

Income Tax

IMP. 81-2/R1 Source of income
Date of publication: July 31, 2003

Reference(s): *Taxation Act* (R.S.Q., c. I-3), ss. 28 and 81

This bulletin cancels and replaces bulletin IMP. 81-2 dated April 28, 1995.

This bulletin explains the test used by the Ministère du Revenu to determine whether a taxpayer may deduct a loss from a business or property. The bulletin applies to any assessment or reassessment, made after May 23, 2002, that challenges the existence of a source of income and therefore the right of a taxpayer to deduct a loss claimed. It has been revised to take into account the decision of the Supreme Court of Canada in the case of *Stewart v. Canada* (2002 SCC 46).

APPLICATION OF THE ACT

1. Under subparagraph ii of paragraph c of section 28 of the *Taxation Act* (the “Act”), in computing a taxpayer’s income for a taxation year, the taxpayer’s losses incurred during that year from a business or property, *inter alia*, should be deducted. In this regard, section 81 of the Act provides that a taxpayer’s loss for a taxation year from a business or property is the amount of such loss computed, with the necessary modifications, by applying the provisions of Part I of the Act respecting computation of income from that source.

2. Where a loss from a business or property is involved, the existence of a source of income must first be established from a fiscal point of view, in order to allow for the deduction of expenses from the related revenue, and to determine the extent of the loss that may be deducted in computing the income for the year in which the loss was incurred or the taxable income for another taxation year.

APPROACH

3. Henceforth, in order to determine whether a source of income exists, the commerciality of a venture must be examined. If there is no personal or hobby element, the commerciality of the venture is conceded and a source of income is established. If there is a personal or hobby element, the commercial intent must be predominant in order to concede the commerciality of the venture and consider that a source of income exists.

4. If the existence of a source of income is established, the type of income source (business or property) and, if relevant, the geographical source of the income (Québec, Canada or elsewhere) must be determined in order to make the tax adjustments provided by the Act. After the tax adjustments have been made, the loss will be allowed to the extent provided by the Act.

5. The concept of a hobby or other personal pursuit advanced in the *Stewart* case is to some extent a reformulation of the prevailing reasonable expectation of profit test developed in prior case law. That test relied on the concept of a personal or non-business element. Despite the reformulation, the first determination to be made under the new test is whether there is a non-business motive behind the venture generating the losses. Thus, in that regard, prior tax jurisprudence is still useful in determining what constitutes a hobby or other personal pursuit.

6. Strictly speaking, the case law has not defined the concept of a hobby or other personal pursuit but rather has simply recognized, sometimes inconsistently, that a taxpayer's course of conduct involved a personal or hobby element. In that regard, a personal element need not be distinguished from a hobby element, since, in order to avoid a possible bone of contention, both elements are referred to as the basis of assessment.

7. A taxpayer's alleged hobby or other personal pursuit is determined according to the **actual or intended** use of the property by the taxpayer or someone related to the taxpayer within the context of the venture generating the loss. According to tax jurisprudence, in this context, a related person means an ascendant, a descendant or even a friend of the taxpayer, which is not necessarily the same meaning as under section 19 of the Act.

8. On the other hand, it is important to determine whether the loss generated by the venture is from a business or from property, and thereby pre-judge, to some extent, the nature of the income. In fact, according to tax jurisprudence, if a business is carried on from home, the use of the residence is not considered to be for a hobby or other personal pursuit. For example, the losses from an architectural or law practice or a plumbing or electrical business carried on from the family home may not be contested by invoking the presence of a personal or hobby element with respect to the use of the taxpayer's home to carry on any of those businesses. Therefore, in such cases, the predominant commercial intent of the taxpayer need not be established.

9. Ultimately, the following situation might develop. A taxpayer, who overall is operating at a loss and who runs a business from home (home being a triplex, two units of which the taxpayer rents to people unrelated to the taxpayer), would probably be allowed the loss from the business because it is considered a source of income. Under the case law, such a use of the home is not considered to be for a hobby or other personal pursuit, although the expenses related to the home may have created or increased the loss. On the other hand, that taxpayer would probably not be allowed the loss from the property because, under the same case law, the property is not considered a source of income. In such a situation, the courts have held the use of the property to be for a hobby or other personal pursuit.

10. However, where a commercial element is present in conjunction with a personal or hobby element, the taxpayer's predominant intent must be established by using the non-exhaustive criteria suggested in the *Stewart* case. If the commercial element is found to be predominant, the

existence of a source of income will be established, the expenses will be deductible and a tax loss may be claimed. On the other hand, if the personal or hobby element is found to predominate over the commercial element, the taxpayer's venture will not constitute a source of income, no expense greater than the revenue related thereto will be deductible and no loss may be claimed by the taxpayer in that regard.

11. To make this appraisal and establish the predominant element, all six of the following criteria should be considered:

- (a) the profit and loss experience in past years;
- (b) the taxpayer's training;
- (c) the taxpayer's intended course of action;
- (d) the capability of the venture as capitalized to show a profit;
- (e) the taxpayer's anticipated capital gain (not merely the eventual capital gain);
- (f) the reasonable expectation of profit test, which still involves the following elements established by prior case law:
 - the time required to make an activity of this nature profitable;
 - the presence of the necessary ingredients for profits ultimately to be earned;
 - the profit and loss situation for the years subsequent to the years in issue;
 - the number of consecutive years during which losses were incurred;
 - the increase in expenses and decrease in income in the course of the relevant periods;
 - the persistence of the factors causing the losses;
 - the absence of planning;
 - the taxpayer's failure to adjust the course of conduct;
 - the scale of the operation;
 - the people involved;
 - the context.

12. If a source of income is established, tax adjustments are brought into play. The new approach advanced by the decision in the *Stewart* case is outlined in the schedule that follows.

THREE-STEP ANALYSIS TO DETERMINE WHETHER A SOURCE OF INCOME EXISTS AND TO MAKE THE RESULTANT COMPUTATIONS

The following outline indicates how to determine whether a source of income exists with respect to a venture generating losses and how to make the resultant fiscal computations.

Step 1:

- Establish the accounting income or loss (accounting adjustments come into play; matching, reconciliation, etc.).

Step 2:

- Establish whether a source of income exists by examining the commerciality of the venture.

In the absence of any personal or hobby element, the commerciality of the venture is conceded, the existence of a source of income is recognized and the losses are allowed as deductions, after certain tax adjustments have been made. Proceed immediately to Step 3 to make those adjustments.

If a personal or hobby element co-exists with a commercial element, the existence of a source of income will be recognized only if a predominant commercial intent is established.

The assessment of whether there is a predominant commercial intent is made using the six criteria.

If a predominant commercial intent is established, the commerciality of the venture and, therefore, the existence of a source of income are recognized, and the losses are allowed as deductions, after certain tax adjustments have been made. Proceed to Step 3 to make those adjustments.

If a predominant commercial intent is not established, there is no source of income, so no tax loss is possible and the inquiry ends at this point.

Step 3:

- Establish the extent of the tax loss (tax adjustments come into play; capital versus income, reasonable nature of an expense, personal or living expenses, restricted farm loss, etc.).