Federal Court of Appeal | Cour d'appel fédérale

Date: 20221123

Docket: A-317-20

Citation: 2022 FCA 200

CORAM: **WEBB J.A.**
GLEASON J.A.
LASKIN J.A.

BETWEEN:

DARRELL BROWN

Appellant

and

HIS MAJESTY THE KING

Respondent

Heard at Toronto, Ontario, on October 27, 2022.

Judgment delivered at Ottawa, Ontario, on November 23, 2022.

REASONS FOR JUDGMENT BY: WEBB J.A.

CONCURRED IN BY: GLEASON J.A.
LASKIN J.A.

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REASONS FOR JUDGMENT

WEBB J.A.

[1] Mr. Brown is appealing the judgment of the Tax Court of Canada (2020 TCC 123) dismissing his appeal from reassessments made under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "Act") in relation to his 2011, 2012 and 2013 taxation years. Mr. Brown also brought a motion to introduce new evidence in this appeal.

[2] The main issue in this appeal is whether the Tax Court Judge erred in finding that there was a personal element to Mr. Brown's management services activity. Mr. Brown was providing management services to a numbered company owned by himself and his wife. The numbered company operated an art gallery. The Tax Court Judge found that, since Mr. Brown commenced the management services activity because his wife was no longer able to manage the gallery as a result of her illness and pregnancy, it was a personal endeavor.

[3] For the reasons that follow, I would allow this appeal and dismiss Mr. Brown's motion to introduce new evidence.

I. Background

[4] Mr. Brown is a lawyer and his spouse, Lyudmila Bezpala-Brown, is a visual artist and art historian. They decided to open an art gallery in Toronto. A numbered company was formed for the purpose of operating the gallery, with Mr. Brown owning 51% of the common shares and Ms. Bezpala-Brown owning the remaining 49% of the common shares. Their friend Fariz Ahmadov was also involved with the operation of the gallery.

[5] Ms. Bezpala-Brown and Mr. Ahmadov conducted extensive market research to determine the likelihood of a successful gallery. They determined that it would be possible to operate a financially successful gallery in Toronto, but it would take five years and considerable investment for it to break even.

[6] In the fall of 2009, Mr. Brown arranged for financing to be obtained from Rotveil Technologies for the new gallery. Ms. Bezpala-Brown's brother was a principal of Rotveil Technologies.

[7] The gallery opened in April 2010 and received a warm reception from the art community. It was also the subject of reviews in newspapers. At that time, Mr. Brown was providing some services to the gallery, but these services were not extensive.

[8] In September 2010, Ms. Bezpala-Brown became ill and was no longer able to run the gallery. She also became pregnant in the fall of 2010. As a result, Mr. Brown became more involved in the gallery business, as did Mr. Ahmadov.

[9] At the beginning of 2011, it became apparent that Mr. Ahmadov was becoming increasingly stressed due to the absence of Ms. Bezpala-Brown. At this time, Mr. Brown also learned that Rotveil Technologies would not be providing funds on an ongoing basis to support the gallery. The expenses of the gallery exceeded its revenue.

[10] On January 4, 2011, the directors of the numbered company passed a resolution to retain Mr. Brown to provide a number of management services to the company. The compensation to be paid to him was a management fee equal to 20% of the amount by which the gallery's annual revenue exceeded $100,000. HST would be paid in addition to the management fee if Mr. Brown was registered under the *Excise Tax Act*, R.S.C. 1985, c. E-15, or if the management fee exceeded $30,000. The resolution also included the following:

> The Corporation shall review this management services arrangement prior to the end of the 2012 calendar year to determine whether a contract shall be entered into for management services over a longer term or whether management services will be taken in-house and the contractual arrangement with Darrell Brown terminated. However, in the event that no management fees have been paid by the Corporation to Darrell Brown at the time of the management services review, Darrell Brown shall have the right to enter into a five-year management services contract on terms to be negotiated between the Corporation and Mr. Brown so that Mr. Brown has the opportunity to recoup losses that may be incurred in the 2011/2012 timeframe through the provision of such management services and profit from management services fees generated and payable from the Corporation's revenue growth over the five-year term.

[11] On October 5, 2012, Mr. Brown and the numbered company signed a written agreement stipulating that he would provide the same services he had been providing following the resolution of the directors in 2011 and for the same compensation arrangement. The term of the agreement was five years.

[12] Mr. Brown provided management services to the gallery during the years in question and each year the gallery did not have sufficient revenues to trigger a payment to him. The total revenue of the gallery for 2011 was $39,000, for 2012 it was $48,513, and for 2013 it was $98,029. The gallery incurred losses of $93,415 in 2011, $121,224 in 2012, and $77,220 in 2013.

[13] Mr. Brown testified that the gallery experienced a number of problems and set-backs including a sale of the building in which the gallery was located to a new landlord who did not want the gallery as a tenant, the refusal of the landlord to allow the gallery to complete renovations to open an art bar, and persistent flooding of the gallery.

[14] Mr. Brown claimed non-capital losses of $90,696 for 2011, $115,200 for 2012 and $113,932 for 2012. Mr. Brown was reassessed to deny the non-capital losses on the basis that his management services activity was not a source of income and that the amounts claimed as expenses were not reasonable. There was no allegation that Mr. Brown was an employee of the numbered company in providing the services in question. At the Tax Court hearing, he conceded that the non-capital losses that are in issue for 2011 should be reduced to $49,086 and for 2012 should be reduced to $45,457.

II. Decision of the Tax Court

[15] The Tax Court Judge referred to the decision of the Supreme Court of Canada in *Stewart v. Canada*, 2002 SCC 46 (*Stewart*) wherein the Supreme Court, in paragraph 50, set out the two-stage approach to determine if a taxpayer has a source of income and, if so, whether the source is a business or property:

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

[16] The Tax Court Judge's conclusion that there was a personal element to the management services is set out in paragraphs 33 and 34 of his reasons:

> [33] The first stage of this approach consists of determining if Mr. Brown provided management services in the pursuit of profit or if it was a personal endeavour. In this case, the evidence clearly showed that during the relevant

> taxation years, there was a personal element to the activity. The evidence is that Mr. Brown only began providing extensive management services to the Gallery because Mrs. Brown became ill and of [*sic*] her pregnancy. These events made her unable to run the Gallery as they both had planned. According to Mr. Brown, in early January 2011, while Mrs. Brown was still ill, the situation took a turn for the worse because Mr. Ahmadov was no longer able to support the pressure of performing the day-to-day activities of the Gallery by himself.
>
> [34] Therefore, the Court finds that Mr. Brown only began providing management services because of Mrs. Brown [*sic*] health issues. The evidence is that it was one of the reasons why he continued to provide management services to the Gallery throughout the relevant taxation years. Therefore, there was a personal element to Mr. Brown's activity during all of the said taxation years.

[17] His conclusion is set out in paragraph 41 of his reasons:

> [41] The Court concludes, on the balance of probability, that Mr. Brown's activity contained elements that suggest that it was a personal activity. The Court also concludes that the activity was not carried on in a sufficiently commercial manner to constitute a source of business. Mr. Brown did not show that his predominant intention was to make a profit from the activity. Therefore, the Minister correctly determined that the business losses claimed by Mr. Brown for the 2011, 2012 and 2013 taxation years had to be disallowed.

III. Issues and Standards of Review

[18] The main issue in this appeal is whether the Tax Court Judge erred in finding that Mr. Brown's personal reasons for providing management services to the numbered company resulted in this being a personal endeavour as contemplated by the Supreme Court in *Stewart*. If there was no personal element to his management services activity, the next question is whether he was pursuing profit in carrying on this activity.

[19] Questions of law will be reviewed on the standard of correctness and questions of fact or mixed fact and law will be reviewed on the standard of palpable and overriding error (*Housen v. Nikolaisen*, 2002 SCC 33).

IV. Analysis

[20] In my view, the Tax Court Judge erred in law in interpreting the decision of the Supreme Court in *Stewart* by focusing on Mr. Brown's personal reasons for providing the management services to find that this activity was a personal endeavour rather than focusing on the activity itself to determine if there was a personal or hobby element to the management services activity.

A. *The Approach to Follow in Determining if there is a Source of Income*

[21] In paragraph 50 of *Stewart*, the Supreme Court set out the two-stage approach to determine if a taxpayer has a source of business or property income for the purposes of the Act. The first stage is described as:

> (i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?

[22] The Supreme Court noted that activities which are clearly commercial in nature do not require any further analysis to determine if a person has a source of income. The Supreme Court clarified in paragraphs 53 and 60 that a personal endeavor is one where there is some personal or hobby element to the activity in question. If there is some personal or hobby element to the

activity, further analysis will be required to determine if it is being carried on in a sufficiently commercial manner to make it a source of income.

[23] The Supreme Court also noted in paragraph 51 of *Stewart*:

> Equating "source of income" with an activity undertaken "in pursuit of profit" accords with the traditional common law definition of "business", i.e., "anything which occupies the time and attention and labour of a man for the purpose of profit".

[24] In *Canada v. Paletta Estate*, 2022 FCA 86 there was no suggestion that there was any hobby or personal element to the activity in question. This Court confirmed that the activity still had to be carried out in pursuit of profit in order to be a source of income. There are undoubtedly many activities which do not have a hobby or personal element. The person undertaking these activities will not have a source of income unless that person is pursuing profit in carrying out these activities.

[25] The approach to determine if a person has a source of income can therefore be rephrased as follows:

- Is there a personal or hobby element to the activity in question?

    - If there is a personal or hobby element to the activity in question, the next enquiry is whether "the activity is being carried out in a commercially sufficient manner to constitute a source of income" (*Stewart*, at para. 60).

- If there is no personal or hobby element to the activity in question, the next enquiry is whether the activity is being undertaken in pursuit of profit.

B. *Is There a Hobby or Personal Element to Mr. Brown's Management Services Activity?*

[26] As noted above, in paragraphs 53 and 60 of *Stewart*, the Supreme Court emphasized that the additional enquiry related to the commerciality of the activity is only triggered if there is a hobby or personal element to the activity in question:

> [53] We emphasize that this "pursuit of profit" source test will only require analysis in situations where there is some personal or hobby element to the activity in question. With respect, in our view, courts have erred in the past in applying the REOP test to activities such as law practices and restaurants where there exists no such personal element: see, for example, *Landry, supra; Sirois, supra; Engler v. The Queen*, 94 D.T.C. 6280 (F.C.T.D.). Where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer's business decisions. Such endeavours necessarily involve the pursuit of profit. As such, a source of income by definition exists, and there is no need to take the inquiry any further.
>
> …
>
> [60] In summary, the issue of whether or not a taxpayer has a source of income is to be determined by looking at the commerciality of the activity in question. Where the activity contains no personal element and is clearly commercial, no further inquiry is necessary. Where the activity could be classified as a personal pursuit, then it must be determined whether or not the activity is being carried on in a sufficiently commercial manner to constitute a source of income. However, to deny the deduction of losses on the simple ground that the losses signify that no business (or property) source exists is contrary to the words and scheme of the Act. Whether or not a business exists is a separate question from the deductibility of expenses. …
>
> [emphasis added]

[27] To determine if the further analysis with respect to the commerciality of the activity is required, the focus is on the activity itself and whether there is any personal or hobby element to the activity. In this case, the activity is management services. The question is therefore whether there is any personal or hobby element to the management services Mr. Brown was providing. In my view, Mr. Brown's decision to provide these management services as a result of his wife's inability to continue to manage the gallery, does not mean that there is a personal or hobby element to his management services activity, as contemplated by the Supreme Court.

[28] Many businesses are passed from one generation to the next. As noted above, the Tax Court Judge found a personal element to Mr. Brown's management services activity when he commenced that activity as a result of his spouse's inability to continue managing the gallery. Applying this logic to an intergenerational transfer of a business, whenever the next generation takes over an endeavour from their parents as a result of their parents' inability to continue the endeavor, the analysis to determine if the next generation is carrying on the activity in a sufficiently commercial manner to qualify as a source of income would be triggered. However, simply because a child takes over an endeavor from his or her parent because that parent is not able to continue conducting that endeavor should not result in a finding that there is a personal element to the endeavor that the child is now undertaking.

[29] A person's personal motivation or reason for conducting an activity cannot, in and of itself, result in there being a personal or hobby element to the activity. It is possible to find a personal reason why any person is carrying on a particular activity. For example, a person may be motivated to conduct a particular activity to generate money to fund his or her personal

lifestyle or because they are personally motivated to provide better services or products than are currently available in the marketplace.

[30] As a result, every activity could potentially be subject to the further analysis to determine if it meets the test of commerciality. In effect, this would mean that the reasonable expectation of profit test (which the Supreme Court restricted to activities that have a personal or hobby element) would be applicable to all activities. This cannot be what the Supreme Court intended in *Stewart*.

[31] In this case, the activity in question is providing management services to the corporation (the numbered company) that was carrying on the gallery business. These management services allowed the gallery to continue to operate. There is no indication that there was any personal or hobby element to these management services. The only personal element identified by the Tax Court Judge was Mr. Brown's motivation to provide these services because his spouse was unable to continue managing the gallery.

[32] In my view, the Tax Court Judge erred in finding that there was a personal element to Mr. Brown's management services activity because he undertook these activities as a result of his spouse's inability to continue to manage the gallery. Since there is otherwise no basis to find that there was any personal or hobby element to Mr. Brown's management services activity, Mr. Brown had a source of income, provided he was pursuing profit in carrying on his management services activity.

C. *Was Mr. Brown Pursuing Profit?*

[33] As noted above, the intention to profit is necessary in order to find that Mr. Brown was carrying on a business. The Tax Court Judge's findings with respect to his intention to make a profit are set out in paragraph 36 of his reasons:

> The evidence is that Mr. Brown provided management services to the Gallery in order to help Mrs. Brown and to offload as much as possible of the Gallery's expenses to himself. This was done in order to allow the Gallery to be in operation until it [*sic*] revenues be sufficient to pay all of its expenses. This is what Mr. Brown stated in his testimony. Based on the evidence, this never changed during the relevant taxation year [*sic*]. Clearly, Mr. Brown did not begin providing services and did not continue to do so with the goal of making a profit. On that basis alone, the Court has concluded that Mr. Brown did not establish on the balance of probability that his predominant intention was not [*sic*] to make a profit from the activity and therefore, the activity was not a source of business income during the relevant taxation years.

[34] The Tax Court Judge based his finding on Mr. Brown's predominant intention. In *Massé v. Canada*, 2003 FCA 351, this Court, after referring to paragraph 60 of *Stewart*, noted:

> [20] Henceforth, the Court may consider the factors enumerated in *Moldowan v. The Queen*, [1978] 1 S.C.R. 480, only to the extent that the activity bears some personal element. More specifically, the existence of a personal element
>
> > ... requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour. (*Stewart*, at par. 54)

[35] The presence of a personal element in the activity in question will trigger the inquiry into the predominant intention of the taxpayer. Absent a personal element in the activity, the question

is whether the taxpayer is pursuing profit in undertaking the activity in question, not whether this was his predominant intention. If the evidence establishes that profit is not being pursued, then the taxpayer is not carrying on a business (*Paletta*, at paragraph 39).

[36] The Tax Court Judge, in concluding that Mr. Brown was not pursuing profit, focused on the deductions claimed by Mr. Brown. In essence, he was evaluating his expectations of profit rather than simply whether he intended to profit.

[37] The question of whether a person is pursuing profit is separate from the question of the deductibility of any expenses claimed. As noted by the Supreme Court in *Stewart*:

> [56] In addition to restricting the source test to activities which contain a personal element, the activity which the taxpayer claims constitutes a source of income must be distinguished from particular deductions that the taxpayer associates with that source. …

[38] The Crown argued that Mr. Brown did not intend to profit because some of the expenses he was claiming were expenses of the gallery and the arrangement between Mr. Brown and the gallery did not include a direct reimbursement of these expenses. However, the absence of a provision in the arrangement requiring a direct reimbursement of the expenses he was claiming, does not necessarily lead to the conclusion that he was not pursuing profit. If the management fee (based on the annual revenue of the gallery) exceeded the amounts he claimed as expenses, he would realize a profit. If all the amounts he claimed as expenses were not properly claimed as expenses, the threshold at which he would realize a profit is even lower. The question, however,

is whether, in providing the management services, he was pursuing profit, not whether he had a reasonable expectation of profit or whether a different business model could have been chosen.

[39] The terms of the arrangement between Mr. Brown and the numbered company illustrate that the absence of a provision providing for direct reimbursement of the gallery expenses that he was claiming does not necessarily mean that he was not pursuing profit. The management fee was 20% of the annual revenue of the gallery in excess of $100,000. For example, if the gallery would have had revenue of $350,000, this would generate a management fee of $50,000 ($350,000 - $100,000 = $250,000 x 20% = $50,000). This would exceed the amounts he now is claiming as expenses for 2011 and 2012. Since no management fee was payable in any of the years in issue, the amount of the loss that he claimed for 2011 and 2012 was almost equal to the amount of the expenses that he had claimed.

[40] For 2013, the loss claimed (and the amount of expenses claimed) was $113,932. If the gallery would have generated an annual revenue of $670,000, the management fee would have been $114,000. This would have covered all of the expenses that Mr. Brown claimed, including the gallery expenses he claimed and his own expenses. Whether the gallery business would have realized a profit after paying this management fee is not in issue in this appeal. The question in this appeal is whether Mr. Brown was pursuing profit, not whether the numbered company was pursing profit.

[41] Therefore, the absence of a clause in the agreement providing for a direct reimbursement of gallery expenses claimed by Mr. Brown does not mean that he was not pursuing profit in

providing the management services to the numbered company. The directors' resolution referred to above also contemplated the adoption of a five-year management services agreement to allow Mr. Brown to recoup his losses and realize a profit.

[42] The Crown does not dispute that the numbered company was carrying on a business in operating the gallery and therefore that the numbered company was pursuing profit in operating the gallery. Mr. Brown was providing the management services that allowed the numbered company to operate the gallery. As noted by the Tax Court Judge in paragraph 36 of his reasons, "Mr. Brown provided management services to the Gallery in order to help [Ms. Bezpala-Brown] and to offload as much as possible of the Gallery's expenses to himself … to allow the Gallery to be in operation until it [*sic*] revenues be [*sic*] sufficient to pay all of its expenses". While the Tax Court Judge found that this supported his conclusion that Mr. Brown was not pursuing profit, in my view, this would support the opposite conclusion.

[43] Mr. Brown's management services activity was inextricably linked to the gallery business. His revenue was a percentage of the gallery's gross revenue. The more successful the gallery was, the more revenue this would generate for his management services activity. By providing the management services that allowed the gallery to continue to operate until it could generate sufficient revenue to cover all of its expenses, Mr. Brown's intent was to allow the gallery to generate revenue which, in turn, would generate the management fees payable to him, and hence, profit for his management services activity.

[44] There is also no allegation in the Reply filed by the Crown in the Tax Court that the arrangement between Mr. Brown and the numbered company was a sham. Therefore, there is no allegation that the contract between Mr. Brown and the numbered company did not reflect the obligations of the parties.

[45] As a result, in my view, there is no basis to conclude that Mr. Brown was not in pursuit of profit in providing the management services to the numbered company and, therefore, on the balance of probabilities, he was in pursuit of profit in providing these management services.

D. *The Deductibility of the Expenses Claimed has not been Determined*

[46] However, this does not mean that he is entitled to deduct all of the expenses that he has claimed in computing his income for the purposes of the Act. Although he was pursuing profit, the amount of profit, or in this case his loss, must be determined in accordance with the provisions of the Act. The question of whether the expenses Mr. Brown claimed are deductible for the purposes of the Act is a separate question that was not addressed by the Tax Court Judge.

[47] As a result, I would refer the matter back to the Tax Court to determine the amount of the non-capital losses for the purposes of the Act, if any, from Mr. Brown's management services business for his 2011, 2012 and 2013 taxation years.

V. Motion to Introduce New Evidence

[48] The new evidence Mr. Brown is seeking to introduce relates to the commerciality of the gallery and his management services activity. This evidence is not relevant to the issue as determined above, and on this basis alone I would dismiss the motion.

[49] However, a few additional comments on the motion are warranted. The motion attempts to introduce, on appeal, a 34-page affidavit of Ms. Bezpala-Brown and over 80 new documents. The affidavit includes argument as well as testimony that was not before the Tax Court.

[50] An appeal to this Court is not a trial *de novo*. If the lengthy affidavit and the many new documents would have been admitted, the Crown would have had the right to cross-examine Ms. Bezpala-Brown and, in effect, the appeal would have become a new trial. As noted recently by the Supreme Court in *Nova Chemicals Corp. v. Dow Chemical Co.*, 2022 SCC 43, at paragraph 72, the Supreme Court is not a court of first instance and it is not the role of that Court to review the entire record and make factual findings. These comments apply equally to this Court.

VI. Costs

[51] After the hearing of the appeal, the parties notified the Court that they had reached an agreement with respect to the costs for the motion, the appeal, and the Tax Court hearing. However, costs are to be determined by the Court and, in my view, no costs should be awarded in relation to the motion or this appeal as success was divided. As well, since I would refer the

matter back to the Tax Court, the costs of the Tax Court hearing should be determined once the final decision of the Tax Court is rendered.

VII. Conclusion

[52] As a result, I would dismiss Mr. Brown's motion to introduce new evidence, without costs. I would allow the appeal, without costs, and I would set aside the judgment of the Tax Court. I would remit the matter back to the Tax Court to determine the amount of the non-capital losses for the purposes of the Act, if any, from Mr. Brown's management services business for his 2011, 2012 and 2013 taxation years.

"Wyman W. Webb"
J.A.

"I agree.
Mary J.L. Gleason J.A."

"I agree.
J.B. Laskin J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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