REVISITING STEWART AND WALLS: SOURCE OF INCOME IN THE POST-PALETTA WORLD – THE EXXONMOBIL AND CHAD DECISIONS

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First published by the Canadian Tax Foundation in the July 2026 issue of *Tax for the Owner-Manager*.

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This article discusses two recent decisions, both of which address the evolving source-of-income jurisprudence in the wake of the FCA decisions in *Canada v. Paletta (Estate)* (2022 FCA 86) and *Brown v. Canada* (2022 FCA 200). The first is the TCC's decision in *ExxonMobil Canada Resources Company v. The King* (2026 TCC 42), which concerned the deductibility of feasibility study costs related to a natural gas pipeline project. The second is the FCA's decision in *Chad v. Canada* (2026 FCA 84), in which the taxpayer appealed a TCC finding that no source of income existed in respect of losses from a "straddle-trading" strategy employing foreign-exchange (FX) forward contracts.

In *ExxonMobil*, there were several issues in dispute; however, the focus of this article is exclusively on the source-of-income issue.

The facts of *ExxonMobil* are extensive and complex. In this article, we highlight only the central facts. The appellant in the case, ExxonMobil Canada Resources Company ("ECRC"), deducted the sum of $36,207,810 ("the costs") on account of expenditures incurred in respect of a feasibility study to evaluate and advance a pipeline project from Prudhoe Bay on the North Slope of Alaska, through western Canada, and into the lower 48 US states ("the study").

The study was undertaken under the Alaskan Gas Pipeline Project Agreement ("the project agreement"), and the costs represent ECRC's proportionate share of the study expenses, acquired when ExxonMobil Production Company assigned to ECRC a portion of its interest in the project agreement.

The minister of national revenue denied the costs on the principal basis that they were not incurred by the appellant for the purpose of gaining or producing income from a business, as required by paragraph 18(1)(a). However, at the hearing, the minister raised an additional argument: that the appellant had no source of income against which to deduct the costs.

In support of the source-of-income argument, the minister relied on the FCA decisions in *Paletta Estate* and *Brown*, arguing that, although the study did not have any personal or hobby elements, the court was nonetheless required to determine whether the costs in connection with the study were undertaken in pursuit of profit.

The TCC reviewed the recent history of the source-of-income jurisprudence, including *Stewart v. Canada*

(2002 SCC 46), citing the SCC's two-stage approach to determining whether there is a source of income. That 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?

Justice Lafleur stated that "[i]n *Stewart*, the Supreme Court also made it clear that this 'pursuit of profit' analysis is required only when there is a personal or hobby element to an activity" and that this approach was confirmed in the SCC's companion decision to *Stewart*, *Walls v. Canada* (2002 SCC 47).

The TCC also noted that the decision in *Stewart* presumes that a commercial activity is undertaken in pursuit of profit, citing the decision in *Stackhouse v. The King* (2023 TCC 156). In addition, the court stated that, in *Paletta*, the FCA "seems to have extended the application of the 'pursuit of profit' test to activities that appear to be commercial activities, but the evidence shows that the activities are not in fact conducted with a view to profit." Justice Lafleur also noted that, in *Brown*, the FCA "rephrased the test enacted in *Stewart* by requiring a 'pursuit of profit' analysis in situations where there is no personal or hobby element to an activity."

The TCC summarized this jurisprudence by noting that "*Stewart* is clear that when there is no personal or hobby element then no further analysis is needed," but that "*Brown* and *Paletta Estate* require that a pursuit of profit analysis be conducted regardless of the activities' personal or commercial nature."

The court then concluded that "the state of the law is such that it is unclear whether an analysis of the taxpayer's pursuit of profit is required when an activity is conducted in an entirely commercial manner," but it also stated that "[t]he foundational Supreme Court decisions suggest that no enquiry is necessary, however, as discussed above, more recent jurisprudence from the Federal Court of Appeal suggests that a pursuit of profit analysis is required."

Justice Lafleur agreed with the TCC decision in *Stackhouse* that "when an activity has no personal or hobby element, requiring an examination as to whether there was a pursuit of profit from that activity is adding to the test as found in *Stewart*."

Given the court's view regarding the "present state of the case law," Justice Lafleur opted to apply both tests—namely, the source-of-income test, as set out originally in *Stewart*; and the "extended" test articulated by the FCA in *Paletta* and *Brown*. After an extensive analysis, the TCC concluded that under both tests, the appellant had a source of business income.

The decision in *ExxonMobil* lays the groundwork for the FCA's decision in *Chad*. Notably, *ExxonMobil* was released on the day of the hearing in *Chad*, and counsel in *Chad* explicitly referred to the decision in their arguments.

We covered the TCC's decision in *Chad* in the January 2025 edition of this newsletter, and so we refrain here from revisiting the facts in detail. In brief, the appellant engaged in trading FX forward contacts, using a "straddle-trading strategy" that resulted in losses in 2011 and gains in 2012, with the gains exceeding the losses by a small amount. In his 2011 taxation year, the taxpayer had deducted $9.6 million of the losses. The minister reassessed the taxpayer's 2011 taxation year, asserting, among other things, that the trades were not a source of income. The TCC held that, although the taxpayer's trading activity was not a personal endeavour or hobby, the taxpayer had not undertaken the

activity in pursuit of profit. Therefore, he had no source of income and the TCC dismissed his appeal.

At the FCA, the taxpayer argued that the TCC had erred in law by following the decision in *Paletta*, because that decision was not consistent with the SCC's decisions in *Stewart* and *Walls*. In the alternative, the taxpayer argued that the TCC had erred in its application of the pursuit-of-profit test set out in *Paletta*.

The FCA rejected both arguments.

With respect to the decision in *Paletta*, the taxpayer argued that the decision reformulated the source-of-income test in a manner "wholly incompatible with the Supreme Court's direction in *Stewart* and *Walls*," and that the decision in *Stewart* requires an analysis into pursuit of profit "only where there is some personal or hobby element." The taxpayer also argued that *Paletta* "resurrected 'reasonable expectation of profit'" as the source-of-income test, notwithstanding that the Supreme Court expressly rejected that approach in *Stewart* and *Walls*. On that basis, the taxpayer submitted that *Paletta* was "manifestly wrong" and should not be followed.

The FCA rejected these arguments. It held that, to find *Paletta* manifestly wrong, the court needed to be satisfied that the decision overlooked "a relevant statutory provision or a case that ought to have been followed." The court held that the taxpayer had not met that standard.

The FCA also rejected the taxpayer's interpretation of *Stewart*, holding that it relied on a selective reading of that decision.

The court further held that *Paletta* did not reinstate the reasonable expectation of profit (REOP) test. It also noted that the SCC had denied leave to appeal in *Paletta*.

With respect to the REOP test, the FCA held that "[a]n intention to pursue profit and a reasonable expectation of profit are different concepts," and that "[w]hile the former is required for a source of income, the second is not." However, the FCA also held that REOP "may be relevant to determining whether an activity is a source of income, but it is neither the only nor a conclusive factor."

The FCA also held that no clarification of the source-of-income test was necessary, stating that *Paletta* had already "explained the Supreme Court's teachings" by "carefully reading and analyzing *Stewart* and *Walls*—companion decisions released at the same time—together," and that "[t]hrough that exercise, [the FCA] demonstrated that those decisions preclude an activity pursued with no purpose other than loss from being a source of income." However, we note that the activities in *Walls* were commercial in nature, had no personal element, and were tax-motivated. Moreover, the trial judge had stated that "the Partnership was unable to make a profit because it was effectively under capitalized" (see *Walls v. R*, [1996] 2 CTC 14, at 20).

In reaching this conclusion, the FCA relied on the decision in *Moloney (M.) v. Canada* ([1992] 2 CTC 227), for the proposition that *Walls* supported the holding in *Moloney* that "the reduction of his own tax cannot by itself be a taxpayer's business," notwithstanding that the SCC had distinguished the case. The FCA reached this conclusion because, in its view, the SCC had not criticized *Moloney* and had, in fact, quoted that passage from *Moloney* in *Walls*. We note that *Moloney* was distinguished by the SCC because it involved a sham, which the TCC in *Chad* had ruled was not the case; and that the SCC in *Walls* found that there was a source of income even though the putative source of

income (a storage park) was described by the trial judge as a "tax shelter" for whose existence "the reduction of tax was the sole motivation."

The FCA agreed that *Brown* "rephrased the approach to be taken to determine whether a person has a source of income," but also held that "there can be no question that *Brown* follows *Paletta Estate*" and that "*Brown*'s rephrasing is just that; it does not reflect a change in approach."

Finally, the FCA rejected the taxpayer's argument that "*Brown* and *Paletta Estate* require every taxpayer to lead evidence to establish that they have an intention to profit for every activity," holding that such an inquiry is warranted where "the evidence reveals that, despite the appearances of commerciality, the activity is not in fact conducted with a view to profit." We note that the rephrasing in *Brown* does not contain this caveat. The FCA has now developed the concept of the "appearance of commerciality," which appears to refer to activities that are commercial in nature but are not undertaken with an intention or view to profit. However, the SCC in *Stewart* had stated at paragraph 53 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.*" (Emphasis added.) In *Walls*, the SCC had stated at paragraph 19, referring back to paragraph 53 of *Stewart*, 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.*" (Emphasis added.) This principle was applied in *Walls* to a storage park operation that the trial judge had held was "unable to make a profit because it was effectively under capitalized."

The FCA then addressed the taxpayer's alternative argument that the TCC had misapplied *Paletta* even if it was correctly decided. The FCA rejected this contention, holding that the TCC had concluded that the taxpayer's intention "in implementing the [trades] was . . . to incur a loss" and that the court was not prepared to reweigh the evidence in the absence of a palpable and overriding error. Importantly, the taxpayer had argued that the TCC had ignored expert evidence showing that there had been a possibility of profit. The FCA rejected that argument, holding that the TCC had in fact explicitly considered that possibility in paragraphs 24-34 and 52-61 of its decision. We note, however, that the TCC does not appear to have made a factual finding on whether such a possibility existed. Rather, it appears to have explicitly ruled only that the taxpayer had no intention to profit.

Unless leave is sought to appeal the FCA's decision in *Chad*, and is granted by the SCC, the FCA's ruling may be the final word on the source-of-income test for the time being. *Stewart* is generally understood to have rejected the REOP test. This test was rejected by the SCC because of, in part, "its vagueness and uncertainty of application," and because it could result in "second-guess[ing] *bona fide* commercial decisions of the taxpayer." The FCA in *Chad* has confirmed that, regardless of whether personal or hobby elements are present, a taxpayer must have an intention to pursue profit for there to be a source of income. For a source of income to exist—according to the FCA decisions in *Paletta*, *Brown*, and *Chad*—a taxpayer does not require a reasonable expectation of profit, but it does require an intention to pursue profit. The intention to pursue profit may not be synonymous with a reasonable expectation of profit. However, they do bear a high degree of conceptual similarity. (The principal difference seems to be that the REOP test assesses the reasonableness of the taxpayer's expectations of profit, whereas the intention-to-profit test does not.) In our view, the two tests may differ in theory but will not do so in practice. *Chad* risks reviving the REOP test in substance, if not in name.

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Tax for the Owner-Manager
Volume 26, Number 3, July 2026