TAX FOR THE Owner-Manager

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The Stackhouse Case: Interpreting Stewart in View of Paletta and Brown

This article will discuss the recent case of *Stackhouse v. The King* (2023 TCC 156), with a focus on Owen J's comments on the "source of income" concept in view of the FCA's decisions in *Brown v. Canada* (2022 FCA 200) and *Canada v. Paletta* (2022 FCA 86). We wrote about the source-of-income topic in an earlier issue of this newsletter: see "Brown v. Canada: REOP Redux?" in the April 2023 issue of *Tax for the Owner-Manager* ("the April 2023 article").

The specific issue in *Stackhouse* was the deductibility of certain farm losses incurred by the appellant, Dr. Dianne Stackhouse, in respect of her 2014 and 2015 taxation years. Specifically, the appellant was reassessed to restrict her deduction of farming losses that she incurred to $17,500 in each of those taxation years on the basis that subsection 31(1) of the ITA applied to each year. The appellant had claimed losses in respect of her farming activities in the amount of $530,363 and $595,904, respectively, in her 2014 and 2015 taxation years.

Subsection 31(1) of the ITA limits a taxpayer's losses in respect of a farming business to a restricted amount if "a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income that is a subordinate source of income for the taxpayer."

In the decision, after an extensive review of all relevant facts and applying subsection 31(1) to those facts, Owen J held that the appellant's chief source of income was her medical practice and that her farming business was a subordinate source of income. On that basis, the appeal was dismissed.

Background to the Source-of-Income Test

The general test for whether a source of income is present was set out by the SCC in *Stewart v. Canada* (2002 SCC 46). In paragraph 50, the court adopted the following two-part test to determine whether a source of income exists:

> (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?

Critically, in *Stewart*, the SCC stated in paragraph 53 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 companion case of *Walls v. Canada* (2002 SCC 47), the SCC reconfirmed, with respect to the first stage of the test, that "[w]here an activity is clearly commercial, the taxpayer is necessarily engaged in the pursuit of profit, and therefore a source of income exists."

As we noted in our April 2023 article, *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 in *Stewart* had rejected this approach because of, in part, "its vagueness and uncertainty of application," and because it could result in second-guessing bona fide commercial decisions of taxpayers.

In *Brown*, the FCA had held 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."

Because of this conclusion, the FCA in *Brown* restated 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.

In our April 2023 article, we stated that this restatement by the FCA was inconsistent with the decision in *Stewart* because it effectively required consideration of whether the taxpayer is "pursuing profit" regardless of whether a personal or hobby element was present (or, in other words, in "clearly commercial" situations). We noted that this restatement by the FCA reopened the door to what in substance amounted to REOP cases—a result that the SCC in *Stewart* aimed to stop.

Owen J's Appraisal of the Brown Decision

In *Stackhouse*, Owen J was tasked with applying subsection 31(1) of the ITA to the facts at hand. He stated that the current version of subsection 31(1) reflected a legislative attempt to restore the meaning given to the provision to what it had been before the SCC's decision in *Canada v. Craig* (2012 SCC 43). That decision had changed the way that the test had been previously applied by the SCC in *Moldowan v. The Queen* ([1978] 1 SCR 480).

Accordingly, Owen J started his analysis by reviewing the decision in *Moldowan*. He noted that Dickson J had observed that in the case of farming, the phrase "source of income" must contemplate the existence of a business. Owen J then

reviewed the two-part test in *Stewart* (along with the accompanying commentary by the SCC) and the "rephrasing" of the test in *Stewart* by the FCA in *Brown*, and he concluded that "[w]ith respect, this rephrasing [did] not reflect the test stated in *Stewart*, nor is it justified by the approach taken by Noël, C.J. in [*Paletta*]."

In *Paletta*, according to Owen J, Noël J had questioned the proposition that "where an activity appears to be inherently commercial, it is a source of income even where the activity is not in fact carried on for commercial reasons or with a view to profit." Owen J found that the assumption underlying the two-part test in *Stewart* is that a commercial activity is undertaken for profit. Accordingly, he held that "unless there is some reason to question this assumption in the circumstances of a particular case, an activity that is on its face clearly a commercial activity as opposed to a personal undertaking is considered a source of income."

In support of this conclusion, Owen J stated that, in *Paletta*, Noël J had "found that because the evidence revealed that there was no pursuit of profit notwithstanding the apparently commercial nature of the transactions there could not be a business source of income." In Owen J's view, however, Noël J was not proposing an additional layer of inquiry into whether a commercial activity was in pursuit of profit. Owen J concluded that Noël J had "recognized that the peculiar facts of the *Paletta* case called into question the validity of the assumption underlying the test in *Stewart*" and had found that the transactions in *Paletta*, although having the appearance of being commercial, were in fact not "clearly commercial" when all the relevant facts were accounted for.

Accordingly, Owen J stated that the second step in the FCA's rephrasing, in *Brown*, of the test in *Stewart* adds "a separate inquiry into whether a taxpayer pursues a commercial activity for profit." He concluded that such an approach "would return the test to its state prior to the decision in *Stewart*, where the 'pursuit of profit' aspect of a business was the focus even for clearly commercial activities."

Owen J then requoted part of paragraph 60 of *Stewart* for emphasis: "Where the activity contains no personal element and *is clearly commercial, no further inquiry is necessary*" (emphasis and double emphasis added by Owen J). In order to apply subsection 31(1) of the ITA to the facts at hand, the TCC needed to determine whether the appellant's farm was a source of income. Therefore, Owen J applied his analysis to the appellant's farm. The court found that there was no evidence that called into question the assumption underlying the test in *Stewart* that the appellant pursued her clearly commercial farming activity for profit. Accordingly, the court concluded that the appellant's farm was clearly a commercial activity and was, therefore, a source of business income under *Stewart*.

Conclusion

In our view, Owen J has correctly analyzed the effect of *Brown* on the decision in *Stewart*. In *Paletta*, the FCA was dealing with very peculiar facts. Those facts dealt with transactions that had been determined to have no personal or hobby elements and yet were nonetheless held to be not commercial in nature. This conclusion in *Brown* was the result of a factual determination by the TCC that the taxpayer had no intention to profit. As we noted in our April 2023 article, it was open to the TCC to reach an alternative conclusion on that point.

For practitioners dealing with disputes that hinge on the determination of whether a source of income exists and in which the additional inquiry proposed by *Brown* may prove problematic, it may be helpful to adopt the interpretation articulated by Owen J in *Stackhouse*. In *Paletta*, in our view, the FCA distinguished *Stewart* in respect of situations where, although no hobby or personal element exists, the taxpayer has no intention to profit. We are also of the view that *Stewart* is still good law, and a binding precedent. Therefore, in determining whether a source of income exists, further inquiry into whether there is the "intention to profit," in situations where there are no personal or hobby elements, should be required only when there is evidence that calls into question the "pursuit of profit" assumption underlying the test in *Stewart*.

Perhaps the SCC, at some future date, will revisit the jurisprudence to resolve the ambiguity that appears to have arisen from the decision in *Brown*. We hope that, in the interim, Owen J's comments and conclusions will prove helpful to courts tasked with applying the existing jurisprudence.

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