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"Reasonable Expectation of Profit" is Dead

The latest on taxation

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On May 23, 2002, the Supreme Court of Canada (SCC) released its long-awaited decision in the case of Brian J. Stewart v. the Queen. In 1986, Mr. Stewart purchased four condominiums from which he earned rental income. All four condominiums were highly leveraged with Mr. Stewart paying only $1,000 cash for each unit. Projections indicated that the properties would generate negative cash flows, as well as losses, for a 10-year period before becoming profitable.

From 1990 to 1992, Mr. Stewart claimed total losses of over $58,000 and used these losses to offset other income. These losses occurred primarily as a result of significant interest expense on the money borrowed to acquire the condominiums. The CCRA disallowed these losses on the basis that Mr. Stewart had no "reasonable expectation of profit" (REOP) and therefore no business was being carried on. If no business existed, then business losses cannot have arisen to be claimed against other income. Both the Tax Court of Canada and the Federal Court of Appeal upheld the CCRA's position.

The SCC's decision

The SCC reversed both lower courts' findings and found in favour of Mr. Stewart, allowing the deduction of the losses. According to the court, "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" (i.e., a business). Instead, the SCC introduced a two-stage approach that should be used to determine whether a taxpayer's activities constitute a source of business or investment income. Step one is to ascertain whether the taxpayer's activity is undertaken in "pursuit of profit," or whether it’s personal. If it is not personal, then the second step is to discern whether the income earned is business or investment income.

The first test is only relevant if there is some personal element to the activity. For example, if a condominium is purchased for investment purposes but a taxpayer uses it personally (or perhaps allows relatives to use it), then there may be a personal element to the investment. However, where the purchase of an investment property has no personal element, the taxpayer's "pursuit of profit" is established. As the SCC stated: "for what purpose would the taxpayer have spent his time and money in this activity if not for profit?"

Once it has been determined that the first step has been taken and that the activity has a sufficient degree of commerciality to be actually considered a source of income, the next issue to consider is whether the expenses that created the loss are deductible (in the Stewart case, the interest expense).

Interest deductibility

In the SCC's recent decision in Ludco, the taxpayer was permitted to deduct $6 million of interest expense incurred for the purchase of shares despite the fact that only $600,000 of dividends was received. In reviewing the wording of the Act, which states that interest on borrowed money is deductible if it was borrowed "for the purpose of earning income," the SCC concluded that the Act does not say that the sole, main, or primary purpose of an investment has to be to earn income. In fact, the primary purpose may be to realize an ultimate capital gain. In other words, as long as one of the purposes of the purchase of the shares was to earn income (which was clearly evident from the fact that the taxpayer did receive dividends from these shares), then the interest was deductible.

In Stewart, the CCRA argued that an anticipated capital gain should not be included in assessing whether a taxpayer had a reasonable expectation of profit. The SCC disagreed saying "the motivation of capital gains accords with the ordinary business person's understanding of 'pursuit of profit' and may be taken into account to determine whether the taxpayer's activity is commercial in nature." That being said, simply purchasing property in anticipation of an ultimate capital gain is not a source of income for the purposes of interest deductibility. However, an anticipated capital gain may be a factor in assessing whether there is a source of income.

Implications for investors

By confirming interest deductibility in these circumstances, this case is yet another win for the Canadian investor who deducts interest on money borrowed to purchase investments with a reasonable expectation of earning income but which, in fact, generate little, if any, income. This case, however, has wider applications; the current denial of deductions by the CCRA of losses generated by many tax shelters because of "no reasonable expectation of profit" will likely now be put on hold unless the CCRA can come up with another weapon – like the general anti-avoidance rule, for example – with which to attack these shelters. For the time being, however, it appears that the doctrine of REOP is dead.