

Docket: 2006-3484(IT)I

BETWEEN:

JAMES FALKENER,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on August 20 and 21, 2007, at Kelowna, British Columbia

By: The Honourable Justice E.A. Bowie

Appearances:

Counsel for the Appellant: Dewey Lotoski

Counsel for the Respondent: Selena Sit

JUDGMENT

The appeals from reassessments of tax made under the *Income Tax Act* for the 1998, 1999, 2000, 2001, 2002 and 2003 taxation years are allowed, with costs, and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that:

- (i) section 31 of the *Act* does not apply in any of the years under appeal;
- (ii) in computing his income, the appellant is entitled to deduct the disputed expenses for pet supplies and veterinary fees as set out in Exhibit A-2; and
- (iii) in computing his income, the appellant is entitled to deduct additional expenses and the additional capital cost allowance as agreed upon between the parties and recorded in Exhibit A-2.

Signed at Ottawa, Canada, this 25th day of September, 2007.

“E.A. Bowie”

Bowie J.

Citation: 2007TCC514
Date: 20070925
Docket: 2006-3484(IT)I

BETWEEN:

JAMES FALKENER,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Bowie J.

[1] There are six appeals before me from income tax assessments for the taxation years 1998, 1999, 2000, 2001, 2002, and 2003. The principal issue in each year is whether Mr. Falkener's farming losses are to be limited under the provisions of section 31 of the *Income Tax Act* (the *Act*). The Minister of National Revenue, by his assessments, has also disallowed certain of the expenses that Mr. Falkener seeks to deduct in computing his income, on the basis that they are personal expenses and their deduction is therefore precluded by paragraph 18(1)(h) of the *Act*.

[2] Mr. Falkener was born in Canada in 1957. When he was two years old, his family moved to England and he lived there until 1977, when he returned to Canada. During much of the 18 years that he spent in England, he lived with his family on a farm. His grandfather was a farmer, as were a number of his other relatives, but he did not himself engage in farming during this period of his life. He completed his high school education in England, and returned to Canada to live when he was about 20 years old. He worked at a number of different occupations, none having to do with farming, before deciding in his 30s to become an insurance adjuster. He became a licensed insurance adjuster in 1989, and continued fulltime in that occupation until the end of 1993.

[3] It was in the early 1990s that Mr. Falkener started thinking about a change of lifestyle, and he came to consider llama farming as an occupation that he could pursue into his retirement years. He purchased a property of about five acres with a house and a barn on it, about 50 kilometres east of Kamloops, B.C. He also met a Mr. Govett at about that time. Mr. Govett was already established in the llama raising business, and was enjoying some success at it. Mr. Govett encouraged him, and he did a considerable amount of research into the business of raising llamas. He visited other farmers to view their operations, and he read about the subject. Mr. Govett had prepared a pro forma business plan for the use of himself and others, and he shared it with Mr. Falkener as well. As a result of his researches, Mr. Falkener concluded that a property of five acres would be quite adequate to support a herd of 20 llamas. He moved onto the property that he and his wife had bought, and began to make the necessary improvements to enable it to be used as a llama farm.

[4] During the next two or three years, Mr. and Mrs. Falkener spent a considerable amount of time, energy and money to improve the property by erecting fences, feeding shelters for the animals, and other such structures, and dividing the land into a number of paddocks and distinctly separate fields in which to graze the animals. They improved the water system and rewired the barn. They also began a considerable renovation and extension of the house, both to improve the living space and to accommodate some aspects of the business, such as recordkeeping and processing the llama fibre. Not all of this was done in the years between 1991 and 1993; it has been a continuing process over a considerable number of years.

[5] Mr. Falkener bought his first llama in 1993. It was a purebred, and it cost \$5,000. Llamas are herding animals; they do not like to live alone. Mr. Falkener was able to borrow a llama to live with the first one that he purchased. His plan was to build, through a combination of buying and breeding, a herd of about 20 high quality animals. This herd would then potentially provide him, he believed, with what would eventually be a six-figure income. The revenue would be derived in part from the sale of animals, and in part from the animals' fibre. He explained that high quality stock can be sold to other breeders, while lesser quality animals could be sold for a variety of uses, albeit at much lower prices. The fibre is obtained by shearing the animals annually, in much the same way that sheep are sheared. The wool is then carded and woven into fabric.

[6] In furtherance of this plan, Mr. Falkener bought two more llamas in each of 1993 and 1994; one was born in 1994, three in each of 1995, 1996 and 1997, one in 1998, two in 1999 and one in 2000. By 1997, his herd consisted of 15 animals, which is the size it remains today.

[7] One significant event took place in 1996 that Mr. Falkener could not have foreseen, and that had a drastic effect upon his plans. In that year, the Canadian government reversed its long-standing policy that severely restricted the entry of llamas of foreign origin to the country. Both Mr. Falkener and Mr. Govett testified that this change in Canada's policy had a very far-reaching effect on the prices that mature llamas could fetch in Canada. Not only was the supply of llamas greatly increased by imports, but there was a considerable amount of panic selling among llama farmers, many of whom were relatively new to the market and had little experience of the market forces. Prices of breeding stock collapsed almost overnight to about 10% to 20% of what they had formerly been. From Mr. Falkener's point of view, the timing could not have been worse; he had purchased his animals before the market collapsed, but did not have animals ready for market until after.

[8] Faced with this change in the economic environment, Mr. Falkener decided that he would not sell into such a depressed market, but would hold on to his herd instead. He and Mr. Govett were both of the view that the market would recover, if not completely then at least to some extent, once it became apparent to Canadian llama farmers that the country was not about to be flooded with imported animals. To some extent they have been proven correct, although prices remain significantly lower than they were before 1996. With no revenue from sales of animals, Mr. Falkener needed a source of funds to continue to pay the expenses associated with maintaining the herd. He has begun to develop the sale of fibre as a revenue source, but that is certainly not capable of sustaining the expenses of maintaining the herd while waiting for the market to recover.

[9] In 1997, Mr. Falkener took steps to have his insurance adjuster's license reinstated. A series of natural disasters in the late 1990s gave rise to numerous insurance claims in the United States, and a concomitant demand for the services of freelance insurance adjusters. Mr. Falkener was able to secure some of this work for himself. It required him to travel quite extensively throughout the southern and midwestern United States, but by doing so he was able to secure a cash income sufficient to meet the needs of the farm during the years from 1998 to 2003. His wife had been a participant with him in the operation of the farm from the outset, and she was able to do what was required during his absences.

[10] The assessor took the view that the llama farm was a sideline or incidental business to Mr. Falkener, and that he remained primarily an insurance adjuster. This conclusion is not supported by the evidence before me. If that were the case, I do not believe that he would have surrendered his license when he did. He also would most

probably have spent more time than he did on the adjusting business and less on the farm. He testified that when he took on adjusting work after 1996, he made it clear to the insurers who retained him that if some unexpected event at the farm required him to return there before the job was done he would leave the site of the claims to attend to the needs of his farm. This, apparently, was acceptable to the clients on most occasions. I accept the appellant's evidence that his return to insurance adjusting was motivated only by the need to find income to replace the income that he had expected to gain through the sale of llama breeding stock, and that the earnings were used to keep the llama farming business afloat.

[11] Mr. Falkener has been an active participant in the provincial and national organizations of llama farmers since he first entered the industry. He also has taken part as both an organizer and an exhibitor in llama shows. One of his animals was awarded second place in its class at a show some years ago. His evidence establishes that he not only has developed an interest in the future of the llama farming industry, but he has also devoted a significant amount of time and effort towards promoting and improving it.

[12] In addition to his inventory of llamas, Mr. Falkener has a Russian wolfhound and two cats on his property. He got his first Russian wolfhound at about the time that he acquired the farm property. After it had to be euthanized in 1998, there was an interval of about two years before he replaced it with another of the same breed. There is an issue between the parties as to certain expenses relating to the dogs and the cats to which I will return later.

[13] There has been a great deal of litigation, much of it at the appellate level, concerning the interpretation and application of section 31 of the *Act*. The leading case, and the only decision of the Supreme Court of Canada on point, is *Moldowan v. The Queen*.¹ Although the Court's unanimous decision in *Moldowan* was recently the subject of severe criticism by the Federal Court of Appeal in *Gunn v. The Queen*,² it remains the binding authority that I must follow concerning the meaning and the application of section 31 of the *Act*. In delivering the Reasons for Judgment of the Court, Dickson J. stated:

¹ [1978] 1 S.C.R. 480.

² 2006 FCA 281.

Although originally disputed, it is now accepted that in order to have a "source of income" the taxpayer must have a profit or a reasonable expectation of profit. Source of income, thus, is an equivalent term to business: *Dorfman v. M.N.R.*, [1972] C.T.C. 151. See also s. 139(1)(a) of the *Income Tax Act* which includes as "personal and living expenses" and therefore not deductible for tax purposes, the expenses of properties maintained by the taxpayer for his own use and benefit, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit. If the taxpayer in operating his farm is merely indulging in a hobby, with no reasonable expectation of profit, he is disentitled to claim any deduction at all in respect of expenses incurred.

[14] It is not disputed by the respondent in the present case that llama farming was a source of income to Mr. Falkener during the years under appeal, and remains one today. The respondent's position is simply that it is not his chief source, either alone or in combination with his insurance adjusting business. This position is based in large part on the financial results, and on the conclusion reached by the Minister's assessor that Mr. Falkener cannot expect that farming will at some future time provide the bulk of his income. At one point in his written conclusion he put it this way:

The chance of ever achieving a profit is minimal, but we will not question REOP [reasonable expectation of profit] at this time.

[15] The *Moldowan* analysis mandates an examination of the comparative financial results, the investment of capital, the relative commitment of time and effort, and consideration of the taxpayer's mode and habit of work, as well as his reasonable expectation of future profitability. A relevant question certainly is whether farming was, at the relevant time, his major preoccupation. The Appellant's reported losses in the farming enterprise, after inventory adjustment, and his net income from his insurance adjusting work (is) are the following:

	<u>Farming loss</u>	<u>Insurance adjusting net income</u>
1998	(\$35,936)	\$82,207
1999	(38,471)	69,818
2000	(32,885)	43,707
2001	(25,778)	101,136
2002	(110,801)	81,359
2003	(390)	91,845

[16] Several things need to be noted in connection with these results. The first is that Mr. Falkener embarked on llama farming shortly before the bottom dropped out of the market for llamas. He began to build his herd with one purchase in 1993. By the time he had animals that he could sell, the prices had dropped to something like 10% of those that prevailed when he entered the industry. His decision to withhold animals from market at those prices was a pragmatic one, based on his belief that prices would recover, at least to some extent. This was a reasonable conclusion, and one shared by Mr. Govett, a more experienced llama farmer. The usual startup problems of a new entrant to an industry were therefore compounded for the appellant both by the nature of the industry and by the sudden shift in market forces.

[17] In his written report, the assessor took the position that Mr. Falkener was likely to have ongoing losses from his farming operations averaging \$1,216 per year. This projection was based on his somewhat arbitrary assumptions that future revenues could be expected to average \$15,000 per year, against future annual expenses of \$16,216. To some extent this dismal projection was influenced by past results. In *Gunn, supra*, the Federal Court of Appeal found that the taxpayer was not limited in deducting his farming losses by section 31, despite having had far greater farming losses and far greater non-farm income in the years under appeal than the present appellant. Mr. Gunn's farming losses averaged almost \$80,000 per year and his non-farm income about \$270,000 per year for the three years under appeal in that case. Mr. Falkener's farming losses for the years under appeal averaged about \$40,000 per year, and his insurance adjusting income less than \$80,000 per year for the six years under appeal. Against this background, Mr. Falkener's faith in his ability to make farming his primary source of income in the future rings no less true than did Mr. Gunn's.

[18] Counsel for the respondent pointed out that the appellant claimed only restricted farm losses when filing his returns for the years under appeal. I place no significance on this. Mr. Falkener has no training in either accounting or law, and he clearly knew nothing about section 31 of the *Act*. His returns were prepared for him by an accountant, not his agent in these appeals, and he accepted that accountant's advice and filed the returns as they had been prepared.

[19] Certainly, Mr. Falkener had far more capital committed to his farming operation than to his insurance adjusting business. The computation in the assessor's report³ indicates about \$145,000 in capital committed to the farm. His

³ Exhibit R-1, Tab 12, p. 5.

income tax returns reveal an investment of some \$7,000 in total committed to the insurance adjusting business, being the cost of a laptop computer, a printer, and a digital camera. He claimed no capital cost allowance for the vehicle that he used, a 1991 Ford Ranger.

[20] From Mr. Falkener's evidence, I conclude that when he was at home on the farm he spent a full workday on farm labour, and in addition his wife contributed considerable time and effort as well. When he was in the United States doing insurance adjusting work, he did that fulltime, but his wife did all the farm work during these interludes. On average, he worked on the farm some 58% of the time and away from the farm 42% in the period from 1999 to 2002. I accept Mr. Falkener's evidence that he worked away from the farm only from necessity. The money he earned in the United States went to pay the bills on the farm.

[21] I have no doubt that when Mr. Falkener made the decision in the early 1990s that he would become a llama farmer rather than an insurance adjuster, he made a change in his chief source of income from insurance adjusting to llama farming. He surrendered his insurance adjuster's license, because he did not expect to earn a living that way again. He devoted his capital and all his energies to llama farming, well aware that it would take time to build a herd and produce marketable animals, but with a reasonable expectation that he would eventually derive "a six-figure income" from it. This was not mere hope. He had made a thorough study of the business before he committed himself, and he had had the benefit of Mr. Govett's pro forma business plan.⁴

[22] In *Moldowan*, Dickson J. distinguished between a farmer who is not subject to the restriction of losses and one who is so restricted in this way:

- (1) a taxpayer, for whom farming may reasonably be expected to provide the bulk of income or the centre of work routine. Such a taxpayer, who looks to farming for his livelihood, is free of the limitation of s. 13(1) in those years in which he sustains a farming loss.
- (2) the taxpayer who does not look to farming, or to farming and some subordinate source of income, for his livelihood but carries on farming as

⁴ Exhibit A-2.

a sideline business. Such a taxpayer is entitled to the deductions spelled out in s. 13(1) in respect of farming losses.⁵

The evidence established unequivocally that since the end of 1993 when he gave up his insurance adjuster's license, the focus of Mr. Falkener's work routine has been the farm. When he applied to reinstate his license in 1997, this did not represent a shift back to his former lifestyle. The focus of his life remained at the farm, and he left it only of necessity to earn money to enable him to remain a farmer. Mr. Falkener is entitled to deduct his losses from farming from his other income without restriction.

[23] The Minister, as well as restricting the appellant's losses, disallowed numerous expenses that he had claimed in computing his income from farming in the years under appeal. During the two days of the trial, the parties were able to reach agreement as to which of those expenses were properly claimed as farm expenses and which were personal, with the exception of certain expenses related to the dogs and cats that the appellant kept on the property. Their agreement was filed as Exhibit A-2. It leaves unsettled certain claims for veterinary services, and for pet supplies such as food in each of the years 1998 to 2000. The appellant's position with respect to these is that the dogs and cats were working animals that he maintained for the purpose of gaining or producing income from the farm, and the expenses of maintaining them are properly deductible in computing his income. The respondent takes the position that the animals were primarily family pets, and that their maintenance was a personal expense, the deductibility of which is barred by paragraph 18(1)(h) of the *Act*.

[24] An amount of \$669.87 was spent in 1998 for the euthanasia and cremation of the first Russian wolfhound that Mr. Falkener bought in 1990 or 1991. Mr. Falkener testified that when he decided to move to the country and became a farmer, he purchased Ryder, a Russian wolfhound. From the time the first llama was housed on the premises Ryder, and later Javelin, who was purchased after Ryder's death, were guard dogs patrolling at night on runways built for that purpose, specifically to repel the coyotes, cougars and other predatory animals that might be expected to attack the llamas if they were unprotected. The need for protection is borne out by the fact that after Ryder died and before Javelin was acquired, one llama was attacked and killed during the night.

⁵ *Moldowan, supra*, at pages 487-8.

[25] The two cats were acquired by Mr. Falkener as kittens. He testified that their primary purpose was rodent control. Not only did small rodents tend to be attracted to the fodder stored on the farm, but gopher holes potentially posed a danger to llamas that might accidentally break a leg by stepping in them. The cats, he testified, repel both the gophers and the smaller rodents.

[26] The assessor testified that when he visited the farm during his audit, the dog and a cat were inside the farmhouse, and that they appeared to be well-groomed. This led him to conclude that they were pets, rather than working animals.

[27] I accept Mr. Falkener's evidence. The utility of dogs bred to hunt and cats with similar instincts on a farm in a remote rural area is surely obvious. The fact that they were permitted into the house does not negative their utility. The dangers that they were to protect against are largely nocturnal, and so it is not surprising that they might be inside during daylight hours. Nor do I accept the respondent's argument that the veterinary fees associated with a terminal diagnosis of cancer and the resulting euthanasia and cremation of Ryder should be disallowed on the basis that those services could not contribute to producing income. If the animal's primary purpose is connected to producing income, as I have found, then the humane treatment at the end of its life is surely an incident of that.

[28] In the result, the appeals are allowed, with costs. The reassessments are referred back to the Minister for reconsideration and reassessment on the basis that:

- (i) section 31 does not apply in any of the years under appeal;
- (ii) the appellant is entitled to deduct the disputed expenses for pet supplies and veterinary fees as set out in Exhibit A-2; and
- (iii) the appellant is entitled to deduct additional expenses and the additional capital cost allowance as agreed upon between the parties and recorded in Exhibit A-2.

Signed at Ottawa, Canada, this 25th day of September, 2007.

“E.A. Bowie”

Bowie J.

CITATION: 2007TCC514

COURT FILE NO.: 2006-3484(IT)I

STYLE OF CAUSE: JAMES FALKENER AND HER MAJESTY
THE QUEEN

PLACE OF HEARING: Kelowna, British Columbia

DATE OF HEARING: August 20 and 21, 2007

REASONS FOR JUDGMENT BY: The Honourable Justice E.A. Bowie

DATE OF JUDGMENT: September 25, 2007

APPEARANCES:

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