
The Evolution of the Reasonable Expectation of Profit Test

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KEYWORDS: REASONABLE EXPECTATION OF PROFIT ■ TAX CASES ■ TAX COURT OF CANADA

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INTRODUCTION

During Justice Bowman's term on the Tax Court of Canada, from 1991 to 2008, one of the areas of the tax law that saw the most significant change as a result of judicial interpretation of the law was the reasonable expectation of profit (or REOP) test.¹ The REOP test was often used by the tax authorities to determine whether a business venture had a serious profit-making objective or whether it was an enterprise that, for one or more reasons, had less focus on profit making and a greater focus on another objective. In the view of the tax authorities, there were usually two main reasons why an enterprise might not have a profit-making purpose:

1. Some enterprises appeared to have no near-term profit potential; rather, they seemed to be designed to create losses to offset a taxpayer's other sources of income, with the ultimate economic profit coming from capital gains from the sale of property at the termination of the venture. For example, a robust

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1 The REOP test derives its origin from judicial decisions relating to the definition of "personal or living expense" currently in section 248 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act") and earlier versions of that section, the first of which dates back to 1939, when it was added to the Income War Tax Act, RSC 1927, c. 97, as amended. For a discussion of the evolution of the pre-1996 judicial history of the test, see John R. Owen, "The Reasonable Expectation of Profit Test: Is There a Better Approach?" (1996) vol. 44, no. 4 *Canadian Tax Journal* 979-1015.

and sometimes volatile real estate market in the 1980s and 1990s led individual taxpayers to make real estate investments. If those investments proved unsuccessful, the tax authorities questioned whether investors had a reasonable expectation of profit when they embarked upon the enterprise.

2. Other enterprises that may have appeared to have a serious business purpose were in fact primarily personal because they were a pure hobby or they indulged a taxpayer's personal interest. For example, a number of cases involved farming or other businesses in which there was some element of personal use or enjoyment such that the business could be seen as disguising a hobby.

These factors made for a very large volume of cases dealing with the REOP test. As a result of decisions of both the Tax Court of Canada—including a number of Bowman J's decisions—and the Supreme Court of Canada, the role and application of the REOP test evolved significantly, leading to the introduction in 2003 of controversial proposed amendments to the Income Tax Act.² This article describes these events and the current state of the law on “reasonable expectation of profit.”

JUSTICE BOWMAN AND THE REOP TEST

During his 17 years on the Tax Court, Bowman J had the opportunity to hear many cases in which the Crown argued that a taxpayer's businesses losses should not be allowed because the taxpayer had no reasonable expectation of profit. According to our survey of the cases, Bowman J heard approximately 35 cases in which the REOP test was the primary issue addressed in the decision. In 18 of the cases, he found in favour of the taxpayer; in another 7, his judgments provided some taxpayer relief; and in 10 cases, he found in favour of the Crown. Generally, he was unwilling to endorse the broad-based REOP test often argued by the Crown; instead, he endorsed arguments that the courts should not be using hindsight to second-guess apparently valid business decisions made by taxpayers.

Bowman J's cautious use of the Supreme Court's decision in *W Moldowan v. The Queen*³ and his unwillingness to use hindsight to deny a taxpayer's losses are illustrated in one of his early judgments, *G Nichol v. Canada*.⁴ Nichol, who clearly had a

2 The proposed amendments were first announced in the 2003 federal budget (Canada, Department of Finance, 2003 Budget, Budget Plan, February 18, 2003), and proposed legislation was subsequently released on October 31, 2003: Canada, Department of Finance, *News Release* no. 2003-055, October 31, 2003 and accompanying “Proposed Amendments to the Income Tax Act Related to the Deductibility of Interest and Other Expenses Related to a Source” and “Notes on Proposed Amendments to the Income Tax Act.” The proposed legislation attracted sharp criticism, and supplementary information contained in the February 23, 2005 federal budget stated that, following extensive consultations, the Department of Finance intended to release alternative proposals: Canada, Department of Finance, 2005 Budget, Budget Plan, February 23, 2005, annex 8. Those proposals have not yet been released, and other comments made by the Department of Finance suggest that they are not a current legislative priority.

3 [1977] CTC 310 (SCC).

4 [1993] 2 CTC 2906 (TCC).

personal interest in and a passion for baseball, incurred losses from operating a minor league baseball team in London, Ontario. After allowing losses for the 1984 and 1985 taxation years, the Canada Revenue Agency (CRA)⁵ sought to deny Nichol's losses in 1986 and 1987.

Dealing with the *Moldowan* decision, Bowman J said:

The Minister disallowed the loss on the basis that in 1986 the appellant did not have a "reasonable expectation of profit" from the operation of the London Royals. This somewhat cryptic reason given in the reply to notice of appeal implies a premise that since there was no "reasonable expectation of profit" there was no "business," on the basis of an observation made by Mr. Justice Dickson, as he then was in *Moldowan v. The Queen*, [1978] 1 S.C.R. 480, [1977] C.T.C. 310, 77 D.T.C. 5213, and that therefore the expenses were not laid out for the purpose of gaining or producing income from a business.

It must be borne in mind that the expression "reasonable expectation of profit" is lifted from the definition of "personal or living expenses," in section 248 of the *Income Tax Act*. That section read as a whole obviously has no application here. Nonetheless, the Department of National Revenue seems to regard the expression as having a significance and existence independent of the definition of "personal or living expenses."

I shall deal with the matter as if the Minister's use of the expression "reasonable expectation of profit" were justified without reference to the definition of "personal and [sic] living expenses."⁶

Bowman J's decision to separate his analysis of the proper treatment of the London Royals' business losses from the definition of personal or living expenses foreshadows the analysis of the REOP test that would come nine years later, when Iacobucci and Bastarache JJ delivered the Supreme Court of Canada's decision in *Stewart v. R.*⁷ Bowman J's cautious and limited application of the *Moldowan* decision directly contrasted with the overreaching enthusiasm for that decision shown by the CRA. As the above quotation from the *Nichol* judgment implies, nothing would have prevented the courts from adopting a REOP test to determine whether an enterprise of a taxpayer was a business or a personal venture. However, the definition of personal or living expenses was relevant for the computation of income from a business or property by virtue of paragraph 18(1)(h) of the Act. Section 18 provides rules for the computation of income from a business or property; accordingly, paragraph 18(1)(h)

5 In 1993, the Department of National Revenue was known as Revenue Canada. On November 1, 1999, it became a separate agency of the federal government and was referred to as the Canada Customs and Revenue Agency (CCRA). On December 12, 2005, its name was changed to the Canada Revenue Agency (CRA) following the formation of the Canada Border Services Agency. Throughout this article, we will refer to the various previous legal forms of the current Canada Revenue Agency as "CRA."

6 *Supra* note 4, at 2907-8.

7 [2002] 3 CTC 439 (SCC). The other decision released at the same time and dealing with the same issue was *Walls v. R.*, [2002] 3 CTC 421 (SCC). We discuss the Supreme Court's reasoning in *Stewart* in the next section of the article.

applies when a source of business (or property) income exists and thus should have no role in determining whether there is such a source of income (or loss). No provision in the Act sets out specific rules to determine whether a source of business income exists. A rule that examined whether there was a reasonable expectation of profit from a source of activity might be one way, albeit a highly subjective way, to determine whether a source of business income existed, but the purpose of the definition of personal or living expenses in section 248 was completely disconnected from such a hypothetical test.⁸

Bowman J's approach in *Nichol* to assessing the REOP test as a stand-alone judicial test was an infrequent moment of clarity for the courts on this issue prior to 2002. His comments in *Nichol*, quoted above, make it clear that in his view the application of paragraph 18(1)(h) and the definition of personal or living expenses are entirely separate from determining whether a taxpayer has a source of business income.

In the *Nichol* decision, Bowman J responded to the Crown's assertions that there was no reasonable expectation of profit as follows:

The Minister's position is that the London Royals was not a business carried on with a reasonable expectation of profit, but rather was a hobby, a labour of love, or an activity carried on by Mr. Nichols with an idealistic or civic-minded motivation having nothing to do with any commercial animus. There is merit in this position. Such considerations were no doubt a factor in what Mr. Nichols did.

I think, however, that the operation of the London Royals was, albeit risky, a commercially motivated operation in which given Mr. Nichols' background and business experience it was not unreasonable to expect a profit. Starting and running any enterprise in the sports and entertainment field is highly risky. It is capable of producing large revenues or large losses. I do not think that it is appropriate for the Minister of National Revenue, who is quite ready to share in the success of an enterprise, to deny the deduction of losses where, with the benefit of hindsight, he considers that the taxpayer should have foreseen that his project would fail. The planning and the projections of the London Royals had too many of the badges of trade and, if I may say so, the *indicia* of commerciality to be dismissed as a mere hobby or an idealistic labour of love.⁹

He continued his commentary on hindsight:

Essentially, what the Minister is saying is that, at the end of 1985, when the revenues had fallen significantly short of the projections, the appellant should have realized that 1986 would not be a successful year and he should therefore have cut his losses and stopped the business in that year. It is a matter of business judgment whether to start a business and it is a matter of business judgment whether and when to terminate it. This taxpayer made the business judgment to continue the operation for another year

8 Until the Supreme Court's decisions in *Stewart* and *Walls*, supra note 7, no court had articulated the logical inconsistency in applying the REOP test in this exact way.

9 Supra note 4, at 2908-9.

notwithstanding the results of the 1985 season. He hoped to turn the business around by forming a new league in 1985, to which the Royals would belong, and in 1986 to improve the team's performance by creating a farm team and by persuading the Canadian Press to give much greater publicity to the Royals' games.

As it turns out none of these remedial actions worked and he discontinued the operation after 1987. He made what might, in retrospect, be seen as an error in judgment but it was a matter of business judgment and it was not one so patently unreasonable as to entitle this Court or the Minister of National Revenue to substitute its or his judgment for it, or penalize him for having made a judgment call that, with the benefit of 20-20 hindsight, that Monday morning quarterbacks always have, I or the Minister of National Revenue might not make today. We were, after all, not there in 1986.¹⁰

In *Kaye v. The Queen*,¹¹ Bowman J found that the taxpayer's enterprise was not a true source of business income or loss. However, he was unwilling to base his decision on the REOP test. Instead, responding to the Crown's assertion that the taxpayer had no reasonable expectation of profit, he said:

I do not find the ritual repetition of the phrase particularly helpful in cases of this type, and I prefer to put the matter on the basis "Is there or is there not truly a business?" This is a broader but, I believe, a more meaningful question and one that, for me at least, leads to a more fruitful line of enquiry. No doubt it subsumes the question of the objective reasonableness of the taxpayer's expectation of profit, but there is more to it than that. How can it be said that a driller of wildcat oil wells has a reasonable expectation of profit and is therefore conducting a business given the extremely low success rate? Yet no one questions that such companies are carrying on a business. It is the inherent commerciality of the enterprise, revealed in its organization, that makes it a business. Subjective intention to make money, while a factor, is not determinative, although its absence may militate against the assertion that an activity is a business.

One cannot view the reasonableness of the expectation of profit in isolation. One must ask "Would a reasonable person, looking at a particular activity and applying ordinary standards of commercial common sense, say 'yes, this is a business'?" In answering this question the hypothetical reasonable person would look at such things as capitalization, knowledge of the participant and time spent. He or she would also consider whether the person claiming to be in business has gone about it in an orderly, businesslike way and in the way that a business person would normally be expected to do. . . .

Ultimately, it boils down to a common sense appreciation of all of the factors, in which each is assigned its appropriate weight in the overall context. One must of course not discount entrepreneurial vision and imagination, but they are hard to evaluate at the outset. Simply put, if you want to be treated as carrying on a business, you should act like a businessman.¹²

10 Ibid., at 2909-10.

11 98 DTC 1659 (TCC).

12 Ibid., at paragraphs 4-5 and 7.

By 2002, just before the Supreme Court delivered its decision in the *Stewart* case, Bowman J seemed to have reached a point of frustration with the Crown and the way in which it presented cases dealing with the REOP test. In *Shaughnessy v. R.*, the judgment set out the following “so-called” assumptions contained in the Crown’s pleadings:

- (f) at all material times the Activity was undercapitalized;
- (g) at all material times the appellant did not plan or make any material changes to the Activity;
- (h) the Appellant has no training in the Activity;
- (i) before starting the Activity, and in subsequent years, the Appellant did not prepare a business plan to determine if it would be profitable; . . .
- (m) the Appellant did not have a reasonable expectation of profit from the Activity during the 1994 and 1995 taxation years;
- (n) the expenses claimed in relation to the Activity are not reasonable in the circumstances; and
- (o) the expenses claimed in relation to the Activity were personal or living expenses of the Appellant and the other owners of the Property.¹³

Bowman J commented on the assumptions, as follows:

Paragraph (m) is of course the mandatory ritual incantation of the mantra REOP. Paragraphs (n) and (o) are simply tossed in for good measure. They have no basis in the evidence and were not argued. They are so far-fetched that they could not possibly have been the basis of the assessments. I presume that pushing a button on the computer to produce paragraphs (n) and (o) requires approximately the same amount of reflection and deliberation as were required to produce paragraphs (f) to (i). The simple fact is that these identical paragraphs appear in replies in virtually every REOP case that comes before this court. It is unacceptable that this type of unthinking regurgitation of stereotypical verbal formulae should appear in all replies in REOP cases.¹⁴

Bowman J’s comments seem to be substantiated by the assumptions pleaded in other cases that he heard, including *Donyina v. R.*¹⁵ He went on in *Shaughnessy* to summarize the state of the REOP test under the law as follows:

In *Donyina v. R.*, [2001] 3 C.T.C. 2741 (T.C.C. [Informal Procedure]), I summarized what appeared to be the principles that [had] been established up to that point in the field of REOP. The appeals from the decisions of the Federal Court of Appeal in *Stewart v. R.*, [2000] 2 C.T.C. 244 (Fed. C.A.), and *Walls v. R.* (1999), [2000] 1 C.T.C. 324 (Fed. C.A.), have recently been heard in the Supreme Court of Canada and we can expect that some fresh light will be shed on this somewhat murky area.

13 [2002] 2 CTC 2035, at paragraph 11 (TCC).

14 *Ibid.*, at paragraph 13.

15 [2001] 3 CTC 2741 (TCC).

The summary in *Donyina* was as follows.

[8] The REOP principle has been evolving. For a period of time after the *Moldovan* case assessors were zealously disallowing losses, that with the benefit of hindsight, they thought resulted from an activity with no REOP. Their fervour has been tempered substantially by such cases as *Tonn et al. v. The Queen*, 96 D.T.C. 6001; *A.G. of Canada v. Mastri et al.*, 97 D.T.C. 5420; *Mobammad v. The Queen*, 97 D.T.C. 5503; *Kublmann et al. v. The Queen*, 98 D.T.C. 6652; *Walls v. The Queen*, 2000 D.T.C. 6025 (under appeal to S.C.C.); *Milewski v. The Queen*, 99 D.T.C. 968 (aff'd. 2000 DTC 6559, F.C.A.); *Kaye v. The Queen*, 98 D.T.C. 1659; *Costello v. The Queen*, 98 D.T.C. 1362; *Smith v. The Queen*, 96 D.T.C. 1886; *Saunders v. R.*, [1998] 2 C.T.C. 3196, and *Roopchan v. The Queen*, 96 D.T.C. 1338, as well as some earlier decisions of this court: *Bélec v. The Queen*, 95 D.T.C. 121; *Nichol v. The Queen*, 93 D.T.C. 1216, and *N. Cipollone v. Canada*, [1995] 1 C.T.C. 2598. The most recent pronouncement on this point is *Keeping v. The Queen*, 2001 F.C.A. 182.

[9] I shall not quote from these cases or analyse them at length. It is, I think, sufficient to summarize some of the principles that they appear to establish.

1. Where there is no personal element the REOP test should be applied sparingly (*Tonn*, *Keeping*, *Bélec* and *Walls*). The absence of a personal element does not establish conclusively that the REOP principle cannot be invoked but such an absence is a factor that carries a great deal of weight (*Mastri*).
2. The Minister or the court should not, with the benefit of hindsight, second-guess the business acumen of a taxpayer who embarks upon a business venture in good faith (*Keeping*, *Tonn*, *Nichol*, *Kublmann*, *Bélec* and *Smith*).
3. The fact that a business or property is 100% financed is not in itself a reason for applying the REOP principle (*Milewski*, *Mobammad* and *Saunders*).
4. A taxpayer should be allowed a reasonable period of time to get the business established (*Keeping*). Such a period will vary with the circumstances and may well be lengthy (*Milewski*).
5. The REOP principle should not be invoked as a substitute for analysis. Before invoking REOP the assessor should examine the expenses to determine whether they are reasonable or for any other reason not deductible (*Smith*, *Costello* and *Cipollone*).
6. For an expectation of profit to be reasonable it has to be not "irrational, absurd and ridiculous" (*Kublmann*).
7. The fact that an investment or a business is motivated in part by tax considerations is not relevant in determining whether there is a business, nor is tax motivation in itself relevant in determining the deductibility of expenses if a business exists (*Stuart Investments Limited v. The Queen*, 84 D.T.C. 6305) unless of course the Minister chooses to invoke the general anti-avoidance rule in section 245, in which case we are into a fundamentally different ball-game.
8. The initial question where losses are claimed and denied is whether they are personal or living expenses, the statutory definition of which

includes the REOP test. If they are not, the REOP test must be applied with extreme care and the question becomes “Is there a business?” The existence of REOP is only one factor in that determination (*Kaye*).

9. Reasonableness operates both in the context of the existence of a business, where section 67 disallows the deduction of expenses to the extent that they are unreasonable, and also at the liminal stage of determining whether there is a business (*Kaye*).
10. If what is ostensibly a rental property was acquired and held in the course of an adventure in the nature of trade and it was reasonable to expect a profit on the resale the losses (*i.e.* carrying costs net of rentals received) should not be disallowed on the basis of REOP (*Roopchan*). The court should however examine with some care an *ex post facto* declaration that property that was carried for some years at a loss is part of a speculative venture in which the motive was resale at a profit. This is not something that one would expect someone readily to admit if the property were sold at a profit.
11. If the taxpayer has several rental properties, some yielding a profit and some a loss, it is improper to apply REOP to the losing properties and ignore the profitable ones. The entire investment picture should be considered (*Smith*).
12. When to start a business and when to abandon it are business decisions in which neither the taxing authorities nor the court should intervene (*Nichol*). Nonetheless if losses go on being incurred year after year for an inordinate length of time sooner or later one has to apply what I shall call the “Enough is enough” principle and decide that what might have been a viable business has, with the effluxion of time, become hopeless and the best thing to do with it is to give it a decent burial. Nonetheless, a businessman’s judgement to maintain a business must be treated with great respect.¹⁶

As the summary above indicates, by 2002 Bowman J was forced to deal with a number of sometimes conflicting decisions of the Tax Court and the Federal Court of Appeal. Much of the confusion derived from the inconsistent application of the *Moldovan* decision. Some decisions relied more heavily on the REOP test in determining whether a source of business income existed, while others used the REOP test sparingly, if at all. However, in spite of this array of judgments, the principles of Bowman J’s analysis remained clear: the REOP test has limited application where the business lacks a personal element, and the REOP test does not permit the Crown to use hindsight to deny losses. The eighth principle in particular is worth repeating:

The initial question where losses are claimed and denied is whether they are personal or living expenses, the statutory definition of which includes the REOP test. If they are not, the REOP test must be applied with extreme care and the question becomes “Is there a business?” The existence of REOP is only one factor in that determination (*Kaye*).

16 Supra note 13, at paragraphs 15-16.

This passage more than others appears to reflect the views that Bowman J expressed nine years earlier in the *Nichol* decision: the real question is not whether the taxpayer had a reasonable expectation of profit, but whether or not there is a business. As we shall see, the Supreme Court justices who decided the *Stewart* case had obviously had been reading Bowman J's judgments.

THE SUPREME COURT AND THE REOP TEST

Iacobucci and Bastarache JJ, speaking for the court in *Stewart*, disclosed their views on the application of the REOP test by the lower courts very early in their judgment:

[D]ecisions have varied in the application of this test. Although some cases have held that the reasonable expectation of profit test should only be used at the threshold stage of distinguishing between commercial and personal activities, others have used the test as a tool to assess the profitability of various *bona fide* commercial ventures in order to determine whether the taxpayer has a source of income, and is therefore entitled to deduct losses relating to that source. . . .

In our view, the reasonable expectation of profit analysis cannot be maintained as an independent source test. To do so would run contrary to the principle that courts should avoid judicial innovation and rule-making in tax law. Although the phrase "reasonable expectation of profit" is found in the *Income Tax Act*, S.C. 1970-71-72, c. 63 (the "Act"), its statutory use does not support the broad judicial application to which the phrase has been subjected. In addition, the reasonable expectation of profit test is imprecise, causing an unfortunate degree of uncertainty for taxpayers. As well, the nature of the test has encouraged a hindsight assessment of the business judgment of taxpayers in order to deny losses incurred in *bona fide*, albeit unsuccessful, commercial ventures.

It is undisputed that the concept of a "source of income" is fundamental to the Canadian tax system; however, any test which assesses the existence of a source must be firmly based on the words and scheme of the Act. As such, in order to determine whether a particular activity constitutes a source of income, the taxpayer must show that he or she intends to carry on that activity in pursuit of profit and support that intention with evidence. The purpose of this test is to distinguish between commercial and personal activities, and where there is no personal or hobby element to a venture undertaken with a view to a profit, the activity is commercial, and the taxpayer's pursuit of profit is established. However, where there is a suspicion that the taxpayer's activity is a hobby or personal endeavour rather than a business, the taxpayer's so-called reasonable expectation of profit is a factor, among others, which can be examined to ascertain whether the taxpayer has a commercial intent.¹⁷

There is a noteworthy confluence of thought between the comments made by Iacobucci and Bastarache JJ and those made by Bowman J on where and how a REOP test should be applied.

¹⁷ *Stewart*, supra note 7, at paragraphs 2, 4, and 5.

Iacobucci and Bastarache JJ went on to review the sometimes contradictory decisions of the Tax Court of Canada and the Federal Court of Appeal, and quoted from Bowman J's decision in *Allen et al. v. The Queen*¹⁸ as follows:

In contrast to the above cases, other decisions, particularly those of Bowman A.C.J. of the Tax Court of Canada, have taken a different view of the applicability [of the] REOP test. In *Allen v. R.* (1999), 99 D.T.C. 968 (T.C.C. [General Procedure]), aff'd. 2000 D.T.C. 6559 (Fed. C.A.), Bowman J.T.C.C. (as he then was) held at paras. 18-25 that the REOP test had no application in a situation similar to the one at bar, where, with near 100 percent financing, the taxpayers formed a partnership which carried on a rental business and incurred losses:

In my opinion, the respondent has misapplied the [REOP] doctrine. We are dealing here with two individuals who have invested, through a limited partnership, in a perfectly viable business that started making a profit in the second year. There was no personal element involved—neither appellant has any intention of residing in the apartments. . . .

.....

How then does the fact that the acquisition of the limited partnership interests was financed substantially by the borrowing of money through the Equity Notes and Second Equity Notes at what, on the evidence, was a favourable interest rate, turn a viable and profitable business into one that had no reasonable expectation of profit and was, therefore, not a business and not a source of income? The investment was clearly long term and *bona fide*, with the expectation that in the fullness of time the debt would be paid down and ultimately paid off and the appellants would have a lasting investment. The Minister's position, as revealed in the portions of the examination for discovery that were read in, is that once the income from the partnership exceeded the interest charges, the non-business will become a business and the Minister will start to tax.

.....

Whatever else may be said about 99% financing of an investment, it certainly cannot be said that its result is that the vehicle in which the taxpayer has invested did not carry on a business. This is wrong as a matter of logic, law and common sense. The Minister is seeking to limit the deduction of the amount of interest which is permitted by paragraph 20(1)(c) by intoning the ritual incantation [REOP], where it is obvious and admitted that the partnership is carrying on a profitable business.

.....

The [REOP] principle may have some application where a person tries to write off losses from a hobby such as horseracing (*Rai v. The Queen*, February 8, 1999, file number 98-925(IT)I); or from collecting antique Coca-Cola bottles (*Kaye v. The Queen*, 98 D.T.C. 1659); or renting a portion of the basement of that person's dwelling to a relative and trying to write off 2/3 of the costs of the house. *It operates at the liminal stage of questioning the existence of a business. Where*

18 99 DTC 968 (TCC); aff'd. 2000 DTC 6559 (FCA).

there is no personal element and a genuine business exists the [REOP] doctrine has no application. . . . [Emphasis added by the Supreme Court.]

Bowman J.T.C.C. has expressed a similar view in a variety of cases: see, for example, *Nichol v. R.* (1993), 93 D.T.C. 1216 (T.C.C.), *Bélec c. R.* (1994), 95 D.T.C. 121 (Eng.) (T.C.C.), *Kaye v. R.* (1998), 98 D.T.C. 1659 (T.C.C.).¹⁹

After reviewing the cases, Iacobucci and Bastarache JJ concluded that “[t]he only coherent message that emerges from a survey of the cases which have followed *Moldowan* is that the proper role of ‘reasonable expectation of profit’ is in need of clarification.”²⁰

It is not difficult to infer that Iacobucci and Bastarache JJ believed that one of the few judges in the lower courts who properly understood the application of the REOP test was Bowman J. In concluding that the REOP test should be rejected as a stand-alone test to determine whether a taxpayer has a source of income, they quoted from Bowman J’s decisions three more times, as follows:

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.²¹

The comments of Bowman J.T.C.C. in *Allen, supra*, at paras. 20 and 22, aptly illustrate the problems which result from intermingling the question of the existence of a source of income with the issue of the deductibility of expenses, in particular, interest expenses, and are worth repeating:

How then does the fact that the acquisition of the limited partnership interests was financed substantially by the borrowing of money through the Equity Notes and Second Equity Notes at what, on the evidence, was a favourable interest rate, turn a viable and profitable business into one that had no reasonable expectation of profit and was, therefore, not a business and not a source of income? . . .

. . . .

Whatever else may be said about 99 percent financing of an investment, it certainly cannot be said that its result is that the vehicle in which the taxpayer has invested did not carry on a business. This is wrong as a matter of logic, law and common sense. The Minister is seeking to limit the deduction of the amount of interest which is permitted by paragraph 20(1)(c) by intoning the ritual incantation [REOP], where it is obvious and admitted that the partnership is carrying on a profitable business.²²

19 *Stewart, supra* note 7, at paragraph 33.

20 *Ibid.*, at paragraph 34.

21 *Ibid.*, at paragraph 52.

22 *Ibid.*, at paragraph 59.

As stated by Bowman J.T.C.C. in *Bélec, supra*, at p. 123: “It would be . . . unacceptable to permit the Minister [to say] to the taxpayer . . . ‘The fact that you lost money . . . proves that you did not have a reasonable expectation of profit, but as soon as you earn some money, it proves that you now have such an expectation.’”²³

Iacobucci and Bastarache JJ concluded their analysis of the proper application of the REOP test as follows:

In summary, the issue of whether or not a taxpayer has a source of income is to be determined by looking at the commerciality of the activity in question. Where the activity contains no personal element and is clearly commercial, no further inquiry is necessary. Where the activity could be classified as a personal pursuit, then it must be determined whether or not the activity is being carried on in a sufficiently commercial manner to constitute a source of income. However, to deny the deduction of losses on the simple ground that the losses signify that no business (or property) source exists is contrary to the words and scheme of the Act. Whether or not a business exists is a separate question from the deductibility of expenses.²⁴

That conclusion reads much like a number of Bowman J’s prior decisions, which are referred to throughout the Supreme Court’s decision in *Stewart*. It is clear that his influence on the evolution of the REOP test has been profound.

With the REOP test dead and buried, the CRA managed to persuade the Department of Finance that since there is no judicial REOP test, a legislative test must be introduced. It quickly became evident that a legislative test will encounter many of the same problems faced by the judicial test.

LEGISLATIVE RESPONSE TO COURT DECISIONS

As we noted at the outset, before and during Bowman J’s term on the Tax Court of Canada, the tax authorities often attempted to use the REOP test to disallow a taxpayer’s losses in situations where the activity had no personal or hobby element but the activity was seen as being designed to create losses to offset other sources of income, with the ultimate economic profit coming later in the form of a capital gain.

Throughout this period, a number of targeted legislative provisions were enacted, all generally designed to curb the arbitrage sought by taxpayers as a result of the timing and character mismatch that could occur where fully deductible expenses were incurred and the economic profit was realized later, perhaps as a capital gain. Although these provisions did not invoke the REOP test, the practical result was to deal with some of the tax policy concerns that seemed to be driving the CRA to reassess in a number of REOP cases.

The legislative provisions included the following:

23 Ibid., at paragraph 60.

24 Ibid.

- *Limited partnership at-risk provisions.* Legislation was introduced, generally applicable after 1986, in response to the concern that taxpayers could invest in limited partnerships and be entitled to tax benefits worth more than the actual amount of the investment.²⁵ The provisions did not eliminate the ability to claim deductions for interest and other expenses, but did limit the amount of losses that limited partners were allowed to claim to the at-risk amount of their investment in the partnership.
- *Prepaid interest provisions.* In the early 1990s, a number of financing transactions became popular and were aimed at exploiting the difference in the tax treatment of payments of interest and payments of principal in respect of a loan. The provisions in place at the time permitted the deduction of the prepaid interest. On July 22, 1991, the Department of Finance released draft legislation that was “designed to prevent business borrowers from claiming tax deductions for interest payments when these, in effect, represent the repayment of the principal of a debt obligation.”²⁶ The legislation did not actually prevent the deduction of prepaid interest, but simply deferred the deduction.²⁷
- *Tax shelter rules.* In December 1994, in a joint statement, the ministers of finance and national revenue announced the introduction of proposals²⁸ to limit the deductions that taxpayers could claim, to add requirements to register all “tax shelters,” and to extend the base for alternative minimum tax.²⁹ The proposals were introduced as a response to “abusive” tax-shelter arrangements. These arrangements were perceived to be abusive in the sense that they avoided the impact of the limited partnership at-risk rules and thereby allowed taxpayers to deduct amounts in excess of the cost of their investments for which they were at risk of loss. Much of the avoidance was attributable to the financing of expenditures and the cost of property with limited-recourse debt.
- *Matchable expenditure provisions.* The targeted proposals continued with the introduction of the “matchable expenditure provisions”³⁰ announced in November 1996.³¹ The transactions that led up to the introduction of these provisions involved mutual fund limited partnership commissions financed through these arrangements. Originally the arrangements were allowed a

25 Subsection 96(2.1) added by SC 1986, c. 55, section 25(1), applicable after February 25, 1986.

26 Canada, Department of Finance, *News Release* no. 91-077, July 22, 1991.

27 Subsections 18(9.2) to (9.8) added by SC 1994, c. 7, schedule VIII, section 8(6), applicable to 1992 and subsequent taxation years.

28 Canada, Department of Finance, *News Release* no. 94-112, December 1, 1994.

29 The tax shelter rules were added by SC 1998, c. 19, section 80, applicable to every expenditure made by a taxpayer or a partnership after November 17, 1996 with some grandfathering.

30 Section 18.1 added by SC 1998, c. 19, section 80, generally applicable to expenditures made after November 17, 1996.

31 Canada, Department of Finance, *News Release* no. 96-082, November 18, 1996 and accompanying “Backgrounder.”

100 percent writeoff, later restricted by the CRA's administrative policy to a one-third maximum deduction each year.

The backgrounder accompanying the Finance news release stated that

these measures constrain the tax-assistance in such structures by matching the cost of an investor's investment to the periods during which the investment earns income. In this way, investors cannot create losses in the early years of an investment that off-set income from other sources and which would otherwise be subject to tax.³²

- *Weak-currency debt.* In 2001, an anti-avoidance provision was enacted that was intended to eliminate the tax benefits for debtors associated with weak-currency debt.³³ The legislation overrode the decision in *Shell Canada Ltd. v. R.*,³⁴ which dealt with New Zealand dollar borrowings. The provisions were designed to negate the benefits sought by taxpayers who borrowed in a "weak currency" with a high interest rate with the expectation of realizing a gain when the weak-currency borrowing was repaid. Through the use of hedging transactions, taxpayers were able to lock in the higher interest rate deductions, which would be offset by an economic gain when the debt was repaid.

The government continued to add specific provisions to deal with the tax policy concerns associated with taxpayers' claiming deductions in early years to be offset by income or capital gains realized later. Although these provisions had the effect of dealing with many of the tax policy concerns that appeared to be behind some of the REOP cases, the CRA continued to push REOP cases through the courts, generally, though not exclusively, for taxation years before the legislative changes came into effect.

Finally, following the decision in *Stewart*, the CRA acknowledged that the REOP test would no longer be used to determine whether there was a source of income under the Act and that it would essentially restrict the use of the REOP test to those situations where there was some personal or hobby element to the activity.³⁵

About eight months before rendering the decision in *Stewart*, the Supreme Court released its decision in *Ludco Enterprises Ltd. v. Canada*.³⁶ In *Ludco*, the taxpayer deducted approximately \$6 million in interest charges on borrowed money used to purchase shares that yielded some \$600,000 in dividends. On disposition of the shares, the taxpayer realized a significant capital gain. The court rejected the arguments put forward by the Crown that for the purposes of the interest deductibility test in paragraph 20(1)(c), income means "net income," and that the real purpose of the borrowing was to generate a capital gain. The court held that income

32 "Backgrounder," supra note 31, at 1.

33 Section 20.3 added by SC 2001, c. 17, section 14(1), applicable to taxation years ending after February 27, 2000.

34 [1999] 4 CTC 313 (SCC).

35 See *Income Tax Technical News* no. 25, October 30, 2002, questions 2 and 3.

36 2001 SCC 62.

meant gross income and that all that was necessary was to have an ancillary purpose of earning gross income.

Not long after the decision in *Ludco*, the Supreme Court, in *Stewart*, dealt with the issue of deductibility of losses arising from interest costs exceeding rental income on four rental condominiums. A comment in the judgment that undoubtedly added to the government's concern from a policy perspective was the statement that "in our view, the motivation of capital gains accords with the ordinary business person's understanding of 'pursuit of profit,' and may be taken into account in determining whether the taxpayer's activity is 'commercial in nature.'"³⁷

In response to the decisions in *Stewart* and *Ludco*, the Department of Finance, in the February 18, 2003 federal budget, announced its intention to consider legislative changes to deal with the deductibility of interest and other expenses, stating:

Recent court decisions have raised uncertainties as to how taxpayers are to treat expenses, in particular interest, in computing income from a business or property for purposes of the Income Tax Act. Most notably, these decisions could lead to inappropriate tax results where a taxpayer derives a tax loss by deducting interest expenses, even if under any objective standard there is no reasonable expectation that the taxpayer would earn any income (as opposed to capital gains), or where the presence or the prospect of revenue (as opposed to income net of expenses) is enough to conclude that an expenditure was incurred "for the purpose of earning income."

Neither of these results is consistent with appropriate tax policy, nor would they have been generally expected under prior law and practice. Therefore legislative amendments to the Income Tax Act will be considered in order to provide continuity in this important area of the law. Before finalizing any proposals, however, the Department of Finance will release them for public consultation, with a general goal of ensuring that they restore continuity with the expected consequences before these recent court decisions.³⁸

On October 31, 2003, Finance released draft legislation and technical notes³⁹ proposing a statutory test for the deduction of interest and other expenses. Although a more focused approach might have been anticipated, the proposals adopted a more general REOP test:

3.1(1) A taxpayer has a loss for a taxation year from a source that is a business or property only if, in the year, it is reasonable to expect that the taxpayer will realize a cumulative profit from that business or property for the period in which the taxpayer has carried on, and can reasonably be expected to carry on, that business or has held, and can reasonably be expected to hold, that property.

(2) For the purpose of subsection (1), profit is determined without reference to capital gains or capital losses.⁴⁰

37 *Stewart*, supra note 7, at paragraph 68.

38 2003 Budget, Budget Plan, supra note 2, at 342.

39 See supra note 2.

40 "Proposed Amendments," supra note 2.

Finance received many submissions on the draft legislation pointing out the deficiencies and problems with the proposals.⁴¹ Particularly troubling was the requirement that taxpayers would have to demonstrate each year that it was reasonable to expect that they would earn a cumulative profit during the whole period in which they had carried on or could reasonably be expected to carry on the business or during the period that they had held or could reasonably be expected to hold the property.

The proposals, if enacted, would have created a great deal of uncertainty and likely would have resulted in an unending number of disputes between taxpayers and the CRA as to whether a cumulative profit could reasonably have been expected. One can easily envisage the CRA challenging deductions claimed by taxpayers and including in their reasons the “ritual repetition” of assumptions criticized by Bowman J in many of his REOP decisions.⁴²

In the February 23, 2005 federal budget, the Department of Finance indicated its intention to undertake a “more modest legislative initiative that would respond to these concerns while still achieving the Government’s objectives,”⁴³ and that it would release the alternative proposal for comment. As of the date of this article, no alternative proposal has been released. In fact, there has been very little from Finance on proposed section 3.1, other than a letter from the minister of national revenue stating that the “Department of Finance Canada continues to receive submissions on the draft legislation and intends to address the concerns raised prior to enacting it.”⁴⁴

There does not appear to be any compelling need for a broad-based statutory REOP test to limit general taxpayer expenditures. However, the issue of finding the appropriate policy and a practical solution to the question of when and how much interest (and similar financing costs) should be deductible will continue to challenge tax policy makers. The analysis and commentary that occurred following the relatively recent introduction (and subsequent withdrawal) of provisions restricting the deductibility of interest on borrowings to make certain types of foreign investments⁴⁵ highlight yet another example of the difficult policy issues that arise.

A redrafted legislative solution seems to have been dropped from the list of priorities for now. However, it is likely to reappear in the not too distant future, as governments strive to raise tax revenues to deal with current deficits without resorting to broad-based tax increases. We can only hope that if new measures are proposed, they are drafted with proper consultation, and in a way that does not lead to the uncertainty that would be created by adopting REOP-style proposals.

41 See, for example, the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute for Chartered Accountants, “Re: October 31, 2003 Draft Proposals Regarding the Deductibility of Interest and Other Expenses,” submission to the Department of Finance, Canada, February 19, 2004.

42 See, for example, the comments quoted above at notes 12 (*Kaye*) and notes 13 and 14 (*Shaughnessy*).

43 2005 Budget, *supra* note 2, annex 8, at 410.

44 CRA document no. 2006-0177371M4, April 26, 2006.

45 Section 18.2, repealed (without ever taking effect) by SC 2009, c. 2, section 6(1).