TAX FOR THE Owner-Manager

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## Brown v. Canada: REOP Redux?

The recent decision in *Brown v. Canada* (2022 FCA 200) addressed a question concerning whether a source of income relating to management services had been provided by a taxpayer. At first blush, this decision does not appear very significant except as a restatement of the source-of-income test articulated in *Stewart v. Canada* (2002 SCC 46). But this first impression is somewhat misleading. Carefully reviewed, the *Brown* decision appears to confirm a significant change in the way the source-of-income test in *Stewart* is to be applied.

### *The Facts in Brown*

The facts in the case are relatively simple. The taxpayer (Mr. Brown) was a lawyer, and his spouse was a visual artist and art historian. The taxpayer and his spouse decided to open an art gallery. A numbered company was formed to operate the gallery, with the taxpayer owning 51 percent of the common shares and his spouse owning the remaining common shares. The taxpayer and his spouse had extensively researched this venture. Their research had led them to conclude that, although a financially successful art gallery would be possible in Toronto, it would take five years and considerable investment just to break even.

External financing for the art gallery was secured from a firm of which the taxpayer's brother-in-law was a principal. The gallery opened in April 2010 and received a positive reception from the art community and media. At that time, the taxpayer was not heavily involved in the operations of the gallery. However, when the taxpayer's spouse became ill in September 2010 and then, later the same year, pregnant, the taxpayer became more involved in the gallery's business. In 2011, the external financing dried up.

In early January 2011, the taxpayer contracted with the gallery to provide it with a number of management services. The taxpayer was to be paid a management fee equal to 20 percent of the amount by which the gallery's annual revenue exceeded $100,000. This arrangement was followed up with a signed five-year agreement, dated October 5, 2012.

The taxpayer provided management services to the gallery for several years, and each year the gallery's revenues were insufficient to trigger a payment to him. Because of the nonpayment of these management fees, the taxpayer incurred significant losses in 2011, 2012, and 2013. The taxpayer was reassessed to deny the non-capital losses on the basis that (1) his management services activity did not constitute a source of income, because he could not reasonably expect to make a profit from the activity; (2) the expenses were not business expenses, because they were not claimed for the purpose of gaining or producing income from the activity; and (3) the amounts claimed as expenses were not reasonable.

### *The Decision in Stewart*

Before reviewing the FCA's decision in *Brown*, let us consider the SCC's decision in *Stewart*. *Stewart* is generally understood to be the case that rejected the "reasonable expectation of profit" (REOP) test, which had previously formed part of the source-of-income jurisprudence. The SCC found that the earlier REOP test "has been applied independently of provisions of the Act to second-guess *bona fide* commercial decisions of the taxpayer" and "runs afoul of the principle that the courts should avoid judicial rule-making in tax law." As a result, the court also stated that "the REOP test is problematic owing to its vagueness and uncertainty of application." The court held, accordingly, that the REOP test "should not be accepted as the test to determine whether a taxpayer's activities constitute a source of income."

The FCA in *Brown* reviewed the ITA's basic rules (in sections 3 and 9) for computing income, and set out the two-pronged test in *Stewart* for determining whether a source of income exists. This test is as follows:

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

The FCA proceeded to explain these tests in greater detail. A review of the SCC's holdings in *Stewart* is required in order to understand the subtle shift that has occurred in the present case.

The SCC in *Stewart* had stated in paragraph 53 of the decision that "[w]e 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." In the same paragraph, the court stated that "[w]here 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." In paragraph 54, however, the SCC also stated that, "in order for an activity to be classified as commercial in nature,

the taxpayer must have the subjective intention to profit," and that "this determination should be made by looking at a variety of objective factors."

In the companion case of *Walls v. Canada* (2002 SCC 47), the SCC had restated the two-pronged test in *Stewart* to determine whether a taxpayer's activities constituted a source of business or property income, and the court reconfirmed its views on the first prong of the test as follows:

> In addition, at para. 53 of that case, we emphasized that the first stage of this test will only be relevant when there is some personal or hobby element to the activity in question. Where an activity is clearly commercial, the taxpayer is necessarily engaged in the pursuit of profit, and therefore a source of income exists.

## *The TCC Decision*

At the TCC, the taxpayer in *Brown* lost because the court found that he had begun providing management services only because of his spouse's health issues; owing to that factor, the court found that there had been a personal element to the taxpayer's activities during the relevant years. Accordingly, the court held, in dismissing the appeal, that the taxpayer's activities included elements suggesting that his provision of services was a personal activity. The court concluded, furthermore, that the activity was not carried on in a sufficiently commercial manner to constitute a source of business.

The FCA decision rejected this reasoning and held that the TCC had erred by focusing on the taxpayer's personal reasons for providing the management services. In the view of the FCA, the required analysis was a determination of whether the activity itself was a personal endeavour, not whether the activity was motivated by personal reasons.

## *A Revised Test for a Source of Income?*

The FCA in *Brown*, in its review of the SCC's decision in *Stewart* and of the two-pronged test, cited its own recent decision in *Canada v. Paletta* (2022 FCA 86), and stated that *Paletta* stood for the proposition that even where there is no personal or hobby element to the activity in question, "the activity still had to be carried out in pursuit of profit in order to be a source of income."

The SCC's comments about profit relate to the category of borderline cases in which there is a personal or hobby element and "pursuit of profit" is one of the factors used to determine whether an activity with personal or hobby aspects is "carried out in accordance with objective standards of businesslike behaviour." As noted above, the SCC's test in *Stewart* states that a purely commercial activity would necessarily have an intention to profit and, therefore, would be a source of income.

Importantly, the FCA in *Paletta* apparently took the view that the decision in *Stewart* did not seem to contemplate an activity that has no personal or hobby elements but does not have an intention to profit economically without the consideration of tax effects. In *Paletta*, the FCA stated that a person undertaking an activity that does not have a hobby or personal element will not have a source of income unless that person is pursuing profit in carrying out that activity.

The decision of the FCA in *Paletta* is predicated on the TCC's conclusion that Mr. Paletta had no intention of making a profit and that the sole purpose of each year's trading was the creation of tax losses. This trading was found to have no personal or hobby element. It is worth noting that the argument of the taxpayer—that there was always a possibility of profit and risk of loss from a straddle trade—was rejected.

The FCA in *Brown* appears to have taken its decision in *Paletta* and filled in this gap in a way that has arguably modified the SCC's original test. In *Brown*, the FCA summarized the test in *Stewart* as follows:

> Is there a personal or hobby element to the activity in question?
>
> - If there is a personal or hobby element to the activity in question, the next enquiry is whether "the activity is being carried out in a commercially sufficient manner to constitute a source of income."
> - If there is no personal or hobby element to the activity in question, the next enquiry is whether the activity is being undertaken in pursuit of profit.

## *The Test in Brown*

In the *Brown* case, the SCC's distinction did not prove material. As noted above, the FCA rejected the TCC's decision because it had focused on the taxpayer's personal reasons for providing the services rather than on whether the activity was a personal endeavour. The FCA also rejected the Crown's contention that the taxpayer's incurring of the gallery's expenses and not being reimbursed for them by arrangement with the gallery were evidence that he was not pursuing a profit. The FCA held that, in fact, the taxpayer's management services activity was inextricably linked to the gallery business, allowing it to operate until it could generate sufficient revenue to cover all of its expenses. Accordingly, the FCA held that the taxpayer's intent was to allow the gallery to generate revenue that, in turn, would generate the management fees payable to him and, as a result, profit for his management services activity. Therefore, the FCA held that the taxpayer was providing his services in pursuit of profit.

The FCA declined to rule on whether the expenses incurred by the taxpayer were deductible; it returned the matter to the TCC to determine the amount, if any, of the non-capital losses,

for the purposes of the ITA, from the taxpayer's management services business for his 2011, 2012, and 2013 taxation years.

### *Conclusion*

This decision, in conjunction with the decision in *Paletta*, should be of general concern to tax advisers. Although the change introduced to the source-of-income test is subtle, it is nonetheless significant. It now appears that the SCC's two-pronged test in *Stewart*—which had been understood (simplistically) as restricting intention-to-profit questions to cases with a personal or hobby element—has been replaced with a test that requires a consideration of whether the taxpayer is "pursuing profit" regardless of a personal or hobby element. In our view, this new test is not consistent with the decision in *Stewart*. Leave was sought from the SCC to review the decision of the FCA in *Paletta,* but it was denied. As a result, advisers are left with case law that appears to reopen the door to what in substance amount to REOP cases, a result that the SCC in *Stewart* aimed to stop.

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