Docket: 2008-3796(IT)G

BETWEEN:

MICHAEL COVELEY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of
Solbyung Coveley (2008-3797(IT)G), on October 9, 10, 11 and 12, 2012,
at Toronto, Ontario.

Before: The Honourable Justice Johanne D'Auray

Appearances:

Counsel for the Appellant:	Leigh Somerville Taylor
Counsel for the Respondent:	Samantha Hurst
	Alisa Apostle

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* for the 2005 and 2006 taxation years are dismissed. For the 2005 taxation year, the appellant is not entitled to claim an ABIL on the basis that the loans were not made for the purpose of gaining or producing business income from cStar. If I had found that the loans by Mr. Coveley bore interest, his claim for an ABIL for 2005 would still have failed since the debt did not become bad in 2005. Accordingly, the appellant is not entitled to carry forward a non-capital loss to his 2006 taxation year.

Costs are awarded to the respondent.

Signed at Ottawa, Canada, this 20th day of December 2013.

"Johanne D'Auray"

D'Auray J.

Docket: 2008-3797(IT)G

BETWEEN:

SOLBYUNG COVELEY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of
Michael Coveley (2008-3796(IT)G), on October 9, 10, 11 and 12, 2012,
at Toronto, Ontario.

Before: The Honourable Justice Johanne D'Auray

Appearances:

Counsel for the Appellant:	Leigh Somerville Taylor
Counsel for the Respondent:	Samantha Hurst
	Alisa Apostle

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* for the 2005 and 2006 taxation years are dismissed. For the 2005 taxation year, the appellant is not entitled to claim an ABIL on the basis that the debt did not become bad in 2005. Accordingly, the appellant is not entitled to carry forward a non-capital loss to her 2006 taxation year.

Costs are awarded to the respondent.

Signed at Ottawa, Canada, this 20th day of December 2013.

"Johanne D'Auray"

D'Auray J.

Citation: 2013 TCC 417
Date: 20131220
Docket: 2008-3796(IT)G

BETWEEN:

MICHAEL COVELEY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Docket: 2008-3797(IT)G

BETWEEN:

SOLBYUNG COVELEY,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

D'Auray J.

A. Introduction

[1] The appellants are the co-founders of cStar Technologies Inc ("cStar"). They are husband and wife.

[2] cStar was incorporated on March 30, 1998 and is in the business of developing wireless communication applications which enable machines and business systems as well as machines and people to communicate wirelessly.

[3] Mrs. Solbyung Coveley is the shareholder, president and chief executive officer of cStar. She is also an employee of cStar.

[4] Mr. Michael Coveley is the chief technology officer and senior vice-president of cStar. He is also an employee of cStar.

[5] Starting in 1998, the appellants made loans to cStar comprising of their unpaid remuneration, cash advances and corporate expenses that they paid on behalf of cStar with their personal credit cards.

[6] In filing their income tax returns for the 2005 taxation year, each appellant claimed an allowable business investment loss ("ABIL").

[7] In filing their 2006 income tax returns, each of the appellants claimed against their income a non-capital loss carry-forward arising from their ABIL claims in 2005.

[8] The Minister of National Revenue (the "Minister") disallowed the ABILs claimed by the appellants for their 2005 taxation year, as well as the non-capital loss carry-forward for their 2006 taxation year, on the basis that the appellants did not meet the requirements of the *Income Tax Act* (the "Act") for claiming an ABIL.

B. Issues to be decided

[9] The issues to be decided in these appeals are the following:

(a) Are the appellants entitled to deduct an ABIL in computing their income for their 2005 taxation year?

(b) Are the appellants entitled to carry forward non-capital losses in computing their income for their 2006 taxation year?

C. The evidence

The appellants

[10] Mr. Coveley holds mechanical and electrical engineering degrees and has studied at MIT. He has worked in Canada, the United States, Japan, Germany and Switzerland. Mr. Coveley stated that he has many inventions to his credit such as the first hand-held unattended point-of-sale terminal, a car alarm for Rolls-Royce, and

created one of the first homodynamic mechanical hearts to measure variant body hypertension conditions. He was also forerunner inventor of the aluminum foil that is used in most kitchens today. In the early 1990s, Mr. Coveley incorporated Omega Digital Data Inc. ("Omega").

[11] Mrs. Coveley earned a Bachelor of Arts in Korea, and completed an Executive MBA at the University of Toronto while working for Omega. She was recognized as a woman entrepreneur of Canada in 2004.

[12] Omega folded in 1998, approximately 6 months after the appellants resigned. The appellants each claimed an ABIL in the amount of $1,252,000 resulting from Omega's dissolution, which they carried forward from 1999 until the ABILs ran out in 2004.

[13] During the years in issue, the appellants did not draw their salaries from cStar, instead they automatically loaned them to cStar. cStar issued T4s to the appellants for those salaries. According to the T4 of Mr. Coveley, from a salary of $135,267.76 for the 2005 taxation year, an amount of $2,500 was withheld for income tax purposes while nothing was withheld for the Canada Pension Plan. According to the T4 of Mrs. Coveley, from a salary of $135,555.92 for her 2005 taxation year, an amount of $2,500 was withheld for income tax purposes and $1,861.20 was withheld for the Canada Pension Plan. The same pattern of minimal withholdings occurred in the other taxation years. Without their claims for non-capital losses to offset their incomes, the appellants would have owed considerably more in taxes.[1]

[14] The salaries of the appellants were determined by Mrs. Coveley with the assistance of cStar's accountant, Mr. Draganjac. Those salaries were based on the scientific research and experimental development ("SRED") credit available in each year. The amounts received by cStar as SRED credit were based in part on the salaries paid by cStar for scientific research.

[15] In light of cStar's innovative technology, the appellants firmly believed that one day cStar would be successful and profitable. This is why the appellants chose to continue cStar's operations.

cStar

[1] Although the appellants' salaries should have not been included in their income, as the salaries were not received by them. Subsection 5(1) of the Act.

[16] During the taxation years under appeal, Mrs. Coveley was the president, chief executive officer and sole shareholder of cStar.

[17] During the taxation years under appeal, Mr. Coveley was the chief technology officer and senior vice-president of cStar, but he was never a shareholder. He stated that he did not need to be a shareholder because he and his wife were good partners and he trusted her.

[18] Mr. Draganjac was cStar's external accountant. He began acting as the external accountant shortly after cStar was founded and was the external accountant during the taxation years under appeal.

[19] Mrs. Coveley was in charge of cStar's financial affairs and performed the final review of its ledgers and other accounting records before sending them to Mr. Draganjac.

[20] Mr. Coveley was not involved in cStar's financial affairs. He trusted his spouse with all of his and cStar's financial affairs. His salary was determined by his spouse, Mrs. Coveley, and by Mr. Draganjac. He did not review his income tax returns prior to signing them. He knew that his salary was being loaned to cStar, but was not aware of the amounts of the loans.

[21] The number of cStar's employees varied between 6 and 20 during the years under appeal.

[22] Mr. Coveley stated that, through cStar, his engineering team developed a virtual gateway and the world's first wireless LAN. cStar conceived many applications for the gateway, such as:

(a) wireless vending equipment and protocols to enable vending machines to communicate with technical support and to be monitored remotely;

(b) the world's first protocol for cell phone and hotel room key vending, allowing customers to use their cell phones or room keys as e-wallets;

(c) the "stealth tag", a chip about a tenth of the thickness of a human hair, used to assist in the inspection of products shipments; the chip is connected to a "hair" that runs around the edge of the shipping paper and act as an antenna; if that antenna is broken, as by breaking into the shipping container, the chip in the shipping paper will reveal this to the government inspectors; this stealth technology would assist in tracking

fraudulent medication and other such substances being shipped around the world;

(d) a device to track equipment in hospitals and thus help detect thefts, and also to track where doctors, patients and even visitors are located in a hospital;

(e) a dispensing machine for reagents poisons and dangerous substances used in hospital research centres; the machine cStar invented would give researchers access to such products at all hours; access to drugs could also be tracked by the device.

[23] During the years under appeal, cStar applied for SRED credits. While Mrs. Coveley was in charge of the applications for SRED credits and the subsequent financial audits, Mr. Coveley was responsible for the scientific side of the applications.

[24] During the years under appeal, cStar did not generate significant revenues. It derived its operating funds from the SRED credits and from third-party investors.

[25] Mr. Coveley owned many patents. Some of them did not fit the business model of cStar. Mr. Coveley stated that he would assign patents to cStar once they fitted cStar's business model.

The appellants' investments in and loans to cStar

[26] Mr. Coveley could not remember how much start-up money he invested in cStar at the time of incorporation. He stated that with his savings he paid for the equipment and, before the incorporation of cStar, paid the salaries of the engineers.

(a) <u>The appellants' loans to cStar</u>

(i) Salaries

[27] The appellants' unpaid salaries constituted the major part of the loans made by them to cStar. The appellants' salaries over the years were:

	Mr. Coveley	Mrs. Coveley
1999	n/a	n/a
2000	$304,000.00	$200,000.00
2001	$200,311.00	$200,000.00
2002	$200,000.00	$200,000.00

2003	$135,418.00	$135,485.00
2004	$80,317.00	$140,589.00
2005	$135,267.76	$135,555.92
2006	$140,274.56	$140,572.64

(ii) Expenses of cStar paid by the Coveleys

[28] The appellants also loaned money to cStar to cover its expenses. They used their personal credit cards to do so. Mrs. Coveley stated that, since cStar did not have any income, it could not apply for a credit card.

[29] Therefore, in addition to the unpaid salaries, cStar owed the Coveleys all the expenses incurred by them on its behalf. The interest and annual fees on the appellants' credit cards were also charged to cStar in their entirety and formed part of the appellants' loan accounts with cStar.

[30] Both appellants repeatedly testified that none of the amounts credited to the cStar loan accounts were personal in nature. Mrs. Coveley stated that only in exceptional circumstances would the appellants use their credit cards for personal expenses. On such occasions, the expenses would be identified on the credit card statements as personal expenses and would not be included in the loan accounts of cStar.

[31] However, according to the respondent, during the years 1998 to 2005, both appellants charged personal expenses to cStar and had the expenses recorded as loans owing by cStar to them. In Mrs. Coveley's case, the personal expenses amounted to $209,185.28, while in Mr. Coveley's case they amounted to $19,405.47.

(iii) Mrs. Coveley's second mortgage

[32] Mrs. Coveley took out a second mortgage on the family residence for an amount of $77,000, which she loaned to cStar.

(iv) Mrs. Coveley's family

[33] In 1998, Mrs. Coveley's family in Korea and in Japan made personal loans to Mrs. Coveley in the total amount of $126,900 plus interest. There was no documentation supporting the loans to Mrs. Coveley from her family. Mrs. Coveley loaned the amounts in question to cStar, where they formed part of Mrs. Coveley's loan account.

(b) Interest on the appellants' loans

[34] There is contradictory evidence as to whether the loans made by the appellants to cStar were interest bearing. Mrs. Coveley submitted in evidence two promissory notes, one for Mr. Coveley and the other one for herself. Both promissory notes were signed by Mrs. Coveley. The promissory notes, dated April 7, 1998 state: "The undersigned hereby promises to repay on demand all past and future loan advances made by [the Appellants] to 1288145 Ontario Limited [now cStar] plus simple interest at ten percent (10%)".

[35] Although Mr. Coveley relied on his promissory note to support the claim for interest, his testimony on this point was less than clear. On cross-examination, he stated interest accrued on his loans for the first two or three years. At that point, he stated, cStar's accountant, Mr. Draganjac, told him that there was no point in claiming interest because the loans would not be repaid for quite a while, so adding interest was pointless. As Mrs. Coveley agreed with Mr. Draganjac's decision and since she was in control of the management and financial side of cStar, Mr. Coveley went along with the decision not to accumulate interest on his loans.

[36] The documentary evidence did not support the contention that the appellants' loans were interest bearing. In their returns for the 2005 taxation year prepared by Mr. Draganjac, it was indicated that an ABIL was claimed for "Funds advanced from 1998 to March 31, 2005 – Non interest bearing". In addition, no interest income was included in the income of the appellants. cStar never paid interest to the appellants and the interest on their loans was not accounted for in cStar's financial statements. However, Mrs. Coveley testified that cStar kept its own separate accounting record of the accumulated interest.

[37] Moreover, in a letter faxed to Dr. Waters, an important investor in cStar, on December 11, 2003, Mrs. Coveley indicated that "[n]o interest was accrued on Unpaid Salary and Startup Capital injected by M Coveley & S Coveley".

[38] On July 12, 2006, Mr. Draganjac, on behalf of the appellants, similarly indicated on the ABIL questionnaire faxed to the Canada Revenue Agency (the "CRA") that the interest on the loans was "0".

[39] During his testimony, Mr. Draganjac stated that the response on the questionnaire was a mistake by his accounting firm and that the loans bore interest. In response to a letter dated August 16, 2007 from Ms. Paajanen, appeals officer at the

CRA, Mr. Draganjac indicated that Mr. Coveley's loan bore interest at the rate of 10%. No supporting document was provided by Mr. Draganjac to Ms. Paajanen at that time.

Third-party loans and investments

(a) Victor Chen

[40] Mr. Victor Chen, who was a classmate and friend of Mrs. Coveley while she was studying for her executive MBA, made two loans to Mrs. Coveley for cStar: the first one, on October 14, 1998, was an amount of $20,000; the second, on October 11, 2000 was an amount of $15,000. The loans were repaid to Mr. Chen on August 18, 2005 with compound interest.

(b) Dr. William Robert Waters

[41] Dr. William Robert Waters, a professor of Mrs. Coveley while she was studying for her executive MBA, started investing in cStar on October 26, 1998, when he subscribed for 200,000 common shares at a price of $10 per share.

[42] Beginning on October 31, 2000, Dr. Waters loaned funds to cStar in monthly instalments of $100,000. The last such advance from Dr. Waters was made on October 31, 2003. By then, the loan amounted to $3.7 million. Although Dr. Waters tried to formalize his original purchase of shares and the loan, he was unable to reach an agreement with Mrs. Coveley. Hence, no written agreement existed between cStar and Dr. Waters.

[43] cStar used the SRED credits it had received to reimburse $1.4 million to Dr. Waters. cStar stopped repaying Dr. Waters after January 31, 2003.

[44] A company named XDL was interested in buying Dr. Waters' interest in cStar. A due diligence review was undertaken by XDL. The deal fell through because XDL wanted more control over the management of cStar. According to Dr. Waters, at XDL they "were uncomfortable when all was said and done with what arrangement they could make with Mr. Coveley and Mrs. Coveley. I think it was fair to say that they felt that there was not enough strength in what they had to offer to follow through with me, since any arrangement they made was not simply taking my shares but from their perspective was involving themselves in the management of the organization to a considerable degree".

[45] Dr. Waters decided to sell his investment in cStar and his cStar debt, since Mrs. Coveley did not want to sign a general security agreement strengthening his position regarding his investment. Mrs. Coveley did not want to lose control over cStar's technology. Dr. Waters was also of the view "that the company was not going to be able to continue effectively".

[46] Dr. Waters sold his shares (for which he had paid $2 million) to Toris Investment ("Toris") for $20,000, and the $ 2.3 million debt owing to him, he sold to Toris for $130,000.

[47] In July 2006, the president of Toris came to Dr. Waters and told him that there was hope again for cStar. As a result, through Toris, Dr. Waters loaned $105,000 to cStar on July 31, 2006. Dr. Waters made multiple advances to cStar in the following months through Toris. Dr. Waters stated that by December 21, 2007, cStar owed Toris an amount of $2,015,000.

(c) 2060845 Ontario Inc

[48] After Dr. Waters stopped funding cStar in 2003, cStar continued its operations with the assistance of another investor, 2060845 Ontario Inc. ("206"). The persons behind 206 were people that Mr. Draganjac introduced to the Coveleys. Under a joint venture agreement, 206 agreed to contribute $3,300,000 to cStar at the rate of $75,000 per month. Mrs. Coveley testified that the agreement was conditional on cStar generating revenue. She stated that notice was given by 206 almost immediately upon signing that the lending would stop in December 2005. An amount of $ 900,000 was invested in cStar by 206.

(d) Mr. Joseph Draganjac

[49] Mr. Joseph Draganjac loaned money personally to Mrs. Coveley for cStar. This was quite unusual since he was the accountant for both cStar and the appellants. He testified that he made the loans because they were "friends" and she was "desperate". The first loan of $50,000 was made on November 25, 2004 and repaid on April 29, 2005. The second loan of $50,000 was made on August 17, 2005 and paid back by Mrs. Coveley on November 10, 2005. Mrs. Coveley stated that she used the second personal loan from Mr. Draganjac to repay Mr. Chen.

(e) Mrs. Coveley's Family

[50] As I stated earlier, in 1998 the family of Mrs. Coveley in Korea and in Japan loaned her an amount of $126,900 plus interest. Mrs. Coveley then loaned the funds to cStar. As of December 31, 2005, cStar still owed $116,000 to Mrs. Coveley.

The bad debt determination

[51] Mrs. Coveley and Mr. Coveley claimed ABILs of $1,191,757.74 and $1,659,982.92 respectively on their 2005 income tax returns. They amended their ABIL claims on October 7, 2011, namely, the day they filed their Amended Notices of Appeal. The new ABIL claims were $766,577.91 for Mrs. Coveley and $1,745,671.02 for Mr. Coveley.

[52] Both appellants testified that as of December 31, 2005, their prospects of collecting their loans from cStar were non-existent. According to Mrs. Coveley, after 206 stopped funding cStar in November 2005, cStar was no longer able to meet its obligations of approximately $85,000 monthly. In addition, the premises of cStar were hit by a tornado in August 2005 and Mr. Coveley had become ill in 2004.

[53] With annual expenses averaging approximately $1 million, cStar reported a net loss in each year of its operations during the relevant period. cStar's yearly financial statements for its taxation years ending on March 31 reflect the following:

	Revenues	Expenses	SRED Credits	Net Loss for the Year	Accumulated Deficit
1999	$0	$1,569,223	$321,580	$1,247,643	$1,247,643
2000	$ 49,241	$1,445,308	$300,627	$1,111,218	$2,358,861
2001	$ 76,905	$1,412,364	$354,200	$1,363,559	$3,368,220
2002	$215,810	$1,563,468	$481,649	$ 866,009	$4,234,229
2003	$121,379	$1,357,467	$427,694	$ 929,773	$5,164,002
2004	$171,972	$1,158,280	$395,068	$ 847,620	$6,011,622
2005	$ 82,140	$ 891,174	$335,968	$ 709,916	$6,721,538
2006	$0	$1,018,622	$367,352	$ 905,404	$6,676,942

[54] Besides owing money to the appellants, cStar was also indebted to Dr. Waters and 206. Furthermore, according to Mrs. Coveley, the world economic situation was not favourable to cStar in 2005. She pointed to the dot-com bubble, the tragic events of 9/11 and the severe acute respiratory syndrome ("SARS") outbreak.

[55] A tornado hit the cStar premises on August 19, 2005. The storm lifted the roof off the building and forced sewage up the drains. Due to the flood, cStar lost

equipment and documents. Some compensation was recovered from the insurance company in 2005 and in 2006.

[56] Mr. Coveley, who was the "top gun" at cStar, had been working very long hours in order to prepare for the demonstration of the Stealth Tag to the US Department of Homeland Security. Exhausted by his work, he became ill and was hospitalized with a double pneumonia in December 2004. In March 2005, he relapsed and was rushed to the hospital, where he was in intensive care for a cardiopulmonary failure; as a result he subsequently had to cut his hours of work to not more that nine a day and he was no longer able to travel.

[57] Despite these negative events, the evidence showed that there was still hope for cStar in 2005. A pilot project with respect to the wireless vending machine was conducted at the Ambassador Hotel in Kingston beginning on March 7, 2005. The pilot project was a success and created positive media coverage for cStar. A quotation for the "WLAN Cashless SkyGate Vending Genie System for Hotels - Room Key Card Vending option only" was given to Bell Canada on July 21, 2005, the price quoted being $2,243,000. In August 2005, Coca-Cola Inc. expressed interest in the wireless vending machine. Mrs. Coveley stated the following in an e-mail to cStar's engineers on January 5, 2006:

> [M]y gut feeling is that they [Coca-Cola] will go with our solution for these hotels in Canada . . . because they are running out of time. (thanks to Pepsi's announcement). They want to beat Pepsi with real 'deployment/pilot or not' rather than just announcement which Pepsi just made . . . Folks, we will have a great year! I smell it big time! – End of a huge report!!!

[58] In 2006, cStar entered into a working arrangement with Lucent Technologies Inc. ("Lucent"). Lucent is an American multinational in telecommunication technologies. Pursuant to this agreement, Lucent was to distribute cStar products and solutions. A list of prices was sent by cStar to Lucent on March 16, 2006 and a Master Teaming Agreement was entered between Lucent and cStar on April 25, 2006.

[59] After a successful emergency triage demonstration by cStar at the Sunnybrook Hospital in the late summer of 2005, cStar was contacted in March 2006 to do a similar triage at another location, in the United States.

[60] cStar was also having discussions in 2005 with the US Department of Homeland Security, which had asked cStar in December 2004 to organize a presentation of its "stealth tag" in Washington.

[61] As I have already stated, in July 2006 Dr. Waters, through Toris, started re-investing in cStar. In addition, cStar could use its SRED credits for its 2004 and following taxation years since cStar had stopped using the SRED credits to repay Dr. Waters.

Timing of the bad debt determination

[62] Both the appellants testified that they claimed an ABIL on Mr. Draganjac's advice. In his testimony, Mr. Draganjac summarized his ABIL recommendation to Mrs. Coveley as follows:

> Again if I recall, the factors that went into the decision was no. 1, Mrs. Coveley for herself and for her husband wanted to quantify their efforts in this business, their sweat equity, if you will, so that was one of the issues.
>
> The other issues or the other issue was I believe, and again the specifics I don't know, but I believe one of the investors Dr. Waters, I know he was an investor, there was part of his investment was in shares, and part of it was his loans. I believe the arrangement with him was that at some point these loans would be turned into shares for him and for Mr. and Mrs. Coveley. So the fact that they took a salary to reflect their efforts in the business would have increased their loans because they were not taking the money. It was basically their consideration was the debt from the company rather than actual funds.
>
> Of course the third consideration with these management salaries was the SR&ED component because that was just like all technology companies, they depended to a great extent on that program, and taking salaries or not taking salaries made a big difference in terms of the SR&ED credit. That was, to the best of my recollection, the discussion we had, and then it was at that point that I advised Mrs. Coveley that I think we have a legitimate claim for this ABIL to basically offset those salaries.

[63] Mr. Draganjac testified that he was not aware of any attempts made by the appellants to recover their loans.

[64] The appellants did not submit any evidence with respect to efforts they may have made to recover their loans.

[65] cStar continued to operate after the determination by the appellants that their debts had gone bad.

[66] Throughout 2005 and 2006, the appellants continued to loan their salaries to cStar. As a result, their loan accounts increased again after 2005. cStar continued to purchase equipment such as computers and wireless modems, and ordered business cards for six people. Following the flood in August 2005, cStar added new facilities to its lab, which resulted in the creation of a network operational centre.

Amount of the ABIL

[67] The outstanding balance of the appellants' loans to cStar on December 31, 2005 was $1,745,671.02 for Mr. Coveley and $766,577.91 for Mrs. Coveley. These amounts differ from the amounts of the ABILs that were originally claimed by the appellants in their 2005 personal income tax returns filed on April 24, 2006.

[68] Mr. Draganjac recognized that his accounting firm made two mistakes with respect to the ABIL amounts claimed by the appellants.

[69] The first mistake related to the ABIL amounts: they were based on the figures in the financial statements of cStar for the year ending on March 31, 2005 instead of being based on the figures for December 31, 2005. Accordingly, the transactions that occurred in the loan accounts of the appellants between March 31, 2005 and December 31, 2005 were not taken into account in the original determination of the ABILs. Mr. Draganjac did not correct the amount of the ABILs claimed by the appellants. By the time he realized that there were mistakes, the appellants' tax issues were being handled by the law firm of Thorsteinssons. Mr. Draganjac assumed the corrections would have been made by counsel handling the appellants' tax issues.

[70] The second mistake acknowledged by Mr. Draganjac related to the accounting for Mrs. Coveley's loan. He stated that he had advised Mrs. Coveley to temporarily include in her loan account amounts that cStar received from 206, namely, $75,000 per month. He intended to advise her later on as to how to properly enter these amounts in cStar's accounting records. Mrs. Coveley left the amounts received from 206 in her loan account. Accordingly, Mrs. Coveley's loan account and hence her ABIL was overstated by $300,000 on March 31, 2005 and by $900,000 on December 31, 2005. The amounts received from 206 should have being capitalized in cStar instead of being reflected in Mrs. Coveley loan's account.

[71] Mr. Draganjac testified that he corrected the error on cStar's 2006 income tax return, but did not make any adjustments to Mrs. Coveley's loan account on her income tax return for the 2006 taxation year. Mrs. Coveley stated that she did not notice that her ABIL was overstated in 2005 since she had signed her 2005 income tax return without reviewing it.

[72] Mr. Draganjac stated that he relied on the amounts provided by Mrs. Coveley when he made the claim for her ABIL in 2005. Moreover, in the course of the review of Mrs. Coveley's ABIL, the CRA requested evidence with respect to the $300,000. On January 7, 2008 Mr. Draganjac, on behalf of the appellants, faxed to the CRA the backs of the four deposit slips for $75,000 in order to justify Mrs. Coveley's loan account. The four deposit slips were forwarded to him by cStar on January 3, 2008.

[73] Mrs. Coveley admitted that the backs of the deposit slips were faxed to Mr. Draganjac's office, but she stated that she was not aware that the four deposit slips had been sent to the CRA to justify her ABIL amount. She added that this was one of the reasons the appellants filed a statement of claim against Mr. Draganjac in the Ontario Superior Court of Justice in February 2012.

[74] On February 25, 2011, the appellants recognized for the first time that Mrs. Coveley's ABIL was overstated by $300,000, when their newly appointed counsel filed a supplementary list of documents. This updated list of documents provided new calculations made by Mrs. Coveley to correct not only the failure to include transactions that occurred between cStar's fiscal year-end and the end of the 2005 calendar year, but also the misallocation to Mrs. Coveley's loan account of funds injected from 206 in cStar. The appellants then filed an Amended Notice of Appeal reflecting those changes on October 7, 2011.

[75] I was not convinced by Mrs. Coveley's testimony that she was not aware that her ABIL was overstated. She admitted that she had submitted to Mr. Draganjac at the end of each year the figures for the loan account balances for her and Mr. Coveley. The numbers she submitted to Mr. Draganjac for her loan account in 2005 would have been overstated by $900,000 at the end of December 2005. When asked whether she was responsible for the numbers sent by cStar, she stated it was Mr. Draganjac's job to correct the numbers if they were wrong. It was clear from the evidence, however, that Mrs. Coveley was hands-on with respect to her and cStar's financial affairs. She had to know that her loan account was overstated.

[76] Mrs. Coveley is a smart and educated woman. I find it difficult to accept that she would have not reviewed her 2005 income tax return and noticed that her ABIL was overstated.

[77] While this evidence does not affect her entitlement to claim an ABIL, it does bring into question her credibility as well as Mr. Draganjac's.

D. Law and analysis

[78] Both parties relied on the four requirements to be met in order to claim an ABIL established by the Federal Court of Appeal in *Rich v Canada*, 2003 FCA 38, [2003] 3 FC 493.

[79] Pursuant to paragraph 38(*c*) of the Act, a taxpayer's allowable business investment loss for a taxation year from the disposition of any property is one half of the taxpayer's business investment loss for the year from the disposition of that property.

[80] "Business investment loss" is defined in part as follows at paragraph 39(1)(*c*): "a taxpayer's business investment loss for a taxation year from the disposition of any property is the amount, if any, by which the taxpayer's capital loss for the year from a disposition after 1977 . . . to which subsection 50(1) applies", exceeds any of the amounts subsequently referred to.

[81] Subsection 50(1) provides:

> **50.** (1) **Debts established to be bad debts and shares of bankrupt corporation** - For the purposes of this subdivision, where
>
> (*a*) a debt owing to a taxpayer at the end of a taxation year (other than a debt owing to the taxpayer in respect of the disposition of personal-use property) is established by the taxpayer to have become a bad debt in the year, or
>
> (*b*) a share (other than a share received by a taxpayer as consideration in respect of the disposition of personal-use property) of the capital stock of a corporation is owned by the taxpayer at the end of a taxation year and
>
> (i) the corporation has during the year become a bankrupt (within the meaning of subsection 128(3)),
>
> (ii) the corporation is a corporation referred to in section 6 of the *Winding-up Act* that is insolvent (within the meaning of that Act) and in respect of which a winding-up order under that Act has been made in the year, or

> (iii) at the end of the year,
>
> (A) the corporation is insolvent,
>
> (B) neither the corporation nor a corporation controlled by it carries on business,
>
> (C) the fair market value of the share is nil, and
>
> (D) it is reasonable to expect that the corporation will be dissolved or wound up and will not commence to carry on business
>
> and the taxpayer elects in the taxpayer's return of income for the year to have this subsection apply in respect of the debt or the share, as the case may be, the taxpayer shall be deemed to have disposed of the debt or the share, as the case may be, at the end of the year for proceeds equal to nil and to have reacquired it immediately after the end of the year at a cost equal to nil.

[82] Subparagraph 40(2)(*g*)(ii) provides:

> (*g*) a taxpayer's loss, if any, from the disposition of a property, to the extent that it is
>
> . . .
>
> (ii) a loss from the disposition of a debt or other right to receive an amount, unless the debt or right, as the case may be, was acquired by the taxpayer for the purpose of gaining or producing income from a business or property (other than exempt income) or as consideration for the disposition of capital property to a person with whom the taxpayer was dealing at arm's length,
>
> . . .
>
> is nil.

[83] According to the Federal Court of Appeal decision in *Rich*, in order to claim an ABIL under paragraph 50(1)(*a*) of the Act and accordingly be deemed to have disposed of their loans for nil proceeds of disposition, the appellants have to establish that:

1. debts were owed to them by cStar, pursuant to subsection 50(1) of the Act;

2. the debts were incurred for the purpose of gaining or producing income from a business or property under subparagraph 40(2)(*g*)(ii) of the Act;

3. in 2005, cStar was a small business corporation as defined in subsection 248(1) of the Act, pursuant to paragraph 39(1)(*c*); and

4. their debts became bad in 2005, pursuant to subsection 50(1).

[84] The respondent does not dispute that cStar was a small business corporation.

(a) Was there a debt owed to the appellants by cStar?

[85] Mr. Coveley and Mrs. Coveley assert that cStar owed them $1,745,671.02 and $766,577.91 respectively on December 31, 2005. The greater part of the debts owed to the appellants by cStar is composed of unpaid salaries and of expenses that the appellants had paid on behalf of cStar.

[86] The respondent argues that the appellants were not able to establish the amounts of the debts, since they had modified the amounts thereof in their Amended Notice of Appeal and had tendered no original documentation in evidence to support the new ABIL numbers. I do not agree with the respondent. I am satisfied with respect to the new corrected amounts claimed by the appellants. It was clear that the ABIL was computed as of March 31, 2005 instead of December 31, 2005. In addition, it was established that the ABIL claimed by Mrs. Coveley was overstated by $300,000.

[87] I will now deal with whether the expenses paid by the appellants on behalf of cStar and the unpaid salaries can form the basis of the debt owed to the appellants. I will later analyze whether some of the expenses paid by the appellants were personal expenses of theirs or were unreasonable in the circumstances.

[88] A "debt" is broadly defined in *Black's Law Dictionary* as a "[l]iability on a claim; a specific sum of money due by agreement or otherwise" (7th ed., 1999, at page 410).

[89] The appellants used their credit cards to pay the corporate expenses of cStar. By crediting these expenses to the appellants' loan accounts, cStar acknowledged that the amounts were owing to the appellants. Consequently, cStar did owe a debt to the appellants with regard to the payment of the corporate expenses.

[90] Also, I agree with the appellants that their accrued salaries form part of cStar's loan accounts. This is consistent with this Court's finding in *Sunatori v The Queen*, 2010 TCC 346, 2010 DTC 1234, aff'd 2011 FCA 254, 2011 DTC 5153. In that case, the appellant received his salary by delivery of a cheque from his employer on December 31 of each year. On the same day, the appellant gave his employer a cheque for the same amount as a loan. Neither cheque was ever presented for

payment. Justice Hershfield declared that the end result was "essentially a bookkeeping entry of the indebtedness of the company for this loan the Appellant made to the company" (at paragraph 12). Justice Hershfield concluded that the appellant's unpaid salary constituted a loan which could validly give rise to an ABIL claim. The Federal Court of Appeal affirmed his decision.

[91] The respondent submits that the finding in *Sunatori* is inapplicable to the present appeals on the basis that no negotiable instruments, such as cheques, were exchanged between cStar and the appellants. However, there is undisputed evidence that the appellants were employed by cStar and that their salaries, although not actually paid by cStar, were recorded by cStar in its accounting records. The accrued salaries were credited to the appellants' loan accounts. In my view, this is sufficient to establish the existence of debts owed to the appellants by cStar.

[92] This finding is also consistent with Justice Webb's decision in *Morrison v The Queen*, 2010 TCC 429, 2010 DTC 1288, where the absence of a negotiable instrument did not prevent Justice Webb from concluding that the amount of the accrued but unpaid salaries had been properly added to the appellants' loan accounts. In her written submissions, counsel for the respondent tried to distinguish *Morrison* by pointing out that, in that case, cheques had been exchanged between the appellants and their employer to effect both the payment of the salaries and the payment of advances to the employer for the taxation year. However, in *Morrison* no cheque was issued to the appellants for the following taxation year and the salary for that year was credited to the appellants' respective shareholder accounts.

[93] For these reasons, I believe that a debt was owed to the appellants by cStar.

(b) <u>The debt was incurred for the purpose of gaining or producing income from a business or property</u>

[94] Subparagraph 40(2)(*g*)(ii) of the Act denies the loss on a debt where the loan was not made "for the purpose of gaining or producing income from a business or property". As recognized by the respondent, it is not necessary that the taxpayer's purpose in making the loan be exclusively or primarily to produce income. The Federal Court of Appeal held in *Rich*, at paragraph 10, that a subordinate purpose is sufficient for the purpose test to be met.

[95] The appellants bear the onus of establishing that they had a genuine intention to earn income from a business or property through the advances they made to cStar: see *Rondeau v The Queen*, 2004 TCC 321, 2008 DTC 3874, at paragraphs 38 and 39.

[96] As a shareholder of cStar, Mrs. Coveley could potentially have earned dividend income. In *The Queen v Byram*, 99 DTC 5117, the Federal Court of Appeal held that the possibility for a shareholder to earn dividend income may create a sufficient nexus between a loan and an income-earning purpose. Justice McDonald stated at paragraph 22:

> . . . Where a shareholder provides a guarantee or an interest free loan to that company in order to provide capital to that company, a clear nexus exists between the taxpayer and the potential future income. Where a loan is made for the purpose of earning income through the payment of dividends, this connection is sufficient to satisfy the purpose requirement of subparagraph 40(2)(*g*)(ii).

[97] *Byram* is applicable to Mrs. Coveley. She meets the requirement of paragraph 40(2)(*g*) of the Act, as there is a sufficient nexus between her loans to cStar and the prospect of earning dividends.

[98] The respondent argued that Mrs. Coveley's loan to cStar was not made to earn business income namely for the period of August 4, 2005 (when cStar tax return for 2005 was filed) to December 31, 2005, because the funds were advanced at a time where there was no reasonable prospect of recovery.

[99] The respondent relies on the decision of this Court in *Kyriazakos v The Queen*, 2007 TCC 66, 2007 DTC 373, to assert that part of an ABIL may be disallowed if amounts continued to be loaned to the debtor after it became clear that there was no possibility of earning income on the loan. That case does not support the respondent's position. The reasons for which part of the ABIL claimed by the appellant in *Kyriazakos* was disallowed were rather that (1) at the time part of the funds were injected into the debtor corporation, the appellant had ceased to be a shareholder, and (2) the appellant had not specified any interest rate on the debt.

[100] Furthermore, the respondent's position that no purpose of gaining or producing income form a business or property can be inferred if the debtor was in a difficult financial position when the funds were advanced is inconsistent with this Court's decisions in *Daniels v The Queen*, 2007 TCC 179, 207 DTC 883, and *Scott v The Queen*, 2010 TCC 401, 2010 DTC 1273.

[101] In *Daniels*, Justice Hershfield relied on the Federal Court of Appeal's decision in *Rich* in holding that even a faint hope of producing income is sufficient. He stated:

> 42 Recalling that the purpose of the ABIL is to encourage investment in small Canadian businesses, it is little wonder to me that a Court would accept a faint hope as sufficient to meet the requisite purpose test. When a family business experiences financial difficulty, the objective rationality of rescue motives might always be questionable with hindsight. Considerable tolerance seems essential. In my view *Rich* stands for such principle.

[102] In *Scott*, Justice Boyle similarly held that it is not unreasonable to continue to advance funds to an insolvent corporation, particularly where making the advance is the only reasonable means of recovering the initial investment. Justice Boyle therefore allowed the appellant to claim an ABIL.

[103] Contrary to Mrs. Coveley, Mr. Coveley is not a shareholder of cStar. Accordingly, his loan advances could not yield dividends. The appellants testified that Mr. Coveley's advances to cStar bore interest at prescribed rate of 10%, as evidenced by the promissory notes allegedly signed by Mrs. Coveley on April 7, 1998.

[104] The appellant have not convinced me that the loans they made to cStar bore interest. Apart from the promissory notes, the documentary evidence did not support the contention that the appellants' loans were interest bearing. I have outlined the evidence with respect to the issue of interest at paragraphs 34 to 39 above, without repeating all the evidence - their 2005 tax returns indicated no interest - the letter faxed to Dr. Waters by Mrs. Coveley in 2003 indicated no interest bearing - the ABIL questionnaire dated July 12, 2006 also indicated that the interest on the loans was 0. I agree with the respondent that the promissory notes were more than likely created after CRA began its audit. Therefore, the appellants did not demolish the assumption of fact made by the Minister that the loans to cStar did not bear interest.

[105] In their written submissions, the appellants stated that Mr. Coveley's advances were made "not only to earn interest on his promissory note, but also to earn employment income for himself". The appellants relied on the decisions in *The Queen v F.H. Jones Tobacco Sales Co.*, [1973] FC 825, *Lomas Development Ltd v The Queen*, 96 DTC 1942, *McKissock v R*, [1997] 1 CTC 2182, and *MacCallum v The Queen*, 2011 TCC 316, 2011 DTC 1225. While these cases support the position that subparagraph 40(2)(*g*)(ii) should not be given a narrow and mechanical reading, they do not hold that earning employment income suffices to meet the purpose test. The wording of subparagraph 40(2)(*g*)(ii) is clear: where there is "a loss from the

disposition of a debt" the debt has to have been "acquired for the purpose of gaining or producing income from a business or property".

[106] Accordingly, I am of the view that the condition that the debt be incurred for the purpose of gaining or producing income from a business or property is fulfilled for Mrs. Coveley, but not for Mr. Coveley. His ABIL claim must therefore be disallowed.[2]

(c) Did the debt became bad in 2005?

[107] Pursuant to paragraph 50(1)(*a*), the appellants must show that they honestly and reasonably determined that their debt became a bad debt in the 2005 taxation year.

[108] Unless there is some evidence that collection of the loan was reasonably possible and that proactive steps could have resulted in the collection of all or part of the loan, it is not necessary for the appellants to prove that all possible recourses for collection were exhausted. What is required is an honest and reasonable assessment by the appellants that their debt had gone bad (*Rich*, at paragraph 15).

[109] As stated by Justice Rothstein in *Rich*, "[t]he assessment of whether a debt is bad is one based upon the facts at a particular point in time" (at paragraph 12). In the present appeals, the relevant point in time is the last day of the relevant taxation year of the taxpayers, i.e. December 31, 2005. The appellants and the respondent agree that, while they do not constitute an exhaustive list, the following factors enumerated by Justice Rothstein in *Rich* are to be assessed to determine if the debt had become bad at that date:

1. the history and age of the debt;

2. the financial position of the debtor, its revenues and expenses, whether it is earning income or incurring losses, its cash flow and its assets, liabilities and liquidity;

3. changes in total sales as compared with prior years;

4. the debtor's cash, accounts receivable and other current assets at the relevant time and as compared with prior years;

[2] Even though, I have decided that Mr. Coveley's claim for an ABIL must fail for this reason, I shall nevertheless consider his claim under the other requirements for an ABIL.

5. the debtor's accounts payable and other current liabilities at the relevant time and as compared with prior years;

6. the general business conditions in the country, the community of the debtor, and in the debtor's line of business; and

7. the past experience of the taxpayer with writing off bad debts.

1. History and age of the debt

[110] The appellants started advancing funds to cStar in 1998 and continued to do so until 2005. No repayments were made with respect to the major part of the loans, namely the salaries.

2. Financial position of cStar, its revenues and expenses, whether it was earning income or incurring losses, its cash flow and its assets, liabilities and liquidity

[111] Since its creation, cStar has never been profitable. With annual expenses averaging approximately $1 million, it reported a net loss in each year of its operations during the years under appeal. cStar's accumulated deficit as of March 31, 2006 amounted to $6,676,942. Mrs. Coveley testified that she realized at the end of 2005 that she could not secure six months of financing for cStar. cStar had payroll obligations, accounts payable, no sales and very limited cash. The interest on Dr. Waters' loan kept accumulating and the appellants owed significant amounts on their personal credit cards.

[112] The appellants testified that Mr. Coveley's health problems and the tornado that hit Toronto on August 19, 2005 negatively impacted cStar's financial situation. cStar received its last $75,000 monthly payment from its joint venture partner on November 30, 2005. Both appellants stated that as of December 31, 2005, they therefore could not recover the debt owed by cStar.

[113] On the other hand, Mrs. Coveley seemed quite enthusiastic and positive about cStar's initiatives and events in 2005. In an e-mail dated January 5, 2006, that Mrs. Coveley sent to cStar's engineers, she stated: "*Folks, we will have a great year! I smell it big time! - End of a huge report!!!*"

[114] Her optimism was not mere bravado. A number of events occurred in 2005 that held promise for cStar. On March 7, 2005, cStar launched a successful project pilot for its vending machine solution. Following that, on July 21, 2005, a quotation

of $2.243 million for the wireless room key card vending system was given by cStar to Bell Canada. In the late summer of 2005, cStar conducted a demonstration of an emergency triage at the Sunnybrook Hospital. During the same period, cStar was having discussions with the US Department of Homeland Security, which had asked cStar in December 2004 to organize a presentation of its "stealth tag" in Washington. Mrs. Coveley also stated that she regained hope when she learned in August 2005 that an executive of Coca-Cola who had objected to contracting with cStar was leaving Coca-Cola. In addition, after the tornado, a decision was made not only to repair cStar's premises but to improve their technological attributes.

[115] While it is well established that past and present circumstances are normally the main considerations in determining whether a debt has gone bad, the Federal Court of Appeal left the door open to the consideration of future prospects of the debtor company. In *Rich*, Justice Rothstein declared at paragraph 14:

> . . . If there is some evidence of an event that will probably occur in the future that would suggest that the debt is collectible on the happening of the event, the future event should be considered. If future considerations are only speculative, they would not be material in an assessment of whether a past due debt is collectible.

[116] Similarly in *Sunatori*, Justice Hershfield stated that future prospects are particularly relevant if the debt is not yet due, for example where no specific terms of repayment exist (at paragraphs 46-56). In the present appeals, no terms of repayment were agreed upon by the appellants and cStar. Consequently, I believe that prospects of future repayment must be taken into account in the evaluation of whether the appellants' advances to cStar had become bad debts. As mentioned by Justice Hershfield, a determination that a loan could not be repaid at the end of a particular year does not mean that it is reasonable to consider that it constituted a bad debt (at paragraph 55).

[117] Although none of the negotiations between cStar and potential clients had led to the signature of a lucrative contract, the appellants were still of the view in 2005 that cStar would be successful.

[118] cStar was also quite active in 2006. A list of prices and quotations, including one for a $6.7 million deployment, was sent to Pepsi at the beginning of 2006. Mrs. Coveley testified that at that time she was optimistic that a large deployment of the vending machines would occur. A Master Teaming Agreement was entered into between Lucent and cStar on April 25, 2006. Pursuant to this agreement, Lucent was to distribute cStar's products and solutions.

3. Changes in total sales as compared with prior years

[119] Since cStar's creation in 1998, its sales have never exceeded its expenses. As shown in the chart below, cStar had no revenue during its fiscal year ending on March 31, 2006. cStar's sales for its fiscal years ending on March 31 were as follows:

1999	2000	2001	2002	2003	2004	2005	2006
$0	$49,241	$76,905	$215,810	$121,379	$171,792	$82,140	$0

4. cStar's cash, accounts receivable and other current assets at the relevant time and as compared with prior years

[120] The following numbers representing cStar's current assets are taken from its yearly balance sheets for its fiscal years ending on March 31:

	1999	2000	2001	2002	2003	2004	2005	2006
Cash	$6,743	$147,254	$150,184	$74,838	$25,159	$84,663	$74,792	$17,353
Accounts receivable			$38,453	$166,809	$230,375	$34,387	$7,475	nil
Inventory	$12,372	$42,992	$45,984	$65,031	$61,576	$44,859	$43,353	$13,353
Prepaid expenses	$6,155	$6,155	$9,832	$11,861	$6,937	$6,887	$6,216	$6,216
SRED tax credits	$361,349	$669,139	$1,031,653	$575,812	$492,066	$467,689	$350,239	$369,747
Loan receivable								$50,000
TOTAL	$386,619	$865,540	$1,276,106	$894,351	$816,113	$638,485	$482,075	$456,669

[121] While cStar's accounts receivable and bank balances as at March 31, 2005 were indeed lower than in previous years, the differences are not significant.

5. cStar's accounts payable and other current liabilities at the relevant time and as compared with prior years

[122] cStar's accounts payable for its fiscal years ending on March 31 were as follows:

1999	2000	2001	2002	2003	2004	2005	2006
$155,082	$229,675	$196,830	$150,056	$45,524	$48,032	$67,323	$85,404

[123] Although the current liabilities of cStar decreased over the years, there was a slight increase in 2005 and 2006.

6. General business conditions in the country, in cStar's community and in cStar's line of business

[124] Little evidence was given by the appellants regarding the world economic situation in 2005. Mrs. Coveley testified that the bursting of the dot-com bubble, the tragic events of 9/11 and the SARS outbreak had negatively impacted cStar's business. The dot-com bubble collapse occurred in 2000-2001, 9/11 occurred in 2001, and the SARS outbreak was in 2002-2003. I understand that these events may have had an impact on cStar, but I fail to understand why the year 2005 would have been different from the previous years in that regard.

7. Past experience of the appellants with writing off bad debts

[125] The appellants each claimed an ABIL in the amount of $1,252,000 resulting from Omega's dissolution in 1998. The non-capital losses were carried forward by the appellants from 1999 until they ran out in 2004.

[126] The analysis of the seven factors has showed that cStar financial position has not changed over the years. cStar was in a difficult financial position but it was not a better or in a worse position on December 31, 2005. Moreover, what I find problematic as regards to the appellants' ABIL claims is that the appellants continued to advance funds to cStar throughout 2005 and after December 31, 2005. The appellants continued advancing funds to cStar after 2005 by loaning their salaries to it and by paying corporate expenses.

[127] cStar purchased nine computers and one projector for its virtual gateway technology in 2005. Three of those computers were purchased on November 22, 2005 and one was bought on December 21, 2005. On November 11, 2005, cStar incurred a $400 expense for vehicle lettering. Similarly, Mr. Coveley continued adding new facilities to cStar's lab after the flood that took place in August 2005, which resulted in the creation of a network operational centre.

[128] Furthermore, the renovations to cStar's premises following the tornado continued into 2006 and beyond. cStar issued purchase orders for computers and wireless modems, and for business cards for six people in 2006.

[129] When asked why she continued to work for cStar without being paid after 2005, Mrs. Coveley responded: ". . . we have great assets, intellectual property, solutions, innovative solutions but a little bit too advanced for the market, and we know someday we will be there. Hope is there, but we know clearly this amount [of debt] we cannot collect".

[130] In *Giahinejad v Canada*, [2001] TCJ No 725 (QL), [2002] 1 CTC 2141, Judge Mogan of this Court determined that because the appellant was lending money to the debtor company at the very time that she determined that the debt had become bad, the claim for an ABIL failed on that basis alone. At paragraph 8, Judge Mogan stated:

> 8 Referring to the Appellant not being able to recover the loans in 1997, on the evidence before me, I could not possibly find that these debts owing to the Appellant by the numbered company were bad debts at any time in 1997. Even on December 1, 1997, the Appellant issued a cheque to the company for $1,830 which cheque was deposited on December 4; and then again on December 28, she issued an even bigger cheque for $2,975, which was deposited on December 29, 1997. She was still investing money in this company in the last month of the year and, indeed, in the last three or four days of the year. I cannot find, therefore, that the company was insolvent or unable to pay her loans when she was still lending money at the end of the year. On that basis alone, the Appellant's appeal cannot succeed.

[131] At paragraph 54 of *Sunatori*, *supra*, Justice Hershfield, referring to *Giahinejad*, held similarly:

> 54 Similarly, in *Giahinejad*, it is implicit that the future potential for collection is relevant. Making advances implicitly suggests something positive in the future which contradicts a bad debt determination at the time of the advance. Following that rationale, a loan not due for some time cannot reasonably be found to be bad today, where the prospects of collection when due are promising as shown by recent advances and by the commitment and drive and ongoing work of the debtor whose actions reflect no sign of an imminent failure of the business.

[132] The Federal Court of Appeal, in confirming Justice Hershfield's decision, declared:

> 7 . . . The appellant cannot maintain at once that he made *bona fide* loans to his company and that the loans gave rise to bad debts on the very day on which they were advanced. A monetary loan, by definition, is an amount advanced in the expectation that it be repaid and the appellant's position throughout, which he reiterated before us, is that he always thought that his company would be profitable.

[133] Therefore, in my view the debt did not become bad on December 31, 2005.

E. Objections

[134] During the trial, the appellants raised two objections that I took under reserve.

First objection

[135] The appellants objected to the respondent introducing as evidence a Statement of Claim filed by the appellants in the Ontario Superior Court of Justice on February 12, 2012 against cStar's accountant, Mr. Draganjac, and his accounting firm, Draganjac Pressman, Chartered Accountants, for breach of their duties and obligations towards the appellants. One of the allegations in the Statement of Claim is that Mr. Draganjac breached his duties and obligations towards the appellants when he advised them to claim an ABIL in 2006 in circumstances where he knew such a claim was not warranted.

[136] The first objection of the appellants is rejected and the Statement of Claim is to be filed as Exhibit R-1. Mrs. Coveley acknowledged the allegations in the Statement of Claim. Despite the contradictions, namely that before this Court the appellants argued that they were entitled to claim an ABIL, yet before a different Court they have submitted that an ABIL should not have been claimed and that Mr. Draganjac and his firm should pay damages for advising them to do so. I am prepared to view the Statement of Claim as a protective appeal in the event that the present appeals would have been dismissed. It is clear that the Statement of Claim is irrelevant in determining the appellant's entitlement to an ABIL.

Second objection

[137] The second objection by the appellants was that it was too late for the respondent to argue in her Reply to the Amended Notice of Appeal that some of the amounts charged to their loans account in cStar were personal in nature and should not form part of the ABIL calculations. The appellants argued that the respondent

was barred from arguing this since the Minister did not rely on that factual basis in reassessing the appellants. The appellants submitted that by making these arguments the respondent was indirectly reassessing expenses that had now been statute-barred for 5 to 11 years. In addition, the appellants argued that they were being prejudiced as they no longer had the documents to justify their expenses, since they were lost in the August 2005 flood.

[138] In her Reply to the Amended Notice of Appeal, the respondent added as an argument that some of the expenses claimed by the appellants in computing their ABILs were personal expenses. The appellants argued that in advancing that argument the respondent opted to ambush the appellants with incomplete summaries from audit records. Accordingly, the appellants submitted that the new arguments put forward in the respondent's Reply to the Amended Notice of Appeal should not be taken into account as it amounts to the reopening of cStar's 1998 to 2005 taxation years with respect to the deductibility of those expenses.

[139] The respondent argued that since the appellants, through their Amended Notice of Appeal, sought to vary the reassessments by amending the amounts that they claimed for their ABILs, the appellants have to establish not only their entitlement to their ABILs but also the amounts of the ABILs. According to the respondent, the appellants have to establish that the amounts claimed as ABILs did not include personal expenses.

[140] In addition, the respondent argued that, by virtue of subsection 152(9) of the Act, she was entitled to argue in her Reply that some expenses charged to cStar were personal expenses and should not be included in the calculation of the appellants' ABILs. Subsection 152(9) states the following:

> 152(9) The Minister may advance an alternative argument in support of an assessment at any time after the normal reassessment period unless, on an appeal under this Act
>
> > (*a*) there is relevant evidence that the taxpayer is no longer able to adduce without the leave of the court; and
> >
> > (*b*) it is not appropriate in the circumstances for the court to order that the evidence be adduced.

[141] In light of my finding that the appellants are not entitled to claim an ABIL, this objection is academic. However, in case I may have erred in finding that the appellants did not prove the debt was bad, I will nonetheless rule on the objection.

[142] I do not agree with the respondent that the appellants have the burden of establishing that they did not include personal expenses in computing their ABIL claims. These facts were not part of the Minister's assumption. Therefore, the burden of proof is on the respondent to establish on a balance of probabilities that they were personal expenses.

[143] Subsection 152(9) authorizes the Minister to advance an alternative argument in support of a reassessment after the normal reassessment period. This Court's decisions in *Loewen v The Queen*, 2007 CarswellNat 6381, 2007 TCC 703, and *Toronto-Dominion Bank v The Queen*, 2008 DTC 3937, dealt with the application of subsection 152(9) of the Act.

[144] In *Toronto-Dominion Bank*, Justice Webb, relying on the unanimous decision of the Federal Court of Appeal in *Walsh*, stated the following, at paragraphs 28 and 29, with respect to the application of subsection 152(9):

> [28] In *Walsh v. The Queen*, 2007 FCA 222, [2007] 4 C.T.C. 73, 2007 DTC 5441, Justice Richard of the Federal Court of Appeal made the following comments in relation to subsection 152(9) of the Act :
>
> > 18. The following conditions apply when the Minister seeks to rely on subsection 152(9) of the Act:
> >
> > 1) the Minister cannot include transactions which did not form the basis of the taxpayer's reassessment;
> >
> > 2) the right of the Minister to present an alternative argument in support of an assessment is subject to paragraphs 152(9)(*a*) and (*b*), which speak to the prejudice to the taxpayer; and
> >
> > 3) the Minister cannot use subsection 152(9) to reassess outside the time limitations in subsection 152(4) of the Act, or to collect tax exceeding the amount in the assessment under appeal.
>
> [29] There is no suggestion in this case that the Respondent is attempting to increase the amount of the income of the Appellant to an amount that would be greater than the amount included in the reassessment or to collect tax exceeding the amount that was reassessed.

[145] As to the interpretation to be given to paragraphs 152(9)(*a*) and 152(9)(*b*), Justice Webb stated that paragraphs (*a*) and (*b*) only apply where a taxpayer is before

the Federal Court of Appeal or the Supreme Court of Canada, since leave to produce relevant evidence is not needed before this Court.

[146] In *Toronto-Dominion Bank*, Justice Webb stated that the death of the key witnesses did not fall within the type of evidentiary problem contemplated by paragraphs 152(9)(*a*) and (*b*) of the Act. At paragraph 48, he stated as follows:

> As a result, I do not agree with the interpretation of this provision as proposed by counsel for the Appellant and the Appellant cannot succeed in its motion based on subsection 152(9) of the Act as this is not a situation where the Appellant is no longer able to adduce evidence without leave of the court. The evidentiary problem of the Appellant is not that the Appellant requires the leave of the court to adduce evidence but that key witnesses are now deceased. This type of evidentiary problem is not the type of evidentiary problem contemplated by paragraphs (*a*) and (*b*) of subsection 152(9) of the Act.

[147] In these appeals, the respondent is not adding a new transaction. The transaction is the same, namely the ABIL claimed by the appellants. In my view, if the expenses were of a personal nature, they cannot validly form part of an ABIL claim as they would not have been incurred for the purpose of gaining or producing income, as required under subparagraph 40(2)(*g*)(ii) of the Act. In addition, the respondent is not increasing the amount of taxes owed, and the type of evidentiary problem contemplated by the appellants does not fall within the ambit of paragraphs 152(9)(*a*) and (*b*) of the Act.

[148] Accordingly, the second objection of the appellants is rejected.

[149] The respondent submitted at trial a list of expenses that the respondent argued were personal in nature. These expenses amounted to $19,405.47 for Mr. Coveley and $209,185.28 for Mrs. Coveley.

[150] When questioned as to the nature of some of these expenses, the appellants were able to provide an explanation as to why they were legitimate business expenses. The only expense that Mrs. Coveley recognized as being personal was an $8 fee for parking at the University of Toronto, incurred when completing her MBA.

[151] However, I believe that Mrs. Coveley's credibility was negatively impacted on a few occasions during her testimony. First, Mrs. Coveley testified that the expenses at Salon de Cal were incurred with clients or in preparation for travel or a media appearance. However, one of these charges was incurred more than a month before cStar was incorporated. Second, Mrs. Coveley stated that she charged a bill from

Richmond Hill Hydro for the appellants' house to cStar because something had blown up when Mr. Coveley was conducting a test, and that it was the only such bill charged to cStar. However, counsel for the respondent then pointed out to Mrs. Coveley a second bill from Richmond Hill Hydro. In addition, although she stated that she did not have time to cook for her family she stated that all the grocery store expenses were for office supplies and home-cooked meals prepared for cStar's staff.

[152] Mrs. Coveley also stated that the expenses incurred at restaurants were all for meals with staff or clients. She stated that all the expenses at stores such as The Bay, Sears, La Vie en Rose, Kiddie Kobbler, Gap Kids and Moores Clothing for Men, and the expenses for cinema tickets were for gifts she gave to clients and clients' wives. Dues for private clubs such as the Richmond Hill Country Club and the Mayfair Racquet Club were also incurred, she testified, for the benefit of cStar's clients. At one point, when she could not explain some veterinary bills, she stated that she did not have any pets at that time but refused to admit that there was no business income purpose to the expenses.

[153] In my view, the respondent was able to demonstrate that some of the answers given by Mrs. Coveley were far-fetched. It is clear that some expenses were personal and should not have been included in the computation of the ABILs. On the other hand, I do not doubt that some expenses - the dry cleaner's invoices for lab coats, the office supplies and some outings to name a few - were legitimately incurred for business purposes.

[154] In light of the evidence, some of the expenses claimed by Mrs. Coveley were personal expenses. The same is also true for Mr. Coveley.

[155] If I had decided that the appellants were entitled to claim an ABIL, I would have reopened the trial or asked for further submissions. In light of the evidence submitted, I am unable to determine what proportion of the expenses were personal expenses.

E. Conclusion

[156] In my view, the appellants did not make an honest and reasonable determination that cStar's debt became a bad debt in the 2005 taxation year.

[157] As the Federal Court of Appeal recognized in *Rich*, *supra*, owner-managers are often in the best position to determine whether there is a reasonable prospect of

collecting their debts. However, an assessment of the considerations previously enunciated leads me to conclude that cStar's situation in 2005 was not different from that in previous years. While cStar was in a precarious financial situation in 2005, this does not suffice to justify a conclusion that the loans made to it had become bad debts.

[158] cStar continued to carry on business after the appellants determined that their debt had gone bad, and is in fact still operating. The appellants are correct in stating that the Act does not require that the debtor corporation cease operations before an ABIL claim for a bad debt is available.

[159] In the present appeals, the appellants' conduct before and after the bad debt determination does not support a finding that there was a reasonable and honest determination that their advances to cStar had become bad debts. Quite the opposite, their conduct suggests that both of them were confident that the market would catch up and that cStar would eventually become profitable.

[160] In addition, there was no evidence that the appellants made reasonable efforts to recover their debts. There was no evidence that the appellants tried to sell any of cStar's assets, such as patents. There was no evidence that they tried to sell any of cStar' shares. The evidence showed that the appellants were not ready to share control of cStar with potential investors.

[161] For all these reasons, I am of the view that the appellants' debt did not become bad in 2005.

[162] The appellants' ABIL claims must consequently be disallowed for the 2005 taxation year. In addition, the appellants are not entitled to carry forward a non-capital loss to the 2006 taxation year, for the following reasons:

(a) As regards Mr. Coveley, the loans were not made for the purpose of gaining or producing business income from cStar. If I had found that the loans by Mr. Coveley bore interest, his claim for an ABIL in 2005 would still have failed since the debt did not become bad in 2005. Accordingly, he was not entitled to carry forward a non-capital loss to his 2006 taxation year.

(b) As regards Mrs. Coveley, the debt did not become bad in 2005. Accordingly, she was not entitled to carry forward a non-capital loss to her 2006 taxation year.

[163] The appeals are dismissed with costs.

Signed at Ottawa, Canada, this 20th day of December 2013.

"Johanne D'Auray"

D'Auray J.

CITATION:	2013 TCC 417
COURT FILE NO.:	2008-3796(IT)G 2008-3797(IT)G
STYLE OF CAUSE:	MICHAEL COVELEY v HER MAJESTY THE QUEEN SOLBYUNG COVELEY v HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	October 9, 10, 11 and 12, 2012
REASONS FOR JUDGMENT BY:	The Honourable Justice Johanne D'Auray
DATE OF JUDGMENT:	December 20, 2013

APPEARANCES:

Counsel for the Appellants:	Leigh Somerville Taylor
Counsel for the Respondent:	Samantha Hurst Alisa Apostle

COUNSEL OF RECORD:

For the Appellant:

Name:	Leigh Somerville Taylor
	Firm: Leigh Somerville Taylor Professional Corporation Toronto, Ontario
For the Respondent:	William F. Pentney Deputy Attorney General of Canada Ottawa, Canada