Stewart v. Canada

Brian J. Stewart, appellant;
v.
Her Majesty The Queen, respondent.

[2002] 2 S.C.R. 645
[2002] S.C.J. No. 46
2002 SCC 46
File No.: 27860.

Supreme Court of Canada

2001: December 12 / 2002: May 23.

Present: McLachlin C.J. and L'Heureux-Dubé, Gonthier, Iacobucci, Major, Bastarache, Binnie, Arbour and LeBel JJ.

ON APPEAL FROM THE FEDERAL COURT OF APPEAL (69 paras.)

Income tax — Source of income — Test to determine whether taxpayer has business or property source of income — Whether "reasonable expectation of profit" test appropriate test — Income Tax Act, S.C. 1970-71-72, c. 63, s. 9.

The appellant, an experienced real estate investor, acquired four condominium units from which he earned rental income. The properties were part of a syndicated real estate development, and were sold on the basis that the purchaser would be provided with a turnkey operation, that management would be provided, and that a rental pooling agreement would be entered into. All units were highly leveraged with the appellant paying only $1,000 cash for each unit. The appellant was provided with projections of rental income and expenses in respect of each of the properties. The projections contemplated negative cash flow and income tax deductions for a ten-year period. However, the actual rental experience ended up being worse than what had been set out in the projections. For the taxation years 1990 to 1992, the appellant claimed losses, mainly as a result of significant interest expenses on money borrowed to acquire the units. These losses were disallowed by the Minister of National Revenue on the basis that the taxpayer had no reasonable expectation of profit and therefore no source of income for the purposes of s. 9 of the Income Tax Act, and that the interest expenses were not deductible pursuant to s. 20(1)(c)(i) of the Act. Both the Tax Court [page646] of Canada and the Federal Court of Appeal upheld the decision.

Held: The appeal should be allowed.

The "reasonable expectation of profit" test should not be accepted as the test to determine whether a taxpayer's activities constitute a source of income for the purposes of s. 9 of the Income Tax Act. In recent years, this test has become a broad-based tool used by both the

commercial decisions of the taxpayer and therefore runs afoul of the principle that courts should avoid judicial rule-making in tax law. The test is problematic owing to its vagueness and uncertainty of application; this results in unfair and arbitrary treatment of taxpayers.

The following two-stage approach should be employed to determine whether a taxpayer's activities constitute a source of business or property income: (i) Is the taxpayer's activity undertaken in pursuit of profit, or is it a personal endeavour? (ii) If it is not a personal endeavour, is the source of the income a business or property? The first stage of the test is only relevant when there is some personal or hobby element to the activity. Where the nature of an activity is clearly commercial, the taxpayer's pursuit of profit is established. There is no need to take the inquiry any further by analysing the taxpayer's business decisions. However, where the nature of a taxpayer's venture contains elements which suggest that it could be considered a hobby or other personal pursuit, the venture will be considered a source of income only if it is undertaken in a sufficiently commercial manner. In order for an activity to be classified as commercial in nature, the taxpayer must have the subjective intention to profit and there must be evidence of businesslike behaviour which supports that intention. Reasonable expectation of profit is no more than a single factor, among others, to be considered at this stage.

The deductibility of expenses, which presupposes the existence of a source of income, should not be confused with the preliminary source inquiry. Once it has been determined that an activity has a sufficient degree of commerciality to be considered a source of income, the [page647] deductibility inquiry is undertaken according to whether the expense in question falls within the words of the relevant deduction provision(s) of the Act. 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. To disallow deductions based on a reasonable expectation of profit analysis would amount to a case law stop-loss rule which would be contrary to established principles of interpretation which are applicable to the Act. As well, unlike many statutory stop-loss rules, once deductions are disallowed under the "reasonable expectation of profit" test, the taxpayer cannot carry forward such losses to apply to future income in the event the activity becomes profitable.

In sum, whether a taxpayer has a source of income from a particular activity is determined by considering whether the taxpayer intends to carry on the activity for profit, and whether there is evidence to support that intention. In this case, the taxpayer purchased four rental properties which he rented to arm's length parties in order to obtain rental income. A property rental activity which, as here, lacks any element of personal use or benefit to the taxpayer is clearly a commercial activity. As a result, the appellant satisfies the test for source of income and is entitled to deduct his rental losses. Section 20(1)(c)(i) of the Income Tax Act, which permits the deduction of interest on borrowed money for the purpose of earning income from a business or property, is not a tax avoidance mechanism and, in light of the specific anti-avoidance provisions in the Act, courts should not be quick to embellish provisions of the Act in response to tax avoidance concerns. In addition, since a tax motivation does not affect the validity of transactions for tax purposes, the appellant's hope of realizing an eventual capital gain and expectation of deducting interest expenses do not detract from the commercial nature of his rental operation or its characterization as a source of income.

Cases Cited

Restricted: Moldowan v. The Queen, [1978] 1 S.C.R. 480; *referred to*: Mohammad v. Canada, [1998] 1 F.C. 165; Landry v. Ministre du Revenu national (1994), 173 N.R. 213; Hugill v. The Queen, 95 D.T.C. 5311; Sirois [page648] v. M.N.R., 88 D.T.C. 1114; Tonn v. Canada, [1996] 2 F.C. 73; Corbett v. Canada, [1997] 1 F.C. 386; Allen v. The Queen, 99 D.T.C. 968, aff'd 2000 D.T.C. 6559 (sub nom. The Queen v. Milewski); Nichol v. The Queen, 93 D.T.C. 1216; Bélec v. The Queen, 95 D.T.C. 121; Kaye v. The Queen, 98 D.T.C. 1659; Dorfman v. M.N.R., [1972] C.T.C. 151; Smith v. Anderson (1880), 15 Ch. D. 247; Terminal Dock and Warehouse Co. v. M.N.R., [1968] 2 Ex. C.R. 78, aff'd 68 D.T.C. 5316; Erichsen v. Last (1881), 4 T.C. 422; Hickman Motors Ltd. v. Canada, [1997] 2 S.C.R. 336; Ludco Enterprises Ltd. v. Canada, [2001] 2 S.C.R. 1082, 2001 SCC 62; Canderel Ltd. v. Canada, [1998] 1 S.C.R. 147; Roopchan v. The Queen, 96 D.T.C. 1338; Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411; Shell Canada Ltd. v. Canada, [1999] 3 S.C.R. 622; Engler v. The Queen, 94 D.T.C. 6280; Neuman v. M.N.R., [1998] 1 S.C.R. 770; Walls v. Canada, [2002] 2 S.C.R. 684, 2002 SCC 47.

Statutes and Regulations Cited

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), ss. 18(1)(a), (h), 248(1) "personal or living expenses" [am. 2000, c. 12, s. 142 (sch. 2, s. 9(r))].
Income Tax Act, S.C. 1970-71-72, c. 63 [now R.S.C. 1985, c. 1 (5th Supp.)], ss. 3(a), 9(1), (2), 13, 18(1)(a), (h) [rep. & sub. 1988, c. 55, s. 10(3)], 20(1)(c)(i), 67, 248(1) "personal or living expenses".
Income War Tax Act, R.S.C. 1927, c. 97 [previously S.C. 1917, c. 28], ss. 2 "personal and living expenses" [ad. 1939, c. 46, s. 2], 6(f).

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APPEAL from a judgment of the Federal Court of Appeal (2000), 254 N.R. 326, 2000

Court of Canada, 98 D.T.C. 1600, [1998] 3 C.T.C. 2662, [1998] T.C.J. No. 310 (QL). Appeal allowed.

Richard B. Thomas and Lisa Wong, for the appellant. Richard Gobeil and Donald G. Gibson, for the respondent.
[Quicklaw note: Please see complete list of solicitors appended at the end of the judgment.]

The judgment of the Court was delivered by

IACOBUCCI and BASTARACHE JJ.:—

I. Introduction

¶ 1 This appeal requires the Court to consider the appropriate use of what has come to be known as the "reasonable expectation of profit" test. The test originated with the following comments of Dickson J. (as he then was) in the seminal case of Moldowan v. The Queen, [1978] 1 S.C.R. 480, at p. 485:

> 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 ....

¶ 2 Since then, decisions 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.

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¶ 3 The present appeal is just such a case. The appellant, Brian Stewart, purchased four condominium units from which he earned rental income. For the tax years in question, the appellant incurred losses, mainly as a result of significant interest expenses. These losses were disallowed by the Minister on the basis that the taxpayer had no reasonable expectation of profit, and therefore no source of income.

¶ 4 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.

¶ 5 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 [page651] 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.

¶ 6 In the present appeal, the taxpayer purchased four rental properties which he rented to arm's length parties in order to obtain rental income. There was no personal element to the taxpayer's endeavour, and its commercial nature was never questioned. As a result, the appellant's rental activities constitute a source of income from which he is entitled to deduct his rental losses. We would therefore allow the appeal.

II. Facts

¶ 7 The appellant held senior positions with the Toronto Transit Commission in the years 1990 to 1992, the tax years relevant to this appeal. Between 1986, and 1992, his annual income ranged from $65,000 to over $90,000. The appellant was also an experienced real estate investor and had in the past acquired and disposed of several rental properties.

¶ 8 In 1986, the appellant acquired the four condominium rental units that are the subject of this appeal. The properties were part of a syndicated real estate development promoted by the Reemark Group, and were sold on the basis that the purchaser would be provided with a turnkey operation, that management would be provided, and that a rental pooling agreement would be entered into. The Reemark Group also arranged financing for the projects.

¶ 9 The first two units, the "White Oaks" units, located in London, Ontario, were purchased for $72,990 each. These units were financed by a first mortgage of $52,553, initially amortized over a 30-year period. Additional financing came in the form of two promissory notes totalling $19,437. The second two units, the "Park Woods" units, located in Surrey, British Columbia, were purchased for $74,990 and $58,990 and were similarly financed. All units were highly leveraged with the appellant [page652] paying only $1,000 cash for each unit. The appellant was provided with projections of rental income and expenses in respect of each of the properties. The projections contemplated payout of the promissory notes over a period of years terminating in 1994. They also projected negative cash flow and income tax deductions for a ten-year period in all cases. However, the actual rental experience of the four units ended up being worse than what had been set out in the projections provided by Reemark to the appellant, owing to worse than expected rental and vacancy rates.

¶ 10 The appellant tried to reduce the amount of financing on the units. In 1991, he increased the frequency of first mortgage payments on the units from monthly to weekly, thereby reducing the amortization period significantly. He sold one of the Park Woods units in 1991 and used the proceeds to pay down the debt on the other unit. By 1994, the appellant had paid off the promissory notes on all of the units. The appellant also exited the White Oaks rental pool arrangement in 1995 because of high vacancies and poor management and set up his own management company. In 1996, he changed management companies for the Park Woods unit.

¶ 11 For the taxation years 1990, 1991 and 1992, the appellant claimed losses of $27,814, $18,673 and $12,306, respectively. The losses resulted primarily from interest expenses on money borrowed to acquire the units. The Minister of National Revenue reassessed the appellant, disallowing his losses on the units for these taxation years solely on the basis that he had no reasonable expectation of profit for the years in question.

¶ 12 The appellant argued that the fact that the purchases were almost 100 percent financed was not [page653] determinative of whether he had a reasonable expectation of profit, and he argued that he should be able to deduct the carrying charges for monies borrowed to finance the rental losses. The respondent argued that the appellant had had no reasonable expectation of profit but had purchased the properties as a tax shelter, attracted by the promises of income tax deductions and capital gains projections promoted by the vendor Reemark. The appellant had followed the vendor's plan instead of following his usual investment practices, and chose not to pay down the debt owing at times when he clearly had money with which to do so.

¶ 13 The Tax Court of Canada found that the appellant's rental losses were not deductible in computing his income for income tax purposes because there was no reasonable expectation of profit. The Federal Court of Appeal dismissed the appeal.

III. Relevant Statutory Provisions

¶ 14 Income Tax Act, S.C. 1970-71-72, c. 63 (now R.S.C. 1985, c. 1 (5th Supp.))

> 9. (1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is his profit therefrom for the year.
>
> 18. (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> (a) 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;
>
> ...
>
> (h) personal or living expenses of the taxpayer, other than travelling expenses incurred by the taxpayer while away from home in the course of carrying on his business;

> 20. (1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that [page654] source or such part of the following amounts as may reasonably be regarded as applicable thereto:
>
> ...
>
> (c) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on
>
> (i) borrowed money used for the purpose of earning income from a business or property...
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> ...
>
> or a reasonable amount in respect thereof, whichever is the lesser;
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> 248. (1) In this Act,
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> ...
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> "personal or living expenses" includes
>
> (a) 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 ....

IV. Judgments Below

A. Tax Court of Canada, 98 D.T.C. 1600

¶ 15 McArthur J.T.C.C. characterized the issue as whether the appellant had a reasonable expectation to profit from the subject rental properties such that there existed a source of income from which he could deduct rental losses incurred in the years under appeal. While recognizing that the comments of Robertson J.A. in Mohammad v. Canada, [1998] 1 F.C. 165 (C.A.), in respect to reasonable expectation of profit were obiter, McArthur J.T.C.C. found them to be instructive and of assistance in determining the outcome. In light of these comments, he considered the crux of the appeal to be whether the appellant possessed the intention to pay down the principal on the rental units, regardless of whether this actually occurred. Without an intention to reduce the amount of the principal owing on each [page655] unit, there could be no reasonable expectation of profit.

¶ 16 According to McArthur J.T.C.C., the effect of the Reemark plan was to use rental losses to offset income and then to realize a gain at the end of the day from the expected capital appreciation of the properties. Accordingly, the Reemark plan held out no expectation of profit from rental income.

¶ 17 While noting that the appellant deviated from the Reemark plan somewhat, McArthur J.T.C.C. found instructive the fact that the appellant had deviated from his usual practice of paying down 25 percent of the purchase price on his prior rental property investments in order to reduce the risk that income expenses would exceed rental income. He also emphasized that in 1988 the appellant chose to advance $40,000 in principal toward the purchase of a condominium for his own use, and, in 1990, he sheltered $50,000 in an RRSP rather than paying down more of the indebtedness. Thus, he had several opportunities to reduce the outstanding indebtedness and chose not to. McArthur J.T.C.C. concluded that having considered all the evidence, he was not satisfied that the plan the appellant followed was realistic in its ability to pay down a sufficient portion of the principal on the subject properties so as to create a positive cash flow. As a result, he concluded that the reasonable expectation of profit test was not satisfied, and therefore that the appellant had no source of income from which to deduct expenses under s. 20(1)(c).

B. Federal Court of Appeal (2000), 254 N.R. 326

¶ 18 Rothstein J.A. for the court noted that the reasonable expectation of profit test derives from the well-known case of Moldowan, supra. In that case, Dickson J. determined that in order to have a source of income for purposes of the Act, the taxpayer must have a profit or a reasonable expectation of profit. The appellant argued that the Moldowan test only [page656] applied where there was an element of personal use, and so did not pertain to the properties in question. Rothstein J.A. disagreed, saying, at para. 7 that "[t]he Moldowan principle is that in order to have a source of income, the taxpayer must have a profit or a reasonable expectation of profit."

¶ 19 Rothstein J.A. commented that the reasonable expectation of profit test is not an opportunity for the Minister to second-guess the business judgement of the taxpayer, but found that this was not why the learned Tax Court judge found that there was no reasonable expectation of profit in this case. According to Rothstein J.A., the lower court's finding was based on the fact that the Reemark plan held out no expectation of profit from the rental income, and instead offered rental losses to offset other income and eventually realize a gain from the appreciation in value of the property. Rothstein J.A. also accepted the Tax Court judge's finding that the appellant did not have a realistic plan to produce a profit. It followed that there was no source of income, and therefore that the interest expenses claimed by the appellant were not deductible pursuant to s. 20(1)(c).

V. Issues

¶ 20 1. Is the "reasonable expectation of profit" test set out by the Court in Moldowan the test for determining whether the taxpayer has a business or property source of income under the Act? If not, what is the test?

2. Did the courts below err in disallowing the appellant's interest expense deductions pursuant to the provisions of s. 20(1)(c) of the Act on the basis that there was no source of income?

[page657]

VI. Analysis

A. The Test to Determine Whether the Taxpayer has a Business or Property Source of Income Under the Act

(1) A Brief Overview of the Cases Leading up to Moldowan

¶ 21 It well accepted that the Canadian tax system adopted the concept of "source" from the English taxation statutes, and that the Act has always referred to income from various "sources": see V. Krishna, The Fundamentals of Canadian Income Tax (6th ed. 2000), at pp. 102-3. However, the term "source" is not defined in the Act, and it has been left to courts to determine the nature and scope of the various sources of income in the Act.

¶ 22 With respect to the phrase "reasonable expectation of profit", this wording first appeared in the Income War Tax Act, R.S.C. 1927, c. 97 (previously S.C. 1917, c. 28) ("IWTA"), through a 1939 amendment which added a definition of "personal and living expenses" to the IWTA: S.C. 1939, c. 46, s. 2. That amendment 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 a profit;

This definition was relevant to s. 6(f) of the IWTA which read, "[i]n 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 phrase "reasonable expectation of profit" still appears in the virtually unaltered definition of "personal or living expenses" (now found in s. 248(1)), which in turn relates to s. 18(1)(h). Section 18(1)(h) disallows the deduction of personal or living expenses from business or property [page658] income. It can be seen, therefore, that the statutory use of the phrase "reasonable expectation of profit" has changed little since its introduction into the IWTA.

¶ 23 Despite this fairly restrictive statutory use of the term "reasonable expectation of profit" (to disallow deductions for expenses of properties not maintained in connection with a business carried on with a reasonable expectation of profit), one author notes that several cases began to expand the use of the phrase in viewing "reasonable expectation of profit" as a general requirement of the "source of income" concept:

> 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." [[1964] C.T.C. 45, at p. 51 (Ex. Ct.)] Seven years later, in 1971, the Federal Court -- Trial Division in CBA Engineering Ltd. v. MNR [71 D.T.C. 5282, at p. 5286] 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" [[1972] C.T.C. 151, at p. 154].
> (C. Fien, "To Profit or Not to Profit: A Historical Review and Critical Analysis of the 'Reasonable Expectation of Profit' Test" (1995), 43 Can. Tax J. 1287., at p. 1298)

From this, the author concludes at p. 1299 that "[i]t appears that CBA Engineering Ltd., Dorfman, and [D.A.] Holley [v. MNR, [1973] C.T.C. 539 (F.C.T.D.)] may well have been the springboard to Revenue Canada's adoption of a broadly based 'reasonable expectation of profit' test." In any event, [page659] these early cases were certainly germane to the decision in Moldowan.

¶ 24 In Moldowan, the taxpayer carried on a horse-racing activity. The Minister had conceded that this activity constituted a business; the issue before the Court was whether the taxpayer's farming was his chief source of income such that he could fully deduct his losses under s. 13 of the Act. As such, the following comments of Dickson J. at pp. 485-86 relating to "reasonable expectation of profit" were obiter:

> Although originally disputed, it is now accepted that in order to have a "source of income" the taxpayer must have a profit or a reasonable expectation of profit. Source of income, thus, is an equivalent term to business: Dorfman v. M.N.R. [[1972] C.T.C. 151]. See also s. 139(1)(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.
>
> There is a vast case literature on what reasonable expectation of profit means and it is by no means entirely consistent. In my view, whether a taxpayer has a reasonable expectation of profit is an objective determination to be made from all of the facts. The following criteria should be considered: the profit and loss experience in past years, the taxpayer's training, the taxpayer's intended course of action, the capability of the venture as capitalized to show a profit after charging capital cost allowance. The list is not intended to be exhaustive. The factors will differ with the nature and extent of the undertaking: The Queen v. Matthews [(1974), 74 D.T.C. 6193]. One would not expect a

> farmer who purchased a productive going operation to suffer the same start-up losses as the man who begins a tree farm on raw land.

¶ 25 Since this Court's decision in Moldowan, the "reasonable expectation of profit" or "REOP" test [page660] has been applied by the Minister and the courts in a variety of situations in order to determine whether a taxpayer has a source of income, whether business or property. However, as the above discussion indicates, equating the phrase "reasonable expectation of profit" with a "source" of income for the purposes of the Act is a case law expansion of the use of that phrase in the definition of "personal or living expenses" in the Act. As such, it is appropriate to examine the REOP test closely in order to determine whether it should be accepted as a stand-alone source test, or whether there is a better approach to assessing the existence of a source. Indeed, the wide range of approaches that courts have taken to the REOP test alone calls for clarification.

(2) Post-Moldowan REOP Cases

¶ 26 Since Moldowan, courts have differed in their acceptance of the REOP analysis as the appropriate test for the source of income determination, and a brief survey of some of these cases is a useful starting point for an evaluation of the Moldowan test.

¶ 27 Although cases where the Minister has disallowed deductions or losses on a "no reasonable expectation of profit" basis have taken a range of positions, they can generally be categorized into two groups: those which accept the use of the test where there is no personal element to the taxpayer's activities, and those which hold that the test has no application unless there is a personal or hobby aspect to the endeavour.

¶ 28 In Landry v. Ministre du Revenu national (1994), 173 N.R. 213 at paras. 1 and 3, the majority of the Federal Court of Appeal held that the taxpayer who had come out of retirement to practice law at the age of 71 did not satisfy the REOP test and thus had no source of income from which to deduct the losses that [page661] his practice had incurred. Writing for the majority, Décary J.A. quoted and accepted the Tax Court judge's application of the test:

> 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. As I see it, the reasonable expectation of a profit is a general rule applicable to any activity which may give rise to business income.... [Emphasis added.]

Décary J.A. then concluded that:

> It is possible for someone, with the best will in the world, to practise an activity that takes all his or her time and that activity may still not be a business for the purposes of the Income Tax Act.... For the purposes of determining whether there is a source of income, only an activity that is profitable or that is carried on with a reasonable expectation of profit is a business.... [Emphasis added.]

¶ 29 This decision was followed in Hugill v. The Queen, 95 D.T.C. 5311 (F.C.A.), in which the taxpayer's deductions in respect of rental properties were disallowed. At p. 5311, the Federal Court of Appeal affirmed the Tax Court of Canada's determination that the taxpayer's business plan was unrealistic and therefore that there was no reasonable expectation of profit:

> In reaching this decision, the Tax Court judge had regard to: the constant losses suffered by the taxpayer since 1984; the lack of improvements required if the properties were to be rented during both the summer and winter seasons; and the fact that the venture "has been, and continues to be, under capitalized". It is true that the applicant had a "plan" which if realized might reasonably have resulted in a profit but unfortunately it was a plan which changed from year to year as his personal financial circumstances changed. In the circumstances, the reasoning of Mr. Justice Décary in Landry [v. Ministre du Revenu national (1994), 173 N.R. 213, at paras. 1 and 3] is particularly apt: "There comes a time in the life of any business operating at a deficit when the Minister must be able to determine objectively ... that a reasonable expectation of profit has turned into an impossible dream."

[page662]

¶ 30 A similar approach was taken in Sirois v. M.N.R., 88 D.T.C. 1114 (T.C.C.), where the taxpayer ran a restaurant business that suffered losses from 1976 to 1984. The Minister disallowed the losses for the 1981 and 1982 taxation years. Couture C.J.T.C. reviewed the operations of the business, including seating capacity and opening hours in order to determine whether a reasonable expectation of profit existed so as to allow the taxpayer to deduct the losses. At pp. 1115-16, he concluded that:

> ... for the 1981 taxation year, considering that the restaurant was operated with seating for only twenty (20), four days a week, and that since 1976 the operations had shown a loss, there was no realistic reasonable expectation of profit in these circumstances.
>
> For the 1982 taxation year, however, when the situation was entirely different, I am of the opinion that the respondent ... was not justified in presuming that there was no reasonable expectation of profit in such circumstances.

¶ 31 Although cases such as Landry, Hugill, and Sirois evidenced a willingness on the part of the Tax Court of Canada and the Federal Court of Appeal to reassess the business decisions of taxpayers, in Tonn v. Canada, [1996] 2 F.C. 73, the Federal Court of Appeal appeared to temper this approach somewhat. In that case, the taxpayers purchased a rental property which incurred losses. In allowing the taxpayers to deduct these losses, Linden J.A., at paras. 26 and 28, made the following remarks with respect to the REOP test:

> But do the Act's purposes suggest that deductions of losses from bona fide businesses be disallowed solely because the taxpayer made a bad judgment

> call? I do not think so. The tax system has every interest in investigating the bona fides of a taxpayer's dealings in certain situations, but it should not discourage, or penalize, honest but erroneous business decisions. The tax system does not tax on the basis of a taxpayer's business acumen, with deductions extended to the wise and withheld from the foolish....

...

[page663]

> The Moldowan test, therefore is a useful tool by which the tax-inappropriateness of an activity may be reasonably inferred when other, more direct forms of evidence are lacking. Consequently, when the circumstances do not admit of any suspicion that a business loss was made for a personal or non-business motive, the test should be applied sparingly and with a latitude favouring the taxpayer, whose business judgment may have been less than competent.

However, to this Linden J.A. added that it was open for courts to determine that "though the taxpayer genuinely intended the pursuit of profit through a purely commercial activity, the intention was unrealistic, the expectation of profit unreasonable, and hence, the activity was not a business" (para. 36).

¶ 32 In Corbett v. Canada, [1997] 1 F.C. 386 (C.A.), Linden J.A. applied the REOP test to a situation where the taxpayer had defaulted on mortgage payments in respect of a rental property which was subsequently ordered to be sold to the mortgagee. The Minister disallowed the deduction of interest payments on the mortgage in respect of the interim period before the mortgagee acquired the property on the basis that the taxpayer had no reasonable expectation of profit. At para. 20, Linden J.A. upheld the Minister's assessment and the application of the REOP test to these facts:

> In cases such as this, therefore, where it is clear that no profit could be earned in the year or forever after because of the judicial sale proceedings, Moldowan is applicable.... This is not a case of second-guessing poor business decisions that do not yield profit, which was the case in Tonn.

¶ 33 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 REOP test. In Allen v. The Queen, 99 D.T.C. 968 (T.C.C.), aff'd 2000 D.T.C. 6559 (F.C.A.) (sub nom. The Queen v. Milewski), 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 [page664] 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.

...

[page665]

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

Bowman J.T.C.C. has expressed a similar view in a variety of cases: see, for example, Nichol v. The Queen, 93 D.T.C. 1216 (T.C.C.); Bélec v. The Queen, 95 D.T.C. 121 (T.C.C.); Kaye v. The Queen, 98 D.T.C. 1659 (T.C.C.).

¶ 34 It is evident from this brief review that the REOP test has not been interpreted and applied in a consistent manner. The cases dealing with this concept fall along a spectrum. At one end are the decisions which consider REOP to be the test by which the viability of the taxpayer's business plan is assessed, whatever the activity in question happens to be, and to determine whether this activity deserves to be considered a "source of income". At the other end of the spectrum are the cases which use the REOP analysis only where the activity in question contains a personal or hobby element, and then only as a factor in determining whether this activity is sufficiently commercial to be labelled a "source of income". The 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.

(3) Problems with the REOP Test

¶ 35 Since Moldowan, there has been a fair amount of judicial and academic criticism of the alleged misuse of the REOP test. These comments can be generally classified into two types. First, some critics allege that there is no statutory foundation for using "reasonable expectation of profit" as the test to determine whether a source of income exists. Second, it is argued that, even if Moldowan did set [page666] out a legitimate "source" test, the test is problematic and should be rejected.

¶ 36 In Dickson J.'s obiter comments with respect to reasonable expectation of profit, he cites Dorfman v. M.N.R., [1972] C.T.C. 151 (F.C.T.D.), as authority for the proposition that in order to have a source of income the taxpayer must have a reasonable expectation of profit. However, several commentators have pointed out that Dorfman stands for a slightly different proposition. In particular, in Dorfman, the Federal Court, Trial Division was dealing with an argument by the Minister that because the taxpayer had not realized net farming income for the year, that farming could not be a source of the taxpayer's income. In rejecting that argument, Collier J., at p. 154, stated that:

> I cannot accept the interpretation put by counsel for the Minister in this case on the words "source of income": that there must be net income before there can be a source. In my view the words are used in the sense of a business, employment, or property from which a net profit might reasonably be expected to come.

In other words, the court was addressing the contention that the phrase "source of income" required a net profit. In response to this particular argument, the court held that, where an activity had a reasonable expectation of net profit, this was enough to constitute a source of income. Put in other terms, the fact that an activity is being carried on with a reasonable expectation of profit is sufficient for the activity to constitute a source of income.

¶ 37 It has been pointed out that, as a matter of logic, the fact that an activity carried on with a reasonable expectation of profit is a sufficient requirement for a source of income (the proposition from Dorfman) does not entail that a reasonable expectation of profit is a necessary requirement for a source of income (the proposition from Moldowan): see B. S. Nichols, "Chants and Ritual Incantations: Rethinking the [page667] Reasonable Expectation of Profit

Test", 1996 Conference Report, Report of Proceedings of the Forty-Eighth Tax Conference, vol. 1, 28:1, at pp. 28:4-28:5; S. Silver, "Great Expectations: Are they Reasonable?", Corporate Management Tax Conference 1995, 6:1, at pp. 6:6-6:7. In other words, it is argued that by taking the comments from Dorfman out of their particular context and applying them generally, Moldowan mistakenly equated "source of income" with "reasonable expectation of profit".

¶ 38 Indeed, equating the term "business" with the phrase, "reasonable expectation of profit" does not accord with the traditional common law definition of business, which is that "anything which occupies the time and attention and labour of a man for the purpose of profit is business" (Smith v. Anderson (1880), 15 Ch. D. 247 (C.A.), at p. 258; Terminal Dock and Warehouse Co. v. M.N.R., [1968] 2 Ex. C.R. 78, aff'd 68 D.T.C. 5316 (S.C.C.)). In addition, early cases dealing with the proper definition of a business rejected looking exclusively at one factor. For example, in Erichsen v. Last (1881), 4 T.C. 422, at p. 423, the English Court of Appeal stated:

> 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.

Thus, to equate "source of income" with "reasonable expectation of profit", at least in the instance of a business source, is not in line with these earlier characterizations of "business".

¶ 39 The view has also been taken that Dickson J. did not intend to set out a broadly applicable source test in Moldowan, but instead that he was simply distinguishing between mere hobbies and bona [page668] fide businesses: see J. R. Owen, "The Reasonable Expectation of Profit Test: Is There a Better Approach?" (1996), 44 Can. Tax J. 979, at p. 1002. This view stems from the fact that in the same paragraph where Dickson J. equates a business with a reasonable expectation of profit, he states "[i]f 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": Moldowan, supra, at p. 485. As well, various cases have held that the Moldowan test is only applicable where there is some personal element to the taxpayer's endeavour: Hickman Motors Ltd. v. Canada, [1997] 2 S.C.R. 336, at paras. 69 and 72; Allen, supra; Nichol, supra; Bélec, supra.

¶ 40 In light of the definition of "business" developed in earlier cases, as well as the dubious scope of Dickson J.'s obiter reference to "reasonable expectation of profit" in Moldowan, which may also have been a mistaken application of that phrase as used in Dorfman, the REOP test should not be blindly accepted as the correct approach to the "source of income" determination. This conclusion is strengthened by the fact that subsequent cases have run the gamut with respect to the application of the REOP concept.

¶ 41 It has also been argued that the limited use of the phrase, "reasonable expectation of profit" in the Act, does not support its use as a stand-alone source test. As mentioned above, the phrase first appeared in the Act in the definition of "personal or living expenses". The current version of that definition, in s. 248(1) (R.S.C. 1985, c. 1 (5th Supp.)), reads:

"personal or living expenses" includes

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(a) 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 common-law partnership or adoption, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit;

The phrase "personal or living expenses" relates to s. 18(1)(h) of the Act which now reads:

> 18. (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> ...
>
> (h) personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer's business;

Silver, supra, at p. 6:4, contrasts this limited statutory use of the phrase "reasonable expectation of profit" with its broader judicial application:

> In any event, while the definition of "personal or living expenses" in subsection 248(1) is inclusive rather than exhaustive, it is clear that the provision and paragraph 18(1)(h) have limited application. The legislation establishes a "reasonable expectation of profit" test only in connection with expenses incurred in the maintenance of properties and only in connection with expenses from which the taxpayer may derive some use or benefit.
>
> It can be seen, therefore, from an examination of the Act that the statutory provisions that employ a "reasonable expectation of profit" test are specific in nature and would not appear to support a broad application of this test by Revenue Canada and the courts.

¶ 42 Thus, the only way to accept "reasonable expectation of profit" as the test to determine whether a taxpayer has a source of income is to adopt an interpretive rule of law which is independent of the provisions of the Act. As this Court observed in Ludco Enterprises Ltd. v. Canada, [2001] 2 S.C.R. 1082, 2001 SCC 62, at para. 53, "this Court has repeatedly stated that in matters of tax law, a court should always be reluctant to engage in judicial innovation and rule making". Although it is true that the term [page670] "source" is undefined in the Act, and courts must frequently determine whether a taxpayer has the requisite source of income, there is a distinction between judicial interpretation and judicial rule-making, and, in our respectful view, several cases have crossed the line between use of REOP as an interpretive aid to assess whether a source of income exists and use of REOP as a stand-alone "source" test. The fact that

completely different natures, indicates that the test has transcended its use as a mere interpretive tool, and has taken on a life of its own. Indeed, in Tonn, supra, at para. 25, the Moldowan test was described as a "common law formulation respecting the purposes of the Act" which was "ideally suited to situations where a taxpayer is attempting to avoid tax liability by an inappropriate structuring of his or her affairs."

¶ 43 As stated by this Court in Canderel Ltd. v. Canada, [1998] 1 S.C.R. 147, at para. 41, "[t]he law of income tax is sufficiently complicated without unhelpful judicial incursions into the realm of lawmaking." In our view, the range of uses and interpretations that courts have given to the phrase "reasonable expectation of profit", and the corresponding uncertainty this has created for the taxpayer, are illustrative of the dangers inherent in this type of judicial exercise. Moreover, even if one were to accept the use of the REOP test as a legitimate source of income standard, there are numerous practical difficulties which arise in its application that suggest to us that the test is ill-suited for this purpose.

¶ 44 It has been pointed out that it is unclear what exactly the REOP test refers to by the term "profit". For example, it is unclear whether the capacity for profit should be determined after taking into account depreciation and, if so, whether capital cost allowance or accounting depreciation should be used: see [page671]Roopchan v. The Queen, 96 D.T.C. 1338 (T.C.C.), at p. 1341. Even if the basis for calculating profit was clear, it is still uncertain how much expected profit would be required, in what time frame, and whether the amount of expected profit should vary with the risk of the venture: see Fien, supra, at pp. 1304-6. For example, a high-risk venture may incur substantial losses which may be disallowed by virtue of a reasonable expectation of profit analysis; however, it is highly unlikely that, where such a venture does pay off, the Minister would abstain from an assessment on the ground that there was no reasonable expectation of profit and therefore no business.

¶ 45 The vagueness of the REOP test encourages a retrospective application which, as pointed out by Bowman J.T.C.C. in Nichol, supra, at p. 1219, causes uncertainty and unfairness:

> [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 National Revenue might not make today....

¶ 46 In addition, the way in which a particular venture is capitalized may have significant effects on its profitability. The extent of capitalization, rates of interest, and level at which a venture is capitalized (for example partner financing versus partnership financing, or corporate financing versus shareholder financing) may have significant effects on the bottom line, and it is difficult to see why the characterization of a commercial venture as a source should depend on the extent or method of financing: see Fien, supra, at pp. 1306-7.

¶ 47 To summarize, in recent years the Moldowan REOP test has become a broad-based tool

used by both the Minister and courts in any manner of [page672] situation where the view is taken that the taxpayer does not have a reasonable expectation of profiting from the activity in question. From this it is inferred that the taxpayer has no source of income, and thus no basis from which to deduct losses and expenses relating to the activity. The REOP test has been applied independently of provisions of the Act to second-guess bona fide commercial decisions of the taxpayer and therefore runs afoul of the principle that courts should avoid judicial rule-making in tax law: see Ludco, supra; Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411; Canderel, supra; Shell Canada Ltd. v. Canada, [1999] 3 S.C.R. 622. As well, the REOP test is problematic owing to its vagueness and uncertainty of application; this results in unfair and arbitrary treatment of taxpayers. As a result, "reasonable expectation of profit" should not be accepted as the test to determine whether a taxpayer's activities constitute a source of income.

(4) "Source of Income": The Recommended Approach

¶ 48 In our view, the determination of whether a taxpayer has a source of income, must be grounded in the words and scheme of the Act.

¶ 49 The Act divides a taxpayer's income into various sources. Under the basic rules for computing income in s. 3, the Act states:

> 3. The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year determined by the following rules:
>
> (a) determine the aggregate of amounts each of which is the taxpayer's income for the year ... from a source inside or outside Canada, including, without restricting the generality of the foregoing, his income for the year from each office, employment, business and property; [Emphasis added.]

With respect to business and property sources, the basic computation rule is found in s. 9:

[page673]

> 9. (1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is his profit therefrom for the year.
>
> (2) Subject to section 31, a taxpayer's loss for a taxation year from a business or property is the amount of his loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source mutatis mutandis.

¶ 50 It is clear that in order to apply s. 9, the taxpayer must first determine whether he or she has a source of either business or property income. As has been pointed out, a commercial activity which falls short of being a business, may nevertheless be a source of property income. As well, it is clear that some taxpayer endeavours are neither businesses, nor sources

with respect to the source question can be employed:

(i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?
(ii) If it is not a personal endeavour, is the source of the income a business or property?

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

¶ 51 Equating "source of income" with an activity undertaken "in pursuit of profit" accords with the traditional common law definition of "business", i.e., "anything which occupies the time and attention and labour of a man for the purpose of profit": Smith, supra, at p. 258; Terminal Dock, supra. As well, business income is generally distinguished from property income on the basis that a business requires an additional level of taxpayer activity: see Krishna, supra, at p. 240. As such, it is logical [page674] to conclude that an activity undertaken in pursuit of profit, regardless of the level of taxpayer activity, will be either a business or property source of income.

¶ 52 The purpose of this first stage of the test is simply to distinguish between commercial and personal activities, and, as discussed above, it has been pointed out that this may well have been the original intention of Dickson J.'s reference to "reasonable expectation of profit" in Moldowan. Viewed in this light, the criteria listed by Dickson J. are an attempt to provide an objective list of factors for determining whether the activity in question is of a commercial or personal nature. These factors are what Bowman J.T.C.C. has referred to as "indicia of commerciality" or "badges of trade": Nichol, supra, at p. 1218. Thus, where the nature of a taxpayer's venture contains elements which suggest that it could be considered a hobby or other personal pursuit, but the venture is undertaken in a sufficiently commercial manner, the venture will be considered a source of income for the purposes of the Act.

¶ 53 We emphasize that this "pursuit of profit" source test will only require analysis in situations where there is some personal or hobby element to the activity in question. With respect, in our view, courts have erred in the past in applying the REOP test to activities such as law practices and restaurants where there exists no such personal element: see, for example, Landry, supra; Sirois, supra; Engler v. The Queen, 94 D.T.C. 6280 (F.C.T.D.). Where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer's business decisions. Such endeavours necessarily involve the pursuit of profit. As such, a source of income by definition exists, and there is no need to take the inquiry any further.

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¶ 54 It should also be noted that the source of income assessment is not a purely subjective inquiry. Although in order for an activity to be classified as commercial in nature, the taxpayer must have the subjective intention to profit, in addition, as stated in Moldowan, this

form, the first stage of the above test can be restated as follows: "Does the taxpayer intend to carry on an activity for profit and is there evidence to support that intention?" This requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour.

¶ 55 The objective factors listed by Dickson J. in Moldowan, at p. 486, were: (1) the profit and loss experience in past years; (2) the taxpayer's training; (3) the taxpayer's intended course of action; and (4) the capability of the venture to show a profit. As we conclude below, it is not necessary for the purposes of this appeal to expand on this list of factors. As such, we decline to do so; however, we would reiterate Dickson J.'s caution that this list is not intended to be exhaustive, and that the factors will differ with the nature and extent of the undertaking. We would also emphasize that although the reasonable expectation of profit is a factor to be considered at this stage, it is not the only factor, nor is it conclusive. The overall assessment to be made is whether or not the taxpayer is carrying on the activity in a commercial manner. However, this assessment should not be used to second-guess the business judgment of the taxpayer. It is the commercial nature of the taxpayer's activity which must be evaluated, not his or her business acumen.

¶ 56 In addition to restricting the source test to activities which contain a personal element, the activity which the taxpayer claims constitutes a source of income must be distinguished from particular deductions that the taxpayer associates with that [page676] source. An attempt by the taxpayer to deduct what is essentially a personal expense does not influence the characterization of the source to which that deduction relates. This analytical separation is mandated by the structure of the Act. While, as discussed above, s. 9 is the provision of the Act where the basic distinction is drawn between personal and commercial activity, and then, within the commercial sphere, between business and property sources, the characterization of deductions occurs elsewhere. In particular, s. 18(1)(a) requires that deductions be attributed to a particular business or property source, and s. 18(1)(h) specifically disallows the deduction of personal or living expenses of the taxpayer:

> 18. (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> (a) 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;
>
> ...
>
> (h) personal or living expenses of the taxpayer ....

¶ 57 It is clear from these provisions that the deductibility of expenses presupposes the existence of a source of income, and thus should not be confused with the preliminary source inquiry. If the deductibility of a particular expense is in question, then it is not the existence of

the source to which it is purported to relate. The fact that an expense is found to be a personal or living expense does not affect the characterization of the source of income to which the taxpayer attempts to allocate the expense, it simply means that the expense cannot be attributed to the source of income in question. As well, if, in the circumstances, the expense is unreasonable in relation to the source of income, then s. 67 of the Act provides a mechanism to reduce or eliminate the [page677] amount of the expense. Again, however, excessive or unreasonable expenses have no bearing on the characterization of a particular activity as a source of income.

¶ 58 In addition to the fact that the deductibility, or otherwise, of an expense is a separate question from the existence of the underlying source of income, it is also true that the profitability of the activity to which the expense relates does not affect the deductibility of the expense. In particular, there have been a number of cases where a taxpayer's large interest expenses have resulted in net losses, which in turn have caused the Minister to conclude that there is no reasonable expectation of profit, and therefore no source of income from which the interest expenses can be deducted. However, as stated above, reasonable expectation of profit is but one factor to consider in determining whether an activity has a sufficient degree of commerciality to be considered a source of income. Once that determination has been made, then the deductibility inquiry is undertaken according to whether the expense in question falls within the words of the relevant deduction provision(s) of the Act. Although it is true that the phrase "personal or living expenses" in s. 18(1)(h) is defined with reference to the phrase "reasonable expectation of profit", as we pointed out above, this definition has a narrow scope. In addition, it has been pointed out that the definition refers to a business carried on "for profit or with a reasonable expectation of profit". However, since, to get to s. 18, it must already have been determined under s. 9 that a business or property source exists, and since a business is defined as an activity undertaken "in pursuit of profit", it is hard to imagine a situation where the phrase "business carried on for profit or with a reasonable expectation of profit" would add any further restrictions to the activity in question: see Owen, supra, at p. 1009.

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¶ 59 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 % 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.

Clearly the existence of financing does not indicate that the underlying activity should not be characterized as a source of income. On the contrary, the fact that an activity has been financed externally is an indication that the taxpayer is operating his or her activity in a businesslike manner. As such, the existence of financing is an element which adds to the commerciality of a venture, and thus operates in favour of characterizing the activity as a source of income.

¶ 60 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 [page679] 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. As suggested by the appellant, to disallow deductions based on a reasonable expectation of profit analysis would amount to a case law stop-loss rule which would be contrary to established principles of interpretation, mentioned above, which are applicable to the Act. As well, unlike many statutory stop-loss rules, once deductions are disallowed under the REOP test, the taxpayer cannot carry forward such losses to apply to future income in the event the activity becomes profitable. 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.'"

B. Application of the Source Test to the Case at Bar

¶ 61 As stated above, whether or not a taxpayer has a source of income from a particular activity is determined by considering whether the taxpayer intends to carry on the activity for profit, and whether there is evidence to support that intention. As well, where an activity is clearly commercial and lacks any personal element, there is no need to search further. Such activities are sources of income.

¶ 62 In this case, the appellant was engaged in property rental activities. He owned four rental condominium units from which he earned rental income. The fact that there was no personal element to these properties was never questioned. The units were all rented to arm's length parties and there was no evidence that the appellant intended to make use of any of the properties for his personal benefit. In our view, a property rental activity which lacks any

element of personal use or benefit to the taxpayer [page680] is clearly a commercial activity. For what purpose would the taxpayer have spent his time and money in this activity if not for profit? As a result, the appellant satisfies the test for source of income. Although this is sufficient to dispose of the appeal, in our view a few additional remarks are warranted.

¶ 63 Even if the appellant had made use of one or more of the properties for his personal benefit, the Minister would not be entitled to conclude that no business existed without further analysis. A taxpayer in such circumstances would have the opportunity to establish that his or her predominant intention was to make a profit from the activity and that the activity was carried out in accordance with objective standards of businesslike behaviour. Whether a reasonable expectation of profit existed may be a factor that is taken into consideration in that analysis.

¶ 64 The Minister and the courts below made much of the fact that the appellant anticipated a capital gain from the eventual sale of the properties. It was argued that it was this anticipated gain, and not rental profits, which motivated the taxpayer. As well, the Minister argued that an anticipated capital gain should not be included in assessing whether the taxpayer had a reasonable expectation of profit. As such, it was the Minister's submission that the appellant should not have been allowed to deduct his interest payments under s. 20(1)(c)(i) as amounts paid in respect of borrowed money used to produce income from a business or property. The application of the REOP test by the Minister was motivated by the policy concern that Canadian taxpayers should not have to subsidize mortgage payments made in respect of properties where the primary motivation is a long-term capital gain.

¶ 65 In response to this argument, it must be remembered that s. 20(1)(c)(i) is not a tax avoidance [page681] mechanism, and it has been established that, in light of the specific anti-avoidance provisions in the Act, courts should not be quick to embellish provisions of the Act in response to tax avoidance concerns: Ludco, supra, at para. 39; Neuman v. M.N.R., [1998] 1 S.C.R. 770, at para. 63. In addition, in Walls v. Canada, [2002] 2 S.C.R. 684, 2002 SCC 47, the companion to this case, we point out at para. 22 that a tax motivation does not affect the validity of transactions for tax purposes. As such, the appellant's hope of realizing an eventual capital gain, and expectation of deducting interest expenses do not detract from the commercial nature of his rental operation or its characterization as a source of income. Moreover, in Ludco, supra, at para. 59, this Court specifically stated that s. 20(1)(c)(i) does not require the taxpayer to earn a net profit in order for interest to be deductible:

> The plain meaning of s. 20(1)(c)(i) does not support an interpretation of "income" as the equivalent of "profit" or "net income". Nowhere in the language of the provision is a quantitative test suggested. Nor is there any support in the text of the Act for an interpretation of "income" that involves a judicial assessment of sufficiency of income. Such an approach would be too subjective and certainty is to be preferred in the area of tax law. Therefore, absent a sham or window dressing or similar vitiating circumstances, courts should not be concerned with the sufficiency of the income expected or received. [Emphasis added.]

¶ 66 Indeed, a clear analogy can be drawn between the facts in Ludco, and the facts in the case at bar. In Ludco, the taxpayer deducted approximately $6 million in interest charges on borrowed money used to purchase shares which yielded some $600,000 in dividends. On disposition of the shares the taxpayer realized a significant capital gain. The Minister disallowed the deduction of interest under s. 20(1)(c) on the basis that the borrowed money was not used for the purpose of earning income from property. This Court held at para. 54 that, in order to come within the scope of s. 20(1)(c)(i), the taxpayer had to show that "considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made". The taxpayer satisfied [page682] this test, and the Court allowed the interest deduction.

¶ 67 Similarly, in this case, the taxpayer's interest payments exceeded his rental income for the years in question. Although the taxpayer only disposed of one of the properties during the relevant time period, the Reemark plan held out the prospect of an eventual capital gain on disposition. As in Ludco, the appellant used borrowed money to engage in a bona fide investment from which he had a reasonable expectation of income, and thus, he falls within the scope of s. 20(1)(c)(i).

¶ 68 With respect to whether or not an anticipated capital gain should be included in assessing whether the taxpayer has a reasonable expectation of profit, we reiterate that the expected profitability of a venture is but one factor to consider in assessing whether the taxpayer's activity evidences a sufficient level of commerciality to be considered either a business or a property source of income. Having said this, 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. Of course the mere acquisition of property in anticipation of an eventual gain does not provide a source of income for the purposes of s. 9; however, an anticipated gain may be a factor in assessing the commerciality of the taxpayer's overall course of conduct.

VII. Conclusion

¶ 69 For these reasons, we conclude that the appellant's rental activities constituted a source of income. As a result, we would allow the appeal with costs throughout, set aside the judgment of the Federal Court of Appeal and refer the assessments for the taxation years in issue back to the Minister for reassessment on the basis that the taxpayer had a source of income from which he was entitled to deduct losses from the rental properties in question.

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