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Restricted Farm Losses (Section 31 of the *Income Tax Act*) – A Judicial Revolution is Upon Us

The restricted farm loss rule contained in section 31 of the *Income Tax Act* (the “Act”) has been terrorizing part-time farmers since 1952. “Farming” is defined broadly in subsection 248(1) of the Act to include “tillage of the soil, livestock raising or exhibiting, maintaining of horses for racing, raising of poultry, fur farming, dairy farming, fruit growing and the keeping of bees ...”. Simply owning a racehorse will qualify you as a farmer¹ and subject you to the special rules in the Act used to compute the income or loss from your farming business,² including section 31.

Generally, when a taxpayer is engaged in a non-farming business during a taxation year, the Act provides that any loss computed in the taxation year from that business can be deducted from income from other sources (such as income from employment, property or other businesses).³ However, if the loss is from a farming business, the ability to deduct the farming loss from other sources of income is subject to section 31, which might cause the deduction of the loss to be restricted.

Section 31 of the Act reads as follows:

31. (1) Loss from farming where chief source of income not farming

Where 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 ... the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be ... [the lesser of the actual farming loss and \$8,750].

If section 31 applies, irrespective of the actual amount of the farming loss as calculated, the maximum farming loss that can be deducted from other sources of income in that taxation year is \$8,750. To the extent that the farming loss incurred in a taxation year exceeds \$8,750, the excess loss is a “restricted farm loss”⁴ deductible only against farming income earned in other taxation years, which, under paragraph 111(1)(c) of the Act, can be carried back three years and carried forward 20 years. It follows that, if section 31 does not apply, there is no restriction on the

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calculation of the deductible business loss from farming. This means that the entire loss can be deducted from other income in that taxation year, and under paragraph 111(1)(d), any unused “farm loss”⁵ may be carried back three years and carried forward 20 years for deduction against any other sources of income in those years.

Of course, any net income earned in a taxation year from a farming business is fully taxable, without restriction.

A typical section 31 scenario would involve a taxpayer, such as a professional, who earns income from that activity in addition to operating a farming business, such as a horse racing business. If the taxpayer incurs a loss in excess of \$8,750 from his or her horse racing business, the deduction of that loss from his or her professional income will be restricted by section 31 unless the taxpayer is able to prove that his or her chief source of income in the year in question was the horse racing business or a combination of the horse racing business and his or her profession.

Historically, it has always been an uphill battle for a taxpayer to defeat the applicability of section 31 in these circumstances, with the result that many taxpayers have suffered the wrath of this harsh and discriminatory rule. Until now, that is. In a series of recent cases, the Federal Court of Appeal has reformulated the section 31 analysis so that the rule will be applied with consistency and fairness. This new interpretive regime has withstood the test of time

and resulted in several recent taxpayer victories in the courts.

Legal Analysis – Section 31 of the Act

A thorough review of the jurisprudence relating to section 31 of the Act shows a distinct evolution of how the judiciary has interpreted and applied section 31 over the course of time. As one of the most litigated provisions in the Act, there are many cases dealing with section 31, each relying on what is understood to be the state of the law at the time, but in some cases muddled in confusion due to ambiguous principles in place with respect to the interpretation of section 31 or reliance on outdated, inappropriate or overturned concepts. The original leading authority on the interpretation of section 31 is the 1977 decision of the Supreme Court of Canada in *Moldowan v. The Queen*⁶ (“*Moldowan*”), which is reviewed in more detail below. I will refer to *Moldowan* as the “first generation” of section 31 cases, since it was the leading authority and applied as such from the period 1977 to 2002 (and is still considered a leading authority, subject to the evolution of certain principles described below).

In 2002, the Supreme Court of Canada in *Stewart v. Canada*⁷ (“*Stewart*”) stepped in to emphatically reject the application of the “reasonable expectation of profit” (“REOP”) test that had been set out in *Moldowan* and applied in farming cases since *Moldowan*. *Stewart* and other decisions are the “second generation” of cases, since this was a landmark decision that permanently changed the section 31 analysis outlined in *Moldowan* from 2002 onward.

The final landmark case, and the case that represents the judicial revolution by the Federal Court of Appeal to halt the uncertainty caused by the sporadic and inconsistent interpretation of section 31 by prior courts, is *Gunn v. The Queen*⁸ (“*Gunn*”). *Gunn* is referred to as the “third generation” of authority with respect to the interpretation of section 31 since *Gunn* strengthens the analysis by incorporating the Supreme Court of Canada’s modern approach to the interpretation of taxing statutes (which was developed starting in the 1980s, after *Moldowan* had been decided utilizing the traditional approach to statutory interpretation). This modern approach, referenced by Sharlow, J.A.⁹ (citing *Canada Trustco Mortgage Co. v. The Queen*¹⁰), is that:

[t]he interpretation of section 31 requires a textual, contextual and purposive analysis to find a meaning that is harmonious with the *Income Tax Act* as a whole, and that achieves consistency, predictability and fairness so that taxpayers may manage their affairs intelligently.

Each of *Moldowan* and *Stewart* are reviewed generally below to provide context for the basis of prior court decisions, and *Gunn* is reviewed in more detail as the current standard of analysis.

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First Generation of Cases – *Moldowan* (1977–2002)

The early cases were decided on the principles outlined by the Supreme Court of Canada in *Moldowan*, which divided farmers into three classes: (i) the hobby farmer who cannot deduct farming losses; (ii) the “sideline business” farmer who was restricted by section 31 to deducting a maximum of \$8,750 of farming losses per year; and (iii) the farmer whose livelihood is farming and is therefore entitled to unlimited deduction of farming losses. The primary test utilized during this period of case law was the REOP test which, if your farming activities satisfied this test, moved you at least into the classification of a sideline farmer conducting a business and entitled you to the deduction of the capped farm loss amount outlined in section 31 (\$8,750), but no more. If the taxpayer could further prove that farming was his or her chief source of income (or that it, in combination with another source, was his or her chief source of income), then section 31 would not apply and all farming losses would be fully deductible.

The practical application of the principles outlined in *Moldowan* in the subsequent cases was to determine firstly, if the taxpayer had a REOP (where the REOP test factors include profit and loss experience, start-up costs, the capability of the venture to show a profit, etc.) and, if so, then secondly, whether farming was the taxpayer’s chief source of income (where the factors considered include time spent, capital committed, profitability, etc.). As will become clear in the analysis of *Gunn* below, the determination of whether farming is the taxpayer’s chief source of income (the “principal question”) is only half of the analysis that needs to be undertaken when analyzing section 31. (The other question to determine is the “combination question” discussed below.)

Second Generation of Cases – *Stewart* (2002–Present)

The second generation of cases resulted from the Supreme Court of Canada’s decision in *Stewart*, which rejected the REOP test outlined in *Moldowan* as the test to use in order to determine if a taxpayer operates a business (i.e., a source of income that is taxable under the Act and from which losses may be deducted). While *Stewart* was not a farming case of any type, it did replace the *Moldowan* REOP test with a “commercial manner” test that would be utilized in section 31 farming cases after 2002 when a determination was required to be made as to whether a farmer was engaged in a business or not (which is a prerequisite to deducting farming losses from other income). The Supreme Court of Canada felt that intervention was required since the REOP test was being utilized (in farming cases and otherwise) to create unfair results and

“encouraged a hindsight assessment of the business judgment of taxpayers in order to deny losses incurred in *bona fide*, albeit unsuccessful, commercial ventures”.¹¹

In *Stewart*, the Supreme Court of Canada stated that in order to determine whether a particular activity constitutes a business, the first stage of the test is to simply distinguish between commercial and personal activities.¹² Where there is no personal or hobby element, then the activity is commercial and the taxpayer’s pursuit of profit is established. Even if the nature of a taxpayer’s venture contains elements that suggest that it could be considered a hobby or other personal pursuit, but the venture is undertaken in a sufficiently commercial manner “in accordance with objective standards of businesslike behaviour”, the venture will be considered a business. This is the “commercial manner” test that must be satisfied only if there is a personal element associated with the activity. However, such assessment should not be used to second-guess the business judgment of the taxpayer – it is the commercial nature of the activity which must be evaluated, not his or her business acumen.¹³

Further, where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer’s business decisions as such endeavours necessarily involve the pursuit of profit.¹⁴

It is important to note that in *Stewart*, the Supreme Court of Canada appears to eliminate the profitability analysis in the determination of whether a business exists where the activity is commercial in nature, and goes so far as to say that the characterization of an activity as a business presumes that the taxpayer intends to carry on that activity in pursuit of profit.

Third Generation of Cases – *Gunn* (2006–Present)

Gunn is characterized as the third generation of authority on the basis that the Federal Court of Appeal in this case built on the principles outlined in *Moldowan* (those principles that have survived) and *Stewart*, which resulted in the development of a direct modern analysis of the specific wording of section 31 (using current Supreme Court of Canada authority), and in particular, outlined the tests to be employed to determine if the “combination question” applies to a given set of facts.

The “combination question” is the second question that must be answered when analyzing section 31 of the Act (the first question is the “principal question”, being whether farming is the taxpayer’s chief source of income, determined with the assistance of *Moldowan* and *Stewart*). The combination question requires the determination of whether a taxpayer’s chief source of income is from farming “or a combination of farming and some other source of income” which, if satisfied, removes the applica-

bility of section 31 and permits full deduction of farming losses.

The Federal Court of Appeal in *Gunn* also goes out of its way to harshly criticize the purpose and tax policy behind the existence and application of section 31 of the Act, which is further discussed below.

Detailed Analysis of the *Gunn* Decision

In *Gunn*, the Court re-evaluated the meaning of the opening words of section 31 of the Act¹⁵ and broke down the textual analysis by stating that section 31 applies only if the answer to both of the following questions is no:

1. the “principal question” – is farming the taxpayer’s chief source of income?

and

2. the “combination question” – is the taxpayer’s chief source of income a combination of farming and some other source of income?

The key principle in *Gunn* is how the combination question should be interpreted, which is described by the Federal Court of Appeal as follows:¹⁶

In my view, the combination question should be interpreted to require only an examination of the cumulative effect of the aggregate of the capital invested in farming and a second source of income, the aggregate of the income derived from farming and a second source of income and the aggregate of the time spent on farming and on the second source of income, considered in the light of the taxpayer’s ordinary mode of living, farming history, and future intentions and expectations. This would avoid the judge-made test that requires farming to be the predominant element in the combination of farming with the second source of income, which in my view is a test that cannot stand with subsequent jurisprudence. It would result in a positive answer to the combination question if, for example, the taxpayer has invested significant capital in a farming enterprise, the taxpayer spends virtually all of his or her working time on a combination of farming and the other principal income earning activity, and the taxpayer’s day to day activities are a combination of farming and the other income earning activity, in which the time spent in each is significant. [emphasis added]

It follows that there are three questions or factual requirements for which a taxpayer must provide sufficient evidence to a court which, if accepted by the court, will result in the taxpayer being successful in answering the combination question in the affirmative (meaning that section 31 will not be applicable to restrict the deduction of farming related losses). Each requirement is outlined below:

Requirement #1: The taxpayer has invested significant capital in a farming enterprise.

Requirement #2: The taxpayer spends virtually all of his or her working time on a combination of farming and the other principal income earning activity.

Requirement #3: The taxpayer’s day-to-day activities are a combination of farming and the other income earning activity and the time spent on each is significant.

Mr. Gunn was a lawyer who owned a farm on which he grew crops and operated a cattle breeding business. With respect to the time spent on each activity being significant, the Federal Court of Appeal made it clear that the farming activity need not be the predominant activity¹⁷ and that 20 hours of farming work per week (in Mr. Gunn’s case) was accepted as significant in relation to the 50 hours per week spent in his legal practice.¹⁸

A number of first generation section 31 cases tended to rule against taxpayers on the basis that their farming operations were not profitable. In *Gunn*, the Federal Court of Appeal expressly disagreed with the lower court’s comment that “if it is unlikely that the taxpayer’s farming operations will ever be profitable, notwithstanding all the time and capital the taxpayer is willing and able to devote to farming, the conclusion must be that farming is not a chief source of the taxpayer’s income”.¹⁹ This statement was rejected on the basis that Mr. Gunn’s evidence was that he anticipated that his farm had a potential for profit. More importantly, it is noted that even if the lower court relied on profitability arguments to answer the principal question not in Mr. Gunn’s favour (i.e., that farming did not constitute Mr. Gunn’s chief source of income), the Court was then obliged to consider the combination question as it related to Mr. Gunn, based on the tests outlined above.²⁰ It should be noted that the test outlined above with respect to the combination question does not make any reference to a profitability requirement; rather, it makes reference to the analysis being based on the taxpayer’s “future intentions and expectations”.

Therefore, if profitability is to be weighed as a factor to consider in the section 31 analysis, the landmark cases examined above indicate that such an analysis is only undertaken in the context of determination of the principal question (i.e., whether farming is the taxpayer’s chief source of income), and not the combination question, which focuses more on the day-to-day activities and intentions of the taxpayer.

In *Gunn*, the Federal Court of Appeal came to the conclusion that, based on the combination question contained in section 31 of the Act being answered in the affirmative, Mr. Gunn’s chief source of income was a combination of farming and the practice of law. Therefore, Mr. Gunn was entitled to full deduction of his farming losses.

Judicial Consideration of *Gunn*

The *Gunn* decision has proven to have distinct precedential value stemming from the modern analysis undertaken and the setting down of a clear interpretive rule for determining the answer to the combination question in the context of a section 31 analysis. This, in addition to the criticism of how previous courts have interpreted section 31 in such a way as to produce unfair results for taxpayers, makes *Gunn* the leading decision when the combination question is to be analyzed (as opposed to the principal question in which case *Moldowan* and *Stewart* are the leading authorities).

Gunn has been followed or considered in the following cases, all of which were decided in favour of the taxpayer: *Stackhouse v. The Queen*²¹ (doctor with large-scale farming operation including horse breeding, organic crops and cattle); *Loyens v. The Queen*²² (dentist husband and lawyer wife who operated a horse breeding and emu business); *Johnson v. The Queen*²³ (engineer who operated a cattle, lamb, goat and turkey farm); *Scharfe v. The Queen*²⁴ (police officer who operated a cattle farm); and most recently in *Craig v. The Queen*²⁵ (lawyer who operated a horse breeding and racing business).

The Future of Section 31

In *Gunn*, the Court stated that the intended target of section 31 remains unclear.²⁶ After noting the considerable judicial criticism of section 31 since 1977 (after *Moldowan*) and after reviewing the available authorities, Sharlow, J.A. stated that "I have been able to find nothing that provides a satisfactory explanation for the existence of section 31 of the *Income Tax Act*" and further states that "[i]f the same flawed justification for section 31 survives to this day, there would be a cogent argument for Parliamentary review of section 31".²⁷

This commentary by the Federal Court of Appeal provides a strong hint to legislators that section 31 of the Act should be reviewed, and presumably repealed. In the mean time, part-time farmers who have a fact pattern supported by the third generation of legal authority spawned by *Gunn* are positioned at an historical high point in terms of legal artillery to fend off the deleterious effects of section 31.

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A number of tax lawyers from Fraser Milner Casgrain LLP write commentary for CCH's CANADIAN TAX REPORTER and sit on its Editorial Board as well as on the Editorial Board for CCH's CANADIAN INCOME TAX ACT WITH REGULATIONS, ANNOTATED. Fraser Milner Casgrain lawyers also write the commentary for CCH's FEDERAL TAX PRACTICE reporter and the summaries for CCH's WINDOW ON CANADIAN TAX. Fraser

Milner Casgrain lawyers wrote the commentary for CANADA–U.S. TAX TREATY: A PRACTICAL INTERPRETATION and have authored other books published by CCH: FEDERAL TAX PRACTICE; CHARITIES, NON-PROFITS AND PHILANTHROPY UNDER THE INCOME TAX ACT; CORPORATION CAPITAL TAX IN CANADA; and CANADIAN TRANSFER PRICING. Tony Schweitzer, a Tax Partner with the Toronto Office of Fraser Milner Casgrain LLP, and a member of the Editorial Board of CCH's CANADIAN TAX REPORTER, is the editor of the firm's regular monthly feature articles appearing in TAX TOPICS.

Notes:

¹ *Juster v. The Queen*, 74 DTC 6540 (F.C.A.).

² Sections 28 to 31 of the Act, which include the ability to use the cash method of accounting and permits farmers to expense the cost of animals as inventory (subject to the inventory adjustment rules contained in section 28).

³ Section 3 and subsection 9(2) of the Act.

⁴ "Restricted farm loss" is defined in subsection 248(1) and subsection 31(1.1) of the Act.

⁵ "Farm loss" is defined in subsection 248(1) and subsection 111(8) of the Act.

⁶ *Moldowan v. The Queen*, 77 DTC 5213 (S.C.C.).

⁷ *Stewart v. Canada*, 2002 DTC 6969 (S.C.C.).

⁸ *Gunn v. The Queen*, 2006 DTC 6544 (F.C.A.).

⁹ *Ibid.* at paragraph 15.

¹⁰ *Canada Trustco Mortgage Co. v. The Queen*, 2005 DTC 5523.

¹¹ *Supra* note 7 at paragraph 4.

¹² *Ibid.* at paragraph 52.

¹³ *Ibid.* at paragraph 55.

¹⁴ *Ibid.* at paragraph 53.

¹⁵ *Supra* note 8 at paragraph 15.

¹⁶ *Ibid.* at paragraph 83.

¹⁷ *Ibid.* at paragraph 83.

¹⁸ *Ibid.* at paragraph 9 and paragraph 92.

¹⁹ *Ibid.* at paragraph 85.

²⁰ *Ibid.* at paragraph 87.

²¹ *Stackhouse v. The Queen*, 2007 DTC 620 (T.C.C.).

²² *Loyens v. The Queen*, 2008 DTC 4698 (T.C.C.).

²³ *Johnson v. The Queen*, 2009 DTC 1245 (T.C.C.).

²⁴ *Scharfe v. The Queen*, 2010 DTC 1078 (T.C.C.).

²⁵ *Craig v. The Queen*, 2010 DTC 1032 (T.C.C.) aff'd by 2011 DTC 5047 (F.C.A.).

²⁶ *Supra* note 8 at paragraph 51.

²⁷ *Ibid.* at paragraph 54.

Technical News No. 44

The CRA has issued Income Tax Technical News No. 44, dated April 14, 2011. It contains the questions and answers from the CRA Roundtable at the Canadian Tax Foundation's 2009 annual conference in Toronto. A summary of the issues discussed at the Roundtable was published in TAX TOPICS No. 1971-72, dated December 17, 2009. Technical News No. 44 has been posted on CCH's federal income tax News Tracker and will be reproduced on CCH Online and on DVD under Canadian Tax Reporter, CRA

Publications, Income Tax Technical News and in volume 8 in print, as soon as possible.

Remission Orders

Notices of three recent remission orders granted to individuals were published in the *Canada Gazette*, Part II, dated April 13, 2011. In the Mildred Jacobs Remission Order (P.C. 2011-482, SI/2011-24), a late-filing penalty of over \$16,000 and arrears interest of over \$131,000 were remitted for the 1994 taxation year because the collection of these amounts "is unjust and unreasonable based on the circumstances of her case". In the Kathryn Strigner Remission Order (P.C. 2011-488, SI/2011-26), amounts of Part I tax from 1993 to 2003 and all relevant interest were remitted because the amounts arose from circumstances beyond the taxpayer's control and represent a financial setback for the taxpayer. Similarly, in the Pierre Dupuis Remission Order (P.C. 2011-489, SI/2011-27), amounts of income tax under Part I, a small late-filing penalty, and arrears interest were remitted for the 1995, 1996, 1997 and 1999 taxation years because the amounts resulted from circumstances beyond the taxpayer's control and represent a financial setback for the taxpayer. As discussed in CCH's FEDERAL TAX PRACTICE subscription product, written by practitioners at Fraser Milner Casgrain LLP and available online and on DVD, a remission order is an extraordinary measure to provide complete or partial relief from federal income tax and certain other tax and non-tax amounts. It allows relief to be provided when it cannot otherwise be achieved through tax legislation, assessing or other actions. The legal authority for granting remission is subsection 23(2) of the *Financial Administration Act*. These remission orders have been posted on CCH's federal income tax News Tracker and will be added to the collection in the CANADIAN TAX REPORTER online and on DVD under "Related Statutes, Federal, Financial Administration Act".

Manitoba Budget

The 2011-2012 Manitoba Budget was presented on April 12, 2011. For individuals, the Budget announced that the basic personal amount, the spousal amount and the eligible dependant amount will each increase from \$8,134 to \$8,384 in 2011 and to \$8,634 in 2012, and the maximum Primary Caregiver Tax Credit will be increased from \$1,020 to \$1,275. A new Children's Arts and Cultural Activity Tax Credit was announced for 2011 with a maximum credit of \$54 (10.8% of up to \$500 of expenses). Some temporary credits that were scheduled to expire have been extended, including the Community Enterprise Development Tax Credit and several components of the Co-op Education and Apprenticeship Tax Credits, extended to December 31, 2014, and the Mineral Exploration Tax Credit extended to flow-through agreements entered into before April 1, 2015.

For businesses, the Budget introduced a 15% refundable Cultural Industries Printing Tax Credit for Manitoba printers and a new Neighbourhoods Alive! Tax Credit. The Neighbourhoods Alive! Tax Credit provides a maximum credit of \$15,000 for corporations who partner with community organizations. For installations after April 12, 2011, the Green Energy Equipment Tax Credit will increase from 5% to 7.5% for geothermal heat pumps and from 10% to 15% for other geothermal heating equipment. Certain credits that were scheduled to expire at the end of 2011 have been extended to December 31, 2014. These include the Book Publishing Tax Credit, the Manufacturing Investment Tax Credit and the Odour Control Tax Credit. As well, the Budget introduced a capital tax exemption for banks and trust and loan corporations with taxable paid-up capital under \$4 billion. The Budget documents have been posted on CCH's provincial News Tracker. They are also available from the Manitoba section of the MANITOBA AND SASKATCHEWAN TAX REPORTER on CCH Online and on DVD.

Recent Cases

Note that the paragraph references following the case digests below are to paragraphs in the "New Matters" division in Volume 7. The full text of each case is reproduced in the publisher's loose leaf DOMINION TAX CASES.

Corporation's application for judicial review for collection of unremitted source deductions dismissed

The Minister assessed the corporate taxpayer for unremitted source deductions owing for 2001 and 2002, and then caused the Federal Court to certify this amount under s. 223(2) of the *Income Tax Act* as a tax debt owing. On its application to the Federal Court for judicial review, the taxpayer argued that (a) the obligation to pay its tax debt did not arise until a notice of assessment was issued and mailed to it; (b) the certificate of the tax debt owing (the "Certificate") could only be issued upon the taxpayer's default in paying that assessment; and (c) without proof that the assessment was actually issued and mailed to it, the Certificate was invalid and should be quashed.

The taxpayer's application was dismissed. The taxpayer's arguments were untenable. Admittedly, the Minister's evidence that the assessments in issue were placed in the Canada Revenue Agency mail stream and mailed to the taxpayer was sufficient to prove that they had been issued and mailed. However, the jurisprudence that requires the Minister to issue and mail notices of assessment to taxpayers involves cases pertaining to personal income tax, and not to payroll taxes such as the ones in this case. Therefore, the Minister was not required to mail

the assessments to the taxpayer prior to obtaining the Certificate, and the Certificate was not a nullity as the taxpayer had alleged.

¶47,603, *Dupont Roofing & Sheet Metal Inc.*,
2011 DTC 5031

CRA's denial of taxpayer's proposed payment plan arrangement was reasonable

The taxpayer had a history of late-filing tax returns, and had previously entered into payment plan arrangements with the Canada Revenue Agency (the "CRA") to pay outstanding tax liabilities, though he never completely cleared the tax debt at year's end. In 2003, the taxpayer suffered from medical issues, and he failed to file returns for the years 2004 to 2007. He subsequently received a notice of assessment in July 2008 for \$765,751.59 of tax owing. The taxpayer again sought a tax payment plan, but was turned down by the CRA. He paid amounts for the 2004 assessment, since his proposal was rejected, but again proposed a payment plan for other years, and again was denied. The taxpayer sought judicial review of the CRA's decision denying his request.

The taxpayer's application was dismissed. The CRA has discretion to deny payment plans as it sees fit, and in the circumstances, it acted reasonably in denying the taxpayer's request.

¶47,604, *Burkes*, 2011 DTC 5032

Taxpayers not entitled to voluntary disclosures program relief since CRA had already started enforcement action

The individual taxpayer, B, was the sole director and shareholder of the two corporate taxpayers, which had never filed corporate returns, and B's personal returns had not been filed since 1999. The taxpayers defaulted on a payment schedule arranged to cover unpaid amounts for 1998 and 1999. Various requests were made by the Canada Revenue Agency (the "CRA") from 2000 to 2002 for the taxpayers to file returns. Contact was lost with B for several years when he moved and failed to inform the CRA of his new address. Arbitrary assessments were sent to B for the years 2000 to 2004, although he claimed he never received them. After several requests in 2008 to file his 2006 personal return, that return was filed in May 2008. In August 2008, the taxpayers filed a request for relief under the voluntary disclosures program (the "VDP"), which was denied on the basis that enforcement action had been taken against them. B sought a judicial review of the CRA's refusal to apply the VDP, claiming that once he filed his 2006 return the enforcement action had expired, that conversations between 2000 and 2002 had taken place too long ago to be considered, and that arbitrary assessments are not enforcement actions.

The taxpayers' application for judicial review was dismissed. The standard of review was reasonableness. The guidelines as set out in the Information Circular stipulate that the application of the VDP is discretionary, and that disclosure will not be considered voluntary if enforcement action has been initiated by the CRA. Enforcement actions include requests by the CRA for unfiled returns and any direct contact by CRA employees for non-compliance. Enforcement actions have no expiry date and, accordingly, the March 2008 request was an enforcement action that precluded the taxpayers from applying for the VDP. The CRA's argument that the arbitrary assessments were also enforcement actions was not tenable, as an arbitrary assessment just creates liability and makes it possible to start collection proceedings. However, the numerous conversations and the March 2008 request did qualify as enforcement actions, and the application for judicial review was dismissed.

¶47,605, *Bontje et al.*, 2011 DTC 5033

Share transfer in 2008 for 2003 services not required to be included in 2003 income as "amounts receivable"

In 2003, 9098-3016 Québec Inc. ("9098") sold a mining property to Ressources Mirabel Inc. ("Mirabel"). In 2008, 9098 paid the taxpayer for his services on this sale by transferring to him 100,000 shares of Mirabel (the "Mirabel Shares"). On the assumption that the Mirabel Shares were worth \$40,000 in 2003, the Minister, in a reassessment made four days beyond the normal reassessment period, added this \$40,000 to the taxpayer's income for 2003 as an "amount receivable" under s. 12(1)(b) of the *Income Tax Act*, and imposed penalties for gross negligence. On the taxpayer's appeal to the Tax Court of Canada, the Minister conceded that the penalties should be deleted.

The taxpayer's appeal was allowed. The \$40,000 value the Minister placed on the Mirabel Shares was unsupported by any reliable evidence. Conversely, the taxpayer's conduct in assuming that the Mirabel Shares were valueless in 2003, and therefore not required to be mentioned in his 2003 return, was that of a reasonable person using common sense under the circumstances. The Minister therefore failed to discharge the onus of showing that the taxpayer's conduct lacked the degree of care needed to justify a reassessment beyond the normal reassessment period. There was also no evidence that the \$40,000 was an "amount receivable by the taxpayer in respect of property sold or services rendered in the course of a business" in 2003, within the meaning of s. 12(1)(b)). The Minister was therefore ordered to reassess on the basis that the \$40,000 was not required to be included in the taxpayer's income for 2003.

¶47,607, *Baribeau*, 2011 DTC 1105

Allowable business investment losses were denied for lack of documentary or testimonial evidence

The taxpayer appealed reassessments for the years 1999 to 2001 disallowing his claim for an allowable business investment loss ("ABIL") deduction based on the losses from the purchase and resale of shares. The taxpayer worked in the travel industry, becoming a consultant and teacher at a community college. He met C, who was also in the travel industry, and did some consulting work for him. At some point, C acquired two travel businesses, Select Travel and Travelsphere, and sold a majority share in Travelsphere to the taxpayer. By March 31, 1990, the taxpayer alleged that C owed him \$217,500 for a series of loans made to C between 1982 and 1984, and for unpaid work he did for C. As C was unable to repay the monies owing, the taxpayer testified that he entered into two agreements with C, whereby the taxpayer purchased a total of 160 shares of Select Travel from C. He first purchased 75 common shares for \$90,000 (\$1,200 per share) and then a further 85 shares for \$127,500 (\$1,500 per share). He then alleged that he sold the 160 shares in 1999 to V, the manager of Select Travel, for \$37,500. He relied on C to set the prices of the shares, based on 70-80% of one year's gross revenue. The Minister argued that these transactions never took place and denied the ABIL deduction on that basis.

The taxpayer's appeal was dismissed. The explanations given by the taxpayer were not credible. As evidence of the loans to C, he produced cancelled cheques. Only one was made out to C, and the taxpayer's testimony that C had directed him to make payments to third parties on his behalf was not supported by the evidence. There were discrepancies between his evidence and the shareholder directory of Select Travel. The taxpayer claimed he owned no shares of Select Travel until his purchase from C, yet the register showed he had subscribed for 100 shares in 1982. The prices allegedly paid for the shares made no sense, as gross revenues had multiplied fivefold between the purchase from C and the resale to V, yet the shares were purchased for five times less. No independent valuation was done, nor was there any evidence about bargaining for

the share transactions. The agreements of purchase and sale of the shares produced by the taxpayer required that all the transactions be recorded in the minute book of Select Travel, yet that was not done. Neither C nor V was called to give any evidence that might support the taxpayer's claims. Based on the testimony heard, the taxpayer neither purchased nor resold the shares, and he did not incur any allowable business investment loss.

¶47,610, *Lobo*, 2011 DTC 1109

No misrepresentation in claiming principal residence exemption from gain realized on sale of residence

On May 7, 2001, the taxpayer purchased a property (the "Property") for \$12,000. He constructed a principal residence on the property and moved into that residence in October 2001. The taxpayer rented the residence to third parties in November 2002, and sold the property on April 10, 2003 for \$148,000, resulting in a profit of \$70,814. The Minister included that profit in the taxpayer's income for 2003 in a reassessment made beyond the normal reassessment period. The Minister's position was that the taxpayer was in the construction business and had a history of purchasing and reselling properties at a profit since 1996. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. The law does not require a taxpayer to report profits in the way that best pleases the Minister. The taxpayer's explanation that the sale of the Property was prompted by his mother giving him a riverfront property on which to build a residence was reasonable. Reporting the profit from the sale of the Property as an exempt profit from the sale of a principal residence was also reasonable and involved no misrepresentation. The Minister therefore failed to show that the reassessment beyond the normal reassessment period was justified under s. 152(4)(a)(i) of the *Income Tax Act*. The reassessment was therefore vacated.

¶47,612, *Cameron*, 2011 DTC 1111

Notice: Readers are urged to consult their professional advisors prior to acting on the basis of material in *Tax Topics*.



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