mr. Legault each year. At their 2005 meeting, Mr. Legault introduced him to the Mail it Safe software and proposed buying a franchise. The appellant declined the offer, feeling that he did not have the necessary funds, and made RRSP contributions instead.

(c) At their 2006 meeting, Mr. Legault again proposed buying a Prospector franchise. Once again, the appellant opted instead to contribute to his RRSPs.

(d) In 2007, at their annual meeting, Mr. Legault proposed for a third time that the appellant buy a Prospector franchise. This time, Mr. Legault explained that the Mail it Safe software had gained important clients, including Revenu Québec, the Barreau du Québec and its New York counterpart. In addition, Mr. Legault explained that 2007 would likely be the last year that such franchises would be offered.

(e) Mr. Legault gave him two brochures at this meeting:

(1) [TRANSLATION] "Franchise Prospector World™: 2007 Edition" (Exhibit A-3.1, Volume 1, page 59);

(2) [TRANSLATION] "Mail it Safe: 2006 Launch and 2007 Vision" (Exhibit A-3.2, Volume 1, page 101).

The brochure [TRANSLATION] "Franchise Prospector World™: 2007 Edition" was 41 pages long, approximately 6 pages of which (mostly in an appendix) discussed the tax implications. The rest of the brochure dealt with the history of PIN and Network; the partnership with IBM; the software being marketed (Solutions Prospector and Mail it Safe); the nature of the franchise (that is, the exclusive marketing rights in a given territory, the terms of payment and the payment of royalties); the marketing strategy; the 2006 valuation by Wise, Blackman; a copy of the contracts; and a summary of the contracts. The brochure [TRANSLATION] "Mail it Safe: 2006 Launch and 2007 Vision" discussed the adaptation of Mail it Safe to various platforms (Lotus Notes, BlackBerry and Mail it Safe Freedom); Network's participation in trade fairs targeting the legal market; the partnerships with organizations such as the Corporation de services du Barreau du Québec, the Greater Montréal Real Estate Board, IBM and the New York County Lawyers' Association; the valuation by Wise, Blackman; the vision for 2007; the research and development activities; and the franchisee recommendation program. There was no mention of the tax implications of the franchises.

(f) The appellant did not give an immediate answer to Mr. Legault's suggestion. He went home and, after thinking it over, contacted Mr. Legault to ask him for additional information. Mr. Legault sent him the documentation, including the contracts. The appellant explained that he read everything in full before making a decision.

(g) The appellant accepted Mr. Legault's proposal and opted to buy one single Prospector franchise in 2007 instead of contributing to his RRSPs: [TRANSLATION] "I put all my eggs in one basket" (Examination of the Appellant, Transcript, January 30, 2012, Questions 82 and 108.) He explained his reasons for buying the franchise in the following words:

> [TRANSLATION]
> [109] Q. And why did you opt to invest in Prospector?
>
> A. Well, it was a long-term investment with the expectation of getting a lot of sales and getting dividends.
>
> [110] Q. You said to be able to get dividends.
>
> A. Yes.
>
> . . .
>
> [112] Q. What were the benefits you hoped to get from this investment?
>
> A. Well, the benefits. . . Well, there was a tax component, an investment, like all the investments I had made since the beginning. There was that component. The second part, well, it was mostly to give me income in the long term; it was really a long-term investment for. . . I had an expectation that the. . . knowing the information technology field and the possibilities of Mail it Safe, I really saw a potential for sales.
>
> JUDGE:
>
> [113] Q. So, to sum up, your investment was both a long-term investment that you hoped. . . or you still hope, I don't know, will pay you dividends, and evidently, there was a tax benefit attached to this product.
>
> A. Exactly.
>
> MICHAEL H. LUBETSKY:

[114] Q. At the time, what was your assessment of Mail it Safe?

A. Well, it was an innovative product that was really in terms. . . computer security that was really a necessity. I still believe it's a truly necessary product because now, as Mr. John demonstrated, when you send an e-mail, well, it travels all over the place in the world before it gets to the recipient. To date, I think. . . we haven't heard of a major scandal in that respect, but it's just a matter of time because now that there are doctors and lawyers sending information to their clients, if the information ends up, so to speak, in the wrong hands, well, the information could be disclosed, and there could be consequences.

(Examination of the Appellant, Transcript, January 30, 2012, Questions 109, 110 and 112 to 114)

. . .

GUY DU PONT:

[420] Q. So, my colleague asked you whether this—I don't remember the exact words, but more or less—that this investment, this franchise purchase was much more than any other investment you had made before? Is that correct?

A. Yes.

[421] Q. And could you explain to the Court why you agreed to such an investment that was bigger than all the investments you had made up till now?

A. The main reason, it's really because I had. . . according to the presentation I was given on Mail-it-Safe, I really saw significant income-earning potential in terms of the long-term performance. It's really a long-term investment.

(Examination of the Appellant, Transcript, January 31, 2012, Questions 420 and 421)

(h) The purchase of the franchise was a long-term investment. The appellant added that he did not expect to make a profit in the short term. His testimony on this point is worth quoting:

[TRANSLATION]
[380] Q. Is that why you weren't worried about the slow pace of the marketing?

MICHEL LAMARRE: Leading the witness, Your Honour.

GUY DU PONT: Maybe. This time at least I'll withdraw. He's right.

[381] Q. Is that a factor you considered?

A. When I bought the franchise, yes.

[382] Q. And in your assessment of the product's performance, is that a factor you considered? There's no objection.

A. O.K., yes, in effect, it's a. . . I knew that it was a company, that it was a start-up, and that the return on investment could be long term.

(Examination of the Appellant, Transcript, January 31, 2012, Questions 380 to 382)

(i) Mr. Legault had explained to him that he could [TRANSLATION] "delegate the marketing to an agent with a team of salespeople already set up in the United States and in Montréal" (Examination of the Appellant, Transcript, January 30, 2012, Question 63; Examination of the Appellant, Transcript, January 31, 2012, Questions 220 and 228).

(j) On December 21, 2007, he signed the following four documents and then gave them to Mr. Legault:

(1) a franchise agreement (the 2007 franchise agreement), whereby he acquired the right to market Solutions Prospector, Mail it Safe and their derivative products in a designated territory ([TRANSLATION] "Contract of Sale of a Prospector World Franchise", Exhibit A-1.1.1, Volume 1, page 1);

(2) an agency and management agreement (the 2007 agency agreement), whereby he gave Network a mandate to operate his franchise for 94% of the gross revenue (section 3.1 of the [TRANSLATION] "Agency and Management Agreement", Exhibit A-1.1.3, Volume 1, page 16);

(3) a promissory note (the 2007 promissory note), whereby he undertook to pay PIN $200,000 by no later than December 15, 2012, with lump-sum interest at a rate of 7.5% per annum paid annually in advance (promissory note, Exhibit A-1.1.2, Volume 1, page 15);

(4) a cheque for $15,000 to the order of PIN for the first interest payment (cheque dated December 21, 2007, Exhibit A-2.1, Volume 1, page 54).

(k) The 2007 franchise agreement and the 2007 agency agreement were countersigned by Mr. Duhamel on behalf of Network on December 28, 2007 (Examination of the Appellant, Transcript, January 30, 2012, Questions 157 *et seq.*).

(l) When the 2007 promissory note was signed, the appellant understood that he had to pay the amount due upon maturity. He added that nobody told him otherwise. His testimony on this point is worth quoting:

> [TRANSLATION]
> [163] Q. When you signed the contract, how much money did you expect to pay Prospector International before the note's maturity date? How much money did you expect to pay before 2012?
>
> A. The amount of the promissory note, which was $200,000. But yes, I intended to pay, but I hoped to have sales to justify. . . to finance that investment.
>
> [164] Q. And what suggestions or representations did Mr. Legault or anybody else make to you to indicate that this. . . to indicate that you did not have to pay this amount?
>
> A. No representations were made to me in that regard. I had really . . . I had a debt at that time, when I signed this contract for $200,000.
>
> (Examination of the Appellant, Transcript, January 30, 2012, Questions 163 and 164; Examination of the Appellant, Transcript, January 31, 2012, Question 422)

(m) He financed the initial payment of $15,000 with a short-term loan that he later repaid with the tax refund he received a few months later (Examination of the Appellant, Transcript, January 30, 2012, Questions 170 to 176; Undertaking Number 3, contract of loan dated January 29, 2008, Exhibit I-24).

(n) In November or December 2008, Mr. Legault sent him the new contracts. He then called Mr. Legault for an explanation of the changes,

and Mr. Legault told him, among other things, that the term of the note had been extended to 10 years to better reflect the life span of the product, and that this meant the balance due had been increased to $230,000. Mr. Legault also explained to him that [TRANSLATION] "updating contracts on a regular basis was a normal practice with franchises" (Examination of the Appellant, Transcript, January 30, 2012, Questions 235 to 237 and 744; Examination of the Appellant, Transcript, January 31, 2012, Questions 233 to 251; Examination of the Appellant, Transcript, March 21, 2012, Questions 6 to 10; Undertaking 60 E, letter from Mr. Legault dated November 25, 2008, Exhibit I-30).

(o) The appellant was satisfied with Mr. Legault's explanations, and on December 19, 2008, he agreed to the changes and signed a new franchise agreement (the 2008 franchise agreement), the new agency and management agreement (the 2008 agency agreement) and a new promissory note (the 2008 promissory note) (Examination of the Appellant, Transcript, January 30, 2012, Questions 239, 241, 244 and 253; franchise agreement (including promissory note), Exhibit A-1.2.1, Volume 1, page 24; agency and management agreement, Exhibit A-1.2.2, Volume 1, page 47; 2008 promissory note, Volume 1, page 108).

(p) As was the case with the 2007 promissory note, the appellant understood, when he signed the 2008 promissory note, that he had to pay the amount due upon maturity. The appellant adds that no one told him otherwise (Examination of the Appellant, Transcript, January 31, 2012, Questions 422 and 423).

(q) On December 31, 2009, he wrote PIN a cheque for $15,000 (Examination of the Appellant, Transcript, January 30, 2012, Question 508; Examination of the Appellant, Transcript, March 21, 2012, Question 27; cheque dated December 31, 2009, Exhibit A-2.3, Volume 1, page 58).

(r) He attended the 2009 annual general meeting and the 2010 annual general meeting (Examination of the Appellant, Transcript, January 30, 2012, Questions 338, 339, 343, 345, 388 and 389).

(s) After the 2010 annual general meeting, he became a member of the franchisees' committee so that he could keep closer tabs on his investment:

> [TRANSLATION]
> [423] Q. Why did you submit your name for membership in this committee?
>
> A. Well, I wanted to keep tabs on my investment. For me, this was a lot of money, and I wanted to know exactly where it was going.
>
> (Examination of the Appellant, Transcript, January 30, 2012, Question 423)

(t) He also joined the Association (Examination of the Appellant, Transcript, January 30, 2012, Questions 440 and 441).

(u) In 2010, he was notified that a new Web portal had been set up, and he started visiting it once or twice a month (Examination of the Appellant, Transcript, January 30, 2012, Questions 622 and 627).

(v) On August 18, 2010, he agreed to the new 2010 franchise agreements by signing them electronically through the intranet site (Examination of the Appellant, Transcript, January 30, 2012, Question 485; "PIN Franchise Agreement, 2010 Version" (Appellant's Undertakings, Appendix 28), Exhibit A-41, Volume 26, page 10278; Examination of the Appellant, Transcript, March 21, 2012, Question 31).

(w) He then noticed an error in the territory assigned to him in the new contract (a territory in Idaho had been given to him instead of his territory in New York), so he asked Mr. Duhamel to correct it.

> [TRANSLATION]
> [102] Q. Could you explain to the Court why the list, the territory appearing on page 10,302 mentions the state of Idaho and why the list on page 10,660 (*sic*) talks about New York?
>
> A. Yes. When the franchisor, Mr. Bernier, redid the territories in 2010 in a way that was, as I said, more scientific, with Deloitte, at that time, there were, in his view, the territories all had the same weight. So, he made changes, and some kept the same territories while others had their territories changed. He also mentioned to everyone at the 2010 meeting that if anyone wanted a different territory for whatever reason, all they had to do was send in the information, and then he could do it because, as I was saying, it had

been done much more scientifically so that each of the territories had the same weight. When I say weight, it's. . . we're still talking about potential, and when I myself talked to Mr. Drouin, well, I must admit that I don't remember whether it was Mr. Drouin who told, who told me that he had Idaho instead of New York or whether I was the one who mentioned it. I'm a bit confused. It's been. . . it was in 2010, and at that time, what was said with. . . in the conversation I had with Mr. Drouin, in the end, it was why he wasn't keeping the same territory he had in New York, and I simply called the franchisor and asked if he could have his old territory back. Even if it's the same weight, Idaho is worth the same as New York, but at that time, the franchisor just gave the New York territory back.

[103] Q. But did you. . . could you tell the Court whether you have personal knowledge of these facts?

A. Absolutely, I was the one. . . I was the one who brought them together and asked.

(Examination of Mr. Duhamel, Transcript, February 7, 2012, Questions 102 and 103. See also the Examination of the Appellant, Transcript, January 30, 2012, Questions 495 to 504; Examination of Mr. Duhamel, Transcript, February 7, 2012, Question 102; Examination of Mr. Duhamel, Transcript, February 8, 2012, Question 398).

(x) In 2010, he paid PIN $3,500, an amount which took into account PIN's retroactive interest reduction (Examination of the Appellant, Transcript, March 21, 2012, Questions 36 and 42 to 44; change to the agreement, Exhibit I-43).

The appellant's original tax returns for 2007, 2008 and 2009 do not reflect the changes brought in by the 2008 franchise agreement and the 2010 franchise agreement. For example, in the tax returns for 2008 and 2009, the appellant claimed $15,000 in interest charges even though the 2008 contract and the 2010 contract did not allow such deductions. By the time of trial, the appellant had still not amended his tax returns. The appellant's explanations for this and as to what he understood to be his financial obligations under the 2008 contract and the 2010 contract were nebulous, to say the least, and contradictory at times. For example, the appellant testified that the $3,500 payments in 2010 and 2011 were interest payments (see Examination of the Appellant, Transcript, January 30, 2012, from page 128, line 18, to page 129, line 2). This statement is contradicted by Exhibit I-29, which shows that the $3,500 includes capital and interest.

(y) Despite the disappointing return on investment to date, he still believes in the future of his franchise and its future commercial success (Examination of the Appellant, Transcript, January 30, 2012, Questions 652 to 655).

(z) He is not surprised that his franchise has not made any sales yet, as his experience in the field has made him well aware that marketing innovations take time:

> [TRANSLATION]
> [376] Q. And what are the consequences of the fact that this takes a lot of effort?
>
> A. The consequences are that to enter a market in these situations, given that it's a company that you call. . . what you call a start-up, well, it takes an enormous amount of effort, time and resources to successfully enter a new market. You're talking, on average, you're talking between three and five years before successfully entering a new market.
>
> [377] Q. And for the period until the entry is made, what impact does it have on the product's sales?
>
> A. In general, there are very few sales until then. What you try to look for, it's really major clients who are going to let us have letters of reference.
>
> [378] Q. But did this situation come as a surprise to you?
>
> A. No, it was a normal situation for the field.
>
> [379] Q. Were you familiar with this field?
>
> A. I've been working in information technology, software development, validation, verification and project management for 20 years now.
>
> (Examination of the Appellant, Transcript, January 31, 2012, Questions 376 to 379.)

Similar fact evidence

A. Similar fact witnesses

[107] I note that, in its order dated February 27, 2012, the Court rejected the appellant's objection and authorized the respondent to adduce similar fact evidence. The Court heard the testimony of five other taxpayers (the franchisee witnesses), called by the respondent to testify on their acquisition of licences or franchises from Prospector, namely:

(a) Marc Ghanoum, Nephrologist (Dr. Ghanoum);
(b) Gino Villeneuve, Optometrist (Dr. Villeneuve);
(c) Christian Thibault, Orthodontist and Dental Implant Specialist (Dr. Thibault);
(d) Van-Khai Ngô, Dentist (Dr. Ngô);
(e) Dave Rioux, Dental Specialist in Oral Surgery (Dr. Rioux).

[108] The respondent also subpoenaed two financial planners, Pascale Cauchi (Ms. Cauchi) and Charles Godbout (Mr. Godbout), to testify on the activities promoting the licences and franchises. Ms. Cauchi did not testify. With the authorization of the Court, the parties agreed to simply file the transcript of the examination of Ms. Cauchi by Gaétan Paul of the Autorité des marchés financiers rather than have her testify before the Court (see Exhibit I−47).

[109] The respondent subpoenaed these witnesses because she was satisfied that their evidence would increase the likelihood that the agency agreements and the promissory notes signed by the appellant were shams since, according to the respondent, the franchisee witnesses had participated in identical transactions to those of the appellant. In my opinion, a great deal of care and caution must be used when examining this evidence, since all the franchisee witnesses became licensees or franchisees before 2007. The testimony of Dr. Ghanoum reveals, for example, that he acquired two licences in 2003, one licence in 2004, three franchises in 2006 and two franchises in 2007. Dr. Rioux testified that he acquired two licences in 2003, three franchises in 2006 and three franchises in 2007. Dr Ngô stated that he acquired one licence in 2003, one franchise in 2006 and three franchises in 2007. Dr. Villeneuve testified that he acquired one franchise in 2005 and another in 2007. Lastly, Dr. Thibault testified that he acquired one franchise in 2005, another in 2006, and two further franchises in 2007. Another reason for exercising a great deal of caution when analyzing this evidence is that the appellant did not have the same advisor as the franchisee witnesses.

[110] It would be unwise, in my view, to conclude that the examinations of Ms. Cauchi and Doctors Villeneuve, Thibault, Ngô and Rioux by the AMF support the respondent's new position that the actual cost of the franchises, specifically those acquired in 2007, was $45,000 (the new position). In fact, the CRA's questions about the costs of the licences and the franchises did not distinguish between the periods before and after 2007. The vagueness of the AMF's questions could, in my opinion, only lead to answers from which it is difficult to draw any conclusions whatsoever.

[111] The testimonies of the franchisee witnesses reveal the following:

(i) The franchisees did not know the appellant and had not done business with Mr. Legault.

(ii) They had heard about Prospector from Ms. Cauchi whom they trusted and who is still their financial advisor. They explained that Ms. Cauchi described Prospector to them as an investment—which was structured to give tax benefits—in a computer company marketing new, innovative software with long-term growth potential.

(iii) They acquired their franchise licences in order to earn an income.

(iv) They employed an agent to operate their franchises.

(v) In 2007, they acquired new franchises using full recourse promissory notes. Each of the franchisee witnesses explained that he had understood that he had to pay the full balance stated on the promissory note at maturity and that he could no longer simply reassign the franchise.

(vi) In 2008, they had signed new agreements, which, among other things, increased the amount owing to $230,000, in consideration for an extension of the term and a reduction in the interest rate.

(vii) They were not told that they did not have to pay all of the amounts indicated on the promissory notes, be that in 2007 or in 2008.

(viii) Their debt was not insignificant. However, each of them explained that they found that the risk was offset by the tax benefits offered by the franchise and the royalties they expected to make from the franchise.

Their testimony also reveals that they had high incomes and other safer investments.

(ix) They themselves had used Mail it Safe.

(x) They had attended several annual meetings (except for Dr. Ngô, who had attended only one because of his many obligations).

(xi) They had received communications and letters regarding Prospector by e-mail or mail and had read them.

(xii) They were also aware of the partnerships that Network had entered into and the sales it had made.

(xiii) Except for Dr. Thibault, who went bankrupt, they continued to believe that Mail it Safe and CashOnTime had real potential and to hope not only that these programs would sell, but also that a major company would want to buy the technology and the rights to market it.

(xiv) With the exception of their involvement in Prospector, the CRA had almost never challenged their income tax returns.

[112] I must also point out that the testimonies of the franchisee witnesses regarding the following issues were confusing and incomprehensible, to say the least:

(i) the changes to their franchises and licences prior to 2007 and the resulting financial obligations;

(ii) the agreements signed in 2008 and the resulting financial obligations;

(iii) the retroactive agreement of 2010 and the resulting financial obligations.

Very often, their testimonies contradicted the agreements. In addition, the franchisee witnesses were not able to explain why their income tax returns did not reflect their obligations under these agreements. However, must one therefore conclude that the franchisee witnesses perjured themselves when they testified that they had to pay in full the amounts indicated on the 2007 and 2008 promissory notes at maturity? All that confusion and vagueness in their testimonies and the contradictions between their testimonies and the

agreements and their income tax returns can all, in my opinion, be explained by the following facts:

(i) Many complex changes, negotiated not by them but by Ms. Cauchi, were made to the franchisees' financial obligations. The franchisee witnesses testified that they had not read the agreements Ms. Cauchi had negotiated for them. Since they trusted Ms. Cauchi blindly, they signed the agreements she presented them with after briefly explaining to them the nature of the documents and the franchisees' rights and obligations. It is my opinion that the respondent should have subpoenaed Ms. Cauchi to testify. Her testimony would certainly have made it possible to elucidate all of the inaccuracies and contradictions and thus to properly assess the credibility of the franchisee witnesses.

(ii) The structural changes and conversions dated back several years.

(iii) The witnesses never examined their income tax returns, specifically the Statement of Business or Professional Activities (T2125). The franchisee witnesses explained that, in any event, they were not qualified to determine whether they were correct. They also explained that the information in the Statement of Business or Professional Activities had been sent directly by Ms. Cauchi to their accountants, who prepared their income tax returns. Again, it would have been extremely interesting to hear Ms. Cauchi and the accountants in question testify on this matter. Their testimonies would certainly have made it possible to clarify the reason why the Statements of Business or Professional Activities did not reflect the franchisee witnesses' contractual obligations.

(iv) They frequently failed to understand the meaning of the questions they were asked, partly because they confused the meaning of [TRANSLATION] "costs" and [TRANSLATION] "disbursements".

[113] For all of these reasons, it is my view that this evidence does not increase the likelihood that the agency agreements and the promissory notes signed by the appellant are shams. The franchisee witnesses have satisfied me of what is important to know: they undertook to pay at maturity the amounts indicated on the 2007 and 2008 promissory notes. This is especially true in Dr. Thibault's case. In fact, it can hardly be said that Dr. Thibault's testimony is self-serving, since Dr. Thibault has no interest in the current proceeding given his bankruptcy.

[114] The respondent essentially submits that the testimony of Ms. Cauchi confirms her new position (new in that the CRA's pleadings contain nothing in this respect) that the appellant's first three payments (3 x $15,000) were not interest but the actual, total price of the investment as agreed by the parties. The respondent draws this conclusion from the testimony of Ms. Cauchi (Court Reporter's Notes, November 28, 2008, Ms. Cauchi, from page 22, line 20, to page 23, and page 28, lines 10 to 25), where she states that the costs related to the acquisition of a franchise [TRANSLATION] "amount to three (3) times fifteen thousand dollars ($15,000)"; and also from the evidence purportedly showing that none of the terms and conditions of the agreements or of the promissory notes of 2004 to 2008 confirm the payments described by Ms. Cauchi.

[115] The respondent erroneously drew this conclusion from the testimony. First, the CRA erroneously alleged that none of the agreements provided for a $15,000 reimbursement over three years. In fact, these are the terms of the 2006 agreement; see the limited recourse promissory note at Exhibit A−27, Volume 28, page 11077, (page 11121)). The excerpts from the testimony to which the respondent refers to support her new position may relate to 2006. In my view, it is extremely difficult to draw any conclusions from the testimony since the AMF's questions did not distinguish between the period before and the period after 2007. At pages 22 and 28 of her testimony, Ms. Cauchi is probably referring to the pre-2007 agreements, while at page 40, she is referring to a post-2007 franchise. In my opinion, the CRA cannot take advantage of replies to vague questions that led to testimony that is confusing to say the least. Only Ms. Cauchi's testimony would have helped elucidate all of the ambiguities, if indeed there are any. Unfortunately, the respondent did not subpoena Ms. Cauchi to testify.

[116] Mr. Godbout is a tax expert who has worked for Ms. Cauchi since 2006. In support of her new position, the respondent entered into evidence during the cross-examination of Mr. Godbout a letter he had sent to Chantale Laliberté of the Canadian Imperial Bank of Commerce (Exhibit I-55), which concerned the 2007 franchises. In cross-examination, Mr. Godbout was referred to the following excerpt from the letter: [TRANSLATION] "Investors will have to disburse three times $15,000 over three years. After that, the matter is settled." Mr. Godbout explained in cross-examination that he had realized a few days before testifying that there was a mistake in this letter: he had [TRANSLATION] "mixed up" the conditions of the 2005 and 2006 franchise agreements with those of the 2007 agreement (Court Reporter's Notes, March 15, 2012, Mr. Godbout, page 191, lines 18 to 22). Mr. Godbout explained that he believed that, under the 2005 and 2006 agreements, it was enough to make three

$15,000 payments for the franchises since the promissory notes were limited recourse ones (Court Reporter's Notes, March 15, 2012, Mr. Godbout, page 197, lines 10 to 25). The respondent submits that Mr. Godbout's explanations to justify his mistake (according to which the letter to Ms. Laliberté set out the conditions of the 2005 and 2006 franchise agreements) are not credible since they contradict the terms of these agreements. Indeed, the respondent submits that none of the 2005 and 2006 agreements provided for $15,000 reimbursements over three years, even though these are the terms of the 2006 agreement, with a limited recourse promissory note, as they appear in Exhibit A‑72, Volume 28, page 11077 (page 11121). Even though the 2006 agreements provided for $15,000 reimbursements over three years with limited recourse promissory notes, when cross-examined about the terms of the 2006 franchise agreement, Mr. Godbout recognized that his explanation for the errors in his letter to Ms. Laliberté was incorrect. This clearly shows that Mr. Godbout confused the agreements of before and after 2006 while being cross-examined (as, indeed, most of the franchisee witnesses did, and that he did so despite being a tax expert) and that, consequently, it cannot be concluded from this confusion that his explanations for his error in the letter to Ms. Laliberté are not credible. Ultimately, it would be inappropriate, in my opinion, to conclude that this testimony increases the likelihood that the promissory notes and the agency agreements signed by the appellant were shams.

<u>Mr. Beaulieu</u>

[117] From the testimony of Michel Beaulieu (Mr. Beaulieu), a chartered accountant with no interest in the present proceeding, I essentially gather that he did not want to convert his 2005 franchise into a 2007 franchise because he did not want to sign a full recourse promissory note. Mr. Beaulieu's explanations in this regard are worth quoting:

> [TRANSLATION]
>
> [394] Q. Explain why to the Court.
>
> R. The 2007 franchise was a franchise with a full recourse promissory note, so I decided that I wasn't going to get involved. I have assets now; when one is fifty (50) years old, one has assets, and one doesn't want to lose those assets. So, I said to myself that a full recourse promissory note meant that even if Prospector didn't work out, I would have owed some two hundred thousand (250,000) dollars. That was one of the reasons, in fact, it's not, it was the reason why I decided to get out.

Examination of Mr. Beaulieu, Transcript, March 15, 2012, Question 414.

Testimony of Mr. Ouellet

Education and work experience

[118] Mr. Ouellet, the appellant's expert witness, holds a Master's degree in Business Administration (MBA) with a specialization in international marketing from Laval University, a Ph.D. in Management Sciences (Marketing) from the Université Pierre-Mendès-France in Grenoble, and a post-doctoral degree in Innovation Management from the M.I.T. Center for Innovation in Product Development in Boston. He has been a lecturer in marketing at HEC Montréal since 2004 and an associate professor since 2008. He has also collaborated in the international MBA and Doctor of Business Administration programs of various European universities. His research and teaching focuses on product and innovation management, brand management, business-to-business marketing and direct and database marketing. He is the co-author of a university textbook on marketing, and his research has been widely published.

[119] Since 2003, Mr. Ouellet has been working as a marketing consultant for companies of various sizes, particularly start-up companies. He is also the academic associate of a marketing research firm. He has worked as a corporate speaker and trainer for various companies and organizations, and currently hosts a business show. He has received many prizes, grants and awards.

[120] In the past, he has worked as the assistant director of marketing and then director of a Quebec company. For this company, he has developed a network of distributors and resellers in several countries, in addition to forming and supervising a team of representatives and marketing support personnel. He has also acted as the national spokesperson of two well-known corporations (eBay Canada and Doritos).

[121] The appellant asked Mr. Ouellet to assess the commercial viability of a company in respect of (a) the Solutions Prospector, Mail it Safe and CashOnTime products; (b) the franchisee's marketing of these products as "Software as a Service" ("logiciel-service"); and (c) the franchisee's operating the franchise through an agent. Mr. Ouellet's team, composed of himself and two researchers, reviewed the pleadings, the documentary evidence of both parties and the transcripts of the examinations for discovery of the appellant and the CRA auditor; it also met with members of Prospector, the franchisee association and the law firm representing the

appellant. In the light of these documents and of management studies, Mr. Ouellet concluded that a company belonging to a Prospector franchisee is realistic and commercially viable.

Commercial viability of Prospector products

[122] First, it appears from Mr. Ouellet's highly convincing, enlightening and credible testimony that the three Prospector products are [TRANSLATION] "real, functional" products the benefits of which meet actual needs in their target markets. According to Mr. Ouellet, the benefits of Mail it Safe address data confidentiality and protection issues, which, according to studies, are serious concerns, particularly in the health sector. He also explained that CashOnTime, in automating the debt collection procedure, is designed to resolve companies' cash flow problems. He added that, in his opinion, Solutions Prospector met the tracking challenges of a web-based marketing campaign, which continue to be a major challenge for any direct marketing company on the Internet. He concluded that the products were commercially viable in that they had market potential and offered an attractive return on investment.

Commercial viability of Software as a Service

[123] Mr. Ouellet is of the view that the manner in which Prospector products are being run, that is, as Software as a Service, is also commercially viable and promising. However, it makes the marketing of Prospector products more complex and their adoption by potential clients slower.

[124] According to Mr. Ouellet, Software as a Service has significant benefits. Users do not have to install the software on their own servers or computers, or to maintain or operate it, meaning lower software acquisition and adoption costs, as well as quicker implementation and greater flexibility. However, potential users of Software as a Service are reluctant to use this technology mainly because of risks related to data security, the integration of this way of operating with other software programs used by the company, and costs, which may be higher, particularly for larger companies. These concerns mean that it takes a considerably long time for users to decide to use Software as a Service.

[125] Furthermore, Mr. Ouellet is of the view that, in sectors such as debt management, client relations management and e-mail monitoring, current standards and practices are not entirely compatible with the use of Software as a Service. Software as a Service is therefore a radical innovation in these particular sectors. In

contrast to ongoing innovations, radical innovations create their own product category by meeting latent needs in an unexpected or novel manner. Even though this type of innovation generally translates into a distinct, long-term competitive advantage and a substantial return on investment, its marketing presents difficulties. Indeed, considerable time (between 6 and 10 years, or even as much as 12) is required for users to adopt such a product for the long term. In addition, the ability and know-how to market such products are key factors, but few companies and professionals are specialized in this type of marketing. The risk linked to introducing a radical innovation on the market is also higher. Decades can go by before a highly innovative company makes any sales.

[126] Mr. Ouellet also explained that the process for marketing an innovation entails several stages, which any normal company has to go through and on which it has to spend time. Depending on the context, a company may have to undertake certain strategic steps. It may, for example, have to build a business storefront before even launching its sales and marketing activities. In the case of a strategic repositioning, the logical step for a business could be to go as far as suspending its sales activities to concentrate on market segmentation and positioning.

[127] According to Mr. Ouellet, Software as a Service is starting to become a trend. The Software as a Service market is growing in the United States, Asia and Europe. Major companies are turning to this way of operating. Studies see the move towards [TRANSLATION] "cloud" computing, which Software as a Service is a part of, as [TRANSLATION] "the biggest change organizations have had to adapt to since computers entered the workplace 20 years ago". Running Software as a Service is therefore viable and promising, but, since it is a radical innovation, the marketing of this technology is complex and slow.

Responsibility of operating the franchise

[128] Lastly, Mr. Ouellet finds that the appellant made the right business decision in tasking a specialized agent with operating his franchise, given his limited resources. Giving similar mandates to the same agent also contributed to achieving maximum economic benefits.

[129] According to Mr. Ouellet, franchising is a [TRANSLATION] "relatively popular" business approach that is becoming increasingly important and that offers significant organizational benefits, in particular for companies targeting new [TRANSLATION] "niches" or wishing to grow. It is a structure that is often used in the technology sector.

[130] According to Mr. Ouellet, franchisors have obligations towards franchisees. They have to carry out communications and marketing activities and provide franchisees with the necessary sales material, which should include virtual storefronts in the case of software. Indeed, in the field of software marketing, developing storefronts, that is, authority sites to show other clients the benefits of the products being marketed, is highly recommended.

[131] Mr. Ouellet also explained that even though the classic franchising model involved entrepreneur-franchisees operating their franchises themselves, franchisors are more flexible towards franchisees wishing to be involved only part-time. Different forms of allocating work are used nowadays. Franchisees can use a third party or companies or professionals that have a relationship with the franchisors.

[132] To sum up, Mr. Ouellet has satisfied me of the following:

(a) The software in question are real, functional products that meet real needs in the target markets and that have market potential and offer an attractive return on investment.

(b) The operating mode, built on the Software as a Service model, is a radical, avant-garde innovation that has gained in popularity.

(c) The operating mode, built on the Software as a Service model, offers a greater potential return even if its novelty initially caused significant marketing difficulties that contributed to delaying its launch.

<u>Analysis and conclusion</u>

<u>Preliminary objection – the reassessment is invalid and does not impose a burden on the appellant</u>

[133] I will now deal with the appellant's preliminary objection according to which the reassessment is invalid and does not impose a burden on him.

[134] On August 27, 2009, the CRA made a reassessment whereby it disallowed the $85,873.33 in deductions claimed by the appellant in respect of capital cost allowance, eligible capital property and interest with regard to the purchase of a franchise authorizing him to market the software.

[135] The appellant objected to the reassessment on October 28, 2009, and filed an appeal before this Court on December 21, 2010, before the Minister of National Revenue (the Minister) confirmed the reassessment. The appellant submits that, on this date, the CRA had not informed him of the assumptions of fact and law on which it relied to make the reassessment.

[136] The respondent filed the Reply to the Notice of Appeal on March 14, 2011. At paragraph 25 of the Reply, the Respondent sets out the facts it assumed to determine the tax payable; paragraph 26 contains other facts relevant to the appeal.

[137] The appellant submits that the failure to disclose the assumptions should render the reassessment invalid. In the alternative, he submits that the burden to prove the undisclosed assumptions is on the respondent.

[138] The appellant bases his submissions on *Johnston v. M.N.R.*, [1948] S.C.R 486, and on the basic rules of fairness, which, in his opinion, oblige the CRA to disclose the assumptions of fact and law on which it relies before or at the time of making an assessment. In his opinion, that is what emerges from the following excerpt from *Johnston*:

> Notwithstanding that it is spoken of in section 63(2) as an action ready for trial or hearing, the proceeding is an appeal from the taxation; and since the taxation is on the basis of certain facts and certain provisions of law either those facts or the application of the law is challenged. Every such fact found or assumed by the assessor or the Minister must then be accepted as it was dealt with by these persons unless questioned by the appellant.
>
> . . . The allegations necessary to the appeal depend upon the construction of the statute and its application to the facts and the pleadings are to facilitate the determination of the issues. It must, of course, be assumed that the Crown, as is its duty, has fully disclosed to the taxpayer the precise findings of fact and rulings of law which have given rise to the controversy.

[139] The appellant submits that, at the very least, if the CRA fails to disclose certain assumptions that it then reveals in its pleadings, the burden of proof is on the CRA. That principle was confirmed in *Hsu v. The Queen*, 2001 FCA 240, which the appellant cites in the following excerpt:

> . . . the Minister is obliged to disclose the precise basis upon which it has been formulated (*Johnston v. M.N.R.* (1948), 3 D.T.C. 1182 at 1183 (S.C.C.)). Otherwise, the taxpayer would be unable to discharge his or her initial onus of demolishing the "exact assumptions made by the Minister but no more" (*Hickman Motors Ltd. v. The Queen* (1997), 97 D.T.C. 5363 at 5376 (S.C.C.)).

[140] In the case at bar, the appellant submits that the assumptions were not disclosed: neither the reassessment nor the letter dated July 6, 2009, accompanying the draft assessment contained any explanations that revealed any assumption whatsoever.

[141] The appellant alleges that the reassessment therefore has no basis. He submits that since the CRA must disclose all the assumptions of fact and law on which it relies before making a reassessment, if the CRA had established any assumptions, it would have disclosed them.

[142] The appellant submits moreover that there is an overlap between the facts the Minister [TRANSLATION] "assumed" (paragraph 25 of the Reply) at the time of the reassessment and the [TRANSLATION] "other relevant facts" (paragraph 26 of the Reply), for which the onus rests on the CRA. According to the appellant, that overlap makes it impossible to distinguish the facts that the CRA intends to prove from those the CRA allegedly assumed when making the reassessment. He submits that the overlap merely confirms his position that the CRA did not make any assumptions in support of the reassessment and that the reassessment therefore has no basis. In addition, and in the alternative, the appellant submits that overlapping assumptions in the Reply are facts for which the burden of proof is on the CRA.

[143] Lastly, the appellant submits that the absence of assumptions is aggravated by the admissions of Carole Bartolini, the team leader tasked with supervising the two CRA auditors who audited the appellant's company. Ms. Bartolini testified that she had been obliged to follow the instructions from management with regard to [TRANSLATION] "Project Prospector", in which the appellant was involved. According to the appellant, these instructions rendered the [TRANSLATION] "audit" illusory and meaningless: the CRA gave the impression of wanting to have a real dialogue with the appellant, even though it was actually following the steps imposed by management without questioning their relevance. The CRA therefore failed to respect its duty to verify the facts and to apply the applicable legislation before making an assessment. According to the appellant, this merely supports his position that the CRA did not make any assumptions of fact or of law in support of the reassessment and that the reassessment should therefore be invalid.

Respondent's position (see Transcript, May 9, 2012, at pages 360 and following)

[144] Relying on the Federal Court of Appeal's decision in *Orly Automobiles Inc. v. Canada*, 2005 FCA 425, the respondent submits that the CRA does not have to disclose the basis for a reassessment at a particular point in time.

[145] The respondent adds that the facts on which the CRA relied to make the reassessment can be found in the audit report (Exhibit I-60) (the Report). The respondent also submits that the Notice of Appeal reveals that the appellant was aware of the issue, namely, whether the appellant had carried on a business, and that he can therefore not pretend to have been taken by surprise.

[146] Furthermore, relying on the Federal Court of Appeal's decision in *Main Rehabilitation Co. v. Canada*, 2004 FCA 403, the respondent argues that the CRA's actions and conduct during an audit should not be taken into consideration on appeal.

[147] I note that the respondent did not make any statements regarding the burden of proof, counsel for the respondent simply stating at the hearing that, in any case, he had established the facts underlying his arguments.

[148] Since the respondent submitted, among other things, that the basis for the assessment is in the Report and the appellant objected to the Report being entered into evidence, I will first look at the merit of this objection.

[149] In his written submissions, the appellant argues that he was not provided with the Report at the time of the reassessment and that it was also not part of the documents disclosed by the CRA in its list of documents under section 81 of the *Tax Court of Canada Rules (General Procedure)* (the Rules) on June 6, 2011. The Report was not disclosed to the appellant until September 15, 2011, at his request. The appellant states that he obtained the redacted Report on February 21, 2011, in response to an access to information request.

[150] The appellant further submits that Normand Desjardins (a CRA representative) expressly stated in the examination for discovery that the assumptions on which the reassessment was based were listed in the Reply. According to the appellant, this statement is a judicial admission binding the CRA, as acknowledged by the Court in paragraph 12 of *Drouin c. La Reine*, 2011 CCI 519 [not translated]. In the appellant's

view, therefore, if the Report reiterates the facts and the analyses appearing in the Reply, it is superfluous and of no relevance to the Court.

[151] The appellant further submits that since the facts and the analyses appearing in the Report are not referred to in the pleadings, it would be perverse for the CRA to attempt to prove them. In his opinion, over a third of the Report concerns the issue whether the appellant's franchise was a [TRANSLATION] "tax shelter". Yet in *Drouin c. La Reine*, 2011 CCI 519 (specifically paragraphs 29 and 30), the Court rejected the CRA's attempt to amend the Reply in order to include arguments regarding the tax shelter, ruling that this would be an abuse of process. The appellant adds that if is was abusive on the part of the CRA to add [TRANSLATION] "tax shelter" allegations to its Reply the day before the hearing, *a fortiori*, it is absolutely intolerable that the CRA is seeking to introduce into evidence what is essentially an argument on the same subject at the close of the evidence.

[152] The appellant adds that, on six occasions, the Report refers to the conclusions of a valuation of a franchise allegedly performed by the CRA's valuations section. Yet this valuation does not appear in the CRA's list of documents on which it relied. Moreover, when, during Ms. Bartolini's testimony, the CRA sought to adduce the valuation, the appellant objected on the ground that it was expert testimony. During the examination for discovery, the CRA allegedly admitted that the decision not to adduce this valuation as expert testimony was intentional and strategic. The appellant adds that the respondent cannot now seek to adduce the Report, which reiterates the conclusions of the valuation on six occasions and thus prove indirectly what it could not do and waived to do directly. In that regard, I note that when the appellant objected to the filing of this valuation at the hearing, the respondent withdrew its request.

[153] Moreover, according to the appellant, the respondent is seeking to file a valuation through Ms. Bartolini rather than its author, a procedure the Court held unacceptable in *Drouin c. La Reine*, 2012 CCI 94 [not translated], when it rejected Denys Goulet's expert testimony.

[154] Lastly, the appellant submits that the CRA cannot file into evidence for historical purposes the auditor's Report given that he himself filed the two Wise, Blackman reports, on the following grounds: (a) in contrast to the Report, the two reports he filed appear in the appellant's list of documents; (b) contrary to the respondent, the appellant had given the notices required under section 145 of the Rules in a timely manner; (c) contrary to the respondent, the appellant had not made

any judicial admissions rendering these reports superfluous; and (d) the two reports were of real historical interest, contrary to the respondent's Report.

[155] In sum, according to the appellant, by seeking to adduce the Report, the CRA is attempting to do indirectly what the Court expressly prohibited the respondent to do directly, in addition to attempting to encumber the record with clearly irrelevant allegations without reasonable notice to the appellant.

[156] The respondent's position is that it is entitled to adduce this document into evidence under section 89 of the Rules. It submits that it is section 89 rather than section 81 that governs the admissibility of documents. The respondent argues that a document "produced by one of the parties, or some person being examined on behalf of one of the parties, at the examination for discovery" (paragraph 89(1)(*b*)) can be filed in the same way as a document referred to in a party's list of documents (paragraph 89(1)(*a*)).

[157] Moreover, the respondent submits that the principle underlying sections 81 and 89 of the Rules is the parties' disclosing the documents they wish to file. The Report was disclosed to the appellant on two occasions, first, on February 21, 2011, in a redacted version, in reply to a request for access to information, and again, on September 15, 2011, in reply to the respondent's undertakings. The principle of pre-trial disclosure has therefore been respected.

[158] In reply to the appellant's arguments, the respondent adds that the purpose of filing the Report is to rebut the appellant's allegations that the CRA did not make any assumptions of fact and law in support of the reassessment. The Report is therefore entirely relevant and admissible evidence, and there are no grounds for excluding it.

[159] I disagree with the majority of the appellant's arguments. The fact that during the examination for discovery, Mr. Desjardins recognized that the basis for the reassessment could be found in the Reply does not change the fact that the issue here is whether the Crown relied on the facts at paragraph 25 of the Reply to make the assessment. The auditor's draft is therefore relevant. It is also true that most of the Report deals with tax shelters, an argument that was not raised in the pleadings and that the respondent unsuccessfully attempted to add to the Reply. Since the respondent is not seeking to prove the tax shelter argument and the Report is relevant for determining whether the facts in the Reply are the true basis for the reassessment, the Report should be admissible. There is no question here of adducing an evaluation indirectly.

[160] In my opinion, the only issue here is whether the failure to include the document in the list of documents is fatal to the respondent. In other words, does section 89 of the Rules allow one party to file a document that one of its witnesses filed in reply to the undertakings taken during the examination for discovery?

[161] It is useful here to reproduce section 89:

> 89. (1) Unless the Court otherwise directs, except with the consent in writing of the other party or where discovery of documents has been waived by the other party, no document shall be used in evidence by a party unless
>
> > (*a*) reference to it appears in the pleadings, or in a list or an affidavit filed and served by a party to the proceeding,
> >
> > (*b*) it has been produced by one of the parties, or some person being examined on behalf of one of the parties, at the examination for discovery, or
> >
> > (*c*) it has been produced by a witness who is not, in the opinion of the Court, under the control of the party.
>
> (2) Unless the Court otherwise directs, subsection (1) does not apply to a document that is used solely as a foundation for or as part of a question in cross-examination or re-examination.

[162] The respondent did not provide any case in support of its arguments. I did not find any case that specifically discussed the application of paragraph 89(1)(*b*) of the Rules. The case law most often deals with subsection 89(2) of the Rules, which concerns cross-examinations: *Morency v. Canada*, [1998] 2 C.T.C. 2024, *Scavuzzo v. The Queen*, 2004 TCC 806, *Large v. The Queen*, 2006 TCC 509. However, in these three cases, the judges had reservations about the exception to the principle of pre-trial disclosure. In *Sydney Mines Fireman's Club*, 2011 TCC 403, Justice Campbell exercised her discretion under subsections 98(1) and 89(1) of the Rules to allow the filing of documents that were found and disclosed to the opposing party a few days before the hearing.

[163] In other cases, judges have preferred not to allow the filing of documents that did not appear on the list of documents: *Walsh v. The Queen*, 2009 TCC 557, and *Savoy v. The Queen*, 2011 TCC 35. In both of these cases, however, pre-trial disclosure of documents had not been at issue, and it therefore seems that the filing

was entirely subject to the judge's discretion, within the meaning of subsection 89(1) of the Rules.

[164] In *Savoy*, *supra*, Justice Hershfield wrote the following in a footnote (No. 6):

> . . . Nothing in section 89 of the *Tax Court of Canada Rules (General Procedure)* dealing with the admission of documents is permissive of an undisclosed document being allowed short of a direction of the Court to allow it. . . .

[165] I doubt that this comment applies in situations such as this one, covered by paragraphs (*a*), (*b*) and (*c*). The wording of the provision is clear, and the filing of the Report should therefore be allowed, since it is a document that was subject to an undertaking and should therefore be considered as having been filed in cross-examination.

[166] I also share the respondent's opinion that the Report is relevant for determining the basis for the reassessment. Moreover, the appellant had been aware of the Report for several months and therefore did not suffer any prejudice, since the Court will not consider the conclusions based on the evaluation and the other grounds raised. The goal is truth-seeking. Form should not be elevated over substance, and it is in the interest of justice that the Court review a document that is fundamental to the appeal and draw the relevant conclusions from this document.

[167] To return to the appellant's objection that the reassessment is invalid and does not impose a burden on him because the draft assessment dated July 6, 2007 (Exhibit I-59), and the reassessment did not reveal any assumptions of fact and law, no legal rule allows me to conclude that the reassessment has no basis because the assumptions of fact and law were disclosed late. The only issue is whether because of the delay, the burden of proof is shifted.

[168] In *Drouin c. La Reine*, 2011 CCI 519, Justice Lamarre, dealing with a motion to amend the Reply, drew the following conclusions regarding the draft assessment and the new assessment:

> [TRANSLATION]
> 7 In her submissions, the respondent argues that the amendments being sought are made for the purpose of adding legal arguments pertaining to the issue of the tax shelter and that no new facts are added. The respondent submits that in the tax audit of the appellant for the 2008 taxation year, the auditor considered the tax shelter argument in order to refuse the deductions claimed by the appellant for that year.

> The tax shelter therefore provided a basis for the initial assessment. The initial assessment, dated August 27, 2009, filed in the appellant's Reply record under Tab C, does not provide any explanation for the basis of the assessment that amended the appellant's net income. Moreover, a letter had been sent to the appellant previously, on July 6, 2009, whereby the Canada Revenue Agency **(CRA)** explained to the appellant that the audit had only looked at [TRANSLATION] "the capital cost allowance claimed for Class 12, the deduction of eligible capital property and interest charges" and told him that it would make the appropriate adjustments to his tax return (Exhibit E of the appellant's Reply record). The CRA did not mention whether it had looked at the tax shelter issue to make the assessment.

[169] I agree with these conclusions. Having examined each of the two documents, I conclude that they are terse, to say the least, and in fact do not contain an explanation of the basis for the reassessment.

[170] However, the present state of the law does not allow me to reach the same conclusion as the appellant regarding when the Minister is obliged to disclose the assumptions on which he relies.

[171] In *Orly Automobiles Inc. v. Canada*, *supra*, to which the respondent referred, the Federal Court of Appeal found that *Johnston*, *supra*, does not propound a time limit. It simply sets out the Crown's duty of disclosure:

> [13] Counsel for the appellant conceded, when answering a question from the panel, that the case of *Johnston, supra*, does not expressly state that disclosure must be made prior to or at the time of reassessment. As a matter of fact, the case merely stands for the proposition that the Crown must fully disclose to the taxpayer the precise findings of fact and rulings of law which underline the reassessment. It does not establish the specific time-limit advanced by the appellant for doing so.

[172] In *Orly Automobiles Inc. v. Canada*, *supra*, the respondent had made a reassessment on April 27, 1998, and had disclosed the assumptions supporting this assessment about a month later. The appellant, citing *Johnston*, *supra*, had argued before the Federal Court of Appeal that the trial judge had erred in imposing on the taxpayer the burden of disproving the assumptions of facts and law upon which the respondent had relied, since these assumptions had been communicated to the appellant after the assessment was made.

[173] Among other things, the Federal Court of Appeal recalled the purpose of the requirement of disclosure and the appropriate remedy when disclosure was delayed:

> [15] Counsel for the appellant recognizes that there are no cases supporting the position advocated by the author. Indeed, the purpose of the requirement of disclosure is to ensure that the taxpayer can properly and effectively exercise his right to object to the notice of reassessment within the ninety-day period allocated by the Act. It seems to us that, in the vast majority of cases, the appropriate remedy is the seeking and compelling of disclosure. We cannot imagine the taxpayer being refused an extension of the time, as the case may be, to amend a pending appeal or to file an appeal or a notice of objection when disclosure of the assumptions of facts and law has been delayed and, as a result, compliance with the ninety-day time limit is made difficult, if not impossible.

[174] The Federal Court of Appeal also noted that, in any event, the appellant had suffered no prejudice from the fact that the assumptions were communicated to him a month after the notice of reassessment: the appellant had filed an Amended Notice of Appeal and, at the end of the hearing, the appellant's counsel stated that he had filed evidence rebutting *prima facie* the Minister's assumptions.

[175] In the case at bar, about 21 months elapsed before the time the Minister made the reassessment (August 27, 2009) and the time he allegedly, according to the appellant, first disclosed his assumptions (Reply to the Notice of Appeal filed on March 14, 2011). This delay is certainly deplorable, but not to the point of resulting in the nullity of the reassessment or of reversing the burden of proof.

[176] In the case at bar, the appellant does not seem to have suffered any prejudice. The appellant filed an appeal before the Court even before the Minister confirmed the reassessment. After the Reply was filed, the appellant did not file an Amended Notice of Appeal, and, to my knowledge, there was no question of him doing so. On the contrary, it was the respondent who sought to amend her Reply, which, again, indicates that no prejudice was caused. Moreover, as the respondent argued, the appellant correctly stated the issue in his Notice of Appeal.

[177] In the light of my previous conclusions regarding the overlap between paragraphs 25(p), (q) and (s) and paragraphs 26(m), (p), (q) and (cc) of the Reply, it is hard for me to find that the delayed disclosure caused prejudice. Indeed, a review of the facts alleged in the other subparagraphs of paragraph 25 of the Reply (which are not at issue and with which, in any event, the appellant is familiar) leads me to conclude that the issue whether the burden of proof is reversed as a result of the delayed disclosure is rather academic.

[178] In his reply to the respondent's pleadings dated May 10, 2012, the appellant submitted that *Orly Automobiles*, *supra*, did not hold that the respondent may disclose assumptions to the taxpayer in the pleadings. In his view, that case must be interpreted in the light of *R. v. Anchor Pointe Energy Ltd.*, 2003 FCA 294, and *R. v. Anchor Pointe Energy Ltd.*, 2007 FCA 188, in which the Federal Court of Appeal ruled that the Minister could, at the confirmation stage, make new assumptions that the taxpayer has the burden of refuting. He adds that the law is clear: if the assumptions are not disclosed at the time of the assessment or the confirmation, the burden shifts (see Transcript, May 10, 2012, pages 534 to 536).

[179] I cannot arrive at this conclusion based on my reading of the case law submitted to me. In my view, *Orly Automobiles*, *supra*, holds that not disclosing the basis at the actual time of the reassessment will not necessarily have an impact on the burden of proof, especially when the taxpayer has not suffered any prejudice. In both *Anchor Pointe Energy Ltd.* cases, *supra*, the Federal Court of Appeal decided that the word "assessment" refers to a process that stretches from the making of the assessment to the confirmation of the reassessment and that the Crown benefits from a presumption with regard to the assumptions made at any time during this process.

[180] Indeed, at paragraph 22 of *Hsu*, *supra*, which the appellant referred to in his written submissions, the Federal Court of Appeal simply noted the Minister's duty to disclose the precise basis upon which an assessment has been formulated. It said nothing, however, about when the Minister is required to make such a disclosure.

[181] Consequently, even though it would seem to be fair for the taxpayer to be aware of the assumptions underlying his or her assessment before challenging that assessment, nothing in the current state of the law allows me to conclude that the CRA has a duty in that regard. I can therefore not infer that the assessment has no basis merely because the Minister did not disclose his assumptions prior to, or at the time of, making the reassessment.

[182] The applicant, among other things, submitted that the reassessment had no basis because the CRA had failed in its duty to verify the facts and to apply the applicable legislation before making the assessment.

[183] In my opinion, the comments of the Federal Court of Appeal in *Main Rehabilitation Co.*, *supra*, suffice to reject the appellant's argument. My jurisdiction does not allow me to rule on the CRA's manner of proceeding, but is limited to determining whether the amounts could be validly established under the *Income Tax Act*.

[184] Lastly, I note that the appellant drew the Court's attention to the overlaps between certain facts enumerated at paragraph 25 of the Reply and other facts enumerated at paragraph 26 of the Reply. It is useful to reproduce these paragraphs here:

> [TRANSLATION]
>
> 25. . . .
>
> (p) The franchise and the rights related thereto were not acquired for the purpose of earning or generating an income, but rather to obtain a tax benefit.
>
> (q) The appellant acquired the franchise and the rights related therefore solely in order to benefit from tax deductions.
>
> . . .
>
> (s) The fair market value of the franchise and the rights related thereto was nil.
>
> 26. . . .
>
> (m) The applicant did not intend to realize a profit from his franchise; his intention was rather to obtain tax benefits.
>
> . . .
>
> (p) The appellant's goal was to obtain tax refunds and not to carry on a business.
>
> (q) The activities pertaining to the Prospector International franchise were not business activities and did not offer an opportunity for realizing a profit other than by saving taxes.
>
> . . .
>
> (cc) The fair market value of a Prospector International Networks Inc. franchise was very low if not nil.

[185] It is my opinion that there is an overlap between paragraphs 25(p), (q) and (s) and paragraphs 26(m), (p), (q) and (cc), as they set out the same facts, albeit with a different wording.

[186] The Report, which I have decided to admit into evidence, is of no help in distinguishing the assumptions from the relevant facts since the respondent stated at the hearing that both the assumptions it relied on and the other relevant facts were in the Report. I therefore accept the appellant's arguments that the respondent bears the entire burden with regard to paragraphs 25(p), (q) and (s).

[187] In my view, moreover, by applying such a practice in drafting its pleadings, the respondent breaches the requirements of fairness, as described in *Anchor Pointe Energy* (2007), *supra*:

> 29 Fairness requires that the facts pleaded as assumptions be complete, precise, accurate and honestly and truthfully stated so that the taxpayer knows exactly the case and the burden that he or she has to meet: *Canada v. Anchor Pointe Energy Ltd., supra*, at paragraph 23, *Holm et al. v. The Queen*, *supra*, *Canada v. Lowen* [2004] 4 F.C.R. 3, at paragraph 9. (F.C.A), *Grant v. The Queen* et al. 2003 DTC 5160, at page 5163, *First Fund Genesis Corporation v. Her Majesty the Queen* 90 DTC 6337, at page 6340, *Shaughnessy v. Her Majesty the Queen* 2002 DTC 1272, at paragraph 13, *Stephen v. Canada* [2001] T.C.J. No. 250, at paragraph 6.

[188] These facts are not precise and accurate, and the taxpayer cannot clearly know whether or not the burden of proof falls upon him or her. Such a practice on the part of the Crown is deplorable. Indeed, in *Holm v. The Queen*, 2002 CanLII 47030, Associate Chief Justice Bowman, as he then was, made the following comments:

> [19] . . . If the court sees many more instances of pleading incomplete, inaccurate or misleading assumptions we may have to reconsider the whole matter of pleading assumptions and the reverse onus and require the Crown at least to prove that the assumptions were made. I know of no rule in any court that permits the mere pleading of a fact, without evidence, to have the fact taken as true. It is an advantage that the Crown has that it will lose if it abuses it.

[189] In addition, the facts alleged in paragraphs 25(o) and (r) of the Reply can also be found in the Report (respectively at subparagraph 2(a)(ii), at page 6, and section 2.4, at page 11 (which, however, concern the years 2004 to 2006)):

> [TRANSLATION]
>
> 25. . . .
>
> (o) The appellant's only interest in this franchise was to obtain substantial tax benefits, principally to claim the capital cost allowance, which was much higher than

> the amount paid by the appellant, and to make the following tax savings, without earning any income: . . .
>
> . . .
>
> (r) The appellant did not disburse the sum of $15,000 upon the signature of the franchise agreement in order to earn or generate an income.

[190] To sum up, aside from the overlapping facts in paragraphs 25(p), (q) and (s), the appellant has not satisfied me that the CRA did not actually make the assumptions of paragraph 25 to make the reassessment. It must, therefore, be presumed that these statements are a complete and honest communication of the facts on which the Minister relied to make the reassessment. The initial onus of demolishing these assumptions is on the taxpayer.

<u>The law</u>

[191] In my opinion, the evidence produced must be analyzed in the light of the following principles:

A. <u>Nature of the company</u>

[192] The applicable test for determining whether a taxpayers' activities are a source of either business or property income for the purposes of section 9 of the Act is set out in *Stewart v. Canada*, [2002] 2 S.C.R. 645 (*Stewart*), at paragraph 50, and in *Walls v. Canada*, [2002] 2 S.C.R. 684 (*Walls*), at paragraph 20, which read as follows:

> [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.

> [20] Applying these principles to this case, we find that it is clear that the storage park operation constituted a source of income for the purposes of s. 9 of the Act. It is self-evident that such an activity is commercial in nature, and there was no evidence of any element of personal use or benefit in the operation. Although we state in *Stewart*, *supra*, at para. 55, that reasonable expectation of profit may be used as one factor in making the overall determination as to whether or not the taxpayer's activities are personal or commercial, where, as here, the activities have no personal aspect, reasonable expectation of profit does not arise for consideration.

[193] In essence, these two cases hold that the tests of reasonable expectation of profit and the taxpayer's compliance with "objective standards of businesslike behaviour" are only relevant when it comes to distinguishing a business from a hobby. Where the commercial-like activity in question is and cannot be viewed as a personal pursuit, these tests are not relevant (*Stewart*, para. 47, reiterated in *Water's Edge Village Estates (Phase II) Ltd. v. Canada*, [2003] 2 F.C. 25, para. 24).

[194] According to *Stewart*, therefore, the objective factors listed in *Moldowan v. The Queen,* [1978] 1 S.C.R. 480, apply only "where the nature of a taxpayer's venture contains elements which suggest that it could be considered a hobby or other personal pursuit". In that regard, paragraphs 52 and 55 of *Stewart* read as follows:

> [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

> . . .

> [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.

[195] Furthermore, *Walls* holds that an operation that is designed simply to obtain a tax refund is not a business, in the absence of any other commercial activity. In that regard, paragraph 21 of that case reads as follows:

> . . . With respect, the case at bar is distinguishable from *Moloney*. There, the taxpayer was not engaged in a commercial activity, but instead was involved in a sham set up to appear as though it was commercial in nature where in fact the only activity actually engaged in was that of obtaining tax refunds. Here, in contrast, the Partnership purchased and maintained an ongoing commercial operation.

B. Duke of Westminster principle

[196] When a taxpayer assesses a business or investment opportunity, the tax treatment is an important factor that a taxpayer has every right to consider. Furthermore, it has long been recognized that, as a result of the Duke of Westminster principle, taxpayers are entitled to arrange their affairs so as to attract the least amount of tax (see *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, [2005] 2 S.C.R. 601, paragraph 31).

[197] An important corollary arises from this principle, namely that the fact that taxpayers structure their business and amend their agreements to take account of existing and new tax provisions is irrelevant when it comes to qualifying their business.

[198] As the Supreme Court of Canada explained at paragraph 22 of *Walls*:

> Although the respondents in this case were clearly motivated by tax considerations when they purchased their interests in the Partnership, this does not detract from the commercial nature of the storage park operation or its characterization as a source of

> income for the purposes of s. 9 of the Act. It is a well-established proposition that a tax motivation does not affect the validity of transactions for tax purposes: . . .

C. Business operated by an agent

[199] It is trite law that a taxpayer carries on a business even if the taxpayer entrusts an agent to manage the business. The leading case in this regard remains *E.S.G. Holdings Ltd. v. The Queen*, 76 DTC 6158, of the Federal Court of Appeal, where the judge wrote as follows:

> With respect, I do not agree that there is any material difference in principle, in so far as the carrying on of an active business by a corporation is concerned, between carrying it on through the agency of officers or servants of the corporation and carrying it on through the agency of an independent contractor. The question is whether the taxpayer's income is 'from an active business' and, in my view, the answer must be the same in both cases.

[200] It follows that a taxpayer's personal involvement in a business is a red herring and does not affect the fact that the taxpayer has to be carrying on a "business".

D. Financing of the business

[201] The relevant principle is set out in paragraph 46 of *Stewart* and reads as follows:

> In addition, the way in which a particular venture is capitalized may have significant effects on its profitability. The extent of capitalization, rates of interest, and level at which a venture is capitalized (for example partner financing versus partnership financing, or corporate financing versus shareholder financing) may have significant effects on the bottom line, and it is difficult to see why the characterization of a commercial venture as a source should depend on the extent or method of financing: . . .

E. Sham

[202] In *Canada v. Nunn*, 2006 FCA 403, the Federal Court of Appeal summarized the concept of a sham in the following terms:

> [19] However, in my analysis, the Judge erred in grounding her ultimate decision on the doctrine of sham. The Supreme Court of Canada in *Stubart Investments Ltd. v. The Queen* [1984] 1 S.C.R. 536 adopted Lord Diplock's statement in *Snook v.*

London & West Riding Investments Ltd., [1967] All E.R. 518 (C.A.) as to what constitutes sham:

> ... it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create [Emphasis added].

[203] In other words, the elements of a sham require that the parties to an operation deliberately intended to mislead third parties about the actual situation.

F. Section 67

[204] In *Williams*, 2009 TCC 93, the appellant operated a business of providing day care services at her home. This Court examined the substantial body of case law regarding section 67 of the *Income Tax Act*. Quoting from *Ankrah v. The Queen*, 2003 TCC 413, at paragraph 14, the Court wrote as follows:

> [14] Justice Woods in *Ankrah v. The Queen* [2003] 4 C.T.C. 2851 stated as follows:
>
> > [32] The Crown submits that it was unreasonable for Mr. Ankrah to incur large expenditures after the business had incurred losses for several years. It was suggested that instead of spending large sums of money on recruits, the same result could have been achieved by personal training.
> >
> > [33] The difficulty with the Crown's position is that supplants the business judgment of the taxpayer. Mr. Justice Rothstein commented on this in another Amway case, *Keeping v. R.*, [2001] 3 C.T.C. 120 (F.C.A.), at paragraph 5:
> >
> > > With respect, I am of the opinion that the analysis conducted by the Tax Court Judge, [1999] T.C.J. No. 277, amounted to second-guessing the business acumen of the appellant which is not the place of the Courts. As stated in *Mastri v. R.* (1997), [1998] 1 F.C. 66 (Fed. C.A.), at paragraph 12:
> > >
> > > > In summary, the decision of this Court in *Tonn* does not purport to alter the law as stated in *Moldowan*. *Tonn* simply affirms the common-sense understanding that it is not the place of the courts to second-guess the business acumen of a taxpayer whose commercial venture turns out to be less profitable than anticipated.

> In basing his decision on profit margins, potential market opportunities and costs, as well as the appellant's approach to operating his distributorship, the Tax Court Judge was second-guessing the business acumen of the appellant. In doing so, the Tax Court Judge erred in law.

This comment was made in the context of the REOP doctrine but I see no reason why it should not also apply in the context of section 67.

[34] The phrase in section 67 "reasonable in the circumstances" is broad but I do not believe that it should apply to reduce expenses based on poor business judgment. Section 67 is commonly applied to reduce the quantum of expenses in cases where the taxpayer is motivated partly by something other than business reasons, such as a payment of salaries to family members. This was described by Mr. Justice Cattanach in the case of *Gabco Limited v. M.N.R.*, 68 D.T.C. 5210 (Ex. Ct.) at page 5216 as follows

> It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.

In *Williams*, the Court added:

> [15] As noted by Justice Cattanach in *Gabco Limited*, if the court reaches a "conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind" then the provisions of section 67 of the Act would apply. It seems to me that this is consistent with the statement of the Supreme Court of Canada in *Stewart* that section 67 will apply "if, in the circumstances, the expense is unreasonable in relation to the source of income". If an expense is unreasonable in relation to the source of income then "no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind".
>
> [16] It is also important to note that the determination of whether the amount would have been paid by a reasonable business person should also be made as of the time the expenditure was made and not with the benefit of hindsight. When expenditures are being incurred by a business person, that person does not know what the future will hold. Expenses should not be denied simply because a person, with the benefit of hindsight, made a poor business decision. As stated by Justice Rothstein (as he then was) in *Keeping v. R.*, *supra*, in quoting from the decision of that Court in *Tonn*, "it is not the place of the courts to second-guess the business acumen of a taxpayer whose commercial venture turns out to be less profitable than anticipated".

> [17] It is also not appropriate in my opinion to simply deny expenses on the basis that they exceed revenue. This could lead to a conclusion that a person could never incur a loss for tax purposes. Simply the fact that the expenditures exceed revenue is not, in and of itself, sufficient to deny a deduction for such expenditures.
>
> [18] In this particular case, the expenditures that were claimed were for subcontractors, advertising, professional fees, motor vehicle expenses, and telephone.

G. Parties' intention

[205] In *Riopel c. Agence du revenu du Canada*, 2011 QCCA 954, the Quebec Court of Appeal held that [TRANSLATION] "the parties' intention take precedence over the letter of their contract", writing as follows:

> [TRANSLATION]
> [15] *Sobeys* recognized that the parties' intention take precedence over the letter of their contract and that, when it is possible to establish this intention, the contract must be read in a manner consistent with it.
>
> [16] Moreover, *Services environnementaux AES inc.* recognized that:
>
>> [TRANSLATION]
>> [11] The appeal raises the issue of whether the Superior Court may allow a contractual document to be corrected if there is a conflict between the parties' common intention and the intention stated in the document.
>>
>> [12] The Court concludes that it may do so when, as in this case, the application is legitimate and necessary and the sought correction in no way affects the rights of third parties.
>>
>> [13] The appellant's argument concerning the importation into civil law of the common law doctrine of "equitable rectification" does not stand. Quebec civil law already has all the tools required to, under certain conditions, give effect to a contract in accordance with the parties' actual common intention when the wording does not reflect this intention. It is not necessary to resort to a doctrine from another legal system in order to reach this result.
>>
>> [14] There are two ways of analyzing the inaccuracy of the stated adjusted cost base of the shares in the documents recording the transaction of December 15, 1998, between AES and Centre

> technologique: (1) an error that vitiates consent or (2) conflict between the parties' common intention and the intention stated in the contract.
>
> [15] If an error relating to the nature of the contract, the object of the prestation or anything that was essential in determining consent is not inexcusable, the error vitiates consent (art. 1400 C.C.Q.).
>
> [16] The error may be common but, even if it is common, it can only result in the nullity of the contract and not its correction.
>
> [17] Furthermore, a judge who notes not an error but a discrepancy between the parties' common intention (the *negotium*) and the intention they stated in the contract (the *instrumentum*) may take this discrepancy into account by giving effect to the contract (article 1425 C.C.Q.), on condition that, obviously, the application is legitimate and the proposed correction in no way affects the rights of third parties.
>
> [18] Indeed, the rule set out at article 1425 C.C.Q. concerning the interpretation of contracts gives the parties' true intention precedence over the intention stated in the contract.
>
> [19] The judge's power to make the *instrumentum* consistent with the *negotium* is the implicit consequence of this rule, since it makes it possible to match the text of the contract with the parties' true intention; however, once again, the rights of third parties must not be affected (here an analogy is possible with the rules of simulation, at articles 1451 and 1452 C.C.Q.). A recent, unanimous judgment of the Court recognized this explicitly and, if one wishes to base the trial judgment on a firm principle, this is the principle on which it relies.

Preliminary remarks

[206] It is my opinion that the evidence very clearly established the following:

(a) The software had been designed and developed. Not only did the software exist, it also worked the way it had been designed and developed to do.

(b) The software met actual market needs. In this regard, the Court heard the convincing expert testimony of Mr. Ouellet and the testimonies of

experienced entrepreneurs such as Mr. Jones and Mr. Vincent, who believed in the software's potential and who devoted years of their lives to marketing the software in the hope of creating the next Google. Are the conclusion of contracts with paying clients (including the Agence du revenu du Québec) for each of the programs as well as the contracts with and expressions of interest from the Barreau du Québec and its New York counterpart, to say nothing of major partners such as IBM and Cablevision, not irrefutable evidence that the software met real market needs? The fact that the sales were not as successful as hoped is, in my view, not conclusive, as we shall see later on.

(c) Herculean efforts were expended to market the software programs in Canada, the United States and elsewhere.

(d) Developing and marketing the software programs had required significant funding.

(e) The necessary funds were lent first by licensees and then (from 2005 onwards) by the franchisees who acquired licences or franchises.

[207] I note that, essentially, the Minister is not challenging these conclusions of fact. In other words, the Minister now admits that PIN and its affiliate companies were carrying on a business. In fact, the Minister's position is rather that all of the software development and marketing efforts were solely invested to benefit PIN and its affiliate companies. From this argument flows the Minister's position that the appellant did not intend to carry on a business and was not carrying on a business, any more than Network and its affiliate companies were carrying on a business on behalf of the appellant, and that the promissory notes and the agency agreements were shams.

[208] *Prima facie*, the Minister's position that all of the marketing and development efforts were expended solely to benefit PIN and its affiliate companies seems implausible and illogical, to say the least, given that the Minister has not alleged that the licences and the franchises are shams.

[209] To illustrate the implausibility and absurdity of this position, if suffices to imagine the following situation, a situation that is far from being fanciful since the evidence very clearly established that the strategy of PIN and its affiliate companies since 2002 was to attract its first (paying or [TRANSLATION] "strategic") clients and credible partners in order to prove the commercial viability of the software, then to

enter into agreements with value-added resellers in order to achieve maximum market penetration in the United States and elsewhere, and ultimately to incite a giant such as Google or Microsoft to buy everything or to prepare an initial public offering. The disappointing results of this strategy do not, however, change the nature of the business of PIN and its affiliate companies or mean that PIN and its affiliate companies stopped hoping to make a profit. Let's suppose that, thanks to the marketing efforts of Network and/or its affiliate companies (which, according to the Minister's position, were expended solely to benefit Network and its affiliate companies), Network had succeeded in signing a value-added reseller agreement with a major U.S. player that resulted in high sales in the United States, and let's suppose that, shortly afterwards, Microsoft had offered to buy the entire technology for one billion dollars, an offer that was announced with great fanfare in the press as being a major coup for a young Quebec company. What would have happened? First, the franchisees would have, under their licences and franchises (the existence of which the Minister is not disputing), collectively claimed (and rightly so, in my opinion, as we shall see later) a significant share of the gross sales achieved in the United States. Using the same example, the billion dollars would necessarily have served to buy out the franchisees, purchase the software licence fees and the rights to market the software held by the franchisees under their licences and franchise agreements, even if these agreements contained ambiguities, misconceptions and even mistakes. Indeed, a buyer such as Google or Microsoft would not have invested one billion dollars without ensuring that it owned all the rights to market the software in the United States. If PIN and its affiliate companies are as deceitful and crafty as the Minister suggests, they would necessarily have ensured that the licences and franchises were also shams. Indeed, why would PIN and its affiliate companies have taken the chance of sharing the fruits of their marketing efforts (which, according to the Minister, they expended solely to their benefit) with franchisees whose only reason for acquiring a licence or a franchise, according to the Minister, was to obtain tax deductions? It seems inconceivable that PIN and its affiliate companies could have explained their refusal of the franchisees' collective claim for their fair share of the U.S. sales by telling them, "You're not entitled to a thing since you only paid to get tax deductions and never intended to be part of this company." Such a scenario reveals the absurdity of the Minister's position.

[210] In the light of the Minister's admission that the franchises and licences were real, the example shows, in my opinion, that, *prima facie*, it is more likely than not that the franchisees acquired their licences and franchises with the purpose of operating them and of obtaining tax deductions, and that the promissory notes and the management agreements are not shams. In other words, the CRA has never alleged

that the appellant's franchise was a sham. It is almost untenable to argue that the operation of this franchise can be anything other than a commercial activity.

[211] For further illustration, I note that if, in our example, the agency and management agreements had been shams (as the Minister alleges), the franchisees would collectively have received a higher share of the gross sales achieved in the United States thanks to the efforts of the U.S. value-added reseller than if the agency and management agreements were not shams. Indeed, the 2007 franchise agreement does not provide for any royalties to PIN or its affiliate companies, while the 2007 agency and management agreement entitles the agent to fees equivalent to 94% of the gross income generated through the distribution of the software or, in the event that the franchisee participates in the marketing of the software, to 14% of the net income (Exhibit A−1.1.3, Clause 3.1). The 2008 franchise agreement provides for royalties amounting to 20% of the gross income for Prospector (Exhibit A−1.2.1, Clause 12.2 and Appendix A). Assuming that the 2008 agency and management agreement was valid (I will address the question of its validity later on), Prospector and its agent would have been entitled to a total of 88% of the gross income since the agency and management agreement provides for a royalty of 68% of the gross income for the agent (Exhibit A-1.2.2, Clause 3.1). If, on the contrary, the 2008 agency and management agreement was not valid and the 2007 agency and management agreement was the agreement in effect, PIN and Network would have been entitled to 114% of the gross income, through the combined effect of the 2008 franchise agreement and the 2007 agency and management agreement.

[212] Lastly, I note that another piece of evidence illustrates the obvious absurdity and implausibility of the Minister's position that the franchisees did not acquire the rights to market the software in order to exercise these rights. The evidence very clearly reveals that many of the franchisees (including the appellant) attended several meetings organized by Network and its affiliate companies and read the many messages and information letters sent to them by Network and its affiliate companies keeping them informed about the development and marketing of the software in the United States and elsewhere. The evidence even revealed that the appellant attended the annual meeting in April 2009, which was held before his tax record was audited. The annual meeting included a report on the marketing efforts for Mail it Safe and the announcement of the new CashOnTime software. What interest could he and the other franchisees have had in attending a debriefing on the marketing efforts for Mail it Safe and an announcement of the new CashOnTime software? To ask the question is to answer it. *Prima facie*, it is therefore more likely than not that the appellant and the franchisees participated in a commercial activity, contributed to this activity

financially and were interested in it like any other businessperson. If the appellant's and the other franchisees' sole interest in acquiring a franchise was to obtain tax deductions, they would not, in my opinion, have been interested in keeping abreast of the work to market and develop the software. Assuming that the appellant had other intentions makes no sense, especially if one considers that his tax record was not even being audited when he attended the annual meeting.

[213] It seems obvious to me that all the CRA's arguments, whether they were raised explicitly or not, are based on the assumption that there was an elaborate scheme in place that was carried out from 2002 until today. In other words, even though the scheme theory was not referred to explicitly, it is apparent from the allegations made in the Reply and the pleadings. In order to be plausible, however, such a theory would require that, since 2003, thousands of taxpayers (most of whom are doctors and dentists), together with the franchisor and its affiliate companies, have been complicit in an elaborate deception, if not to say a vast criminal conspiracy, to avoid paying taxes. In other words, in asking me to dismiss the appeal, the Minister is indirectly asking me to confirm that all of the promissory notes and all of the agency and management agreements entered into between thousands of franchisees and the franchisor since 2002 are shams and that therefore all of these individuals are essentially fraudsters, despite the fact that at the end of an extensive search and seizure of the main stakeholders, the Minister failed to find any counter letters or material evidence suggesting that the promissory notes and management agreements were shams. The respondent's theory, if it is established, necessarily means that the appellant and the franchisee witnesses who testified (including Christian Thibault, who, as a result of his bankruptcy, has no interest in the matter and whose testimony is therefore not self-interested) perjured themselves. The Minister's thinly veiled accusations are very serious. For this reason, and because of the apparent implausibility and absurdity of the Minister's position, I examined the evidence and the Minister's arguments with a great deal of circumspection, reflection and care.

Respondent's position

[214] The respondent bases its analysis on *Stewart v. Canada*, *supra*. She submits that in order to determine whether there is a source of income and, hence, a business, one must ask whether the activity of the taxpayer is undertaken in pursuit of profit, or whether it is a personal endeavour. According to the respondent, this depends not only on the taxpayer's subjective intention to profit, but also on a variety of objective factors that establish that the taxpayer carried out a commercial activity in accordance with objective standards of businesslike behaviour. In the respondent's

opinion, that is the import of paragraphs 53 and 54 of *Stewart* and in *Symes v. Canada*, [1993] 4 S.C.R. 695. These standards or objective factors, which were listed by Justice Dickson in *Moldowan*, *supra*, make it possible to make an "overall assessment . . . whether or not the taxpayer is carrying on the activity in a commercial manner" (paragraph 55 of *Stewart*). The respondent cites, *inter alia*, *Madell v. The Queen*, 2008 TCC 264, affirmed by 2009 FCA 193, where which Justice Little adopted this approach.

[215] The respondent adds that tax considerations are not incompatible with the commercial nature of an investment, as the Supreme Court of Canada determined in *Walls v. Canada*, *supra*. However, for there to be a source of income, there must be business considerations, otherwise the activity cannot be [TRANSLATION] "clearly commercial in nature". Consequently, an activity that is undertaken to give the impression that it is commercial in nature, even though in fact the only activity actually engaged in is that of obtaining tax refunds, is not, according to the respondent, a source of income. The respondent also cites *Moloney v. Canada*, [1992] F.C.J. No. 905 (QL), *Bendall v. Canada*, [1995] T.C.J. No. 1 (QL) (T.C.C.), and *St-Laurent v. The Queen*, 2007 TCC 540.

Appellant's intention

[216] The respondent submits that, in the case at bar, the appellant acquired the franchise for the sole purpose of reaping tax benefits.

[217] Citing *Walls*, *supra*, the respondent argues that for there to be a source of income, there must be commercial motivations; otherwise the activity cannot be of a commercial nature. In the case at bar, the respondent alleges that the appellant acquired the franchise with the sole purpose of enjoying tax benefits, since he showed [TRANSLATION] "a complete lack of interest in anything regarding the marketability of his first business and did nothing to ensure that the franchise would provide him with any kind of income". More specifically, the respondent submits that the inquiries made by the appellant before purchasing his franchise and his conduct after acquiring it merely confirm the respondent's position that the appellant's sole purpose when acquiring the franchise was to reap tax benefits.

[218] In that regard, the respondent has compiled a long list of items the appellant did not verify when he acquired the franchise, such as the price of the software, competing products, the history of the other franchises, the total number of other franchises, the break-even point, potential clients, PIN's and Network's senior

managers and employees, the incorporation of PIN and Network, the agent who managed the franchise for the appellant and the agent's ability to generate sales.

[219] Contrary to the respondent, I do not believe that the absence of extensive inquiries is indicative of the appellant's intention. Moreover, requiring that the appellant had thoroughly looked into all aspects of the Prospector company is not in line with the principles laid down in *Stewart*. In my opinion, taxpayers may invest in a company on the advice of their broker or another advisor whom they trust, without inquiring into the price of the company's products, the company's competitors, the sales and profit history, the company's senior managers, potential clients and the company's incorporation. Again, an absense of inquiries does not prove that a taxpaying investor was not in pursuit of profit. If they were no longer able to rely on their long-standing advisors, few Canadian taxpayers could claim tax deductions in respect of their investment in a company.

[220] The evidence rather shows that the appellant's motivations were both tax-related and commercial. Indeed, the appellant's steps when he acquired the franchise clearly establish that he had commercial motivations. Mr. Legault, the financial advisor he had been dealing with since the mid-1990s, suggested that he purchase the franchise in 2005 and 2006 (Transcript, January 30, 2012, Questions 37, 43, 57 and 65). Mr. Legault told him that he himself had invested in the company (Transcript, January 30, 2012, Questions 78 and 79). The appellant explained that he had decided not to buy the franchise in 2005 and 2006 because he lacked the necessary funds (Transcript, January 30, 2012, Questions 61, 62 and 64). He decided to only buy RRSPs, as he had done in previous years (Transcript, January 30, 2012, Questions 63 and 64). In 2007, Mr. Legault suggested a third time that the appellant purchase a franchise. He explained to the appellant that the Mail it Safe software had attracted major clients such as Revenu Québec, the Barreau du Québec and the Barreau's New York counterpart (Transcript, January 30, 2012, Question 67). Mr. Legault also told him that 2007 would probably be the last year in which such franchises would be offered (Transcript, January 30, 2012, Questions 801 to 804). Before signing the agreements, the appellant reviewed two brochures (Transcript, January 30, 2012, Questions 100 and 329 to 333). One of the brochures (A-3.1, Volume 1, page 59) described the history of PIN and Network; the partnership with IBM; the software being marketed (Solutions Prospector and Mail it Safe); the nature of the franchise; the marketing strategy; the valuation of Wise, Blackman; and the tax implications. The second brochure (A-3.2, Volume 1, page 101) dealt with adapting Mail it Safe to various platforms; Network's participation in trade fairs targeting the legal market; partnerships with, among other organizations, the CsBQ, the CIGM, IBM and the New York County Lawyers' Association (NYCLA); Wise, Blackman's valuation; the

company's vision for 2007, research and development activities and the franchisee recommendation program. The brochure did not mention the tax consequences of the franchises. After the 2007 annual meeting, the appellant thought about the suggestion and contacted Mr. Legault one or two days later to ask him to send him the paperwork, including the franchise agreement, the agency agreement and the promissory note, and to mark with sticky notes where he had to sign (Transcript, January 30, 2012, Questions 86 and 87). The appellant did not deem it necessary to make additional inquiries because he trusted his long-standing financial advisor, who himself had invested in the franchises (Transcript, January 30, 2012, Questions 98 and 100).

[221] The respondent submits that the appellant's conduct after he purchased the franchise also shows that he had solely acquired it to obtain tax benefits.

[222] In her written submissions, at paragraph 59 of her analysis, [TRANSLATION] "Drouin's motivations for acquiring a franchise", the respondent makes the following statement:

> [TRANSLATION]
> [59] Another indication of Drouin's complete lack of interest in his franchise is the fact that, during 2007, Drouin would have had every interest in operating the franchise himself. In fact, the 2007 franchise agreement (A-1.1.1) does not provide for any royalties should Drouin have done so without going through the agent!

In other words, to show that he intended to make a profit, the appellant, according to the respondent, should have essentially left his employment and gone door to door to sell software in the territory assigned to him in the United States.

[223] The respondent's position that the appellant had to personally participate in operating his franchise to show that not only he but also his so-called commercial activities were serious is simply unfounded in law. As stated by Chief Justice Jackett in *ESG Holdings Ltd.*, *supra*, "the question as to how active the proprietor was in the business activities would not seem to be relevant. To me, this would seem self-evident and its statement does not constitute the enunciation of any general principle". The appellant always intended to operate the business through his agent, as was done by the taxpayers in *Stewart* and *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536.

[224] The respondent also submits that the appellant showed an absence of interest in his franchise (after he purchased it) by not having any contact with Network representatives before the April 30, 2009, meeting.

[225] In my opinion, the evidence rather shows that the appellant's behaviour after his purchase was consistent with his opinion that Network was in the process of marketing Mail it Safe and its derivative products for his benefit. The evidence shows that in 2008, Mr. Legault informed the appellant that everything was going well. Mr. Legault had him sign new agreements and told him that the term of the promissory note had been extended to 10 years in order to better reflect the product lifetime, in return for an increase of the balance owing to $230,000. Mr. Legault informed him that this was a [TRANSLATION] "normal operation" and that the agreements were updated regularly to respect new standards and new legislation (Transcript, January 30, 2012, Questions 237 to 241). The appellant received the February 16, 2009, invitation to the April 30, 2009, general meeting (Exhibit A-40). I note that nowhere in this document is there any mention of tax consequences. The appellant attended the meeting (Transcript, January 30, 2012, Question 338) when he did not yet know that his file was being audited (according to the testimony of Ms. Bartolini of the CRA, the file was assigned to auditor Nathalie Belzile in mid-May 2009, and the first form was sent to the appellant on June 1, 2009) (Transcript, March 19, 2012, Questions 16 and 20). What interest could the appellant have had in attending the April 30, 2009, meeting (which included an update on Mail it Safe marketing efforts and the launch of the new product CashOnTime) if his sole goal in acquiring the franchise was to obtain tax benefits? To state the question is to answer it. The appellant also testified that he read all the information sent to him by Network. Again, why would the appellant have read these releases before the annual meeting if his sole purpose in acquiring the franchise was to obtain tax benefits?

[226] Moreover, the respondent criticizes the appellant for not having a [TRANSLATION] "plan" for [TRANSLATION] "rectifying the situation". In my opinion, this criticism is unreasonable, given the history of his participation in the business. I note that the appellant became a franchisee in December 2007. He was not expecting any returns in the short term because of the nature of the products. In 2008, Mr. Legault assured him that everything was going well. In 2009, he attended his first meeting, where Mr. Vincent and Mr. Yacoub announced that the company had been sold and that new software had been developed. A few months later, he learned that his company was being audited. The question is how the appellant could have known in summer 2009 that he would have to prepare a [TRANSLATION] "recovery plan" for his franchise.

[227] The appellant provided an honest testimony according to which he was motivated by two considerations when he acquired the franchise in 2007: first, taking advantage of tax benefits and, second, making a profit from this long-term investment. Since he was familiar with the computer industry, he saw great sales potential in Mail it Safe (Transcript, January 30, 2012, Question 112). The testimony of the five franchisees is similar. All seemed to be credible, honest witnesses (including Dr. Thibault, whose bankruptcy ended the dispute with the CRA and who, consequently, no longer has an interest in the proceeding at bar). They submitted that they acquired their franchises because they saw it as a good investment that would also allow them to reduce their tax burden.

Commercial nature of the franchise

[228] The respondent's arguments regarding the commercial nature of the appellant's franchise are found at paragraphs 556 to 560 of the respondent's written submissions, as reproduced below:

> [TRANSLATION]
>
> 556. As in *Madell*, *Moloney* and *Bendall*, the evidence shows that, during the year at issue and at any other relevant point in time, Drouin did not carry out any activities to market his franchise, any more than his agent Network did (section 2.3 of the Facts).
>
> 557. The Drouin franchise "is nothing more than a pale imitation of a business" (see *Bendall*, above at note 16, paragraph 13) and the structure that was set up serves merely to make it look commercial. Even though Network or even MIS could have carried out activities to their own benefit, at no point was it intended for the marketing activities to benefit Drouin or the other franchisees.
>
> 558. With regard to the marketing efforts, the evidence shows that none of the marketing activities was carried out for Drouin's franchise, be it by Drouin himself or through his agent (sections 2.3.2 and 2.3.3 of the Facts).
>
> 559. We have thus seen that, on December 27, 2007, when Drouin signed the franchise agreement and the 2007 agency and management agreement, Network already no longer had any employees assigned to developing and marketing the software. Network also no longer had an office or employees in the U.S. territory, that is, the territory allegedly assigned to franchisees such as Drouin. Lastly, no marketing efforts were made based on the specific list of Drouin or any of the other franchisees. It was impossible to undertake marketing efforts on any of the franchisees' territories (sections 2.3.2. and 2.3.4 of the Facts).

> 560. During the year at issue and at any other point in time, there were no marketing activities for the Drouin franchise. Before Drouin even signed the 2007 agency and management agreement, Network could not have intended to act as agent to do the marketing on behalf of Drouin since, in any case, it did not have the resources to do so.

[229] In short, the respondent essentially admits the following:

(i) The software existed:

(ii) Herculean efforts had been expended to market the software in Canada, the United States and elsewhere;

(iii) Developing and marketing the software had required significant funding;

(iv) The necessary funds had been lent by licensees and franchisees.

[230] I repeat that the respondent's position is that all of the development and marketing efforts were undertaken solely to benefit PIN and its affiliate companies. In other words, the respondent submits that the commercial activities of Network and MIS were never carried out on behalf of the franchisees.

[231] As I explained earlier (see paragraphs 208 to 211), the respondent's position seems implausible and illogical, since the respondent does not challenge the existence of the appellant's franchise. I could have understood the respondent's position if the respondent had alleged that the franchise (like the promissory note and the agency agreement) was a sham. Indeed, if it had been intended that the marketing efforts solely benefited PIN and its affiliate companies (as the respondent submits), it seems clear that the parties would have entered into a (oral or written) agreement to ensure that PIN and its affiliate companies did not have to share the fruits of their marketing efforts (efforts that are not being disputed by the respondent). I repeat, if PIN and its affiliate companies were as deceitful and crafty as the respondent suggests, they would have necessarily arranged (by concluding an agreement with the franchisees) for the franchises to be shams in order to ensure that the franchisees did not benefit from their marketing efforts.

[232] Regarding Network's lack of activity as of 2007, the evidence has revealed the following:

(i) In 2007, after three years of costly efforts, Network realized that its strategy for taking the United States by storm was not working and that it needed a new business plan for marketing its two computer programs in the franchises' territory. Network therefore decided to spend its efforts on making Mail it Safe successful in Quebec, which was not part of the territories assigned to the franchises, and to then use Quebec as a storefront that would benefit all franchisees (Examination of Mr. Duhamel, Transcript, February 8, 2012, Question 913; Transcript, February 28, 2012, Questions 33 and 36; and Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 656 to 658).

(ii) To implement the strategy, Network hired Mr. Yacoub. Mr. Yacoub's efforts bore fruit, and on July 9, 2007, an agreement was concluded between Network and the Ordre des conseillers en ressources humaines et en relations industrielles agrées du Québec. Network was successful in making several sales in Quebec in 2007. Moreover, in the second half of 2007, Network and the Montreal office of IBM were conducting intense negotiations.

(iii) Mr. Yacoub hired other executives in 2007, including Mr. Vincent and Mr. Lamontagne.

(iv) In December 2007, it was decided to create MIS to provide a structure for Mr. Yacoub's work. The creation of MIS had two objectives. First, Mr. Yacoub and Mr. Lamontagne did not want to have to deal with the dispute with the tax authorities. Second, the creation of a new company made it easier to issue shares as an incentive for senior managers. The Network employees who worked on developing the two software programs were transferred to MIS.

(v) Even though MIS was successful in selling Mail it Safe to credible clients in 2007 and 2008, the results were disappointing. As a result, in 2008, for the third time in six years, it was decided to develop a new commercial computer program based on the tracking technology previously developed by Network. In August 2009, work to develop the commercial program CashOnTime therefore began.

[233] Indeed, the respondent submits, when the appellant signed the agreements on December 28, 2007, Network no longer had any employees assigned to developing and marketing the two programs, nor did it have offices and employees in the United

States. The question now is the following: does the lack of marketing activities on the part of Network as of 2007 therefore mean that the franchise was not of a commercial nature?

[234] The fact that Network chose to cease operations while waiting for MIS to create a storefront in Quebec before resuming its efforts in the United States in order to find value-added resellers and to attract a giant does not, in my opinion, detract from the franchise's commercial nature. *Malo v. The Queen*, 2012 TCC 75, is instructive in this regard. Moreover, if I rely on what expert Mr. Ouellet said, namely that, when it comes to radical innovations, and specifically in the field of software, it is important to build storefronts and to perform case studies to reassure the rest of the market (Transcript, March 13, 2012, page 87, lines 17 to 25), the strategy Network adopted seems logical and appropriate in the circumstances.

[235] It was clear for Mr. Vincent that, even though there was no legal relationship between the franchisees and MIS, that MIS's activities had two major impacts on the franchises:

(a) the creation of a storefront in Quebec would facilitate future efforts in the United States, especially with regard to finding value-added resellers in order to attract a giant;

(b) the technological improvements to Mail it Safe and the development of derivative products would immediately be added to the franchises under the franchise agreements (Examination of Mr. Vincent, Transcript, January 25, 2012, Questions 659 to 663).

[236] It is also true that the agreements entered into with Prospector could have been interpreted as MIS being a competitor of the franchisees. Yet, as one can see from the testimony of Mr. Klein (Transcript, April 3, 2012) and Exhibits A-136 and A-138, MIS's and PIN's respective roles were clarified so as to respect the parties' initial intention: MIS's role was to develop the software and to market it only in Canada, and PIN was to market the software abroad, through its network of franchises. Contractual errors are run-of-the-mill in business, and they do not automatically destroy the legal relationships between parties. In such cases, one must consider the parties' intention. In the matter at bar, the parties' initial intention regarding MIS's role was clear.

Factors and objective elements

[237] The respondent correctly submitted that an activity that is undertaken to give the impression that it is commercial in nature where in fact the only activity actually engaged in is that of obtaining tax refunds is not a source of income. The respondent submits that in the case at bar, the evidence clearly shows that PIN and its affiliate companies had set up a structure and undertaken activities to give the impression that the franchisees' business was commercial, although in fact the only activity engaged in was that of obtaining tax refunds. In other words, the evidence clearly shows, according to the respondent, that there was elaborate deception to conceal the franchisees' true intention in acquiring franchises, which was to obtain tax benefits.

[238] In that respect, the respondent argues that Network did not carry out any marketing activities on behalf of the appellant's franchise in a specific marketing territory, meaning that it was impossible to reap a profit from the sale of the software. It is my opinion that the fact that the marketing activities were not carried out in the appellant's specific territory does not mean, however, that it was impossible for the appellant (and the franchisees) to realize a profit from his franchise. In support of this opinion, let's return to the example where Microsoft offered one billion dollars to buy the technology and the rights to market the software. It is undeniable that Microsoft would not have invested such an amount without ensuring that it owned all the rights to market the software in the United States. It is therefore more likely that in such a situation, a substantial share of the billion dollars would have been used to buy out the franchisees collectively and to purchase their rights to market the software in the United States even if each franchise's territory was vague. Indeed, it is more than likely that, after its initial verification, Microsoft would have required PIN to obtain from all the franchisees a waiver of their rights to market in the United States. PIN would have had no choice but to pay the franchisees a substantial share of the one billion dollars, probably shared equally. Given the agreements, the news releases PIN sent to the franchisees and the promises made to the franchises, PIN could not have told the franchisees, "You're not entitled to any of the one billion dollars because your territories are unclear". In such a situation, the search for a logical interpretation that is consistent with the parties' intention would probably have resulted in the amount allocated by Microsoft to the rights to market the software in the United States being equally distributed between the franchisees. I also note that the 2007 and 2008 franchise agreements include a shotgun clause, under which franchisees must agree to an important change if 75% of the franchisees convened for that purpose are in favour of the change, on the condition that, if the change is a sale, the sale is realized under the same conditions for all franchisees (Exhibit A-1.1.1, Clause 2.2 and Exhibit A-1.2.1, Clause 3). Furthermore, the fact that the franchisees do not

know what their territories are and that the territories were not assigned without delay does not affect the legal relationship created between the parties or the description of their commercial activities. The apparent vagueness surrounding the territories assigned to each of the franchisees does not cause the franchise agreements to become null and void, but simply requires searching for a logical interpretation that is consistent with the parties' intention. In my opinion, the confusion about the territories is largely attributable to two simple facts:

(a) First, the description of the territory evolved significantly over the years, in conjunction with access to a databank.

(b) Second, the evidence has established that, since the birth of PIN, the guiding principle was to attract the first clients and credible partners, then enter into an agreement with important value-added resellers in order to achieve maximum market penetration in the United States, and ultimately, to attract a giant such as Google or Microsoft to buy everything, producing a profit for all of the franchisees. Given this guiding principle and the fact that the implemented strategy had not yet borne fruit, the specific territory of the franchisees was of little importance to the franchisees and therefore not of particular interest to the franchisees or PIN and its affiliate companies.

In *Malo*, *supra*, each investor owned "a certain number of designated trees" (paragraph 2(d)), and the trees were designated only after the contract was concluded. Some trees may even have been planted after the contracts were signed. The lack of precision about the nature of the property purchased did not prevent the Court from finding that the appellant was carrying on a business.

[239] To illustrate that the whole thing was a deception, the respondent also submits that when the appellant bought the franchise in 2007, Solutions Prospector was no longer being marketed, and Mail It Safe did not allow the company to be profitable. The respondent adds that the 2008 franchise agreement did not include CashOnTime and that this program was only actually marketed after the period at issue. In other words, the respondent submits that these elements show once again that the appellant's business could not be profitable and that the motivation that pushed the appellant to buy the franchise could only have been tax-related.

[240] The fact that Mr. Mathieu's use of Mail it Safe inspired the creation of CashOnTime, and MIS's and PIN's promises to the franchises, lead me to believe that CashOnTime was a derivative program that the appellant and the franchisees could

market under the 2008 franchise agreement. Indeed, in an update dated December 10, 2008, MIS informed the franchisees of the creation of CashOnTime and of the marketing of this software (Exhibit A-109, page 11509). On February 16, 2009, MIS announced to the franchisees that CashOnTime had been [TRANSLATION] "officially launched" and invited them to a meeting on April 30, 2009, the goal of which was [TRANSLATION] "to share [with them] MIS International's business plan". In the minutes of this meeting, sent to the franchisees in July 2009, PIN reiterated the objectives and described the steps under way and the CashOnTime market studies being performed (Exhibit A-22.1.36, Volume 17, page 7419). The evidence further reveals that the efforts to market CashOnTime were initiated in 2008, while the program was still at the [TRANSLATION] "vapourware" stage, that is, it wasn't completely ready. This is what appears from a presentation to MIS's management on August 28, 2008 (Exhibit A-22.1.29, Volume 17, page 7314), and an update sent to the franchisees (Exhibit A-109, page 11509). I note, moreover, that the efforts to market Mail it Safe continued in 2008 (Exhibit A-109, page 11509) and that there were sales during that year (Exhibit A-31, pages 10028, 10055, 10078 and 10114).

[241] The respondent concludes from the fact that, in the case at bar, only the Mail it Safe software was being or could be marketed (Solutions Prospector no longer being marketed) when the appellant purchased his franchise in 2007 that the business was no longer viable and that the appellant was therefore not carrying out a commercial activity but was rather participating in a sham set up to appear as though it was commercial in nature where in fact the only activity actually engaged in was that of obtaining tax refunds. In other words, the respondent indirectly alleges that the fair market value ("FMV") of the franchise at the time of its acquisition in 2007 was nil, since, in fact, the franchise entitled the appellant to market a single product (in the matter at bar, Mail it Safe) and that the appellant's motivations when buying the franchise could therefore not have been commercial. First, I note that the Minister (who had the burden of proof) did not establish that the FMV of the appellant's franchise in 2007 was nil. Moreover, it is my opinion that the appellant's motivations when he acquired the franchise in 2007 were commercial, the evidence revealing that what the appellant was told before he acquired the franchise in 2007 had satisfied him that his investment would be profitable in the long term. The evidence also revealed that PIN and its affiliate companies were convinced in 2007 that Mail it Safe would be a success. In 2007, after some costly efforts, Network realized that its strategy for taking the United States by storm was not working and that it required another business plan for marketing the software in the franchisees' territory. Network therefore decided to temporarily suspend marketing the software in the United States. The strategy was for MIS to first develop a storefront in Quebec, which would then serve as a springboard for marketing the software in the United

States. It is therefore difficult for me to conclude from this evidence regarding the parties' conduct that they participated in a sham set up to appear as though it was commercial in nature.

MarketX

[242] Since MarketX had not been incorporated when the appellant signed the agency agreement in 2008, the respondent submits that [TRANSLATION] "during the period at issue", only Network existed and could have acted as agent for Drouin". However, the respondent submits [TRANSLATION] "that Network never acted as agent for Drouin during the year at issue". The respondent adds that [TRANSLATION] "if, however, Network had acted as agent for Drouin in 2008 (in replacement of MarketX, which never saw the day), it would have been subject to the only agreement in effect, namely, the agreement to which it was a party, the 2007 agency agreement". Consequently, according to the respondent, [TRANSLATION] "during the years at issue, the 2008 version of the franchise agreement combined with the only agency agreement in effect, that of 2007". According to the respondent, this combination [TRANSLATION] "resulted in Drouin being obliged not only to pay his franchisor 20% of his gross income (Exhibit A-1.2.1, Clause 12.2, page 38) but also to pay his agent 94% of his gross income (Exhibit A-1.1.3, clause 3.1, page 18)". Lastly, the respondent adds that [TRANSLATION] "the result of both agreements in effect being applied was absurd, since it meant Drouin having to pay 114% of his gross income in royalties and commissions to his supposed partners".

[243] The respondent submits that the fact that MarketX did not exist when the 2008 agency agreement was signed is another clue that the appellant had participated in a sham set up to appear as though it was commercial in nature where in fact the only activity actually engaged in was that of obtaining tax refunds.

[244] The evidence has revealed that the appellant signed an agency agreement with Network in 2007 in order for Network to market his franchise (Exhibit A-1.1.3). On December 19, 2008, the appellant signed a new franchise agreement and an agency agreement with MarketX (Exhibit A-1.2.1), a company that was to be created in order to put [TRANSLATION] "some distance between the international franchisor and the agent" (Testimony of Mr. Teasdale, Transcript, January 26, 2012, Question 420). According to the testimony of Mr. Duhamel, PIN had to give MarketX the mandate to market the franchises, and, in turn, MarketX had to give this mandate to Network (Transcript, February 6, 2012, Question 385). MarketX was never incorporated, and it wasn't until March 2009, during the sale to Mr. Bernier, that Mr. Duhamel became

aware of this (Transcript, February 6, 2012, Question 433; and Transcript, March 21, 2012, Questions 82 to 84). The appellant testified that he learnt that his agent didn't exist at the April 30, 2009, annual meeting. The appellant therefore took for granted that Network remained his agent, since MarketX had been supposed to replace Network (Transcript, January 30, 2012, Questions 459, 460, 464 to 474, 724 and 758 to 761; and Transcript, March 21, 2012, Questions 23 and 24). According to a resolution on March 25, 2009, entitled "Resolution of Board of Directors of Prospector International Network Inc." (Exhibit A-80), PIN would take over all of MarketX's rights and obligations. In short, the appellant was without an agent for barely three months.

[245] First, the respondent's allegation that [TRANSLATION] "Network never acted as an agent for Drouin during the year at issue" seems unfounded. Indeed, according to the 2007 agency agreement, Network was the appellant's agent until December 18, 2008, the date on which the appellant signed the 2008 agency agreement. At most, therefore, the appellant was without an agent for 11 days during the period at issue in 2008. In any event, as of 2007, no marketing activities were carried out in the franchisees' territory, given MIS's strategy of first developing a storefront in Quebec, which would then serve as a springboard for marketing the software in the United States.

[246] In my opinion, the issue here is not whether the 2008 agency and management agreement is null and void and whether, as a result, the 2007 agency agreement remained in effect, but rather whether the fact that the anticipated restructuring did not happen as planned is a clue that the parties participated in a sham again set up to appear as though it was commercial in nature where in fact the only activity actually engaged in was that of obtaining tax refunds.

[247] In the light of the evidence, it seems clear to me that the fact that the restructuring did not happen as planned does not show that the parties participated in a sham. When PIN and the appellant realized that MarketX did not exist (a few months after the signing of the 2008 agency and management agreement), they did not even bother rectifying the situation in writing because, in their minds and in actual fact, Network had not ceased being the appellant's agent. We must not forget that, at the end of the day, a contract is made through an exchange of consent between parties. The fact that Network temporarily suspended its marketing activities in the territory of the franchisees (for the reasons explained above) does not mean, however, that Network stopped being an agent.

[248] Indeed, the combined effect of the 2008 franchise agreement and the 2007 agency agreement created an [TRANSLATION] "absurd situation" since, according to percentages determined in these agreements, the proportion of the gross income earned by the appellant would be negative. When faced with an [TRANSLATION] "absurdity", the obvious solution is to seek a logical interpretation that is consistent with the parties' intention. It seems clear from the evidence that, in the minds of the parties and in actual fact, Network never ceased being the real agent and the conditions governing its mandate were those set out in the 2008 agency and management agreement.

Are the 2007 and 2008 agency agreements shams?

[249] The lack of marketing efforts on behalf of the franchisees leads the respondent to challenge the very existence of the 2007 and 2008 agency agreements. Under the heading [TRANSLATION] "Other relevant facts", the Minister alleges at paragraph 26 of the Reply to the Notice of Appeal that the agency agreements were shams. The fact that the burden of proving the sham allegations rests on the respondent is not being disputed. But the respondent has failed to satisfy this burden.

[250] For there to be a sham, the parties must enter into an agreement to deliberately deceive the tax authorities about the rights and obligations created by the agreement (see *Stubart* and *Nunn*, *supra*). In the case at bar, as in *Stubart*, the agreement recorded in the documents accurately reflects the reality in my opinion, and it is impossible for me to conclude that the appellant signed an agency agreement with the deliberate intention of misleading the CRA. Indeed, Network no longer having any employees for it to be able to market the software on behalf of the franchisees is not enough, in my view, to allow me to conclude that it never intended to market the software. Indeed, Mr. Duhamel provided a logical, detailed explanation for the fact that there was almost no activity on the part of Network as of 2007 (see paragraph 52). Moreover, as I noted in my preliminary remarks, the respondent's admission as to the reality of the franchise makes the fact that the mandate existed more likely (see paragraphs 208 to 211).

Is the promissory note a sham?

[251] The respondent submits that the purpose of the $3,500 payment made in 2010 and the $3,500 payment made in 2011 by the appellant (and the other franchisees) under an agreement entered into between the appellant (and the other franchisees)

and Prospector that amended the 2008 promissory notes (see Exhibits I-29 and I-43) was to conceal the actual agreement between the parties, which was that the parties had agreed to the price of $45,000 for a franchise. The promissory notes are therefore shams, for the following reasons:

(i) The terms of the agreement under Exhibit I-43 were not consistent with the appellant's explanations of the $3,500 payments made in 2010 and 2011. Indeed, the appellant explained that, according to the information he received from his financial advisor, Mr. Legault, he was to pay a total amount of interest of $52,000 (3 x $15,000 + 2 x $3,500 = $52,000) for his franchise (Court Reporter's Notes, January 30, 2012, Mr. Drouin, at page 128, line 18; at page 129, line 2) following the agreement reached between the parties to amend the terms of the 2008 promissory note. According to this agreement, the interest rate was decreased to 1.75%, effective retroactively to 2007, and the annual payments were $3,500, effective retroactively to 2007. The agreement also stipulated that any sum paid by the franchisee over the course of a given year (a period of 12 consecutive months starting from the signature of the promissory note) that exceeded the interest payable and the principal amount to be reimbursed each year ($1,500 in the case at bar) was interest and principal paid in advance, [TRANSLATION] "which the Franchisor could apply to the interest and the principal owed by the Franchisee for a subsequent year". The final result of these amendments, according to Mr. Duhamel, was that the franchisees had to pay $3,500 in 2010 and in 2011, $1,500 of which was a capital payment, and that after 2011, the franchisees would not have to pay anything before the maturity date, when a lump-sum and final payment became due.

(ii) The agreement does not make it possible to determine when it came into effect. It provides that the agreement comes into effect on the date of signature of the promissory note, without specifying whether the promissory note in question is the 2007 or the 2008 promissory note. The respondent notes that Mr. Duhamel's and the appellant's explanations in this regard were confusing.

(iii) The tax treatment of the interest paid by the appellant is not consistent with the promissory notes or the 2010 retroactive agreement.

[252] The onus was on the respondent to show that the promissory note was a sham. The CRA, after an extensive search and seizure of the main stakeholders, was forced to recognize that there were no counter-letters or other documents showing that the obligation to pay on the maturity date was a sham (see the examination for discovery of Normand Desjardins, June 23, 2011, pages 46 and 47). If there was such an elaborate deception, would it not have left traces that the CRA's searches would have discovered? As I mentioned in my preliminary comments, concluding that the promissory note is a sham, to some extent, means indirectly concluding that over a thousand franchisees (most of whom doctors and dentists) concluded an agreement with Prospector or Network to knowingly make a false declaration in order to mislead the tax authorities about their obligation to pay on the maturity date. A sham requires prior planning and the commission of acts or the creation of documents that give third parties a false impression of the actual transaction. This false impression must be deliberate. Among other things, I heard the testimony of the appellant and the five other franchisees chosen by CRA on the nature of the contractual commitments to pay their debt at maturity. In the light of these testimonies, I simply cannot conclude that all these witnesses perjured themselves, as suggested by the respondent, in order to deceive first the CRA and now the Court. Each witness testified honestly that he had bought a franchise to reap tax benefits and to be part of an attractive high-tech company. Each witness testified that he had promised to pay the debt at maturity according to the terms of the promissory note. The respondent's argument that the testimony of these witnesses is suspicious because of their personal interest, therefore making it not credible, is unfounded in my opinion. In any event, this argument can hardly be applied to Dr. Thibault, whose bankruptcy put an end to the dispute with the tax authorities.

[253] Indeed, the contradictions between the agreement and the appellant's testimony, the ambiguities in the agreement, the inaccuracies in the testimony of Mr. Duhamel in that regard, and the appellant's tax treatment of his interest payments, which is not consistent with the terms of the promissory note or the 2010 retroactive agreement, are troubling and may suggest that the promissory note was a sham. In my opinion, these factors are troubling, but not to the point of satisfying me that the promissory note was a sham.

[254] First, the contradictions between the testimony of the appellant and the 2010 retroactive agreement can be explained as follows in my opinion: the agreement is very hard to understand. It was negotiated by the appellant's financial advisor. The events date back a number of years, and the appellant's financial obligations towards PIN and its affiliate companies were the subject of many complex changes. What other explanation is there for the contradiction between the appellant's testimony that

the $3,500 payment in 2010 represented interest and his 2010 income tax return indicating that he was claiming interest charges in accordance with the 2010 retroactive agreement (see Exhibit I-27, Tab 154, Statement of Business or Professional Activities T2125, page 2, line 8710)? The appellant's failure to understand or to remember how his financial obligations toward PIN evolved does not, in my view, affect the validity of his legal relationship with PIN. Indeed, the agreement contains ambiguities. Such ambiguities are run-of-the-mill in business and create a great deal of work for lawyers and judges. They do not, however, remove the franchisees' obligation to pay at maturity. I also find that the fact that Mr. Duhamel's testimony is inaccurate in this respect can also be explained by the complexity and the number of the changes to the franchisees' financial obligations and by their dating back several years.

[255] The many changes to the franchisees' financial obligations can, in my opinion, be explained as follows: every time the maturity date of the promissory notes approached, PIN was faced with the dissatisfaction of the franchisees and, particularly, pressure from the franchisees' financial advisors, first, because of the unsuccessful marketing of the software and, second, because of the increasingly acrimonious dispute with the CRA and Revenu Québec. Under such pressures, PIN had to resign itself to reducing the franchisees' financial obligations by extending the maturity date of the promissory notes and by lowering the interest rate without decreasing the cost of the franchise. That at least is my interpretation of Mr. Duhamel's testimony in this regard (Examination of Claude Duhamel, Transcript, February 7, 2012, Questions 12 and 29 to 33). In short, the parties found a way of postponing the maturity date of the promissory notes without increasing the financial burden on the franchises and without reducing the obligation to pay the $230,000 cost of the franchise. The fact that the parties postponed the maturity date of the promissory notes several times does not mean, however, that these promissory notes are shams. Lastly, I would add that section 80 of the Act provides a comprehensive scheme for cases where franchisees do not reimburse the amounts they owe and for which they claimed deductions. In other words, the franchisees would not be able to avoid paying indefinitely by postponing the maturity dates of the promissory notes.

Reasonableness of the claimed expense

[256] Lastly, the respondent submits that the capital cost allowance of $70,387 claimed by the appellant is not deductible under section 67 of the Act since it is unreasonable in the circumstances. The respondent submits that, under section 67 of

the Act, excessive or unwarranted expenses may be reduced (*Stewart*, *supra*, at paragraph 57) and that this provision can be used to deny the deduction of the whole expense, if it is shown to be unreasonable (*Hammil v. Canada*, 2005 FCA 252).

[257] The respondent also refers to the following excerpt from *Gabco Limited v. M.N.R.*, [1968] 2 Ex.C.R. 511, in which Justice Cattanach set out the following test for the application of section 67:

> It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind.

[258] The respondent submits that the following factors clearly show that the expense claimed by the appellant was unreasonable in the circumstances:

(i) The appellant did not make any inquiries prior to acquiring the franchise in 2007;

(ii) The agent did not make any marketing efforts for the benefit of the appellant, making it impossible to generate sales;

(iii) Given the cost indicated in the franchise agreement, it was impossible for the appellant to profit from his investment. The respondent essentially submits (see pages 32 to 36 of the respondent's submissions) that Network would have had to have achieved annual sales of $582 million over 10 years for the appellant to recover the actual cost of his 2007 investment in the franchise, which, I repeat, was $200,000. Yet, according to the respondent, when the appellant signed his agreement in 2007, a single product (Mail it Safe) was being marketed, and the sales, which, moreover, were not generated to benefit the franchisees, had reached a total of $43,894 (see Exhibit A-81). The respondent adds that Network had to achieve annual sales of $275,000,000 or $459,750,000 (depending on the actual number of franchises) in order for all of the franchisees to recover the $15,000 in interest each of them had agreed to pay in 2007. To some extent, the Minister is submitting that the FMV of the appellant's franchise and the related rights is nil and that therefore the expense claimed by the appellant for the 2008 taxation year is not deductible under section 67 of the Act. I note that the Minister alleged at paragraph 25(s) of the Reply

to the Notice of Appeal that the [TRANSLATION] "fair market value of the franchise and the related rights was nil". The Minister also alleged the following at paragraphs 26(cc), (dd) and (ee) of the Reply:

> [TRANSLATION]
> Reasonableness of the capital cost allowance expense
>
> (cc) The fair market value of a Prospector International Networks Inc. franchise being low if not nil;
>
> (dd) The price paid by the appellant for the Prospector International Networks Inc. franchise was much higher than the fair market value of this franchise and is not reasonable in the circumstances;
>
> (ee) Consequently, the $70,387 claimed by the appellant as a capital cost allowance for the cost of the rights related to the acquisition of the franchise is not deductible since the argument is not reasonable in the circumstances.

(iv) Together, the 2008 franchise agreement and the 2007 agency agreement made it mathematically impossible for the appellant to make a profit, since the total royalties and commissions exceeded 100%.

[259] Since I have already analyzed the factors described in paragraphs (i), (ii) and (iv), above, I will now turn to the question of the FMV of the appellant's franchise and the related rights, since it is the basis of the Minister's assertion that the expense of $70,387 is not deductible under section 67 of the Act.

[260] The phrase "reasonable in the circumstances" used in section 67 of the Act is certainly broad. However, it is my view that it should not be applied to reduce expenses because of the appellant's alleged poor business sense. It is my opinion that the Minister's role and that of the Court is not to "to second-guess the business acumen of a taxpayer whose commercial venture turns out to be less profitable than anticipated" (*Mastri v. Canada (Attorney General)* (C.A.), [1998] 1 F.C. 66, para. 12). I would add that *Williams v. The Queen*, 2009 TCC 93, also referred to by the respondent, is of little assistance in the case at bar since it deals with expenses related to the appellant's home, while the present appeal concerns the cost of property.

[261] Regarding the FMV of an item of property, according to the Federal Court of Appeal as per *Attorney General of Canada v. Nash*, 2005 FCA 386, that the assessment of the appraisal was unnecessary and that the amounts paid by the taxpayers dealing with each other at arm's length was the FMV of the works of art. In the case at bar, the evidence reveals that the parties were dealing with each other at arm's length and were acting freely and in their own interest. Moreover, the Minister (who had the burden of proof) did not establish (with the help of an expert witness for example) that the FMV of the franchises did not reflect the cost of the franchises, and an additional appraisal was therefore not warranted. Even if one assumes that the issue of the FMV is an assumption on the basis of which the reassessment was made, it is my view that the evidence of the sale price of the franchises between the parties dealing with each other at arm's length is *prima facie* evidence that is sufficient for the appellant to discharge his burden. Consequently, the expense claimed by the appellant seems reasonable in the circumstances.

[262] I would add that, even though a cold, retrospective analysis to determine the FMV of a company may be scientifically defensible, it does not reflect the actual situation of the market at the time when the investment was made. As stated by Chief Justice Bowman in *McCoy v. The Queen,* 2003 TCC 332:

> [56] . . . The business landscape is strewn with the cadavers of megadeals that have gone catastrophically sour. I need not mention them by name. They are legion and will be familiar to anyone who reads the business section of the newspapers. Yet when the deals were consummated they were hailed euphorically and the corporate movers and shakers who pulled off these spectacular mergers and acquisitions, sometimes with less analysis than went into the launching of MarketVision, were acclaimed as financial geniuses. When a year or so later the structure falls to the ground the Monday morning quarterbacks shake their heads and ask "How could they have been so stupid? Surely, it must have been obvious that the deal had the seeds of disaster in it from the outset."
>
> [57] My common sense tells me that where a group of businessmen and professionals with sufficiently high incomes that they find tax shelters attractive are prepared to invest substantial amounts of cash for property that they reasonably expect will yield income (including amounts sufficient to pay the principal and interest on their promissory notes) and will produce a tax advantage that the promoters, armed with a favourable opinion from a major law firm, say will result, it is as unreasonable to say that the property was worth nothing or virtually nothing as it is to say that it was worth $55,000,000. Fair market value is in some measure a function of perception at the time whether we are talking about real estate in boom times in the late 1980s, stocks in 1929 before the crash or exotic tulips during the period of tulipmania in 17th century Holland. In that perception irrational or overly optimistic expectations may play a part. A cold blooded analysis five years after the

> event, and after the rosy predictions have proved to be wrong, may be scientifically defensible but it may not reflect the true state of the market at the time. . . .

[263] In conclusion, the evidence shows the following:

(i) The appellant acquired his franchise in order to earn a business income. It is clear that the appellant did not purchase the franchise as a hobby or other personal pursuit. Even if tax considerations were a prime motivation for his acquiring the franchise, they do not result in the appellant's business venture not existing.

(ii) The intention of the appellant's agent was to market the software on behalf of the appellant (and the other franchisees). The information given to the franchisees in updates and at franchisee meetings reveal that marketing efforts were made on their behalf.

(iii) The appellant (and the other franchisee witnesses) were under the obligation to pay the promissory note on the maturity date.

In my opinion, the Minister erred in concluding that, because of the commercial failure of PIN (and its affiliate companies) and of the franchises; and the testimonies of the appellant, Mr. Duhamel and the franchisee witnesses, which were ambiguous, confusing, incorrect and incomprehensible at times and, on occasion, even contradictory; the parties had devised an elaborate stratagem (to be implemented over several years) to give the impression that they were operating a business when the only activity they actually engaged in (still according to the Minister) was that of obtaining tax refunds.

[264] Lastly, the case at bar must be distinguished from *Moloney*, *Bendall*, *Madell* and *St-Laurent*, *supra*.

[265] In *Walls*, the Supreme Court found *Moloney* to be distinguishable, as follows:

> 21 The trial judge referred to the storage park operation as a "tax shelter" and concluded that the reduction of tax was the sole motivation for its existence, citing *Moloney v. The Queen*, 92 D.T.C. 6570 (F.C.A.). However, in that case, a circular scheme was set up for the sole purpose of obtaining tax refunds with no intention on the part of the taxpayer to carry on the business of marketing a speed reading course which was the ostensible purpose of the transactions. It was in this context that Hugessen J.A. stated, at p. 6570:

> While it is trite law that a taxpayer may so arrange his business as to attract the least possible tax, it is equally clear in our view that the reduction of his own tax cannot by itself be a taxpayer's business for the purpose of the *Income Tax Act*. [Emphasis added.]

> With respect, the case at bar is distinguishable from *Moloney*. There, the taxpayer was not engaged in a commercial activity, but instead was involved in a sham set up to appear as though it was commercial in nature where in fact the only activity actually engaged in was that of obtaining tax refunds. Here, in contrast, the Partnership purchased and maintained an ongoing commercial operation.

[266] The present case is distinguishable from *Moloney* in that the evidence has shown that, over the years, a subsidiary of PIN had marketed the software to prestigious, well-known Canadian clients in order to create a storefront, a strategy that was described as being common and key by expert Mr. Ouellet and which would have made it possible to do business with value-added resellers in the United States, in accordance with the company's initial strategy. A great deal of money was invested in the development and marketing of the software, whereas in *Moloney*, the transactions between the related companies were circular and simultaneous, meaning that no capital or credit was engaged by anyone in the so-called business.

[267] I also note that in *Moloney*, Canadian sales were not considered, since the licensee's territory was in the United States. In the case at bar, it has been shown that the Canadian sales were of particular interest to the franchisees.

[268] Moreover, contrary to *Moloney*, the evidence in the case at bar showed the appellant's intention to market, with the help of an agent, the software and to generate a profit from the software. As the evidence has shown, the appellant had two goals, one, to take advantage of tax deductions and to profit from the sale of software or the potential acquisition of the company.

[269] In *Moloney*, the taxpayer also did not have to spend any of his own money and did not take a financial risk. In the case at bar, the appellant had already spent $52,000 of his own money, a sum that was not refundable under any condition, and agreed unconditionally to pay his full recourse promissory note on the maturity date.

[270] The present case can also be distinguished from *Bendall*. In *Bendall*, the taxpayer had participated in a similar operation as that in *Moloney*, with the exception that the related companies did not engage in circular and simultaneous transactions. Justice Bonner came to the conclusion that the appellant's agent was not carrying on a business, while, in the case at bar, a PIN subsidiary was working on

building a storefront. Justice Bonner further stated in his judgment that it was impossible to conclude that the taxpayers seriously expected the agent to market the speed reading courses. In the case at bar, not only were market and sales efforts undertaken, but also Network told the franchisees that it had done a great deal to market the software. In addition, the decision of the taxpayer in *Bendall* to make a new investment two years later, even though he had not achieved any sales, does not apply to the appellant who bought only one franchise.

[271] The appellant's situation is also distinguishable from the situation in *Madell*. In *Madell*, the judge reached the conclusion that the taxpayer could not realize a profit from his investment because he was required to return the entire revenues the sales generated. In the case at bar, the agreements provided the appellant with royalties.

[272] Lastly, in *St-Laurent*, the Court noted that if the facts had been different—if, for example, the appellant had attended meetings, consulted the business plan and examined the objectives—the outcome could have been different. Nothing in the evidence, apart from the taxpayer's vague and unsubstantiated allegations, showed that the taxpayer was pursuing profit.

[273] For all of these reasons, the appeal is allowed, with costs.

Signed at Ottawa, Canada, this 3rd day of May 2013.

"Paul Bédard"

Bédard J.

Translation certified true

on this 9th day of October 2013.

François Brunet, Revisor

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