TAX FOR THE Owner-Manager

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Callaghan v. The Queen: Distinguishing a Source of Income from a Hobby

Callaghan v. The Queen (2020 TCC 28; informal procedure) was concerned primarily with the question whether the activities of the appellants (Michael Callaghan and his spouse, Barbara Van Rassel) were a source of income—namely, a business.

The facts were relatively straightforward. Mr. Callaghan had a longstanding interest in food and had a hobby relating to cured meats and charcuterie. In 2007, his spouse entered Mr. Callaghan into a national chili recipe contest, which Mr. Callaghan won. This success inspired the appellants to transform Mr. Callaghan's victory into a business venture. Mr. Callaghan testified that he saw a great deal of opportunity relating to the growing popular interest in food culture. The appellants hoped to build up a brand directly linked either to the food activities of the appellants or to Mr. Callaghan in his personal capacity as a food celebrity. Once that brand or reputation was established, the appellants planned to monetize it in various ways. It was expected that this process would take time and that the business would grow gradually. At trial, the appellants provided documentation of this plan in the form of "an evergreen document that was updated every year. The version in evidence was . . . produced no later than 2015."

The business, which was unincorporated (and reported as a partnership for tax purposes), was owned equally by each of the appellants. The business developed slowly from 2007 onward and was run from the appellants' home. Mr. Callaghan was the visible face of the business, doing the cooking and photography and producing the videos. Ms. Van Rassel handled the logistics, setup, organization, administration, and bookkeeping. In the years at issue, the principal business activities were attending courses relating to food, participating in food competitions, developing recipes, and catering. The appellants held full-time jobs while they were operating the food venture.

From 2008 to 2014, there was very little gross revenue (in particular, there was no revenue at all in 2008 and only trivial revenue in 2010). Despite the modest revenue, significant expenses resulted in large tax losses accumulated over the relevant taxation years and in-home expenses that could not be used to create current-year losses but were carried forward and could be deducted against future income. In 2013, the appellants may have made a small gross profit. The sum of the losses claimed by the appellants from 2008 to 2014 inclusive was approximately $345,000 without the home expenses.

The minister denied the business losses claimed for the 2008 to 2014 taxation years on the basis that there was no source of income. The minister relied on subparagraph 152(4)(a)(i) to claim that a misrepresentation was made in respect of 2008 through 2011, since those years would otherwise have been statute-barred. In addition, the minister applied gross negligence penalties pursuant to subsection 163(2) with respect to all years.

The TCC applied the decision in *Stewart v. Canada* (2002 SCC 46) and stated that in order to determine whether an activity is a source of income, one must first decide whether there is a personal or hobby element to the activity or whether the activity is purely commercial in nature. If a personal element is present, then one must determine whether the activity is undertaken in "pursuit of profit." The TCC noted that

> [t]here is no exhaustive list of factors to consider and the factors that are relevant may differ depending on the nature of the activity in question. Among the factors that are normally to be considered are the profit and loss experience of past years, the taxpayer's training, the taxpayer's intended course of action and the capability of the venture to show a profit.

The TCC also noted that the SCC in *Stewart* had emphasized that this analysis should not function as an exercise in second-guessing the business judgment of the taxpayer.

The court held that in the present case there was clearly an element that was personal in nature and thus not commercial. The court cited, among other things, Mr. Callaghan's pre-existing hobby and the operation of the activity out of the family home as evidence of this non-commerciality.

Having made this initial determination, the TCC proceeded to conduct the more extensive analysis demanded by *Stewart*. The court held that "[r]eceiving training, attending courses and, up to a certain point, participation in competitions which also enhance the skill and know-how of the Appellants are clearly capital activities of the personal nature, much like education, that are not deductible." In addition, the court held that building a reputation and developing recipes can, at least initially, constitute activities of a capital nature.

Examining the evidentiary record, the TCC concluded that although the activities may initially have been of a personal nature and/or in the nature of capital expenditures, at some

point they developed into a business and therefore a source of income.

The court noted that in 2017 (a taxation year not in dispute), the appellants' activities involved quite a lot of catering and sales to the public, and that they generated gross revenue of $153,324, a gross profit of $98,304, and a net profit of over $10,000 (taking into account the business use of home expenses in the year but before applying suspended home expenses from prior years). In 2018, the business activities involved a TV appearance, endorsements, and paid personal appearances. The 2018 activities generated gross revenue of $83,554, which, while significantly lower than the 2017 revenue, was much higher than the revenue in all years prior to 2017.

On the basis of the foregoing, the TCC concluded that in 2017 there was a business—that is, a source of income. The remaining issue to be decided was when the business began. Because the court later concluded that the years before 2012 were statute-barred, it limited its analysis to the 2012 through 2014 taxation years. It held that nothing in *Stewart* precludes a slow, gradual buildup to a business; however, such a gradual buildup cannot include any period that was "essentially personal training and skills development of a capital nature."

The court held that by 2012, a business was operating on a small scale and constituted a source of income. In support of this conclusion, the court cited a number of activities that contributed to the buildup to the 2017 taxation year, including the winning of a number of prizes; cash endorsements; the catering of two large events in 2014; and in particular a paid appearance in 2014, which the court viewed as playing an instrumental role in the appellants' ability to secure the catering work done in 2017.

The court held that the appellants genuinely believed that they were carrying on a business throughout 2008 to 2014 and, relying on *Salloum v. The Queen* (2014 TCC 366; appeal to FCA dismissed, 2016 FCA 85), held that a misrepresentation was not present. Accordingly, the years outside the normal reassessment period could not be reopened. With respect to the gross negligence penalties, the TCC held that because those penalties can be applied only in circumstances that require a higher degree of intentionality than that required to prove a misrepresentation, that standard clearly could not have been met.

Therefore, the appeal was allowed on the basis that the 2008 to 2011 taxation years were statute-barred; there was a source of income for 2012 to 2014; and gross negligence penalties were to be deleted for all impugned years.

Because *Callaghan* was decided under the informal procedure, it carries no precedential value. Furthermore, although the case does not create new law, it summarizes the law concerning when a business constitutes a source of income capable of generating deductible business losses. Importantly for practitioners, *Callaghan* reminds us that a business often builds up gradually and that large recurring losses, which at first glance might look like evidence of non-commerciality, can in fact be the legitimate base on which later profits are built. When faced with a dispute of this type, the taxpayer may benefit from providing context for any losses claimed. This context may assist the taxpayer in grounding a claim that a source of income exists in the kind of gradual business development model articulated by the TCC in this case.

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