

# TAX COUNSEL

## A HORSE OF A DIFFERENT STRIPE DELINEATING PERSONAL AND BUSINESS EXPENSES

One of the more frequent themes in cases before the Tax Court is the deductibility of claimed business expenses.

Of course, we are all taxed on income. Section 9(l) of the *Income Tax Act* (the "ITA") defines income as the taxpayer's profit from a business or property in a taxation year. Profit is determined largely by a mathematical calculation of the difference between the revenues (or sale proceeds) and expenses. An expense is deductible if it is "incurred by the taxpayer for the purpose of gaining or producing income from the business or property" [s. 18(l)(a) of the ITA]. Section 18(l)(h) of the Act makes it absolutely clear that:

"no deductions should be made in respect of ... personal or living expenses of the taxpayer other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer's business".

Problems frequently arise when the business is not profitable and the expenses claimed have a personal fragrance associated with them. In such cases the Courts have held that the 'reasonable expectation of profit' test is a useful tool by which the tax appropriateness of an activity may be reasonably inferred when other more direct forms of evidence are lacking.<sup>1</sup>

It is very easy though for Canada Customs and Revenue Agency (the "Agency"), using 'the reasonable expectation of profit' test and the absolute clarity of hindsight, to conclude that earlier decisions made by a taxpayer were not reasonable. Entrepreneurs tend not to be confined by lineal thought processes. Unfortunately what might appear creative or ingenious at the outset can often be defined as merely fanciful on a retrospective view.

To bring the whole picture back into focus, we now have the Federal Court of Appeal decision of *Kuhlmann v. Her Majesty the Queen*.<sup>2</sup> The

Kuhlmanns were husband and wife, partners in a medical clinic, and joint operators of an English riding facility which lost money for several years in a row. They had a love of horses. It was that love together with the accumulated losses that resulted in the Federal Court Trial Division characterizing the taxpayers' activities as a hobby and their expenses as non-deductible.

The Federal Court of Appeal overturned the trial decision, stating that the Minister had not succeeded in showing on a balance of probabilities, that the taxpayers' expectation of profit was irrational, absurd or ridiculous. In essence, the Court turned the test around - if the expectation of profit wasn't irrational, absurd or ridiculous, then it must be reasonable.

It can now be fairly stated that, in viewing the deductibility of our client's expenses (assuming the dollar amounts are appropriate), we can use the same process of elimination.

Will the Agency's auditors and appeals officers use this particular strand of logic in their analyses of our clients' affairs? It is unlikely to be their first approach. One can hardly blame them. Their vision is clouded by years of retrospective outlooks. Using cases like *Kuhlman* though, perhaps we can turn their heads and minds around.

1. *Tonn et al v. Her Majesty the Queen* 96 DTC 6001 (F.C.A.)

2. *Kuhlman v. Her Majesty the Queen* 98 DTC 6652 (F.C.A.)

For additional information regarding the Agency's viewpoint see:

IT Bulletin 504R2 - Visual Artists and Writers  
IT Bulletin 322R - Farm Losses  
IT Bulletin 373R2 - Woodlots  
IT Bulletin 334R2 - Hobbies

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"Problems frequently arise when ...the expenses have a personal fragrance about them"

*“The case reports show far more applications for extension denied than allowed”*

# DEADLINES

On your mark, get set.... It seems we're always racing towards deadlines.

Two particularly short, but nevertheless common, deadlines in the tax world are the 90 day period for filing an objection to an assessment, and the similar time period for filing an appeal with the Tax Court of Canada following the confirmation of an assessment or re-assessment.

The provisions in respect to those time periods, and the extensions in relation to them, can be found at sections 166, 167 and 169 of the *Income Tax Act*.

These deadlines are missed most often as a result of the negligence or omissions of our clients; however, that is not always the case. Consider the following true scenario: In November of a certain year, the Minister confirmed assessments for previous taxation years. The taxpayer transmitted the Minister's Notices of Confirmation to his accountant, who within the month, commenced negotiations with Revenue Canada and consulted a solicitor about the possibility of utilizing that solicitor's services. The negotiations went on through to May of the following year.

Unfortunately, the accountant had not realized the taxpayer's deadline for filing an appeal had expired in February. He contacted the solicitor and in June, the solicitor made an application on the taxpayer's behalf for an extension of time to file the appeal.

Extensions for the filing of objections and Notices of Appeal may be granted if the application is made within one year, and the taxpayer demonstrates that:

- within the time otherwise limited in the Act for serving such notice or making such a request, as the case may be, the taxpayer was unable to act or instruct another to act in the tax payer's name, or had a bona fide intention to object to the assessment or make the request or file the appeal,
- given the reasons set out in the application and the circumstances of the case it would be just and equitable to grant the application, and
- the application was made as soon as the circumstances permitted;
- in the case of Notices of Appeal, the taxpayer additionally shows that there are reasonable grounds for the appeal.

In the scenario stated above, the taxpayer's application was granted. He had consulted professional help and, but for a human error, his Notice of Appeal would have been filed. He always had an intention to appeal and his grounds for appeal were reasonable.<sup>1</sup>

Frankly, the case reports show far more applications for extension denied than allowed. In most cases the application is not made as soon as circumstances permit or the taxpayer does not demonstrate a bonafide intention to appeal, object or make the request.

The lesson is clear, diarize all limitation dates without exception and pay attention to your reminder notices. Should one get past you, don't dally. Make the application for extension as soon as possible. To do otherwise may prejudice your client and ultimately cost you dearly.

<sup>1</sup> *Mann v. The Queen*, 99 DTC 175 (TCC)



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Donald P. Mallon, BSc LLB, a partner in Prowse & Chowne, is a seasoned litigator with over 20 years of experience. Focusing on administrative and tax litigation, he draws upon his courtroom and negotiation skills to effectively represent individual and business taxpayers in disputes with Revenue Canada.



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