

Docket: 2004-4751(IT)G

BETWEEN:

KEVIN NEILSON,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on August 10, 2007, at Edmonton, Alberta

By: The Honourable Justice Campbell J. Miller

Appearances:

Counsel for the Appellant: James Yaskowich
Counsel for the Respondent: Margaret McCabe

JUDGMENT

The appeals from reassessments of tax made under the *Income Tax Act* for the 1999 and 2000 taxation years are dismissed, with costs to the Respondent.

Signed at Ottawa, Canada, this 29th day of August 2007 .

“Campbell J. Miller”

C. Miller J.

Citation: 2007TCC512
Date: 20070829
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REASONS FOR JUDGMENT

C. Miller J.

[1] Dr. Kevin Neilson lives in the fast lane, literally. In the years under appeal, he was a fulltime emergency doctor at the University of Alberta Hospital (“UAH”), as well as Medical Director of STARS (an air ambulance service in Northern Alberta): he also drove a racing car in the Trans-Am Series for K2 Motor Sports Ltd., a company in which he was a 50% shareholder. Dr. Neilson paid considerable racing car expenses in 1999 and 2000. In a circular arrangement, he had such costs offset against amounts owed by him to nNovation Learning Group (“NLG”) for work commissioned by him to develop online medical education, as it pertains to emergency departments. All participants in this arrangement were related to the Neilson family. The Minister of National Revenue (the “Minister”) disallowed deductions of \$173,889 in 1999 and \$109,541.89 in 2000 on the basis that the amounts were not expended for the purpose of gaining or producing income from his medical practice. All but approximately \$4,000 of these amounts related to the racing car expenses.

FACTS

Medical Practice

[2] Dr. Neilson has served as an emergency physician for 20 years at the UAH. He described his role as “three-legged”: research, education and patient care. In conjunction with his emergency physician colleagues, a more formal education program for training doctors in emergency work was developed at UAH. Dr. Neilson acknowledged he was not one of the main developers. Two programs were instituted: one for family physicians who wished to add emergency expertise to their practice, and a second, strictly limited to emergency physicians. The first program would lead to the credentials of a CCFPME (Certificate of the College of Family Physicians in Medical Emergency). The second, a four-year program, would lead to the credentials of an FRCP (Fellow Royal College of Physicians). Dr. Neilson considered himself a “dinosaur” as he had neither qualification, notwithstanding his participation in creating such credentialing programs. For this reason, he described his position in UAH in 1999 and 2000 as somewhat tenuous.

[3] In 1999 and 2000, Dr. Neilson was also Medical Director of STARS, the air ambulance program for northern Alberta. He believed he needed to do such things to continue to add value to his work as an emergency physician at UAH.

[4] Dr. Neilson described the teaching leg of his position as being sub-optimal. My impression from Dr. Neilson was that this had more to do with the stresses of working in an emergency department, than actual teaching ability. Most education was on-the-job clinical training, with a student by the doctor’s side as he or she tended to emergency patients. As Dr. Neilson explained, there was not always the time to focus on the teaching – the focus was on the patient.

[5] Dr. Neilson’s mother was an educator. Dr. Neilson had discussions with her about how to improve the teaching of emergency physicians. He resolved that a computer-based program might be the answer. He believed that if he could develop such a program he might accomplish three things:

- (i) First and foremost, secure his position as an emergency physician at UAH, notwithstanding his lack of credentials.
- (ii) Enhance the education of emergency physicians generally.

- (iii) Create potential for future income if the program could be successfully marketed.





nNovation Learning Group

[6] Dr. Neilson's mother, Alpha Neilson and his brother, Kent Neilson, were indirectly the two-thirds owners of NLG, which owned 100% of NLG (US). I will refer to the Canadian and US companies collectively as NLG. NLG was set up by Altha Neilson. She had been a superintendent of education in Red Deer, Alberta, and had spent many years as an educator. She was committed to the idea of online learning for educators and set up NLG with her son, Kent, for that purpose. She believed she had a successful contract with an outfit called Oz News Media, but that substantial contract fell through. It was necessary to cultivate more clients and she believed not just in the teaching industry. In discussions with Dr. Neilson, she was convinced that advertising for more corporate clients, for example in industry and medicine, was a viable solution. After discussions with Dr. Neilson she was satisfied that advertising on a racing car might lead to investors. In NLG's Business Plan 2000, marketing was described as consisting of:

- direct calling – print advertising – direct mail advertising – word of mouth – community involvement generating networking opportunities – conference and convention participation and presentation – permission based email marketing – online advertising – web based word of mouth – cross promotion.

[7] After the discussions with Dr. Neilson, she also concluded NLG could develop software for Dr. Neilson and he could create advertising for her using his race car. NLG did not enter any written agreement with K2 Motor Sport to act as its promoter.

[8] In May 1999, NLG sent a proposal entitled "Feasibility Study" to Dr. Neilson to conduct a study to develop an internet based medical education system (IMES). It set out the following list of items to be provided by NLG to Dr. Neilson at a cost of \$425,000:

-  Coordination and Management of Development
-  Course Content Compilation and Editing
-  Art Design
-  Web Interface and Database Design

- ✚ Conceptual Design
- ✚ Coding
- ✚ Navigation
- ✚ Asset Layout and Creation: graphic, image
- ✚ Interactive Design
- ✚ Animated Illustrations & Text
- ✚ Media Integration

- ✚ Graphical User Interface Development
- ✚ Scalable Database Design & Development
- ✚ Online Web-based Learning Tools Compilation
- ✚ Professional Development Course Design and Development
- ✚ Analysis Software Development
- ✚ Communication Capabilities.

[9] Dr. Neilson made no mention of pursuing the idea of IMES with his colleagues at the University of Alberta. It appears this was intended to be and was his own project. He suggested he was involved in the development of IMES to the extent of ensuring the end product looked like what he anticipated. His explanation in this regard was somewhat sketchy.

[10] According to Dr. Neilson, the IMES project was developed to the extent of the “front-end”. It was unclear what this in fact entailed. It was clear, however, that no substantive medical or clinical modules were ever created. The proposal from NLG did stipulate that Dr. Neilson would retain ownership of the source code. No other documents, apart from the proposal, described the agreement.

[11] NLG rendered regular monthly invoices, prepared by Kent Neilson, to Dr. Neilson in the amounts of either \$10,000 or \$6,000. Dr. Neilson did not pay the

invoices by cheque or cash to NLG. Instead, Dr. Neilson paid expenses of K2 Motor Sports for the operation of a racing car. NLG sponsored the racing car, according to Dr. Neilson, and agreed to offset any costs owed to it by Dr. Neilson by Dr. Neilson's payment of the racing car expenses. This was the arrangement set up by Dr. Neilson.

[12] The work performed by NLG on the IMES project was, according to Mrs. Neilson, done at a rudimentary level: lots more was needed to develop IMES. As Mrs. Neilson put it, more sophistication had to be built in. She did not herself work on the project, so she only had a general idea of what was done. She could not explain in detail how much of the list of work described in the proposal was actually completed. She indicated that work on the "front-end" was most costly and that such work would be for use in IMES, as well as other programs.

Racing Car

[13] Dr. Neilson and his brother were into racing cars to such a degree that in the late 1990s, they sought to move up from the amateur ranks to the professional. They first incorporated K2 Motor Sport on a 50-50 basis. There were a few possibilities of where to race their car. They decided to enter the Trans-Am Series. Dr. Neilson explained that, given the significant increase in cost to go professional, they wanted a series that would provide enough exposure to attract sponsors. Trans-Am had T.V. listings, including with CBS, that attracted a significant viewership. Trans-Am required advertising decals to be appropriately placed on the vehicles. For example, a race sponsor, BF Goodrich, would have to have its name on the windshield of every car in the race.

[14] K2 Motor Sport, through Dr. Neilson's discussion with his mother, arranged to carry NLG's logo on its car. There is no evidence that such sponsorship resulted in any concrete benefit to NLG. Dr. Neilson suggested that sponsorship could run anywhere from \$40,000 to \$100,000 a race. There was no written contract setting out the terms of this sponsorship/advertising arrangement.

[15] K2 Motor Sport, NLG and Dr. Neilson reached an arrangement, whereby the budgeted amount to develop IMES would serve as the amount to sponsor the racing car, and that Dr. Neilson would pay the car expenses directly, keeping a running tally to indicate how such costs would offset the invoices from NLG to Dr. Neilson. A ledger was provided showing every payment. There are car expenses in excess of this arranged method of payment. Dr. Neilson testified that such excess was simply made from personal funds.

[16] The K2 Motor Sport car raced in several races in 1999 and 2000. One race resulted in a crash that demolished the car. This effectively put an end to the three-way arrangement. Dr. Neilson testified that the other reason for terminating the arrangement was because the deductibility of the expenses had been brought into question. He no longer continued to fund the IMES project.

ANALYSIS

[17] The Respondent states the issue as follows: for 1999 and 2000 should Dr. Neilson be permitted to have his professional income from the practice of medicine reduced by expenses incurred through racing cars for sport? This is not how I would ask the question. The question I suggest should go to the nature of expenses; do the facts support a finding that the amounts expended directly on the racing car were in fact expenses on the development of a medical software program, due to the three-way arrangement set up by Dr. Neilson. If the facts support such a finding, then there arises a question as to whether such expenditures were a current expense, a capital expenditure or simply a personal expense.

[18] The Appellant painted a picture of a triangle of three entities needing something and having something to offer. Dr. Neilson needed to secure his job: Dr. Neilson had cash. His mother's company, NLG, needed to attract investors: NLG had computer online learning development expertise. K2 Motor Sport had an ability to offer exposure to potential investors: K2 Motor Sport needed cash. So two agreements were reached: Dr. Neilson hired NLG to develop a medical software program, IMES, and NLG agreed to sponsor K2 Motor Sport. There was no written contract between Dr. Neilson and K2 Motor Sport. Dr. Neilson simply paid K2 Motor Sport's expenses, for which K2 Motor Sport agreed to provide NLG advertising, and for which Dr. Neilson got software development work done by NLG. The Appellant views this arrangement as Dr. Neilson paying NLG for its services by meeting NLG's financial obligation to sponsor K2 Motor Sport. I have some difficulties with this view for a number of reasons:

- (i) First, there is no written contract between K2 Motor Sport and NLG evidencing their agreement. Yes, Dr. Neilson put considerable money into K2 Motor Sport, and yes K2 Motor Sport put NLG's decal on its car: this certainly suggests there was some understanding. Yet, for an agreement involving about \$300,000, there was nothing to indicate the respective parties' commitments and responsibilities; for example, how long was the deal to last, was the funding commitment open-

ended, how could the contract be terminated, in how many races was K2 required to advertise NLG and the list could go on and on. The lack of detail and certainty in this contract leaves the impression there was simply an arrangement of convenience.

- (ii) This impression is solidified by looking at the deal from NLG's perspective. Alpha Neilson testified that the main thrust of NLG's business was aimed at the education sector. While she did suggest she hoped to expand to medical and perhaps real estate, the only medical client she had was her son. There was no evidence of real estate clients. She may have had in mind a broader application of her online education software, but I have not been satisfied she was concentrating on pursuing these sectors in 1999 and 2000. In NLG's Business Plan 2000 the emphasis is clearly on the education sector. The Business Plan made no mention of advertising for investors through the racing car, notwithstanding its extensive list of marketing activities. Mrs. Neilson indicated she felt the racing car advertising was worth it, but she gave no evidence of any investment arising from such advertising, let alone any expressions of interest. I read NLG's involvement as more a matter of Mrs. Neilson helping her son than binding NLG to commit hundreds of thousands of dollars into the racing car for marketing purposes.
- (iii) Third, with respect to the agreement between NLG and Dr. Neilson, although there is a proposal from NLG, again there is no signed contract. Certainly NLG provided invoices and a ledger was prepared offsetting such amounts against the racing car expenditures, indicating some arrangement. Yet there was no written direction from NLG directing Dr. Neilson to pay his bill by paying K2 Motor Sport. If the proposal is accepted as evidence in the contract, payment terms are to be 15 days after invoicing.
- (iv) Fourth, I have not been satisfied how much, if any, work was actually undertaken by NLG on the IMES project. Mrs. Neilson was not herself directly involved. No one who did the work testified. There were no progress reports. There was only Mrs. Neilson's testimony that some work, albeit of a rudimentary nature, had been completed. My understanding was that this "front-end" type work was broadly applicable and not specific to IMES. This casts some serious doubt on

whether Dr. Neilson's payments on the car were in reality payments for IMES.

- (v) Fifth, the question of what Dr. Neilson was really paying for when he made the racing car expenditures was confirmed for me when he testified that the three-way deal terminated for two reasons: the destruction of the car and the viability of the arrangement, permitting the deduction of these expenditures, being questioned. It was clear Dr. Neilson was not prepared to put money into IMES unless the money went to the racing car. Exit the racing car, Dr. Neilson is not prepared to continue to use NLG's services. This was most telling, and has satisfied me that the money Dr. Neilson spent was not on the development of IMES but was on his passion – racing.

[19] The Respondent did not argue this arrangement was a sham transaction. There is sufficient evidence to find there was some sort of agreement between Dr. Neilson and NLG and between NLG and K2 Motor Sport, albeit not written agreements. The Respondent does not appear to deny this. So, can I conclude Dr. Neilson paid the expenses as an investor in K2 Motor Sport, rather than for the development of IMES without resorting to reliance on the concept of sham transaction? I believe I can, as I find a term of the agreement between Dr. Neilson and NLG was a requirement by Dr. Neilson that the racing car expenses be paid; in effect, the agreement itself was that NLG must spend the money on K2 Motor Sport. There is no sham - that was the deal. Yes, NLG was to do something in connection with IMES, but I find the evidence supports the conclusion that software was being developed for other purposes. The amount expended by Dr. Neilson was not consideration for such development.

[20] Once determined that Dr. Neilson's payments were not for IMES, but for the racing car, it follows that such expenses are not deductible. The Respondent's argument was primarily aimed at the non-deductibility of racing car expenses against the source of income being a medical practice. This is self-evident, and was not disputed by the Appellant. There is simply no relation between racing car expenses and the medical practice. It is unnecessary to go through the *Stewart*¹ type analysis to reach this conclusion.

[21] If I am wrong in my view of the arrangement, and had I found that Dr. Neilson's efforts to fund his passion in this roundabout way successfully

¹ *Stewart v. The Queen*, [2002] 2 S.C.R. 645.

created a legal obligation to expend the amount in issue on IMES, he would still be faced with the hurdle of the nature of such expenses. In contracting with NLG was Dr. Neilson incurring a current deductible expense. I find he was not. Paragraph 18(1)(a) limits the deductibility of expenditures as follows:

18(1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;

[22] Dr. Neilson's purpose in developing an online learning software program for emergency doctors was not to gain or produce income from his medical practice. Its purpose, as he emphasized, was first and foremost to provide that extra something to the UAH so that he would not lose his position due to the lack of his credentials. Mr. Yaskowich argued that improving education in emergency at UAH would free up Dr. Neilson's time to create more fees for service. Dr. Neilson did not indicate in testimony that was his purpose. I do not find Mr. Yaskowich's proposition flows from the evidence. I conclude Dr. Neilson's income from his medical practice, based on a fee for service, was not going to be impacted by the introduction of this online program.

[23] Dr. Neilson was adamant that the expenditures were for the purpose of improving his chances of maintaining his position at UAH. There is no evidence from anyone at the UAH that Dr. Neilson's position was in jeopardy. There is no evidence that the IMES program had even been mentioned to UAH officials, let alone whether the result of such introduction would cement Dr. Neilson's position at UAH. This casts some real doubt on his stated purpose to be something other than personal. However, if I accept his testimony, then I view this purpose as more consistent with a capital expenditure: an amount expended to keep a position at UAH – the maintenance of an enduring long-term benefit. This is not a current expense incurred for the purpose of producing income: this is a capital expenditure.

[24] Mr. Yaskowich relied on *obiter* comments in the case of *Consumer's Software Inc. v. Canada*² to suggest that the cost of developing software products, including acquiring a source code, can be considered a current expense. I agree. There may be situations where such expenses are incurred for the purpose of gaining or producing income. This is not, however, one of those situations. It was not

² [1995] D.T.C. 518.

suggested that Dr. Neilson was in the business of profiting from the sale of IMES. Any thought that IMES might be marketed down the road was at best wishful thinking: there was certainly no business planned to do so. The only source of income against which expenditures could possibly be deducted was income from his medical practice. He carried on no other business against which such type of expense could be deducted.

[25] Finally, Dr. Neilson's third stated purpose to improve medical emergency education was praiseworthy, but it does not meet the section 18(1)(a) requirement necessary to claim a current expense.

[26] Given my finding that Dr. Neilson's expenditures were not in the nature of current expenses, it is unnecessary to address the question of the reasonableness of the expenses, other than to emphasize what I have already stated in these reasons: the non arms-length relationship between Dr. Neilson and NLG, the lack of evidence regarding the extent of the work in connection with IMES, the lack of a written contract or any progress reports, the obligation that funds be spent on the racing car and the termination of the arrangement to develop IMES once the racing car was destroyed raise serious doubts that the value of the services performed by NLG equaled the amount levied by Dr. Neilson.

[27] For these reasons, even had I found the racing car expenses were incurred for developing IMES, then Dr. Neilson's purpose was such that such expenditures were of a capital nature or personal nature and not deductible as a current expense.

[28] With respect to the approximate \$4,000 of the expenses which did not relate to the racing car, I heard no evidence to satisfy me these were business rather than personal expenses.

[29] For these reasons, the appeals are dismissed with costs to the Respondent.

Signed at Ottawa, Canada, this 29th day of August 2007 .

“Campbell J. Miller”

C. Miller J.

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