Docket: 2007-3088(IT)I

BETWEEN:

LIANGHONG LI,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on March 4 and 6, 2008, at Toronto, Ontario.

Before: The Honourable Justice Wyman W. Webb

Appearances:

For the Appellant:	The Appellant himself
Counsel for the Respondent:	Kate Leslie

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* for the Appellant's 2003 and 2004 taxation years are allowed, with costs, and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to the following deductions in computing his income for 2003 and 2004:

Expense	**Amount allowed for 2003**	**Amount allowed for 2004**
Office Expenses	$350	0
Food	$243	$320
Telephone/Cellular	$230	$268
Motor Vehicle Expenses:		
▪ Car Repairs	$324	$371
▪ Gas	$552	$406

▪ CAA	$31	$39
▪ Insurance	$464	$574
Parking	$136	$50
Cable TV	$0	$0
Internet	$55	$80
Other Business Expenses	$12,000	$12,000
	$14,385	$14,108

Signed at Fredericton, New Brunswick, this 31st day of March 2008.

"Wyman W. Webb"

Webb J.

Citation: 2008TCC175
Date: 20080331
Docket: 2007-3088(IT)I

BETWEEN:

LIANGHONG LI,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Webb J.

[1] The primary issue in this case is whether the Appellant was carrying on a business in 2003 and 2004. The Appellant claimed business expenses in each of these years and the Respondent has taken the position that the Appellant had not commenced any business. If the Appellant was carrying on a business, the expenses claimed will have to be examined to determine the amounts thereof that are deductible in computing his income for the purposes of the *Income Tax Act* ("*Act*").

[2] The Appellant is well-educated. He received his M.D. from Chongqing Medical College (now Chongqing University of Medical Sciences), Chongqing, Sichuan, China in 1982, his Master of Science of Clinical and Basic Pharmacology in 1985 from the West China University of Medical Sciences and his postdoctoral training as a visiting scientist to the University of Illinois College of Medicine at Rockford, Illinois.

[3] The Appellant is presently a manager of laboratory operations for Diteba Research Laboratories Inc. in Mississauga. Prior to that he held positions as a senior research chemist, research associate, visiting scientist, associate professor and lecturer.

[4] The Appellant has invented a new homogenizer system that will be used in processing tissue samples. The potential customers are laboratories that process tissue samples – university research laboratories, pharmaceutical companies, biopharmaceutical companies, hospital laboratories and forensic laboratories. In the Product and Business Activities booklet introduced as an Exhibit the Appellant estimates that there are 30,000 laboratories that would need this kind of product. The features of his new homogenizer system are described in this booklet as follows:

1. Easy to use for sample processing;

2. No cross-contamination compared to traditional ways and tools;

3. Efficient for number of samples processing;

4. Not expensive

[5] An application for a patent for this product was filed in 2001. Since that time, the Appellant has been working on the components of the homogenizing system and resolving issues related to the motor and switches that would be used, working with the manufacturer to determine how the product will be manufactured and designing the packaging. The Appellant made more than one prototype before finalizing the design of the product. The Appellant indicated that an important step that must be completed before the product can be sold to his potential customers is that the product must receive the approval of Underwriters Laboratories Inc. ("UL"). Two quotations from UL were submitted. The estimated cost of receiving UL approval for the switches is US$21,600 and for the motors is US$4,700. He has not yet received UL approval for the switches or the motors.

[6] The unit has two parts – the motorized part that operates the grinder and the replaceable head set. An invoice dated January 27, 2007 shows that the Appellant received 50 of the motorized units and 5100 of the replaceable parts from China.

[7] The Appellant has not yet sold any of the products, but he did have one of his products in its packaging at the hearing. The Appellant is also working on two other inventions – a new foot massaging unit and a new bone fracture fixation system. The expenses claimed in this case relate to the new homogenizer system.

[8] The issue of whether a person is carrying on a business has been the subject of previous litigation. In *Harquail v. The Queen*, 2001 FCA 320, 2001 DTC 5630, [2002] 1 C.T.C. 25, Justice Desjardins of the Federal Court of Appeal made the following comments on behalf of the Federal Court of Appeal:

> 62 It is not easy to delimit the content of the concept of carrying on business. One can see two outside parameters where the carrying on of business does not occur: on the one hand, when a company, which has been incorporated, has not actually commenced operation and, on the other hand, when a company has become dormant and is only holding annual meetings and filing its returns so as to avoid the forfeiture of its charter. There are, in between, some activities, however, which are signs that a company is operating and which should fall within the spectrum of the concept of carrying on business, even though, for example, the activities are carried on for the purpose of reaching an agreement which eventually is not reached or even though they do not result in the earning of income.
>
> 63 In this line of reasoning, I find helpful the comments made by Jackett J. in *Canada Starch Co. v. Minister of National Revenue* (1968), 68 D.T.C. 5320 (Can. Ex. Ct.), at 5324 -25. While this case turns on the notion of deductible business expenses or capital outlay, the following, which throws some light on the issue of carrying on business, was said:
>
> > [. . .] Similarly, in my view, expenses of other measures taken by a businessman with a view to introducing particular products to the market-such as market surveys and industrial design studies-are also current expenses. They also are expenses laid out while the business is operating as part of the process of inducing the buying public to buy the goods being sold.
> >
> > [emphasis added by Justice Desjardins]
>
> 64 Again, in *Bowater Power Co. v. Minister of National Revenue* (1971), 71 D.T.C. 5469 (Fed. C.A.), at 5481, a case dealing also with deductible business expenses and capital outlay, Noël, A.C.J. stated:
>
> > [. . .] While the hydroelectric development, once it becomes a business or commercial realty is a capital asset of the business giving rise to it, whatever reasonable means were taken to find out whether it should be created or not may still result from the current operations of the business as part of the every day concern of its officers in conducting the operations of the company in a business-like way. I can, indeed, see no difference in principle between all of

these cases.

[emphasis added by Justice Desjardins]

65 In my view, Hall River was carrying on business without interruption since 1978. It was constantly on the look-out for a market to develop its hydroelectric potential. Hall River, therefore, meets the requirement of subsection 110.6(1) of the Act, both in terms of "active business" and in terms of the relevant period, namely "throughout that part of the 24 months immediately preceding the determination time while it was owned by the individual".

[9] The Supreme Court of Canada in *Stewart v. The Queen*, 2002 S.C.C. 46, 212 D.L.R. (4th) 577, 2002 DTC 6969 (Eng.), [2002] 3 C.T.C. 439, 50 R.P.R. (3d) 157, 288 N.R. 297, [2002] 2 S.C.R. 645, stated as follows:

50 It is clear that in order to apply s. 9, the taxpayer must first determine whether he or she has a source of either business or property income. As has been pointed out, a commercial activity which falls short of being a business may nevertheless be a source of property income. As well, it is clear that some taxpayer endeavours are neither businesses nor sources of property income, but are mere personal activities. As such, the following two-stage approach with respect to the source question can be employed:

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

(ii) If it is not a personal endeavour, is the source of the income a business or property?

The first stage of the test assesses the general question of whether or not a source of income exists; the second stage categorizes the source as either business or property.

51 Equating "source of income" with an activity undertaken "in pursuit of profit" accords with the traditional common law definition of "business," i.e., "anything which occupies the time and attention and labour of a man for the purpose of profit": Smith, supra, at p. 258, Terminal Dock, supra. As well, business income is generally distinguished from property income on the basis that a business requires an additional level of taxpayer activity: see Krishna, supra, at p. 240. As such, it is logical to conclude that an activity undertaken in pursuit of profit, regardless of the level of taxpayer activity, will be either a business or property source of income.

52 The purpose of this first stage of the test is simply to distinguish between commercial and personal activities, and, as discussed above, it has been pointed out that this may well have been the original intention of Dickson J.'s reference to "reasonable expectation of profit" in Moldowan. Viewed in this light, the criteria listed by Dickson J. are an attempt to provide an objective list of factors for determining

> whether the activity in question is of a commercial or personal nature. These factors are what Bowman J.T.C.C. has referred to as "indicia of commerciality" or "badges of trade": Nichol, supra, at p. 1218. Thus, where the nature of a taxpayer's venture contains elements which suggest that it could be considered a hobby or other personal pursuit, but the venture is undertaken in a sufficiently commercial manner, the venture will be considered a source of income for the purposes of the Act.
>
> 53 We emphasize that this "pursuit of profit" source test will only require analysis in situations where there is some personal or hobby element to the activity in question. With respect, in our view, courts have erred in the past in applying the REOP test to activities, such as law practices and restaurants, where there exists no such personal element: see, for example, Landry, supra, Sirois, supra, Engler v. R. (1994), 94 D.T.C. 6280 (Fed. T.D.). Where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer's business decisions. Such endeavours necessarily involve the pursuit of profit. As such, a source of income, by definition, exists, and there is no need to take the inquiry any further.
>
> 54 It should also be noted that the source of income assessment is not a purely subjective inquiry. Although in order for an activity to be classified as commercial in nature, the taxpayer must have the subjective intention to profit, in addition, as stated in Moldowan, this determination should be made by looking at a variety of objective factors. Thus, in expanded form, the first stage of the above test can be restated as follows: "Does the taxpayer intend to carry on an activity for profit and is there evidence to support that intention?" This requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour.
>
> 55 The objective factors listed by Dickson J. in Moldowan at p. 486 were (1) the profit and loss experience in past years, (2) the taxpayer's training, (3) the taxpayer's intended course of action, and (4) the capability of the venture to show a profit. As we conclude below, it is not necessary for the purposes of this appeal to expand on this list of factors. As such, we decline to do so; however, we would reiterate Dickson J.'s caution that this list is not intended to be exhaustive, and that the factors will differ with the nature and extent of the undertaking. We would also emphasize that although the reasonable expectation of profit is a factor to be considered at this stage, it is not the only factor, nor is it conclusive. The overall assessment to be made is whether or not the taxpayer is carrying on the activity in a commercial manner. However, this assessment should not be used to second-guess the business judgment of the taxpayer. It is the commercial nature of the taxpayer's activity which must be evaluated, not his or her business acumen.

[10] It is clear that in this case, this activity was being undertaken by the Appellant in pursuit of profit. There is no suggestion that there is any personal element in this endeavor. The Appellant is very proud of his invention, but taking pride in his invention and wanting to bring a product to market does not make this a personal

endeavor. Therefore the Appellant was carrying on a business. The fact that it has taken several years to bring the product to market is more as a result of the nature of the product itself and the fact that it is a new invention that requires time to work out problems and obtain the necessary approvals rather than any indication that the Appellant was not carrying on a business.

[11] However, the next issue is the appropriate amount that the Appellant is entitled to claim for each of these years. The Respondent admitted that most of the amounts claimed by the Appellant had been incurred by the Appellant. The Respondent however admitted that a lesser amount had been incurred for office expenses for 2004 and for food for 2003 than had been claimed and the Respondent did not admit that any amount had been incurred in relation to the other business expenses of $12,000 for each of 2003 and 2004. The Appellant and the Respondent also disagreed on the deductibility of the amounts spent.

[12] While the Appellant is very well-educated and has a lot of experience in the medical and pharmaceutical fields, he is not a good bookkeeper. The records maintained by the Appellant are not adequate. The amount claimed for office expenses includes several items that should be capitalized and items for which there is another separate category of expenses that were claimed. The appropriate amount that is related to the purchase of capital assets, based on the use of such asset in the business, should be added to the appropriate capital cost allowance schedule and the Appellant can then claim capital cost allowance in relation to these items in accordance with the provisions of the *Act* and the *Income Tax Regulations*.

[13] There are amounts included in the claim for office expenses for 2003 that were amounts spent on capital assets. There is an amount of $229.99 for a TV dish. This amount cannot be fully deducted, even if the TV dish was used to connect to the internet, as it is a capital asset. There is also a claim for $88.47 identified as unknown and a claim for $20 for parking tickets but there is also another category of expenses claimed for parking. The total for the list of the 2003 revised summary of office expenses that was submitted was $727.23 but the total amount claimed by the Appellant for 2003 was $570.79. No list was submitted to show what was included in the $570.79. It is difficult to determine the exact amount of office expenses that were incurred in 2003, but I will allow $350 as office expenses for 2003.

[14] The amounts claimed as office expenses for 2004 appear mostly to be for capital expenditures or amounts for expenses (such as cell phone cards) for which a separate amount is also claimed. As a result, no amount will be allowed for office expenses in 2004.

[15] With respect to the amounts claimed for food, the Appellant stated that these amounts related to meetings that the Appellant had with various colleagues and friends in relation to the business. These individuals worked in laboratories that would be potential customers of the Appellant's product. The amount spent for food will be allowed, subject to the application of section 67.1 of the *Act* which will limit the amount claimed to one-half of the amount incurred. The amount claimed by the Appellant for 2003 was $550.63. The Respondent acknowledges that $486 was incurred in 2003 for meals and the Appellant accepted the amount of $486 for 2003 as acknowledged by the Respondent. The Appellant and the Respondent agreed that $641 was incurred in 2004. Therefore the amount that will be allowed for the food will be $243 for 2003 and $320 for 2004.

[16] With respect to the amount claimed for telephone/cellular, the Appellant stated that he would use his phone for both business and personal use and his estimated business use was 35%. I accept his testimony on this and therefore 35% of the amount claimed for the telephone/cellular will be allowed.

[17] With respect to the amount claimed for the motor vehicle expenses, the Appellant stated that the business use of his car would be approximately 40%. I accept his testimony on this matter and therefore 40% of the amount claimed for motor vehicle expenses will be allowed as a business expense. The Appellant also testified that the amounts claimed did not include the amount that he spent on automobile insurance. These amounts were $1,159.48 for 2003 and $1,436 for 2004. Forty percent of the amounts spent on automobile insurance will also be allowed as a business expense.

[18] With respect to the amount claimed for parking, these amounts were for parking tickets that the Appellant had received. In *65302 British Columbia Limited v. The Queen*, 99 DTC 5799, [2000] 1 C.T.C. 57, Justice Iacobucci stated that:

> 23 At issue in the present appeal is whether levies, fines and penalties may be deducted as business expenses from a taxpayer's income. The resolution of this issue involves questions of statutory interpretation and the extent to which public policy considerations may enter into this interpretation. It is my opinion that as a general principle, it is Parliament, and not the courts, who should decide which expenses incurred for the purpose of earning business income should not be deductible. Parliament has made such decisions on many occasions; this is simply not one of them. As such, levies, fines and penalties which are incurred for the purpose of earning income are deductible business expenses.

[19] Following this decision of the Supreme Court of Canada, section 67.6 was added to the *Act*. This section provides as follows:

> 67.6 In computing income, no deduction shall be made in respect of any amount that is a fine or penalty (other than a prescribed fine or penalty) imposed under a law of a country or of a political subdivision of a country (including a state, province or territory) by any person or public body that has authority to impose the fine or penalty.

[20] This section is applicable to fines and penalties imposed after March 22, 2004. This section is not pleaded in the Reply nor was there any evidence with respect to when the parking tickets were issued in 2004. Counsel for the Respondent did not argue this section in relation to the amount claimed for the parking tickets in 2004. As there were no assumptions made in the Reply in relation to the parking tickets, the Respondent had the onus of establishing any facts that would be required to determine if this section would be applicable to the amount claimed for the parking tickets.

[21] In *Pollock v. The Queen*, [1994] 1 C.T.C. 3, 94 DTC 6050, Justice Hugessen, on behalf of the Federal Court of Appeal, made the following comments:

> Where, however, the Minister has pleaded no assumptions, or where some or all of the pleaded assumptions have been successfully rebutted, it remains open to the Minister, as defendant, to establish the correctness of his assessment if he can. In undertaking this task, the Minister bears the ordinary burden of any party to a lawsuit, namely to prove the facts which support his position unless those facts have already been put in evidence by his opponent. This is settled law.

[22] In *Loewen* 2004 FCA 146, Justice Sharlow, on behalf of the Federal Court of Appeal, made the following comments:

> 11 The constraints on the Minister that apply to the pleading of assumptions do not preclude the Crown from asserting, elsewhere in the reply, factual allegations and legal arguments that are not consistent with the basis of the assessment. **If the Crown alleges a fact that is not among the facts assumed by the Minister, the onus of proof lies with the Crown.** This is well explained in Schultz v. R. (1995), [1996] 1 F.C. 423, [1996] 2 C.T.C. 127, 95 D.T.C. 5657 (Fed. C.A.) (leave to appeal refused, [1996] S.C.C.A. No. 4 (S.C.C.)).
>
> (emphasis added)

[23] Leave to appeal the decision of the Federal Court of Appeal in *Loewen* to the Supreme Court of Canada was refused (338 N.R. 195 (note)).

[24] Since the Respondent has not led any evidence with respect to the facts that would be required to determine whether section 67.6 of the *Act* will apply in this case (and in particular whether the parking tickets were issued after March 22, 2004), I cannot consider whether this section would be applicable to the parking tickets issued to the Appellant. The Appellant indicated that 80% of the amounts for the parking tickets would relate to the business. I accept his testimony and 80% of the amounts spent on parking tickets will be allowed as a business expense for each of 2003 and 2004.

[25] With respect to the amount claimed for cable TV, the Appellant failed to establish the necessary connection between the use of the Cable TV and his business. Therefore no amount will be allowed as a business expense for the Cable TV.

[26] With respect to the amount related to the Internet, the Appellant indicated that he used e-mail in relation to his business and the percentage of business use of the Internet would be 50%. I accept his testimony in this regard and 50% of the amount incurred for the Internet charges will be allowed as a business expense.

[27] The amount claimed for other business expenses claimed in each of 2003 and 2004 was an amount of $12,000 in each year. These were amounts that were paid by the Appellant to his brother in China who was dealing with the manufacturer. The receipt indicates that these amounts were for consultation fees and amounts related to the trial production of the product. Throughout 2003 and 2004 the Appellant was dealing with the manufacturer to try to work on the design of the product and the manufacturing process. I accept the Appellant's testimony in this matter and the Appellant is allowed a claim of $12,000 for each year. In 2004 the amount paid to the Appellant's brother was more than $12,000 but the Appellant is only claiming $12,000 for 2004.

[28] As a result, the appeals are allowed, with costs, and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to the following deductions in computing his income for 2003 and 2004:

Expense	**Amount allowed for 2003**	**Amount allowed for 2004**
Office Expenses	$350	0
Food	$243	$320
Telephone/Cellular	$230	$268

Motor Vehicle Expenses:		
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Parking	$136	$50
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Other Business Expenses	$12,000	$12,000
	$14,385	$14,108

Signed at Fredericton, New Brunswick, this 31st day of March 2008.

"Wyman W. Webb"

Webb J.

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COURT FILE NO.:	2007-3088(IT)I
STYLE OF CAUSE:	LIANGHONG LI AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
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REASONS FOR JUDGMENT BY:	The Honourable Justice Wyman W. Webb
DATE OF JUDGMENT:	March 31, 2008

APPEARANCES:

For the Appellant:	The Appellant himself
Counsel for the Respondent:	Kate Leslie

COUNSEL OF RECORD:

For the Appellant:

Name:	
Firm:	

For the Respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada