

SUPREME COURT SCORES ONE FOR TAXPAYERS

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Of the thousands of income tax cases heard every year in Canada, few make it to the Supreme Court of Canada. When that court decides a tax case, and especially when the decision favours taxpayers, it's news. Such is the case with *Stewart v. Canada*, decided on May 23, 2002.

Stewart dealt with the "reasonable expectation of profit" ("REOP") test. This test has long been used by Canada Customs and Revenue Agency ("CCRA") to deny deductions from income. CCRA often uses the test to show that a "business" is a sham, created only to generate losses to apply against other sources of income.

Critics say the REOP test substitutes CCRA's hindsight for legitimate business judgment. It can be easy to look back on a failed venture and see that it could not be successful. It is much more difficult, if not impossible, to look into the future and predict what profits may result.

The problem arises from the ambiguity of the *Income Tax Act*. Rather than defining every source of income and deduction (which would be impossible anyway), the *Act* keys on the broad concept of "source of income". Expenses which are connected to that source can be deducted. If a loss is created, the shortfall can reduce other sources of income.

How is a "source of income" recognized? For many years, CCRA has relied on the REOP test. In their eyes, the terms are synonymous. If a venture has a reasonable expectation of profit, it is a business, and constitutes a source of income from which profits or losses can ensue. If there is no such expectation, it is not a business. In CCRA's opinion, such ventures are merely hobbies, personal undertakings, or other adventures which can not generate deductible losses.

The facts in *Stewart* were similar to most REOP cases. The taxpayer was a Toronto Transit Commission employee. He also was an experienced real estate investor, and purchased interests in some condominium units. The condo projections predicted poor cash flow for at least 10 years. The actual experience was even worse, and the taxpayer claimed losses for several years. CCRA disallowed the losses, claiming that there was no reasonable expectation of profit.

Justices Iacobucci and Bastarache struck down this reasoning. They said it was logically wrong to suggest that a "source of income" is the same thing as a "reasonable expectation of profit". REOP might be an element of determining whether a business existed, but it was only a factor, not the determining feature. CCRA had ceased using REOP as an interpretive aid to assess whether a source of income existed, and had begun to use it as a stand-alone "source" test. This was wrong, the court held.

To the Supreme Court, a two part analysis was needed. Where the activity contained no personal element and sought income from business or property, no further inquiry was necessary. It was a source of income for purposes of the *Act*. Period. Where the activity could be classified as a personal pursuit in whole or in part (for instance, if it included a hobby element or other aspect of personal enjoyment), then it must be determined whether or not the activity was being carried on in a sufficiently commercial manner to constitute a source of income. REOP might be a factor in this determination, but it must not be the only one. Things such as the taxpayer's training, the intended course of action, and the profit and loss experience

in past years might also be important. Even personal activities could be a business if the proper elements were present.

The result of the decision is that taxpayers will not be unduly punished for simply making a bad business decision. The tax system has an interest in investigating the legitimacy of a situation, but it should not penalize honest but erroneous business decisions. As one judge has said earlier, “The tax system does not tax on the basis of a taxpayer’s business acumen, with deductions extended to the wise and withheld from the foolish....”

This is one of the most welcome aspects of the decision. The Court noted that that the law of income tax is complicated enough without unhelpful judicial incursions into lawmaking. The Supreme Court has been criticized for being too activist in recent years. This decision certainly does not follow that trend.

The *Stewart* decision does not open the floodgates for taxpayers. A business will still have to be legitimate, and, especially where personal aspects are involved, proper commercial factors will need to be present. There could, however, be an impact on other areas, such as the restricted deductibility of certain farm losses.

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