To Profit or Not To Profit: A Historical Review and Critical Analysis of the “Reasonable Expectation of Profit” Test

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PRÉCIS
Le régime fiscal canadien est largement fondé sur l’hypothèse fondamentale que seuls les gains et les pertes provenant d’une «source de revenu» doivent être pris en considération dans le calcul du revenu d’un contribuable et de l’impôt en découlant. Cet article traite de l’importance de la capacité d’un contribuable à établir l’existence d’une source et des critères que les tribunaux ont adopté à cet égard. Il porte plus particulièrement sur la doctrine jurisprudentielle visant à identifier une source au moyen d’un critère d’attente raisonnable d’un profit. L’historique législatif et l’évolution de la jurisprudence au Canada ainsi que la position adoptée dans d’autres pays sont également examinés dans cet article. Selon l’auteur, le critère de l’«attente raisonnable de profit», qui peut donner lieu à des résultats irréguliers et injustes, n’a que peu de fondement historiquement. Selon l’auteur, un nouvel examen de la jurisprudence plus ancienne permet de trouver un ensemble de principes plus solides qui devraient être suivis pour déterminer si une source de revenu existe.

ABSTRACT
The Canadian income tax system is largely based on the fundamental assumption that only gains and losses that flow from a “source of income” are to be taken into account in determining a taxpayer’s income and resulting tax. This article deals with the importance of a taxpayer’s being able to establish the existence of a source and the criteria the courts have adopted for this purpose. In particular, it deals with the judicial doctrine that looks to identifying a source by testing for a reasonable expectation of profit. The article examines the legislative history and the development of case law in Canada as well as the position that has been adopted in other countries. According to the author, there is little historical justification for the “reasonable expectation

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of profit” test, which can produce inconsistent and unjust results. The author suggests that a re-examination of earlier case law reveals a sounder set of principles that ought to be followed in determining whether a source of income exists.

INTRODUCTION

The last 25 years have seen an exhausting number of reported cases in which losses from various activities and undertakings have been denied by Revenue Canada and the courts on the basis that there was no “reasonable expectation of profit.” Not only so-called hobby farmers but professionals, restaurateurs, artists, real estate syndicates, and many other taxpayers have been told that although they may have thought they were carrying on a business or some other commercial enterprise, for the purposes of the Income Tax Act they were not.1 They have been told that they had a hobby or a passion or a dream or a recreation or a sport, but not a source of income according to income tax laws, since in the judgment of Revenue Canada or the courts they were not going to make a profit in whatever they were doing. In Revenue Canada’s view, “[i]n order for any activity or pursuit to be regarded as a source of income, there must be a reasonable expectation of profit,” and “[w]here such an expectation does not exist . . . neither amounts received nor expenses incurred are included in the income computation.”

This article first reviews the legislative history and the development of judicial doctrine concerning the “reasonable expectation of profit” test, which over time has been transmogrified from a test of somewhat limited application, originally intended to ensure the non-deductibility of certain lifestyle expenses, into a test almost universally applied by the Canadian courts to determine whether a source of income exists. The article then presents an analysis of the technical and interpretive difficulties encountered in applying a “reasonable expectation of profit” test, and the failure of the courts by and large to address fundamental policy issues in this regard. The article examines briefly how certain other countries have dealt with defining the parameters of what constitutes a source for the purposes of deducting losses. Finally, the article suggests that earlier Canadian case law contains the framework of a better test to determine whether a particular activity or undertaking qualifies as a source. Some amendments to the ITA will be suggested for the purposes of consistency.

Although the analysis that follows deals, for the most part, with taxpayers who are individuals and sources that are in the nature of a business (following most of the important cases), the principles and issues addressed

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the ITA”). Unless otherwise stated, statutory references in this article are to the ITA.

are generally as relevant and applicable to corporate taxpayers as to individuals and as relevant and applicable to property sources as to business sources. This article is based on the case law reported to August 31, 1995.

**LEGISLATIVE HISTORY OF PARAGRAPH 18(1)(H) AND THE DEFINITION OF “PERSONAL OR LIVING EXPENSES”**

The “reasonable expectation of profit” terminology appears in the definition of “personal or living expenses” in subsection 248(1) of the ITA. In turn, paragraph 18(1)(h), which addresses the calculation of income from property and business sources, states that “no deduction shall be made in respect of personal or living expenses of the taxpayer.”

Canada’s first income tax legislation, The Income War Tax Act of 1917, contained no provision analogous to the present paragraph 18(1)(h). In 1927, paragraph 6(f) was added to the IWTA, and read in part: “In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of . . . personal and living expenses.” The purpose of paragraph 6(f) in the IWTA was explained in *Maurice Samson v. Minister of National Revenue*:

The personal and living expenses referred to in section 6(f) are those over which the taxpayer has a large amount of personal control, depending upon the scale of living which he may choose. . . . [I]f personal and living expenses were deductible from income and only the balance left for taxation purposes, the amount of net or taxable income would depend upon the taxpayer’s own choice as to the scale of living he might adopt. . . . It is obvious that the determination of what the taxable income of a taxpayer shall be cannot depend upon or be left to the taxpayer’s own choice.

However, the IWTA contained no actual definition of “personal and living expenses” until 1939, when subparagraph 2(r)(i) was added. It defined “personal and living expenses” to include

the expenses of properties maintained by any person for the use or benefit of any taxpayer or any person connected with him by blood relationship, marriage or adoption, and not maintained in connection with a business carried on bona fide for a profit and not maintained with a reasonable expectation of profit [emphasis added].

In 1939, when the minister of national revenue, J.L. Ilsley, moved the second reading of the bill in the House of Commons (which amended the IWTA to add subparagraph 2(r)(i)), he said:

The effect of this section is to make it impossible for taxpayers to deduct as a business expense the expenses described in section 2, (r) (i), that is the expenses of properties maintained by any person for the use or benefit of any taxpayer or any person connected with him by blood relationship,

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3 SC 1917, c. 28 (herein referred to as “the IWTA”).
4 RSC 1927, c. 97, section 6.
5 [1943] CTC 47, at 64 (Ex. Ct.). See also *Coupland v. The Queen*, 88 DTC 6252, at 6254 (FCTD).
6 SC 1939, c. 46, section 2.
marriage or adoption, not maintained in connection with a business carried on *bona fide* for profit, and not maintained with a reasonable expectation of profit. There are certain wealthy taxpayers in Canada who carry on gentleman farming operations or own stables and establishments of that sort which apparently are not carried on *bona fide* for profit and are not maintained with reasonable expectation of profit. In the operation of these enterprises they incur losses, sometimes very heavy losses, and thereby minimize their taxable income to a considerable degree. It is thought that that particular type of expenditure should be regarded as coming under the personal and living expenses of the taxpayer. This section accomplishes that end.\(^7\)

No other comment or debate concerning this amendment took place in the House of Commons.\(^8\)

As reported in *McLaughlin Executor v. MNR*,\(^9\) the addition of the definition of “personal and living expenses” in subparagraph 2(r)(i) to the IWTA in 1939 was largely a reaction to the 1938 decision of the Exchequer Court in *Hatch v. MNR*.\(^10\) A principal issue in the *Hatch* case was whether the horse-breeding farm and racing stable of the taxpayer’s personal corporation were business operations or, in the words of the court, “recreational operations.” The court in *Hatch* cited several cases that had been decided in the United States, and relied in particular on the 1932 decision of the US Circuit Court of Appeals in *Commissioner of Internal Revenue v. Field*.\(^11\) The court quoted part of the judgment in *Field*:

In *Flint v. Stone Tracy Co.*, 220 U.S. 107 . . . the court repeated a definition of business as “That which occupies the time, attention and labor of men for the purpose of a livelihood or profit.” It is not essential that the taxpayer be engaged solely in one business. He may have interests in several enterprises among which he divides his time. His intention is important. . . .

In the instant case, there is substantial evidence that the enterprises were conducted as a business for profit and with an expectation of ultimate profits. We cannot say that the expectation of profits is unreasonable or forecast continuous losses in the light of experience in cattle or horse breeding and racing. If the right to deduct losses under the statute required that profit appear to the court to be possible, that requirement would be quite general and would be applicable to any enterprise, whether it was farming, manufacturing, or promotion of any character. We may not, in this way, foredoom any business venture. Cattle breeding and horse racing projects are old. Some have been profitable; others have not. It is a matter of intention and good faith, and all the circumstances in the particular case must be our guide. In this case we think the respondent embarked in these

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7 Canada, House of Commons, *Debates*, May 24, 1939, 4467.
8 Ibid., May 22, 1939, at 4356 (first reading of the amending bill); May 24, 1939, at 4466 (second reading of the amending bill); and May 24, 1939, at 4523 (third reading and passing of the amending bill).
9 [1952] CTC 264 (Ex. Ct.).
10 [1938-39] CTC 85 (Ex. Ct.).
11 67 F.2d 876 (2d Cir. 1933).
enterprises with the expectation of making profits; at least he did so, with an earnest and honest intention.\textsuperscript{12}

The court in \textit{Hatch} then concluded that on the evidence it was satisfied “that the farm and stable were operated in good faith for profit and constituted a business.”\textsuperscript{13} In other words, the court emphasized the genuineness of the taxpayer’s intention to earn a profit and not whether the expectation of profit was necessarily realistic. It was then that subparagraph 2(r)(i) of the IWTA added the requirement regarding the maintenance of properties to the effect that the taxpayer not only have a good-faith intention to earn profits, but also have a reasonable expectation of so doing.

Although decided in 1952, the \textit{McLaughlin} case\textsuperscript{14} was concerned with the 1944 and 1945 years, to which the IWTA still applied. McLaughlin was a farmer and cattle breeder near Oshawa; the minister had disallowed his farm operating losses in those two years. McLaughlin had suffered farm losses in every year since 1920. In analyzing subparagraph 2(r)(i) of the IWTA, the court accepted the minister’s contention that the operating expenses were expenses of properties maintained by McLaughlin for the use of his family, so that subparagraph 2(r)(i) potentially applied. The court then went on to say that to defeat the assessment the taxpayer had to establish that he “was engaged in the business or calling of a farmer and cattle breeder \textit{bona fide} for profit” and “that he did so with a reasonable expectation of profit.”\textsuperscript{15} The court found that McLaughlin met both requirements. With respect to the first, the court found that McLaughlin was knowledgeable and committed to farming; the court placed a great deal of emphasis on the testimony of McLaughlin’s widow and his neighbour to the effect that McLaughlin had stated he intended to earn a profit. The court concluded that “[h]e was not merely indulging himself in an activity for pleasure. He was anxious to make a success of his work.”\textsuperscript{16} In other words, the expenses at issue were not merely a matter of lifestyle.

The court had more difficulty with the second requirement, but held that on the evidence McLaughlin did have a reasonable expectation of profit in 1944 and 1945, notwithstanding over two decades of losses.

In 1948 the ITA was enacted to replace the IWTA, effective for the 1949 taxation year.\textsuperscript{17} Paragraph 6(f) of the IWTA, which disallowed the deduction of “personal and living expenses,” became paragraph 12(1)(h) of the ITA, which essentially read the same as paragraph 18(1)(h) of the present ITA. The inclusionary definition of “personal and living expenses” in subparagraph 2(r)(i) of the IWTA became subparagraph 127(1)(ad)(i) of the 1948 ITA, and was reworded to read:

\begin{itemize}
\item \textsuperscript{12} Ibid., at 877-78, quoted in \textit{Hatch}, supra footnote 10, at 98 (emphasis added).
\item \textsuperscript{13} Supra footnote 10, at 98.
\item \textsuperscript{14} Supra footnote 9.
\item \textsuperscript{15} Ibid., at 270.
\item \textsuperscript{16} Ibid., at 269.
\item \textsuperscript{17} SC 1948, c. 52.
\end{itemize}
(ad) personal and living expenses include

(i) the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or adoption, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit [emphasis added].

The change to the disjunctive and the deletion of “bona fide” in the 1948 ITA does not appear to have been a response to any particular case decided prior to 1948, nor do the changes in wording appear to have been considered in any case that followed the enactment of the 1948 ITA.

The change in wording to the definition of “personal and living expenses” is confusing. The *McLaughlin* case rightly held that, prior to the 1948 change, the taxpayer had to demonstrate both that he or she was engaged in the business with a bona fide profit motive and that there was a reasonable expectation of profit. If the change in wording to the disjunctive was intended to create an either/or test, it is questionable why “reasonable expectation” would be needed at all, since the required profit motive would presumably always be present where there was a reasonable expectation of profit. On the other hand, if the deletion of “bona fide” was intended to make the test more strict so that an actual profit was to be required, then the first criterion would be redundant, since such situations presumably would be covered by the “reasonable expectation of profit” in the second criterion.

Indeed, since recent case law (as discussed later in this article) suggests strongly that a reasonable expectation of profit is an inherent ingredient of “business,” one is tempted to ask why there is any need to follow the words “business” in the definition of “personal or living expenses” with the words “for profit or with a reasonable expectation of profit.”

In the 1952 Revised Statutes of Canada, some renumbering of the ITA was done: subparagraph 127(1)(ad)(i) became subparagraph 139(1)(ae)(i), but no change in wording occurred, except that the defined term “personal and living expenses” was changed to “personal or living expenses.”18 When the ITA was remodelled in 1972, paragraph 12(1)(h) was renumbered as paragraph 18(1)(h) and subparagraph 139(1)(ae)(i), which defined “personal and living expenses,” was included as one of the definitions in subsection 248(1), without a change in wording.19 These provisions were carried forward as is into the present ITA, which was enacted for 1985 and the following years.20

It is worth noting that subsection 111(5), which restricts the use of business losses after a change of corporate control occurs, was amended in 1981 to change the requirement that the corporation continue to carry

18 RSC 1952, c. 148, subparagraph 139(1)(ae)(i).
19 SC 1970-71-72, c. 63.
20 RSC 1985, c. 1 (5th Supp.), as amended.
on the same business to a requirement that the corporation continue to carry on the same business “for profit or with a reasonable expectation of profit.” At that time the Department of Finance did not publish explanatory notes regarding amendments to the ITA. Subsequently, the other change-of-control rules in the ITA in subsections 37(6.1), 88(1.1), 125.3(3), 181.1(7), and 190.1(6) adopted the same terminology.

**INTERACTION OF PARAGRAPHS 18(1)(A) AND 18(1)(H)**

Paragraph 18(1)(a) of the ITA provides that no deduction may be made in computing the income of a business or property in respect of an outlay or expense, except to the extent that “it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property.”

Although the common thinking is that personal expenses are by definition not incurred for the purpose of producing income, in theory there must be expenses that are not denied by paragraph 18(1)(a) but are denied by paragraph 18(1)(h); otherwise, paragraph 18(1)(h) would be redundant. Presumably these would be expenses that have a mixed business and personal purpose. However, the Canadian case law generally has tended to characterize an expense as either entirely a business expense or entirely a personal expense, and has ignored any aspect of mixed purpose. (Having a mixed purpose in the context of incurring expenses ostensibly for the purpose of earning revenues while at the same time deriving personal benefit or enjoyment from a particular activity is not to be confused with the issue of the mixed use of certain assets—typically, automobiles or vacation properties, in respect of which expenses normally are allocated between the amount of time the assets are put to personal rather than commercial use.)

The need for an express and separate provision denying personal and living expenses was even less apparent when paragraph 6(f) was first added to the IWTA in 1939. At that time, the predecessor provision in the IWTA to the present paragraph 18(1)(a) was paragraph 6(1)(a), which denied a deduction in computing profit in respect of expenses “not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income.” Such wording is more restrictive than the wording in the present paragraph 18(1)(a), which was first adopted in the 1948 ITA and, one would think, left no room to argue the deductibility of personal expenses.

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21 SC 1980-81-82-83, c. 140, section 70(1).
22 Subsection 111(5) is further commented on later in this article.
23 See Samson, supra footnote 5, at 64; Symes v. The Queen et al., 94 DTC 6001, at 6010 (SCC); and Gwyneth McGregor, Business Deductions Under the Income Tax, Canadian Tax Paper no. 13 (Toronto: Canadian Tax Foundation, 1958), 12.
25 SC 1948, c. 52, paragraph 12(1)(a).
The courts have generally failed to identify any distinction between paragraphs 18(1)(h) and 18(1)(a) (formerly paragraphs 12(1)(h) and 12(1)(a)):

The Defendant must establish, in satisfaction of section 12(1)(a), that the loss is comprised of outlays and expenses made or incurred to gain or produce income from a business and, in satisfaction of section 12(1)(h), that the business was carried on for profit or with a reasonable expectation of profit. Section 4 of the Act provides that the income for a taxation year from a business is its profit for the year. There is therefore no distinction to be made between the objective of gaining or producing income referred to in section 12(1)(a) and the objective of profit incorporated in section 12(1)(h) by virtue of section 139(1)(ae)(i).26

Similarly, the Supreme Court of Canada in the now famous case of Symes v. The Queen et al. said:

Although ss. 18(1)(a) and (h) may, therefore, simply be analytically repetitive or confirmatory of prohibitions already embodied in s. 9(1), they may serve to reinforce the point already made, namely, that the s. 9(1) test is a legal test rather than an accountancy test. . . .

[A]ny treatment of the issue will necessarily blur s. 9(1) with ss. 18(1)(a) and (h).27

Some years ago, one commentator suggested that paragraph 18(1)(h) was probably employed by the legislators as a needed reinforcement to paragraph 18(1)(a) in situations where lifestyle expenses regarding farm properties, etc. might be disguised as deductible expenses:

These statutory provisions [paragraph 18(1)(h) and the “personal or living expenses” definition in subsection 248(1)], taken as a whole, suggest that the concept of a reasonable expectation of profit was originally introduced to distinguish a specific subclass of businesses. . . . In these [hobby farm] cases, a taxpayer is often found to be using his farm property for personal activities as well as for a “business” that is carried on as a hobby without the dedication to profit normally expected in business. It seems appropriate under these circumstances to use paragraph 18(1)(h) to exclude the deduction of personal or living expenses from business income, if the particular business activity (such as farming), can also be carried on for recreational purposes.28

Another commentator recently suggested a slightly different purpose for the presence of paragraph 18(1)(h):

The obvious intent of the provision is to limit the deduction of expenses that, by their very nature, are difficult to categorize. These are expenses that may have a business purpose but that also may result in some benefit to or provide some personal use to the taxpayer.

26 The Queen v. Matthews, 74 DTC 6193, at 6196 (FCTD).
27 Symes, supra footnote 23, at 6010.
Parliament had determined that restrictions should be imposed on such expenses in addition to the requirement of paragraph 18(1)(a).29

However, there has been little analysis of the purpose of the “personal or living expenses” definition in the case law itself. For instance, in D.A. Holley v. MNR30 the taxpayer’s counsel, in attempting to deny the application of that definition to the facts of the case, argued that the expenses in question were not the expenses of properties maintained for the use of the taxpayer. The court rejected this as irrelevant, and stated that “[p]ersonal or living expenses” are not limited to those described in subsection 248(1). [Subsection 248(1)] merely makes it clear that the expenses described in paragraph (i) are included in “personal or living expenses.”31

“SOURCE” OR “BUSINESS” AND THE REASONABLE EXPECTATION OF PROFIT AT COMMON LAW

The Canadian income tax system has always rested on the proposition that taxable sources are distinguishable from non-commercial activity, losses from the latter of which are not included in the income calculation. The concept of “source” was initially derived from the English taxation statutes, which divided various sources of income into schedules.32

Section 3 of the IWTA first defined “income” to include the annual net profit “from a trade or commercial or financial or other business . . . and also the annual profit or gain from any other source” [emphasis added]. Paragraph 3(a) of the present ITA refers to income from any source inside or outside Canada, and sets out “office, employment, business and property” as the most important sources. (For some reason, unlike paragraph 3(a), paragraph 3(d) was drafted to contemplate losses arising only from these specific four sources and not from any other general source.) Other than this, the ITA does not define “source,” and the courts have not attempted to do more than convey a general idea of what a source might be: “The Legislature in using the word ‘source’ meant, not a legal concept, but something which a practical man would regard as a real source of income.”33 Sometimes the courts have referred to a source as an “originating cause” of receipts34 or, more traditionally, as that which bears the “fruit of the tree.”35 As put by James A. Rendall:

31 Ibid., at 543.
34 The Queen v. Kuhl et al., 74 DTC 6024, at 6032 (FCTD).
It is probably fair to say that for Canadian tax purposes, “income” started off in 1917 almost entirely on the basis of “source” concept.

The characteristics of income, as classically stated in conformity with the “source” concept are as follows:

(a) it recurs on a periodic basis;
(b) it proceeds from a productive source;
(c) it represents the creation of new wealth.36

In other words, the receipts from a source are “that which is typically earned by it or which typically flows from it as the expected return.”37

The concept of “business” sketched out in early case law was consistent with this notion of source, and fundamentally involved two components, pursuit of profit and habitual activity—in other words, intention and behaviour (course of conduct). In considering the meaning of the phrase “carrying on a business” in the English Companies Act, the master of the rolls concluded in 1880 that “anything which occupies the time and attention and labour of a man for the purpose of profit is business.”38 Several cases subsequently adopted this definition.39 Lord Justice Cotton, in considering the meaning of a “trade or business” in one of the early taxation statutes in England, said: “[I]n my opinion, when a person habitually does a thing which is capable of producing a profit for the purpose of producing a profit and enters into a contract habitually, he is carrying on a trade or business.”40 After extensive reference to previous British, American, and Canadian case law, Thorson J in the Exchequer Court in the early 1940s took the view that the phrase “trade or business” in the IWTA “contemplates an activity in which the prospect of a gain or profit is involved and the pursuit of a trade or business involves the pursuit of gain or profit.”41 An extensive review of the early case law on the meaning of “business” is contained in A Treatise on the Dominion Income Tax Law by Plaxton and Varcoe.42

There appears to be no statement in the early case law that a reasonable expectation of profit is a condition precedent to the existence of a business or a source. In Erichsen v. Last, for instance, the master of the rolls said:

37 The Queen v. Cranswick, 82 DTC 6073, at 6076 (FCA).
38 Smith v. Anderson (1880), 15 Ch.D. 247, at 258 (CA).
40 Erichsen v. Last (1881), 4 TC 422, at 427 (CA).
41 Samson, supra footnote 5, at 66.
I do not think there is any principle of law which lays down what carrying on of trade is. There are a multitude of incidents which together make the carrying on [of] a trade, but I know of no one distinguishing incident which makes a practice a carrying on of trade, and another practice not a carrying on of trade. If I may use the expression, it is a compound fact made up of a variety of incidents. 43

Many of the earliest Canadian income tax cases in this area dealt with the question whether a taxpayer’s gambling activities constituted a taxable business. Apparently much influenced by early British cases, 44 the Canadian courts initially placed considerable emphasis on determining the subjective intention or motivation of the taxpayer. In Walker v. MNR, 45 decided in 1951, the taxpayer’s betting on horse racing was held to be a business. Hyndman J in the Exchequer Court said:

I do not think that in Walker’s circumstances he could reasonably believe he could afford to lose much money on a hobby of this kind, from which I infer that his intention in embarking on this business was to make profits out of it. If that was his intention, then I think it can be said he was engaged in a scheme other than a hobby, or for amusement, and any winnings would be assessable to tax. 46

Ten years later, in MNR v. H.E. Morden, 47 the Exchequer Court had to determine whether the taxpayer was liable for tax on gambling wins in card games and sporting events. The court said that one must “try to see what is the man’s own dominant object—whether it was to conduct an enterprise of a commercial character or whether it was primarily to entertain himself.” 48 The court in Morden held that the taxpayer’s gambling was not a business on the basis that “[g]ambling was in his blood and it provided him with the excitement he craved. It was his hobby.” 49

In Chapman v. MNR, the court held that the taxpayer’s gambling was not a business, since the taxpayer’s activities “[could not] be said to have amounted to any degree of organization on the appellant’s part for the purpose of indulging in the pursuit of wagering for the purpose of making a profit . . . [or] for the purpose of securing a steady business income therefrom.” 50

A second line of Canadian income tax cases dealt with losses from various farming activities; these are commonly referred to as the “hobby

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43 Supra footnote 40, at 423. See also Mrs. Anna H. Martin v. MNR, [1948] CTC 189, at 193 (Ex. Ct.).
44 See, for example, Cooper v. Stubbs, [1925] 2 KB 753 (CA); Down v. Compston, [1937] 2 All ER 475 (KB); and particularly Graham v. Green, [1925] 2 KB 37 (KB).
45 [1951] CTC 334 (Ex. Ct.).
46 Ibid., at 340.
47 [1961] CTC 484 (Ex. Ct.).
48 Ibid., at 489, quoting In re Lala Indra Sen (1940), 8 ITR (Ind.) 187, at 218 (HC).
49 Supra footnote 47, at 489. Also see MNR v. Beaudin, 64 DTC 5077 (Ex. Ct.).
50 71 DTC 88, at 91 (TAB).

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farm” cases. Between McLaughlin in 1952 and the commencement of the 1970s there appear to be no farm loss cases of note that contain any in-depth analysis of the “source” issue or of the definition of “personal or living expenses” in the ITA. However, it is in the farm loss cases decided for the most part at the start of the 1970s that one does find the judicial statements expressing the germ of the notion that a reasonable expectation of profit is a condition precedent to the existence of a business or source.

The first suggestion to this effect actually appears in the 1964 decision of J.S. Stewart v. MNR, a case concerning the raising of dogs for use in a display advertising business, in which the court stated (in obiter) that a business must be “carried out in good faith with a reasonable expectation of profit.”51 Seven years later, in 1971, the Federal Court—Trial Division in CBA Engineering Ltd. v. MNR52 stated that farming could be either a hobby or an “operation with the expectation of profit,” in which case it would be a source. CBA Engineering Ltd. was followed in 1972 by O. Dorfman v. MNR, another farming case, in which the Federal Court—Trial Division stated, “In my view the words [source of income] are used in the sense of a business, employment, or property from which a net profit might reasonably be expected to come.”53

In 1973, two decisions of the Federal Court—Trial Division came to substantially different conclusions as to the significance of the “reasonable expectation of profit” concept in the definition of “personal or living expenses” which at that time was found in paragraph 139(1)(ae) of the ITA.

In the 1973 decision James v. MNR, the court held that

[the concept conveyed by the words “with reasonable expectation of profit” in section 139(1)(ae) of the Act in defining “personal or living expenses” ... is one of the indicia to be employed in determining whether or not a taxpayer in a given taxation year is in the “business of farming.” But the converse is not true, i.e., the fact that a taxpayer in a given taxation year or for years before and after, had or appeared to have no reasonable expectation of profit is not proof in itself that he was not in the business of “farming” if other indicia establish or prove that such a taxpayer was in fact in the business of farming.]54

The court in James reviewed the circumstances of the taxpayer’s horse-racing activity, and held that it was carried on in a commercial manner such that his losses were deductible as business losses.55

One month after the James decision, another judge of the Federal Court—Trial Division decided D.A. Holley v. MNR,56 in which the losses of the taxpayer’s horse-raising operation were denied on the basis that the

51 [1964] CTC 45, at 51 (Ex. Ct.).
52 71 DTC 5282, at 5286 (FCTD).
54 73 DTC 5333, at 5341-42 (FCTD).
55 See also E.C. Hammond v. MNR, [1971] CTC 663 (FCTD).
56 Supra footnote 30.
activity was a matter of personal enjoyment and a hobby, “not motivated by the hope of profit.” The court said:

An undertaking must be carried on for profit or with a reasonable expectation of profit for it to come within the generally held concept of the commercial. Profit or the reasonable expectation of it is inseparable from the basics of business. This, I think, is recognized by the wording of section 139(1)(ae)(i).

Furthermore, and in any event, because of the obvious purpose and concept of the Income Tax Act in its entirety it would require clear and unequivocal language for an interpretation which would permit a deduction of losses occasioned by farming, not as a business, but merely as a pleasurable activity per se and without a reasonable expectation of profit. In my view section 13 certainly does not contain such language. 57

The court in Holley obviously did not accept the premise set out in James that the reasonable expectation of profit is only one of the indicia to be considered in each case.

Two other farming cases decided by the Federal Court—Trial Division shortly thereafter followed the approach in Holley; these were The Queen v. Matthews in 1974 58 and McLaws v. The Queen in 1976. 59

It appears that CBA Engineering Ltd., Dorfman, and Holley may well have been the springboard to Revenue Canada’s adoption of a broadly based “reasonable expectation of profit” test. The earliest reported cases containing an appeal on this question (outside of farm loss cases or related animal-breeding or horse-racing cases) occur in 1974. In Huband v. MNR, the issue put to the court was “whether the appellant’s racing of motor cars in 1969 and 1970 was in the nature of a hobby or a sport, or whether it was a business carried on for profit, or with a reasonable expectation of profit.” 60

In Needham v. MNR, the issue was “whether the appellant in his activities as a writer was exercising a hobby or whether he was engaged in writing professionally for profit or with a reasonable expectation of profit.” 61

Although the taxpayers in Huband and Needham were both successful, of far greater significance is the courts’ acceptance of the “reasonable expectation of profit” test as law without the citation of any precedent for this proposition, and with no reference to the definition of “personal or living expenses” (presumably because maintenance of properties was not in issue). It appears that these two cases were litigated on the basis of paragraph 18(1)(a), in which the words “reasonable expectation of profit” do not appear.

In the 1970s cases, the “reasonable expectation of profit” test escaped the confines of the “personal or living expenses” definition, as it were,

57 Ibid., at 542.
58 Supra footnote 26.
59 76 DTC 6005 (FCTD).
60 74 DTC 1039, at 1040 (TRB).
61 74 DTC 1057, at 1057 (TRB).
and took on a life of its own as part of the general “source” concept. Unfortunately, the courts, in setting the stage for a broad application of the test, gave little consideration to the policy issues and practical problems associated with the test.

The landmark case in this area came in 1977, when the Supreme Court decision in *Moldowan v. The Queen* was handed down. In that case the minister had conceded that the taxpayer’s horse-racing activity constituted a business, and the issue before the court was whether the taxpayer’s farming was his chief source of income so that he could deduct his losses fully under section 13 of the ITA (now section 31). The Supreme Court, in an obiter statement (since Revenue Canada had conceded that there was a business) said:

> 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.* [72 DTC 6131], [1972] C.T.C. 151. See also s. 139(1)(ae) 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.

Two years after the *Moldowan* decision, in *Mullin v. MNR*, the minister’s counsel took the position that the farming activity constituted a business but that it was a separate question as to whether the business was carried on with a reasonable expectation of profit. The court rejected this approach in the light of *Moldowan*, stating that “carrying on a ‘business’ presupposes a ‘reasonable expectation of profit.’”

Although *Moldowan* dealt with a farm operation, where many of the expenses presumably would have been involved with the maintenance of properties, the Supreme Court’s judgment did not limit the application of the “reasonable expectation of profit” concept to farm loss cases (or other “property” cases such as vacation property rental cases).

Since *Moldowan*, the Federal Court has considered it axiomatic that

[i]n order for a taxpayer to be regarded as carrying on a business he must have a profit or a reasonable expectation of profit: *Moldowan*. This applies whether in a particular case the activity under consideration is farming or snow removal or something else.

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62 77 DTC 5213 (SCC).
63 Ibid., at 5215.
64 79 DTC 113 (TRB).
65 Ibid., at 115.
66 *Shipowick v. MNR*, 90 DTC 1356, at 1360, footnote 3 (TCC). See also *Landry v. The Queen*, 94 DTC 6624, at 6625, where Mr. Justice Decary in the Federal Court of Appeal (The footnote is continued on the next page.)
Similarly, the Tax Court of Canada has said:

To have a source of income, a taxpayer must have a profit or a reasonable expectation of profit. Source of income, therefore, is an equivalent term to business. If a taxpayer does not have a profit or a reasonable expectation of profit, then he does not have a source of income. And if he does not have a source of income, he does not have a business.67

Over the last 25 years there has been a glut of reported cases in which the “reasonable expectation of profit” test has been applied not only to so-called hobby farms and vacation homes, but also to business and property activities of all sorts.68 The business cases concern such diverse taxpayers and activities as poets,69 musicians,70 baseball teams,71 deep-sea diving for treasure,72 restaurants,73 and even lawyers.74 Most of the cases do not involve the recreational use or maintenance of properties. Revenue Canada is known to be examining real estate ventures, research and development ventures, and film syndications with a view to discerning whether there is a reasonable expectation of profit.

THE CONCEPT OF “BUSINESS” IN TAX STATUTES OTHER THAN INCOME TAX LEGISLATION

The issue of what constitutes a business has been relevant in municipal property taxation as well as for the purposes of the ITA. For a period of time the law in municipal property tax cases was that the profit motive was only one criterion to be used in determining the existence of a business. In Re Windsor-Essex County Real Estate Bd. and City of Windsor,75 decided in 1974, the Ontario Court of Appeal was concerned with whether the Real Estate Board, which operated as a multi-listing service, was liable for municipal business tax as a person “occupying or using land for the purpose of, or in connection with any business” as provided in the 1970 Ontario Assessment Act. Evans JA said:

66 Continued . . .
cited with approval the following statement made by the Tax Court in that case: “I see no reason why the reasonable expectation of profit test should not apply to any profession, liberal or otherwise, any occupation or activity which purports to be in the course of carrying on a business.” C. Landry v. The Queen, [1994] 1 CTC 2049, at 2052 (TCC).

67 Knight v. MNR, 93 DTC 1255, at 1259 (TCC).

68 See Clifford Rand and Susan Thomson, “Memorandum: Reasonable Expectation of Profit,” in 1995 Prairie Province Tax Conference (Toronto: Canadian Tax Foundation, 1995), tab 10; and Silver, supra footnote 29, for an extensive review of recent cases in this area of the law.

69 Booth v. MNR, 79 DTC 595 (TRB).
70 Seymour v. MNR, 82 DTC 1706 (TRB).
71 Nichol v. The Queen, 93 DTC 1216 (TCC).
72 Tobias v. The Queen, 78 DTC 6028 (FCTD); and McEachern v. MNR, 77 DTC 94 (TRB).
73 Sirois v. MNR, 88 DTC 1114 (TCC).
74 Landry, supra footnote 66 (FCA).
75 (1974), 51 DLR (3d) 665 (Ont. CA).
It is quite possible for a business to be liable to assessment and taxation without any intention of making a profit and in my opinion the true test is whether in the light of all the circumstances surrounding the activity, such activity is a truly commercial activity. There is no doubt that an intention to make a profit will be a very important factor in determining whether an activity is a commercial activity but the lack of it does not automatically prevent it from being so characterized.\(^76\)

The Supreme Court rejected this approach in *Re Reg. Assess. Com’r and Caisse Populaire De Hearst*.\(^77\) In commenting on Evans JA’s judgment in *Windsor-Essex County*, the court said:

To attach primary importance to the commercial aspect of an operation in question will offer, in my opinion, no sure or helpful guide. In my view, the commercial activity test is too indefinite to allow consistent application. I agree that, in deciding whether or not an activity may be classed as a business under the provision of s. 7(1)(b) of the *Assessment Act*, all relevant factors regarding an operation must be considered and weighed. However, they must be considered and weighed in order to determine not whether in some general sense the operation is of a commercial nature or has commercial attributes, but whether it has as its preponderant purpose the making of a profit. If it has, it is a business; if it has not, it is not a business.\(^78\)

The Supreme Court did not go so far as to require a reasonable expectation of profit.

The goods and services tax legislation in part IX of the Excise Tax Act\(^79\) also appears to contemplate the existence of a business without a reasonable expectation of profit. Section 123(1) of the Excise Tax Act defines “business” to include “a profession, calling, trade, manufacture or undertaking of any kind whatever, whether the activity or undertaking is engaged in for profit,” and defines “commercial activity” to mean “a business carried on by the person (other than a business carried on by an individual or a partnership, all the members of which are individuals, without a reasonable expectation of profit).”

Revenue Canada itself stated in *GST Memorandum* 200 that “[b]odies such as partnerships, corporations, charities and non-profit organizations may engage in activities without a reasonable expectation of profit which would nevertheless be regarded as commercial activities.”\(^80\)

A parallel between the GST legislation and the definition of “business” in subsection 248(1) of the ITA might be drawn to the extent that the latter definition includes an “undertaking of any kind whatever,” about which the Exchequer Court said the following:

\(^76\) Ibid., at 676.
\(^77\) (1983), 143 DLR (3d) 590 (SCC).
\(^78\) Ibid., at 600.
\(^79\) RSC 1985, c. E-15, as amended.
The expression *an undertaking of any kind* appears to me to be wide enough by itself to embrace any undertaking of the kinds already mentioned in the definition of "business"; that is to say, trades, manufactures, professions or callings, and any other conceivable kinds of enterprise as well.  

**PROBLEMS IN APPLYING THE “REASONABLE EXPECTATION OF PROFIT” TEST**

In *Moldowan*, the Supreme Court opined that “whether a taxpayer has a reasonable expectation of profit is an *objective* determination to be made from all of the facts.” Following *Moldowan*, the courts have consistently made statements to this effect. The Tax Court of Canada has said:

> The existence of a reasonable expectation of profit is not to be determined by the presence of subjective hopes or aspirations, no matter how genuine or deep-felt they may be. The issue is to be decided by objective testing.

The Federal Court—Trial Division has said:

> There exists a burden of proof on every taxpayer who claims a deduction of net losses resulting from a business adventure, to establish that there was, at the time he engaged in and carried on with the business, a reasonable expectation of profit. The reasonableness of the expectation must be viewed objectively and cannot merely consist of an expectation which the taxpayer in good faith entertains to the effect that a profit will eventually be realized.

The Supreme Court in *Moldowan* suggested some criteria to be considered in determining whether there is a reasonable expectation of profit: previous years’ results, the taxpayer’s training and long-term intentions, the capitalization of the venture, etc. Revenue Canada has said that it considers criteria such as history of losses and gross revenues, progress, intended plans, time spent, and knowledge. In theory, the “reasonable expectation of profit” test applies on a year-to-year basis.

However, neither the Supreme Court in *Moldowan* nor the other courts have addressed in any depth certain fundamental and obvious policy issues. Some of these issues are dealt with in the discussion that follows; they serve to demonstrate why the “reasonable expectation of profit” test is so nebulous in many respects.

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81 *J.V. Drumheller v. MNR*, [1959] CTC 275, at 280 (Ex. Ct.) (emphasis in original). See also *Dockman v. MNR*, 90 DTC 1804 (TCC), and *Interpretation Bulletin* IT-496, “Non-Profit Organizations,” February 18, 1983, where Revenue Canada refers to whether or not the non-profit organization is carrying on its activities in a normal commercial manner for profit, but does not refer to a reasonable expectation of profit.

82 Supra footnote 62, at 5215 (emphasis added).

83 *Kerr and Forbes v. MNR*, 84 DTC 1094, at 1095 (TCC). See also *McKay v. MNR*, 93 DTC 1064 (TCC); and *Maloney v. MNR*, 89 DTC 314, at 315 (TCC).


Commercial Profit

Recent case law has tilted in the direction of establishing that a commercial profit must be identified if there is to be a source for income tax purposes; the prospect of tax savings alone will not suffice.

[T]he reduction of his own tax cannot by itself be a taxpayer’s business for the purpose of the Income Tax Act. To put the matter another way, for an activity to qualify as a “business” the expenses of which are deductible under paragraph 18(1)(a), it must not only be one engaged in by the taxpayer with a reasonable expectation of profit, but that profit must be anticipated to flow from the activity itself rather than exclusively from the provisions of the taxing statute.86

Meaning of “Profit”

The “reasonable expectation of profit” test, at least apart from the definition of “personal or living expenses” in subsection 248(1), is a common law concept developed by the courts. However, the common law has no regime of calculating income or profit save for some judicial doctrine enunciated in distinguishing income receipts from capital receipts for trust law purposes.87 Therefore, for the purposes of the common law test, “profit” presumably must be ascertained by using ordinarily accepted principles of accounting. Further, it is clear that “profit” means net profit, not gross revenues.88

Revenue Canada takes the position that an expectation of a capital gain is not sufficient to satisfy the “reasonable expectation of profit” test and that there must be a prospect of earning profit otherwise. This is based on the principle that income or profit from business or property does not include proceeds from the disposition of the source of income (a capital gain).89 In other words, the premise is that capital gains are not derived from a source, and the potential for capital gains does not create a source.

The Supreme Court in Moldowan stated that the capacity for profit is to be determined after charging capital cost allowance. Revenue Canada has said that in situations involving assets subject to accelerated writeoff rates, it is appropriate to amortize the cost of the asset under generally accepted accounting principles to determine whether an activity has a reasonable expectation of profit.90

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86 Moloney v. The Queen, 92 DTC 6570, at 6570 (FCA). See also Loewen v. The Queen, 94 DTC 6265 (FCA); The Queen v. Mara Properties Limited, 95 DTC 5168 (FCA); and The Queen v. Bastion Management Limited, 94 DTC 6272, at 6273 (FCTD).


88 Deputy Minister of Revenue (Que.) v. Lipson, [1979] 1 SCR 833.

89 See The Queen v. Bronfman Trust, 87 DTC 5059, at 5064 (SCC); Hastings v. MNR, 88 DTC 1391 (TCC); and subsection 9(3) of the ITA.

In dealing with non-wasting capital assets such as farm land, the Federal Court—Trial Division said in *The Queen v. Matthews* that

> [t]he conduct of a business whose profits are not expected to reimburse the capital cost of an asset that is not subject to waste or depreciation in the process of production nor to obsolescence by the passage of time or the development of technology does not violate ordinary commercial principles so as to lead to the conclusion that the business is not being carried on for profit or with a reasonable expectation thereof.91

**How Much Profit?**

How much profit must be projected in proportion to the losses incurred along the way or in relation to the capital invested or time spent? Not much, if what the court said in *The Queen v. Matthews* is good law. In *Matthews*, in considering the tree-farming operation at issue, the court suggested that the prospect of few revenue years over a period even longer than a lifetime did not necessarily prevent its being a business. In particular, the court pointed out that “in section [248(1)] the word ‘reasonable’ modifies ‘expectation’ not ‘profit’ and that the term ‘reasonable expectation of profit’ is not synonymous with ‘expectation of reasonable profit.’” 92

If indeed only a profit and not a reasonable profit is required, the vagueness of the “reasonable expectation of profit” test is underscored. On the other hand, who can actually say what a reasonable profit is for each particular venture? Must it be an economic profit? Must it be compared with the returns yielded on other investments? Must a net profit on a cumulative basis be achieved at some point? The parameters of the test tend to become very elastic (notwithstanding the statements in *Moldowan* that the determination is an objective one).

It is interesting to note that Revenue Canada, in an uncharacteristic show of generosity, has stated that “in the case of an artist or writer, it is possible that a taxpayer may not realize a profit during his or her lifetime, but still [may] have a reasonable expectation of profit.” 93

**Proportion of Profit to Risk**

Many projects and ventures (in the film industry and the mining industry, by way of example) are very high-risk: there is a small chance of making a very large profit. In various cases it has been held that the venture’s ability to produce large revenues can justify the undertaking of large risks and losses. This was the position taken in *Nichol v. The Queen*94 regarding the sports and entertainment field, and in *Huband v. MNR*95 regarding the car-racing business.

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91 Supra footnote 26, at 6197.
92 Ibid.
93 IT-504R, supra footnote 85, at paragraph 5.
94 Supra footnote 71.
95 Supra footnote 60.
These sorts of cases illustrate the obstacles that face the taxpayer if the “reasonable expectation of profit” concept is applied. In Tobias v. The Queen, Revenue Canada attempted to deny the losses incurred on a failed expedition of deep-sea diving for buried treasure. The court quashed the reassessments and permitted the losses to be claimed on the basis that the potential rewards justified the high risk taken. Although the taxpayer in Tobias was successful, it is too easy for Revenue Canada, with hindsight, to challenge a failed venture. Not surprisingly, when a deep-sea treasure hunt turned out to be successful in MacEachern v. MNR, Revenue Canada assessed the treasure find as business profits. Even though the risks were very high, and the Tax Court summarized the possibility of success when the venture started as being “slight,” the court upheld the assessment in MacEachern.

How does a taxpayer argue that there was no reasonable expectation of profit once a profit has been earned? As put by Mr. Justice Bowman in Bélec v. The Queen, Revenue Canada should not be able 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.” Consider the many speculative transactions that yield a gain and that are assessed by Revenue Canada as adventures in the nature of trade. The case has yet to be seen in which Revenue Canada has backed off such an assessment on the grounds that there was no reasonable expectation of profit! The “reasonable expectation of profit” test never enters the picture when Revenue Canada seize upon a successful venture.

**Financing**

The other conundrum in the application of the “reasonable expectation of profit” test is the way in which a particular venture is capitalized. Often the difference between a successful business and an unsuccessful one will depend on how heavily the taxpayer has financed the business and on the market rates of interest. To a certain extent it is difficult to see why the characterization of an otherwise bona fide commercial venture as a source should depend on whether the owner capitalizes it with his or her own funds or with borrowed funds. Should the existence of a source for income tax purposes depend so heavily on the debt-to-equity ratio?

In addition, the financing sometimes can be structured in different ways, with a dramatic effect on the bottom line. If, for example, a partnership is financed internally, the revenue projections will be fundamentally different than if the partners finance themselves externally and contribute capital to the partnership. Should the “reasonable expectation of profit” test be applied at the partnership level or the partner level? The same
question will arise with a corporate entity, depending on whether it is the corporation or the shareholder that undertakes the financing. It is worthwhile noting that Revenue Canada generally seems to have no difficulty when a shareholder deducts an interest expense incurred in purchasing common shares of a Canadian corporation, whether or not a dividend flow is anticipated. In fact, the one source that Revenue Canada apparently has yet to challenge on the basis that a reasonable expectation of profit is lacking appears to be equity investments in Canadian corporations.

THE TEST FOR “BUSINESS” IN OTHER COUNTRIES

A brief investigation of the income tax systems of some other countries indicates that Canada alone has tilted so strongly in the direction of a “reasonable expectation of profit” test.

England

In England, profits “in respect of any trade carried on” are taxable pursuant to schedule D, case I of the Income and Corporation Taxes Act 1988. “Trade” is defined in section 832(1) of the Income and Corporation Taxes Act 1988 to include “every trade, manufacture, adventure or concern in the nature of trade.” Aside from the early betting cases, few cases in England (other than tax avoidance cases) appear to have dealt directly with distinguishing trade from non-commercial activities. The question generally has been determined by asking whether the activity is being carried on on a commercial basis with a view to earning profit. A reasonable expectation of profit has not been required.

Australia

In Australia, income taxes are levied under the Income Tax Assessment Act. The inclusionary definition of “business” in section 6(1) of that act is similar to the definition of “business” in subsection 248(1) of the ITA. The degree of organization and other standard commercial indicia are applied to determine whether there is a business. Apparently, some Australian cases contain dicta to the effect that there must be a reasonable expectation of profit. However, the authors of a leading Australian text on income taxation conclude that this is not the better view:

These two decisions contain dicta which also suggest the intention of the taxpayer to make profits in the long term must be based on reasonable

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99 This position was confirmed by the Department of Finance in the technical notes accompanying the proposed new paragraph 20(1)(qq) in the December 20, 1991 draft interest expense legislation (not yet enacted: see Canada, Department of Finance, Release, no. 91-141, December 20, 1991). However, see Ludmer et al. v. MNR, 93 DTC 1351 (TCC) and 94 DTC 6221 (FCTD).


grounds. With respect, this overstates the position. The “genuineness” of the taxpayer’s intention is the critical factor, not the “reasonableness.” Lack of “reasonableness” will obviously affect the credibility of taxpayers when they are attempting to establish a genuine belief. But the court did not emphasize the reasonableness of . . . the taxpayers in [other cases] and . . . accepted the genuineness of the taxpayers although they were “misguided.”

United States

The income taxation laws in the United States are set out in the Internal Revenue Code. Section 162(a) of the IRC allows the deduction of expenses paid or incurred “in carrying on any trade or business.” However, “if such activity is not engaged in for profit,” the deduction of expenses is limited to gross income by section 183 of the IRC.

IRC reg. section 1.183-2(a) states that “the determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case” and that the taxpayer must have the “objective of making a profit.” It is sufficient that the taxpayer has a bona fide expectation of realizing a profit, regardless of the reasonableness of such an expectation.

IRC reg. section 1.183-2(b) sets forth a number of factors to be considered, such as the manner in which the taxpayer carries on the activity, the taxpayer’s expertise, the time and effort expended, the expectation that assets used may appreciate in value, the history of income or losses in the activity, the taxpayer’s financial status, and elements of personal pleasure or recreation involved in the activity.

When section 183 of the IRC was enacted, a “reasonable expectation of profit” requirement apparently was contemplated by Congress but rejected on the basis that it would inappropriately deny losses in certain situations where Congress believed such a result would be inappropriate: the examples given were “the case of a bona fide inventor or a person who invests in a wildcat oil well. . . . [or] the case of a poor person engaged in what appears to be an inefficient farming operation.”

SELECTING A STANDARD FOR THE FUTURE

Given that, since Moldowan, the courts and Revenue Canada consider the “reasonable expectation of profit” concept to be an essential component of “business” and that it functions independently of the “personal or living

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104 Internal Revenue Code of 1986, as amended (herein referred to as “the IRC”).


expenses” definition in subsection 248(1) of the ITA, any activity or undertaking is subject to review on this basis.

In *Landry v. The Queen*, in reviewing the losses suffered by an elderly lawyer in his law practice, the majority of the Federal Court of Appeal took the position that the taxpayer, although he practised full time, was conducting his practice so inefficiently that there was no reasonable expectation of profit and therefore no business. The majority of the court reached this conclusion on an assessment of the taxpayer’s business judgment, not because of any finding that he was practising as a hobby or otherwise for enjoyment. In a dissenting judgment, Mr. Justice Marceau emphasized that the taxpayer was not in practice for his own pleasure and concluded that there was a reasonable expectation of profit. However, he did not directly challenge the finding that the “reasonable expectation of profit” test was the appropriate test to determine the existence of a source or business.

One writer, in a critical analysis of the majority judgment in *Landry*, has suggested that the question ought to be whether the taxpayer has incurred the losses in an activity carried out with a genuine commercial intent or whether the expenditures were made for personal benefit or pleasure; if the venture was commercially motivated, the courts should not be testing the taxpayer’s business judgment by trying to determine whether there was a reasonable expectation of profit.

While very few cases in the last 20 years seem to have taken the position that reasonable expectation of profit should be only one of the criteria (as opposed to being a condition precedent) used in determining whether there is a business, Mr. Justice Bowman in *Nichol v. The Queen*, a 1993 decision, expressed some serious doubts as to the singular importance Revenue Canada places on the “reasonable expectation of profit” concept. He made it clear that Revenue Canada should not quickly substitute its judgment for the taxpayer’s:

> [The taxpayer] 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 Revenue might not make today.

Before the definition of “personal and living expenses” was added to the IWTA in 1939, the law as set out in *Hatch v. MNR* appeared to be

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107 Supra footnote 66 (FCA).


109 Supra footnote 71.

110 Ibid., at 1219 (emphasis added). See also *J. Collins v. MNR*, [1993] 2 CTC 2181 (TCC); and *Bélec*, supra footnote 98.

111 Supra footnote 10.
that one determined whether a loss activity was a source or a business by examining the intention or motivation of the taxpayer, and that the taxpayer’s intention could be challenged by considering the taxpayer’s course of conduct. The 1939 amendment to the IWTA included in the definition of “personal or living expenses” the dual requirements that the business be carried on “bona fide” for profit and with a reasonable expectation of profit. This elevated the “reasonable expectation of profit” concept for the first time (at least in the context of that definition) to the status of a condition precedent to business instead of just one criterion to be considered in the mix.

Clearly, the intention to make a profit is inseparable from the concept of “business” or “source” generally. On the one hand, it can be understood that the fisc naturally will resist absorbing the cost of losses arising from totally unrealistic ventures—what Mr. Justice Bowman has referred to as “idealistic labour[s] of love.” On the other hand, to what degree should the income tax system attempt to filter out failed ventures that are bona fide commercially motivated but that supposedly have or had no reasonable expectation of profit? In regard to the latter, the Canadian courts have never seriously analyzed the inherent problems in the “reasonable expectation of profit” test, which seems to have come into Canadian legislation and jurisprudence somewhat by happenstance.

Aside from the farming and related animal-breeding or horse-racing cases in which the definition of “personal or living expenses” was inevitably raised, until the 1970s the other Canadian cases that dealt with the basic concept of “source versus hobby” emphasized that one was to determine the commercial bona fides of the taxpayer by looking at the taxpayer’s stated intention in the light of all the surrounding circumstances. This early case law did not question the reasonableness of the taxpayer’s expectations, but examined intention and behaviour.

It is submitted that the appropriate test for the existence of a “source” ought not to be whether there is a reasonable expectation of profit but whether the taxpayer can establish that his or her predominant intention is to make a commercial profit in the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour. This is consistent with paragraph 18(1)(a) of the ITA, which looks to the purpose of the expense. Such a test recognizes that the taxpayer’s stated intention is important, but at the same time requires that the bona fides of the taxpayer’s stated intention must be substantiated by the taxpayer’s conduct, and that, in any event, to constitute a business or other source there must be a requisite amount of effort and commitment to further the activity’s profit-making prospects. In applying such a test

112 Supra footnote 71, at 1218.
113 See Walker, supra footnote 45; and Morden, supra footnote 47.
(hereinafter referred to as the “good faith intention and business behaviour” test), a limited or unorganized effort to make a profit would cast doubt on the intention and might point to a casual undertaking for personal pleasure. The practical application of this test would not be dissimilar to the “adventure in the nature of trade” cases, which distinguish transactions on income account from transactions on capital account by analyzing whether the taxpayer’s alleged intention in purchasing the subject asset for investment has been proved or disproved by objective facts.\(^{115}\)

A “good faith intention and business behaviour” test would not expose the fisc to any material risk. The requirement of predominant intention to profit would favour Revenue Canada where there was an ambiguous motive. The requirement of a commercial profit would exclude expenditures incurred only to effect a tax reduction. With respect to farming activity, which is involved in a preponderance of the cases, section 31 of the ITA (with its own interpretive problems) still puts a ceiling on the use of losses if the farming is not a chief source.

\textit{Lorentz v. MNR} is one of the few cases in which a court has attempted to summarize the evidentiary burden that must be met by a taxpayer:

\begin{quote}
[The taxpayer] must place evidence before the Court from which it can be objectively concluded that his conduct was that which could be expected of a reasonably prudent person becoming involved in a commercial undertaking designed to extract profit.\(^{116}\)
\end{quote}

It is submitted (perhaps ironically) that the formulation put forward by Mr. Justice Christie is not literally a test for reasonable expectation of profit but actually resembles the “good faith intention and business behaviour test” suggested above. Mr. Justice Christie’s formulation looks to the behaviour (“conduct”) that is expected of the taxpayer—not the expected prospects of profit—in the light of an intention (“design”) to make a profit. Although the two are not totally separable, it is easier, and makes more sense, to judge a taxpayer’s conduct than to judge the prospects of a business.

Admittedly, a “good faith intention and business behaviour” test is no panacea if one is looking for a foolproof way to determine on which side of the line each case falls. The objective standards of business behaviour to which the courts would look would be much the same as those that have been used in the past in supposedly determining whether a reasonable expectation of profit existed. The outcome of many cases may be no different under a “good faith intention and business behaviour” test than under a “reasonable expectation of profit” test—especially, for instance, with respect to the vacation property rental cases. However, a “good faith intention and business behaviour” test will shift the focus to the taxpayer’s conduct

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\(^{115}\) See \textit{Happy Valley Farms Ltd. v. The Queen}, 86 DTC 6421 (FCTD).

\(^{116}\) 85 DTC 131, at 132 (TCC), per Christie J. See also \textit{Lobban v. MNR}, 92 DTC 2196, at 2202, where the Tax Court of Canada disallowed expenses that in its view no “reasonable businessman would have made.”
and whether commercial methods have been adopted, and away from an assessment of the taxpayer’s business judgment. It should also lessen the difficulties discussed previously concerning what the measure of profits is supposed to be when the taxpayer has to establish that he or she has a reasonable expectation of same. It is submitted that cases such as *Sirois v. MNR*,117 *Derome v. The Queen*,118 and *Landry v. The Queen*119 may well have been differently decided if they had been examined in this light.

The “good faith intention and business behaviour” test should be capable of application to the cases concerning vacation home rental, even though they technically deal with a property source (if a source at all) and not a business source. Although the activity in such cases is more passive, the taxpayer still would have to satisfy the test as to intention to profit and requisite commercial (if not technically “business”) behaviour. To the extent that personal use is made of vacation homes that otherwise qualify as a source, expenses allocated to personal-use time would be non-deductible in the same way that expenses in respect of an automobile or any other mixed-use asset are bifurcated.

There will always be cases that are difficult to decide no matter what test is applied. An inventor or artist or treasure hunter may undertake an activity that 99 percent of the population will consider a hopeless effort—an “impossible dream,” in Mr. Justice Decary’s words.120 Nonetheless, cases such as *Weinberger v. MNR*121 (in which it took the taxpayer 20 years to perfect a lucrative invention) prove the exception and the tenacity of human endeavour.

One or two specific issues should be mentioned. It is submitted that the potential long-term appreciation of capital assets should be considered as at least one factor in assessing the businesslike qualities of the endeavour: it is illogical to completely ignore the possibility for appreciation, which may be a business consideration in the matter though not an operating motivation. Revenue Canada seems to accept this idea with respect to equity investments in corporations but not with respect to real estate investments. With real estate investments, Revenue Canada presumably wants to prevent the recovery by a taxpayer of ordinary deductions through capital appreciation, since capital gains are not fully taxable under the ITA, but this does not mean that the possibility of capital appreciation should be entirely ignored as a business consideration.

Further, it is submitted that highly speculative ventures should be judged in the context of the size of the ultimate profit that might be realized—the reward-to-risk ratio rather than the probability of success.122

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117 Supra footnote 73.
118 93 DTC 25 (TCC).
119 Supra footnote 66 (FCA).
120 Ibid., at 6625. See also *Hugill v. The Queen*, 95 DTC 5311, at 5311 (FCA).
121 60 DTC 322 (TAB).
122 See *Huband*, supra footnote 60.
business people will bet on long shots if the potential winnings are large enough.

A “good faith intention and business behaviour” test might be criticized on the basis that a taxpayer would have to prove his or her sincerity rather than his or her realism. The response to this is threefold. First, the test of predominant intention is rigorous, and, barring an ulterior tax avoidance motive,\textsuperscript{123} it will be the rare taxpayer who will commit to a non-commercial undertaking if the primary purpose is not personal pleasure. While people may derive pleasure from their work, not many will incur continuing losses out of pure passion for their labour unless their activity is in reality a hobby or a recreation:

Appellant was engaged in a farming undertaking, which, from the outset, occupied a great deal of his time, attention and labour. I am also satisfied on the evidence that appellant’s purpose was profit. I cannot believe that anyone would spend the back-breaking hours and days and months which appellant spent on this farm in clearing it, felling the trees, piling the lumber and then building his home and seeding the cleared portion as a hobby or for pleasure. Appellant said his purpose was profit, that he eventually expected to make a living on the farm for his family and I accept his evidence in this connection.\textsuperscript{124}

Second, if the taxpayer’s predominant intention is to make a profit and the taxpayer makes a legitimate effort toward that end, should the loss be denied if the expenses are commercially motivated and not lifestyle expenses?

Where we have a property whose purpose is the production of rent from arm’s length tenants, and there is no element of personal use or enjoyment involved, the question must be asked “If the purpose of the expenditures is not to earn income, what then is its purpose?” . . . . It was not suggested that the appellants’ purpose in incurring the expenses was other than that normally associated with the holding of a rental property. The property was obviously not held as a hobby, or with a view of moving into it as a residence for the appellants. There was no element of personal use or enjoyment.\textsuperscript{125}

Third, there is value in promoting legitimate risk taking. The “taking [of] a risk is the very essence of a venture,”\textsuperscript{126} and, as at least one court has recognized, “many of the successful business operations in Canada today, at their inception, might well have been similarly judged as hopeless by all but the entrepreneur himself.”\textsuperscript{127}

\textsuperscript{123} For instance, see Lipson, supra footnote 88, where an attempt to convert a capital advance into a loss-producing lease was struck down.

\textsuperscript{124} C.G. Harris v. MNR, [1974] CTC 801, at 806–7 (FCTD).

\textsuperscript{125} Eleuteri v. The Queen, [1995] ETC 329 (TCC). See also Samansky, supra footnote 106, at 61, where he makes the point that, “[o]ther things being equal, a person with a salary of $100,000 who loses $20,000 in an unsuccessful business venture that he does not enjoy has the same ability to pay tax as someone else with an $80,000 salary and no business losses.”

\textsuperscript{126} Crépeau v. MNR, 65 DTC 99, at 102 (TAB).

\textsuperscript{127} J.R. Zavitz v. MNR, [1978] CTC 3021, at 3026 (TRB).
It is submitted that paragraph (a) of the definition of “personal or living expenses” in subsection 248(1) of the ITA is pointless and confusing when it incorporates a “reasonable expectation of profit” test specifically in regard to the personal use of properties. The denial of a deduction for “personal or living expenses” is contained in paragraph 18(1)(h), which seems to presuppose the existence of a business or property source, since the opening words of that provision relate to the computation of “the income of a taxpayer from a business or property.” Any concern over personal expenses that a taxpayer might attempt to disguise as business expenses is adequately dealt with by the purpose test in paragraph 18(1)(a) and by section 67, which requires that an expense be reasonable in the circumstances and which the courts have interpreted as a test of whether a “reasonable business man would have contracted to pay such an amount having only the business consideration of the [taxpayer] in mind.” It is submitted that paragraph (a) of the definition of “personal or living expenses” ought to be deleted from the ITA.

With respect to the requirement to carry on the same business with a reasonable expectation of profit that appears in subsection 111(5) and in the other change-of-control provisions in the ITA relating to various tax credit and loss carryforwards, numerous reported cases have addressed the question whether the same business has been continued, but very few have looked at the “reasonable expectation of profit” test in those provisions. While it is imaginable that a corporation might find it worthwhile to continue to carry on an activity at a present (smaller) loss in order to be able to use up a larger amount of previous losses or credits, apparently such situations have not frequently presented themselves. It is doubtful that any greater advantage was taken of subsection 111(5) before the reference to “reasonable expectation of profit” was introduced in 1981. If this reference was deleted from subsection 111(5) and the other change-of-control provisions, Revenue Canada would still have the necessary means to deal with the wilful continuation of a loss activity after a change of corporate control: it would challenge the lack of intention to profit (so that there was no business to begin with) or it would assess on the basis of paragraph 18(1)(a) and the general anti-avoidance rule in section 245.

It is submitted, with respect, that Mr. Justice Bowman’s decision in Nichol v. The Queen implicitly recognizes the principles involved in a “good faith intention and business behaviour” test. If it is otherwise believable that the taxpayer is carrying on the particular activity or undertaking in good faith and with the predominant intention to profit (that is, if the taxpayer is able to demonstrate he or she is committed and

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128 Gabco Ltd. v. MNR, 68 DTC 5210, at 5216 (Ex. Ct.). See also N. Cipollone v. The Queen, [1995] 1 CTC 2598 (TCC); and Eleuteri, supra footnote 125, to the same effect.

129 The only case found by the writer regarding the “reasonable expectation of profit” test in subsection 111(5) is Garage Montplaisir Ltée v. MNR, 92 DTC 2317 (TCC).

130 Supra footnote 71.
knowledgeable, is sufficiently organized, etc.), then Revenue Canada should not pretend to go through the exercise of determining whether an activity that has in fact lost money could have made money if it had been managed differently, or if interest rates had not risen, or if this, that, or some other external event had occurred or not occurred. A good percentage of new businesses prove to be ill conceived. It is impractical to attempt to sort out which failed businesses had reasonable prospects for success after losses have already occurred. Can Revenue Canada legitimately deny that it would have sought to tax any of the ventures in which it has denied losses had the ventures actually earned a profit through some windfall reversal of fortunes?

It is to be cautiously hoped that in the future, the courts, if not Revenue Canada, will realize that the “reasonable expectation of profit” test is unsound in many respects. The test evolved haphazardly, and the law would be better served if it reverted to the older framework, which, in determining whether a source existed, placed the emphasis on judging intention and conduct rather than on the prospects of success for the taxpayer’s enterprise. As well, appropriate safeguards are contained in paragraph 18(1)(a) and section 67 of the ITA to prevent personal expenses from being disguised as deductible business or property expenses.