SOURCE OF INCOME AFTER *PALETTA*

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A. Introduction

Since its inception, the *Income Tax Act* (Canada) (the Act) has taxed income from a source. Yet this foundational concept of income source is not always well understood by taxpayers or the Canada Revenue Agency (CRA), or is simply assumed to exist. Moreover, judicial guidance on source of income has evolved significantly. For a time, courts required a taxpayer to demonstrate a "reasonable expectation of profit" (REOP) in order to establish a source of income and deduct losses, but this encouraged CRA and courts to second-guess the business decisions of taxpayers and use hindsight to deny a profit-making intention where losses were consistently realized. REOP was definitively rejected as the source test by the Supreme Court of Canada (SCC) in 2002 and since then it was generally understood that a taxpayer conducting purely commercial activities with no personal element did not have to demonstrate either an objective REOP or a subjective intention to profit.

However, recent decisions of the Federal Court of Appeal (FCA) in *Paletta* FCA[1], and subsequently *Brown* FCA[2], raise important questions about the meaning of source for income tax purposes. What is now the test for a taxpayer's activity to constitute a source of income from a business or property? How does one distinguish between a commercial activity (a source of income) and a personal or hobby endeavour? What are the circumstances when courts must

[1] *Canada v Paletta,* 2022 FCA 86 [*Paletta* FCA].
[2] *Brown v Canada,* 2022 FCA 200 [*Brown* FCA].

evaluate whether a taxpayer had a REOP, or an intended pursuit of profit, in conducting an activity that purports to be a source of income? And can a purely commercial activity with no personal or hobby element constitute a source of income if it is not carried on in pursuit of profit?

This paper will explore the jurisprudential context leading to the *Paletta* FCA and *Brown* FCA decisions, and critically evaluate the significance of those cases and the source tests they used to determine whether an activity is a source of income (as held in *Brown* FCA) or is not a source of income (as held in *Paletta* FCA). We begin by reviewing the legislative underpinnings for the principle that the only income taxed by the Act is income that is from a source. We then consider the troublesome *obiter* statements in 1977 from *Moldowan* SCC[3] that appeared to elevate the REOP inquiry to become the essential test for source, and we discuss several of the more notorious subsequent cases that applied the REOP test from *Moldowan* SCC inconsistently and arguably inappropriately. We then examine the 2002 companion decisions of the SCC in *Stewart* SCC[4] and *Walls* SCC[5], which together firmly curtailed REOP as the test for determining source and reformulated the "pursuit of profit" source test. With that jurisprudential context established, we then consider the decisions in *Paletta* TCC[6] and *Paletta* FCA, *Brown* FCA and two further very recent Tax Court of Canada (TCC) decisions all dealing with the source of income issue and adopting similar but not identical source tests.

We conclude with our observations on the variations of the source test that have been used in these cases, and we put forward our modest attempt at reformulating the source test. Our

[3] *Moldowan* v. *The Queen*, 77 DTC 5213 (SCC) [*Moldowan* SCC]
[4] *Stewart v Canada.,* 2002 SCC 46 [*Stewart* SCC].
[5] *Walls* v. *Canada*, 2002 SCC 47 [*Walls* SCC].
[6] *Paletta* v. *The Queen*, 2021 TCC 11 [*Paletta* TCC].

restated source test is based on that in *Stewart* SCC but takes into account the *Paletta* FCA and *Brown* FCA decisions, and resists undermining the sensible holdings of *Stewart* SCC and *Walls* SCC by ensuring that courts should not generally need to enquire into a taxpayer's intended pursuit of profit where the activity is purely commercial.

B. Source of Income: Foundational Principles

It is axiomatic that only income from a source is taxable under the Act. This is evident from the definition of income in paragraph 3(a):

> "The income of a taxpayer for a taxation year for the purposes of this Part is the taxpayer's income for the year determined by the following rules:
>
> (a) determine the total of all amounts each of which is the taxpayer's income for the year … from a source inside or outside Canada…"

With respect to income sources from a business or property, subsection 9(1) provides:

> "… a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year."

Subsection 9(2) addresses losses. To have a loss that is potentially deductible in computing income for the year pursuant to paragraph 3(d)[7], the taxpayer must first have a source of income:

[7] Such a loss, if it exceeds positive income sources under section 3 in the taxation year, could also give rise to a non-capital loss for a taxation year as defined in subsection 111(8) that can potentially be carried over and deducted under paragraph 111(1)(a) in computing taxable income for a different taxation year.

> "… a taxpayer's loss for a taxation year from a business or property is the amount of the taxpayer's loss, if any, … from that source…"

Most of the "source" cases deal with taxpayers who realize losses from a purported source of business or property income and seek to deduct those losses in computing their section 3 income for the year. Courts are then challenged to determine as a threshold matter whether those activities generating the losses are sources of income. Only if the taxpayer has a source of income can any losses potentially be deducted.

C. *Moldowan* SCC and the REOP Cases

Mr. Moldowan was a businessman who owned a 50% interest in a scrap company. He earned mostly employment and investment income, but he was also actively engaged in training, boarding and racing horses. During the years in question he incurred significant losses from his horse-racing activities and sought to deduct them in full in computing his section 3 income.

Under the version of the "restricted farming loss" rules in effect at the time (similar to current section 31, and which categorized horse-racing activities as "farming"), Mr. Moldowan's losses were limited to $5,000 if his chief source of income was neither farming nor a combination of farming and some other source of income. The SCC held that farming (the horse-racing activities) was a source of income for Mr. Moldowan but not his chief source, alone or in combination with another source, with the result that his losses were restricted to the $5,000 limit.

The future trouble for the source test came from *obiter dicta* remarks of Dickson J, meaning they were incidental and not essential to the decision whether farming was Mr. Moldowan's chief source of income:

> "…[I]t is now accepted that in order to have a "source of income" the taxpayer must have a profit or 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… [W]hether 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."[8]

The problem with this unfortunate statement from the *Moldowan* SCC decision is that, read literally, it elevates a taxpayer's REOP into a necessary condition for the existence of a source of income in all situations, including purely commercial activities. Moreover, by establishing a source test based on objective criteria, it invites the tax authorities and courts to review the business decisions of the taxpayer, and evaluate the reasonableness of those business decisions using objective standards. Making REOP the source test rendered it inevitable that taxpayers whose ventures were not successful, and who thereby suffered losses, could be denied source treatment, and thus denied deduction of the losses, on the grounds that with hindsight their initial expectations of profit were not objectively reasonable.

[8] *Moldowan* SCC, paragraphs 11-12.

This is indeed what played out in some of the subsequent source cases, as described in *Stewart* SCC. Following *Moldowan* SCC, the REOP test was applied inconsistently, in some instances as a means of second-guessing the legitimate business decisions of taxpayers whose ventures were unsuccessful.

For example, in the 1987 *Sirois* TCC[9] case, the taxpayer operated a restaurant but incurred losses in the initial years. The losses were attributable to the seating capacity of the restaurant (20 customers which was considered inadequate), limited hours of operation (only 4 days per week which was considered insufficient), and minimal advertising. The Court held that given these factors, the taxpayer did not have a REOP in those early years of operation, and thus there was no source of income. In subsequent years when the taxpayer extended the hours of operation and increased the restaurant seating capacity, the taxpayer was held to have had a REOP and thus a source of income.

In the 1994 *Landry* FCA[10] decision, the FCA displayed a similar willingness to evaluate and find the taxpayer's business acumen lacking. The taxpayer was a lawyer who had been retired from practice for 23 years but resumed his law practice at the age of 71. He kept no books of account, did not systematically seek clients, had no budget plan, and often did not bill clients when the file was not successful. He incurred significant losses from the legal practice which was apparently conducted in a somewhat disorganized manner.

In holding that the taxpayer had no REOP and thus no source of income, the majority of the FCA (with one dissenting judge) followed *Moldowan* SCC and declared:

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[9] *Sirois* v. *M.N.R.*, 88 DTC 1114 (TCC) [*Sirois* TCC].

[10] *Landry* v. *The Queen*, 94 DTC 6624 (FCA) [*Landry* FCA].

> "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."

The following year, in the 1995 *Hugil* FCA[11] decision, the FCA again used the REOP test to deny losses for purely commercial activities with no personal or hobby element. The taxpayer purchased several cottage properties to rent out, but suffered losses attributed to a lack of improvements to the buildings to make them suitable to rent out during both summers and winters. He had a business plan but did not consistently follow it, and his venture was considered undercapitalized. In holding that the taxpayer did not have a REOP, and thus did not have a source of income, the FCA quoted their prior decision in *Landry* FCA:

> "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."

Yet despite these and other decisions, REOP was not consistently used as the exclusive test for determining a source of income. In 1996, the very next year, the FCA appeared to back away from the REOP test and its invitation to evaluate taxpayers' legitimate business decisions with hindsight. *Tonn* FCA[12] considered a taxpayer who purchased a vacant rental property with two units financed with mortgages, but was unable to lease the properties for a time, such that the ultimate rental revenues were insufficient to cover the financing and other expenses. As was increasingly common in the post-*Moldowan* SCC era, CRA alleged the taxpayer had no REOP

[11] *Hugil* v. *The Queen*, 95 DTC 5311 (FCA) [*Hugil* FCA].
[12] *Tonn* v. *The Queen*, 96 DTC 6001 (FCA) [*Tonn* FCA].

and thus no source of income, and denied the losses. However, the FCA was reluctant to harshly judge the taxpayer's business acumen in conducting his purely commercial activities, suggesting that the REOP test should be reserved for situations where the venture also has a personal or hobby element:

> "[W]hen the circumstances do not admit of any suspicion that a business loss was made for a personal or non-business motive, the test [REOP] should be applied sparingly and with a latitude favouring the taxpayer, whose business judgement may have been less than competent."

Similar reservations about the suitability of REOP as a necessary condition to determine that a source of income exists, particularly when the activities are purely commercial with no personal or hobby element, were expressed in a variety of other cases.[13] These inconsistent approaches to REOP set the stage for the SCC to weigh in decisively to curtail REOP and establish a more appropriate and functional source test.

D. *Stewart* SCC and *Walls* SCC – Source Test is Pursuit of Profit, not REOP

Mr. Stewart was an experienced real estate investor. He purchased four condominiums that were nearly 100% financed with high interest debt. The developer had prepared cash flow projections showing negative cash flows and income tax losses for the first ten years of ownership. There was no suggestion of any personal element to Mr. Stewart's purchase and ownership of the rental properties – they would be rented to arm's length persons, and he did not

[13] See for example *Nichol* v. *The Queen*, 93 DTC 1216 (TCC), *Belec* v. *The Queen*, 95 DTC 121 (TCC), *Kaye* v. *The Queen*, 98 DTC 1659 (TCC), and *Allen* v. *The Queen*, 99 DTC 968 (TCC), affirmed 2000 DTC 6559 (FCA).

purchase them to occupy or for any aesthetic value. In other words, his ownership was exclusively commercial. Nonetheless, CRA asserted that Mr. Stewart did not have a source of (property) income on the grounds that he had no REOP, and denied the deduction of the property losses.

The SCC held for the taxpayer and found that his rental activities were a source of income and his losses were deductible. In a *tour de force* of judicial analysis, the SCC rejected REOP as the correct test for determining a source of income:

> "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 … the REOP test should not be blindly accepted as the correct approach …"[14]
>
> "The vagueness of the REOP test encourages a retrospective application which … causes uncertainty and unfairness."[15]
>
> "The REOP test has been applied independently of the provisions of the Act to second-guess bona fide commercial decisions of the taxpayer…"[16]

But if REOP should never have become the source test as mistakenly implied by *Moldowan* SCC and adopted in cases such as *Sirois* TCC, *Landry* FCA and *Hugil* FCA, what

[14] *Stewart* SCC, paragraph 40.
[15] Stewart SCC, paragraph 45.
[16] Stewart SCC, paragraph 47.

instead should the source test be? The SCC considered that for purely commercial activities with no personal element, REOP should not be considered at all. Several passages are particularly notable and have been widely quoted in the subsequent cases; these are repeated here to provide context for the subsequent controversy in *Paletta* TCC and *Paletta* FCA:

> "[S]ome taxpayer endeavours are neither businesses, nor sources of property income, but are mere personal activities. As such, the following two-stage approach 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 endeavor?
>
> (ii) If it is not a personal endeavor, is the source of the income a business or property?"[17]
>
> "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... 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

[17] *Stewart* SCC, paragraph 50.

> pursuit of profit. As such, a source of income by definition exists, and there is no need to take the inquiry any further."[18]

Yet as loomed large in the subsequent *Paletta* FCA decision, the SCC implied that their reference to "clearly commercial" activities requiring no further enquiry must still evidence a subjective intention to profit, or a pursuit of profit:

> "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 determination should be made by looking at a variety of objective factors. Thus, in expanded form, the first stage of the above test can be restated as follows: Does the taxpayer intend to carry on the activity for profit and is there evidence to support that intention?"[19]

So if the taxpayer must provide objective evidence to establish and support a subjective intention to profit, is there still a continued role for REOP in this inquiry? Does REOP remain relevant to source determination?

> "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."[20]

[18] *Stewart* SCC, paragraph 53.
[19] *Stewart* SCC, paragraph 54.
[20] *Stewart* SCC, paragraph 55.

> "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 enquiry is necessary."[21]

Thus, *Stewart* SCC says that REOP is only to be relevant as one possible factor in providing objective evidence of a subjective intention to profit, and that inquiry is not necessary for purely commercial activities with no personal or hobby element. In speaking of purely commercial activities, the SCC implicitly meant activities that are carried on for profit. The treatment of purely commercial activities not carried on for profit was not explicitly addressed in *Stewart* SCC, but was indirectly at issue in the companion case of *Walls* SCC, and more directly in *Paletta* FCA.

Walls SCC was released at the same time as *Stewart* SCC, and adopted consistent reasoning to constrain REOP as the source test and held that the taxpayer had a source of income and could deduct his losses. The subtle but important difference lay in the facts with respect to the mostly tax-driven motivations. The taxpayer in *Walls* SCC was a member of a limited partnership that owned a mini-warehouse acquired for $2.2 million, which was 100% financed with borrowed funds at a 24% interest rate. The limited partnership also paid management fees of $200,000 annually plus 50% of net operating profit. The result of these commercial terms was that the limited partnership realized substantial losses and these were allocated to the taxpayer.

[21] *Stewart* SCC, paragraph 60.

CRA asserted that the limited partnership did not have a source of income due to an absence of REOP.

The Federal Court Trial Division agreed with CRA and denied the losses. The taxpayer's investment in the limited partnership was described as a tax shelter, set up for the sole reason of reducing taxes, such that the limited partners had no expectation of profit and consequently no REOP. In other words the investment was treated as a purely tax-motivated transaction such that the limited partnership did not carry on a business, and was not a source.

However, the FCA took a slightly different view of the taxpayer's motivations for the investment, holding that the purchase of the limited partnership interest was driven in part by tax considerations, but there was nonetheless a purely commercial activity. Thus in the absence of any personal element, REOP was not the correct test, and there was a source.

The SCC also found that while the partnership was clearly tax-motivated, this did not detract from the commercial nature of the mini-warehouse operation or its characterization as a source of income. In other words, as a factual matter the SCC implicitly treated the venture as not exclusively tax-motivated, such that there was still a residual profit-making purpose, and consequently, consistent with its reasoning in *Stewart* SCC with respect to purely commercial activities, REOP does not arise for consideration and it was a source of income:

> "It is self-evident that such an activity is commercial in nature, and there was no evidence of any element of personal use or benefit…"[22]

[22] *Walls* SCC, paragraph 20.

Following *Stewart* SCC and *Walls* SCC, it was widely accepted for two decades that REOP was no longer the test for determining source. Purely commercial activities with no personal or hobby elements were generally assumed to constitute an income source. But then in 2022 came *Paletta* FCA.

E. The *Paletta* Decisions

Facts and Background

During the 2000 to 2007 taxation years, Mr. Paletta entered into a plan designed to generate non-capital losses through forward foreign exchange trading. Broadly speaking, Mr. Paletta would enter into a set of forward foreign exchange contracts, one of which was long and the other short. The contracts almost exactly offset one another, subject to a slightly different date on which the delivery of the currency was to be made, such that a small positive or negative difference existed between the value of the long leg and the value of the short leg of the straddle. Before the end of each taxation year, Mr. Paletta would close out the loss leg of the straddle, realizing a pre-determined amount of loss for that year, while maintaining the corresponding gain leg of the straddle in place until after the beginning of the following year. Early the following year, the gain leg would be closed out before its value date and the gain realized would be included in computing Mr. Paletta's income for that year.[23]

By repeating this pattern, Mr. Paletta claimed almost $49 million in net losses during the period at issue.[24] According to a finding of fact made by the TCC Judge, Mr. Paletta received over $38 million of income from 2000 to 2007, yet reported only just over $1 million in

[23] *Paletta* TCC at paras 1 – 6.

[24] *Ibid* at para 13.

aggregate taxable income over the same period as a result of the straddle transactions.[25] The Minister reassessed all taxation years at issue in 2014, which was outside the normal reassessment period for each taxation year.[26] The Minister also assessed penalties under subsection 163(2) of the Act for the 2000 to 2006 taxation years, which are generally referred to as "gross negligence" penalties.[27]

The Crown made a number of initial arguments, including that all of the contractual agreements relating to the straddle transactions were shams, that the trades were not legally effective, and that Mr. Paletta did not actually incur the relevant losses.[28] However, before the TCC the Crown ultimately made the primary argument that Mr. Paletta's trading activities were not a "source of income" because a tax loss scheme is not a business. The Crown alleged that Mr. Paletta's predominant motive was the pursuit of tax losses, and accordingly, he did not incur any losses from carrying on a business.[29]

Decision of the TCC

In order to deduct a loss in computing one's income for a taxation year, one must have a source of income. Writing for the TCC, Spiro J. made a number of factual findings, including that the straddle transactions were entered into "for tax deferral purposes", and that there was no business purpose.[30] The decision also considered the fact that Mr. Paletta failed to include any of the gains realized on the closing out of the gain legs in early 2002 in computing his income for

[25] *Ibid* at para 100.
[26] *Ibid* at para 111.
[27] *Ibid* at para 112.
[28] *Ibid* at 147.
[29] *Ibid* at para 149.
[30] *Ibid* at paras 197-199.

that year, resulting in an understatement of income of approximately $8 million for the 2002 taxation year.[31]

Spiro J. then undertook to apply the two-step analysis put forward in *Stewart* SCC, stating that "the most important teaching of *Stewart* for present purposes is this: provided that one's activity is clearly commercial, and that no personal element is involved, there is a source of income."[32] Furthermore, in his view *Walls* SCC affirms that this principle is applicable even in circumstances where the activity in question was entirely tax-motivated.[33] Despite the seemingly condemnatory factual findings made regarding Mr. Paletta's lack of intention to profit, Spiro J. concluded that forward foreign exchange trading is inherently commercial in nature, and because there is no personal or hobby element to the straddle transactions, the second stage of the source analysis is not necessary.[34] Accordingly, the straddle transactions constituted a source of income and the Minister's reassessments for all taxation years other than the 2002 taxation year were vacated.

In addition to the conclusions on source, Spiro J. found that the misrepresentation in Mr. Paletta's 2002 tax return was attributable to neglect, carelessness or willful default.[35] Based on the evidence, Mr. Paletta was fully aware of the nature of the straddle transactions, particularly since the same trading cycle was repeated for several years. Furthermore, his conduct with respect to the filing of his 2002 return fell "far short of the expected conduct of a reasonable person." Accordingly, the Crown's reassessment of the 2002 taxation year to add the unreported

[31] *Ibid* at para 116.
[32] *Ibid* at para 201.
[33] *Ibid* at para 202.
[34] *Ibid* at para 204.
[35] *Ibid* at para 256.

$8 million amount to income after the normal reassessment period was valid, and the Minister's assessment of gross negligence penalties for that 2002 taxation year was justified.

Decision of the FCA

The primary issue before the FCA was whether the TCC properly held that Mr. Paletta's trading activities gave rise to a source of income in the form of a business despite having found that the trades were not made for profit.[36] In overturning the TCC decision, Noel J., writing for the FCA, clarified the source test from *Stewart* SCC:

> "Stewart teaches that, in the absence of a personal or hobby element, where courts are confronted with what appears to be a clearly commercial activity and the evidence is consistent with the view that the activity is conducted for profit, they need go no further to hold that a business or property source of income exists for purposes of the Act. However, where as is the case here, the evidence reveals that, despite the appearances of commerciality, the activity is not in fact conducted with a view to profit, a business or property source cannot be found to exist."[37]

The core of Noel J.'s decision was that the TCC incorrectly applied the two-step approach from *Stewart* SCC. In particular, the TCC erred in finding that because Mr. Paletta was engaged in a clear commercial activity with no personal element, it was bound to hold that a business existed despite the absence of any profit motive.[38] This conclusion of the TCC

[36] *Paletta FCA* at para 2.
[37] *Ibid* at para 36.
[38] *Ibid* at para 37.

effectively did away with the "pursuit of profit" concept, despite being a fundamental component of the source test in *Stewart* SCC.

In addition, Noel J. held that the TCC misconstrued the *Walls* SCC decision as standing for the proposition that an activity that is solely devoted to the reduction of tax is a business. As discussed above, the *Walls* trial decision was decided on an application of the REOP test, finding that the taxpayers were not engaged in a business on the grounds that the "sole" reason for the existence of the activities in question were to avoid paying tax.[39] However, in the appeals that ensued, both the FCA and the SCC concluded that the taxpayers' activities were actually not solely undertaken for the purpose of tax avoidance. In fact, the SCC distinguished between activities that were "clearly" tax motivated versus those that are "exclusively" tax motivated. Accordingly, *Walls* SCC should not have been relied upon to say that an activity devoted exclusively to the avoidance of one's tax can be a business.

With respect to the re-opening of the taxation years at issue, Noel J. found that the Crown succeeded in demonstrating that Mr. Paletta was grossly negligent in portraying his trading losses as business losses even though they were not. Also for this reason, the gross negligence penalty set out under subsection 163(2) of the Act was properly assessed for all taxation years, not just the 2002 taxation year as held by the TCC.[40] These findings of gross negligence were made despite Mr. Paletta having consulted with three tax experts about the foreign exchange straddle plan (albeit in a cursory manner), expert opinion at trial that the trades were conducted

[39] *Ibid* at para 46, citing *Walls v R.,* [1996] 2 CTC 14 (Fed. T.D.).
[40] *Ibid* at para 93.

for profit, and the TCC judgement corroborating Mr. Paletta's position that his trading activity was a source of income.

Paletta FCA raises several concerns. Did it change the source test in *Stewart* SCC? *Paletta* FCA stands for the proposition that a purely commercial activity with no personal or hobby element (such as a purely tax-motivated activity) can fail to be a source. Does that now make it necessary to establish a pursuit of profit motive in all cases as a prerequisite to finding a source? If so, will REOP re-emerge as a key source test even for purely commercial activities with no personal elements?

The FCA holding was premised on the TCC factual finding that the foreign currency straddle trades had a purely tax-driven motive and no business purpose or pursuit of profit. This was a critical distinction from *Walls* SCC, where the taxpayer's activities were found to be clearly tax-motivated but not exclusively tax-motivated as found in *Paletta* TCC[41]. But was there really such a difference? Did *Paletta* TCC go further than warranted in finding in effect that there was no pursuit of profit, even when there was some residual risk from the currency straddles due to the different closing dates for the offsetting legs? Did the TCC get boxed in by this finding that there was not even a miniscule residual profit motive, and did that lead to a profoundly different result in *Paletta* FCA compared to *Walls* SCC with arguably very similar facts?

Further, the holding in *Paletta* FCA with respect to the gross negligence penalties has been perceived in the tax community as rather harsh. The filing position of Mr. Paletta, that his purely commercial (albeit tax-driven) trading activities constituted a source of income, was

[41] *Paletta TCC* at para 70.

arguably consistent with the prevailing understanding of the source test as described in *Stewart* SCC and *Walls* SCC, particularly the passage stating that for purely commercial activities where no personal element is involved, there is a source of income and no further inquiry into the taxpayer's pursuit of profit is required.

Leave to appeal *Paletta* FCA to the SCC was dismissed on March 16, 2023.[42] Several subsequent source of income decisions have been released to date.

F. Case Law After *Paletta*

The *Brown* Decisions

Mr. Brown and his spouse opened an art gallery through an Ontario numbered company, with Mr. Brown continuing to practice as a lawyer while his spouse managed the gallery.[43] Months after the gallery's opening, Mr. Brown's wife became ill and was unable to run the gallery as planned.[44] As a result, Mr. Brown entered into an agreement with the numbered company in order to provide management services to the gallery, with compensation to be paid on a percentage of gross revenues.[45] Mr. Brown claimed a number of business expenses and losses in connection with the provision of the management services, which were subsequently disallowed. The question before the TCC was whether Mr. Brown's management services constituted a source of income against which the losses could be deducted.

The TCC Judge summarized the source test from *Stewart* SCC, and concluded that there was a personal element to Mr. Brown's management services due to the fact that he only began

[42] Add citation.
[43] 2020 TCC 123 [*Brown TCC*] at para 14. We note that *Brown TCC* was released prior to *Paletta FCA.*
[44] *Ibid* at para 15.
[45] *Ibid* at para 17.

providing the services when his spouse developed health issues. In addition, the TCC found that Mr. Brown did not provide sufficient evidence to establish that he expected to make a profit from the activity.[46] Accordingly, the TCC concluded that the activity was not carried on in a sufficiently commercial manner to constitute a source of business, and did not show that his predominant intention was to make a profit.[47]

This decision was overturned at the FCA, which cited *Paletta* FCA in its analysis, and attempted to rephrase the applicable source test from *Stewart* SCC (as discussed in the next section below).[48] Webb J., writing for the FCA, stated that "a person's personal motivation or reason for conducting an activity cannot, in and of itself, result in there being a personal or hobby element to the activity."[49] The TCC had erred in finding that Mr. Brown's activities had a personal element – the only personal element identified was Mr. Brown's motivation to provide these services because his spouse was unable to do so.[50] With respect to whether Mr. Brown was pursuing profit, Webb J. distinguished between pursuing profit and having a reasonable expectation of profit. The fact that the management agreement did not provide a reimbursement for expenses incurred by Mr. Brown goes towards reasonable expectation of profit, which is not the correct test.[51] Rather, by providing the management services that allowed the gallery to continue operating until it could generate sufficient revenue to cover its expenses, Mr. Brown's intent was to allow the gallery to generate revenue which, in turn, would generate the

[46] *Ibid* at para 40.
[47] *Ibid* at para 41.
[48] *Brown* FCA at para 25.
[49] *Brown* FCA at para 29.
[50] *Ibid* at para 31.
[51] *Ibid* at para 40.

management fees payable to him (based on a percentage of the gallery's gross revenue) and therefore, his intent was to pursue profit in providing the management services.[52]

Tweneboah v. The King[53]

The taxpayer in this case was employed as an engineer and had side activities including a website and a painting and cleaning service. The taxpayer deducted certain business losses from the side activities over the course of four taxation years, which expenses were disallowed on the basis that the taxpayer had no source of income, and therefore, no business. By way of example, the taxpayer claimed deductions for 80,000 kilometres of vehicle expenses ostensibly driven in a single year in the course of his side activities, but did not produce logbook evidence in support of these deductions. In his findings of fact, the TCC Judge noted that the taxpayer's children were "deeply involved" in building the website.[54] The decision went on to consider that the taxpayer led no evidence of how he intended to profit from either activity, and was unable to answer questions such as how many services would need to be provided in order to turn a profit, and details of how expenses and revenues were tracked.[55] Referencing *Stewart* SCC*, Paletta* FCA and *Brown* FCA*,* the TCC Judge concluded that the taxpayer had no source of income. Moreover, the Minister was held to have successfully demonstrated, on a balance of probabilities, that the taxpayer made representations attributable to neglect or carelessness, so that the reassessment of the otherwise statute-barred year was permitted.[56]

[52] *Ibid* at para 43.
[53] 2023 TCC 121 [*Tweneboah* TCC].
[54] *Ibid* at para 9.
[55] *Ibid* at para 17.
[56] *Ibid* at para 25.

Because of the personal elements found with respect to the website and painting activities, including the opportunity for the family to spend time together in common activities, the TCC decision reverted to a REOP approach to its analysis. Based on the findings with respect to neglectful or careless misrepresentations and the absence of evidence for some of the claimed expenses, there appears to have been a taxpayer credibility issue. Thus the *Tweneboah* TCC case turned on the evidence and does not appear to advance or change the source test in any meaningful way.

Preston v. The King[57]

The facts of *Preston* TCC involved a taxpayer with a musically talented daughter. The taxpayer entered into a management contract in which he would incur expenses up front and receive a commission if his daughter achieved success in the music industry.[58] The primary issue was whether the appellant was in the business of artist management. Citing *Stewart* SCC and *Paletta* FCA, the TCC considered factors including the taxpayer's training, his intended course of action, and the capability of the activity to show a profit, though these factors will vary. Importantly, the judge noted that this determination is not an evaluation of the taxpayer's business acumen.[59]

In the analysis, Wong J. identified that a personal element existed because the artist in question was the taxpayer's daughter. However, consistent with *Brown* FCA, the fact that the artist was the taxpayer's daughter did not otherwise factor into the decision. Wong J. considered the commerciality of the contractual arrangement by looking to factors such as engaging an

[57] 2023 TCC 136 [*Preston* TCC].
[58] *Ibid* at para 1.
[59] *Ibid* at para 19.

accountant with specific experience in the music industry, the fact that the arrangement was consistent with market practice, and the time spent by the taxpayer learning about the music industry.[60] The conclusion was that the taxpayer had a source of income, in particular he was carrying on the business of artist management, and was entitled to deduct the claimed expenses.[61]

G. What is the Source Test after *Paletta* FCA?

Recall the articulation of the source test from *Stewart* SCC and *Walls* SCC that was primarily concerned with constraining the relevance of a taxpayer's REOP. It asks "(i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavor? (ii) If it is not a personal endeavor, is the source of income a business or property?"[62] Moreover, this "pursuit of profit" test is only relevant when there is some personal or hobby element to the activity. Where the activity is clearly commercial the taxpayer is necessarily engaged in the pursuit of profit, and therefore a source of income exists.

This test essentially equates pursuit of profit and commerciality. If the activity is considered commercial, it is understood to be conducted in pursuit of profit and must therefore be a source. *Stewart* SCC was not expressly contemplating situations where a commercial activity is not carried on in pursuit of profit. There were only two categories explicitly contemplated: commercial activities conducted in pursuit of profit, and personal/hobby activities, with the focus of attention on activities overlapping those two categories – endeavours with personal elements that might nonetheless be conducted in pursuit of profit. Yet as evident from

[60] *Ibid* at paras 23 – 25.
[61] *Ibid* at para 27.
[62] *Stewart* SCC, paragraph 50.

Paletta FCA, and the lower court decision in *Walls* SCC, any restated source test that purports to be comprehensive should also address the additional category of purely commercial activities with no personal element, but which are not carried on in pursuit of profit. These might include exclusively tax-motivated activities, or perhaps commercial activities that run on a break-even basis to provide jobs in a local community, for instance.

In *Paletta* FCA, the source test was rearticulated to address commercial activities not conducted in pursuit of profit in this way: "[W]here …the evidence reveals that, despite the appearances of commerciality, the activity is not in fact conducted with a view to profit, a … source cannot be found to exist."[63] This implies that pursuit of profit is a rebuttable presumption, such that an activity that appears to be purely commercial will be presumed to be conducted in pursuit of profit and thus a source of income without further enquiry, except where there is contrary evidence suggesting there is no pursuit of profit at all.

In *Brown* FCA, the source test from *Stewart* SCC was adapted to take into account the rearticulated source test from *Paletta* FCA 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[64] manner to constitute a source of income.

[63] *Paletta* FCA, para. 36.

[64] The FCA likely meant "sufficiently commercial".

> ● 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."

But this *Brown* FCA restatement of the test suggests that a "pursuit of profit" enquiry must be considered as a final step even for all clearly commercial activities with no personal or hobby element.[65] Yet these are the very situations where the *Stewart* SCC test says that no further enquiry is required. This *Brown* FCA version of the source test is therefore arguably not consistent with either *Stewart* SCC or *Paletta* FCA, which limits further enquiry only to clearly commercial activities where evidence suggests that, despite the appearances of commerciality, the activity is not in fact conducted with a view to profit.

A further variation of the source test was used in *Preston* TCC:

> "Where the activity (a) appears to be clearly commercial, (b) contains no personal or hobby element, and (c) the evidence is consistent with the view that the activity is conducted for profit, then a source of income exists for purposes of the Act. However, where the activity could be considered a personal pursuit, then one must ask if the activity is being carried on in a sufficiently commercial manner so as to be a source of income."[66]

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[65] This concern is also raised by Philip Friedlan and Adam Friedlan in "Brown v. Canada: REOP Redux?", *Tax for the Owner-Manager*, Canadian Tax Foundation, vol. 23, No. 2 (April 2023).

[66] *Preston* TCC, paragraph 18.

This appears closer to the mark. It limits the more detailed enquiry whether the activity is "sufficiently commercial" to situations where there is a personal element, thus maintaining consistency with the test in *Stewart* SCC and avoiding the suggestion from the *Brown* FCA version of the test that all commercial activities are to be subjected to a pursuit of profit test at the final stage of analysis. Yet even this variation is not quite complete, since it does not explicitly establish a rebuttable presumption that a purely commercial activity is a source of income, and it is not clear how to determine if activity with a personal element is conducted in a sufficiently commercial manner. *Stewart* SCC tells us to enquire if the taxpayer subjectively intends to carry on the activity for profit, and is that subjective intention supported by objective evidence (which is not necessarily the same as requiring REOP).

Thus, we propose a modest restatement of the source test to take all of these factors into account:

> Is the activity clearly commercial, with an absence of any personal or hobby element?
>
> - If so, the activity is presumed to be a source of income, unless there is evidence that despite the appearance of commerciality, the activity is not in fact conducted with a view to profit.
>
> If the activity has a personal or hobby element, is the activity carried out in a sufficiently commercial manner, such that the taxpayer intends to carry on the activity for profit and there is evidence to support that intention?

- If so, the activity is a source.

Note that the proposed rebuttable presumption for a purely commercial activity adopts the precise wording from *Paletta* FCA that presumes such an activity is a source of income unless there is evidence it is not in fact conducted "with a view to profit". This is not necessarily the same as "in pursuit of profit" or "with an intention to profit". We believe it should be read as more closely synonymous with "a possibility to profit". In order for the Minister to rebut the *Paletta* FCA presumption of source for a purely commercial activity, there should be a high bar - the Minister should be required to establish there is essentially no possibility for the commercial activity to be profitable. This would retain consistency with *Walls* SCC, where no inquiry into the purely commercial activity was necessary because even though the activity was clearly tax-motivated, it was not exclusively tax-motivated and there was still a residual profit-making opportunity.

H. Concluding Comments

Stewart SCC and its companion case *Walls* SCC were critically important interventions of the SCC to shut down the unfair and inconsistently applied REOP test as the principal determinant whether a taxpayer has a source of income. Yet those cases left open the unaddressed situation where a taxpayer's activity is purely commercial, with no personal element, but not carried on in pursuit of profit – such as a tax-driven activity with no business purpose. *Walls* SCC came close to this situation, but the SCC considered the taxpayer's investment activity in that case to be clearly motivated by tax considerations but not exclusively tax-driven, such that there was still a profit motive. Thus the significance of *Paletta* FCA is to fill this gap not explicitly contemplated by the source test in *Stewart* SCC. *Paletta* FCA establishes that in the (presumably rare) situation of a purely commercial activity not conducted

with a view to profit (such as an exclusively tax-motivated activity), a source of income does not exist.

Despite some initial concerns, arguably *Paletta* FCA has not adversely changed the source test from the sensible articulation in *Stewart* SCC and *Walls* SCC. REOP is still not the primary source test as it became post-*Moldowan*, and none of the subsequent cases has viewed *Paletta* FCA as expanding the circumstances where a taxpayer's REOP should be investigated. REOP remains relevant only as possibly one of the factors to determine if an activity with personal or hobby elements is carried on in a "sufficiently commercial" manner.

More potentially concerning is the formulation of the source test in *Brown* FCA. This could be read as requiring a "pursuit of profit" enquiry for all clearly commercial activities, including those with no personal or hobby element. If this source test were followed, it could potentially upset the purpose of the source test as established in *Stewart* SCC, which was to avoid CRA and courts second-guessing the business judgement of taxpayers, and using hindsight to deny a profit-making intention where a taxpayer has realized consistent losses.

We have therefore proposed a modest restatement of the source test, similar to that articulated in *Preston* TCC but expanded to be somewhat more comprehensive. The proposed source test is based on the solid foundation of *Stewart* SCC. It incorporates the rebuttable presumption concept expressed in *Paletta* FCA by presuming a clearly commercial activity to be a source of income unless (exceptionally) there is contrary evidence that the activity is not conducted with a view to profit. And it avoids the suggestion from *Brown* FCA that the pursuit of profit enquiry should apply to all clearly commercial activities, including those with no

personal or hobby element whatsoever. Most importantly, the proposed test would ensure REOP never again emerges as a key factor to determine if a source of income exists.