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# CHAD V. THE KING: THE SOURCE-OF-INCOME TEST AND TAX-MOTIVATED TRANSACTIONS

The TCC's recent decision in *Chad v. The King* (2024 TCC 142) concerned the deductibility of certain losses realized in the appellant's 2011 taxation year, which were the result of a "straddle-trading" strategy employing foreign-exchange (FX) forward contracts. This decision is of particular interest because it raises important questions about the correct interpretation of the source-of-income test, as articulated in *Stewart v. Canada* (2002 SCC 46) and applied in *Walls v. Canada* (2002 SCC 47), in light of recent decisions in *Canada v. Paletta (Estate)* (2022 FCA 86), *Brown v. Canada* (2022 FCA 200), and *Stackhouse v. The King* (2023 TCC 156).

S. Robert Chad ("the appellant"), a successful businessman, engaged an FX brokerage firm called Velocity Trade International Limited ("Velocity") to implement a strategy known as "straddle trading."

Between November 30, 2011 and March 26, 2012, the appellant entered into 34 FX forward contracts. He entered into forward contracts in pairs, "one long (agreeing to buy a particular amount of US dollars on a future date) and the other short (agreeing to sell the same amount of US dollars on a slightly different future date)." These paired trades were entered into so that one trade would almost, but not completely, offset the other. A complete offset did not occur because there was "always a slight difference between the value date of the long leg and the value date of the short leg," and there was always a positive or negative value at a point in time between the value of the paired "long leg" and "short leg."

The appellant arranged for each FX contract to be closed out before maturity by entering into a new FX contract with an equal and offsetting position. By the end of December 2011, all of the loss legs, as determined by the FX broker, had been closed out, thus crystallizing the losses of $22,017,400 that were claimed as business losses for the 2011 taxation year. In the first quarter of 2012, the appellant closed out the gain legs, which resulted in aggregate crystallized gains of $22,023,600. The crystallized gains in 2012 exceeded the crystalized losses in 2011 by $6,200.

The minister of national revenue advanced several arguments to support denying the 2011 losses, including that the trades were shams, that they were not legally effective, that they did not constitute a source of income, that the appellant had not used the proper accounting method to report the trades, and, finally, that the general anti-avoidance rule (GAAR) applied to deny the losses.

The TCC rejected the sham argument and the argument that the trades were legally ineffective. Sommerfeldt J

reviewed the jurisprudence on the source-of-income question, including the SCC's decisions in *Stewart* and the companion case of *Walls*; the FCA's decisions in *Paletta* and *Brown*; and the arguments advanced by Owen J of the TCC in *Stackhouse*.

*Stewart* (which was applied by the SCC in *Walls*) is generally regarded as the case in which the SCC rejected the "reasonable expectation of profit" (REOP) test, which had previously formed part of the source-of-income jurisprudence. The SCC rejected this approach because of (in part) "its vagueness and uncertainty of application" and because it could result in the second-guessing of taxpayers' bona fide commercial decisions.

In paragraph 50 of *Stewart*, the SCC adopted a two-part test for determining whether a source of income exists:

- Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?
- If it is not a personal endeavour, is the source of the income a business or property?

Critically, in *Stewart*, the court stated: "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" (paragraph 53).

In *Paletta* (whose facts are somewhat similar to those in *Chad*), the FCA had held that "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 . . . source of income exists." However, this conclusion was subject to the holding that "where . . . 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."

In *Brown*, another case dealing with source of income, the FCA restated the test in *Stewart* (based on the FCA's interpretation of *Paletta*) 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 manner to constitute a source of income."
    . . .
  - 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.

In *Stackhouse*, a case dealing with the deductibility of farm losses, Owen J reviewed the two-part test in *Stewart* and the "rephrasing" of the test in *Stewart* by the FCA in *Brown* and concluded that "[w]ith respect, this rephrasing [did] not reflect the test stated in *Stewart*, nor is it justified by the approach taken by Noël, C.J. in [*Paletta*]."

Owen J found that there was an assumption underlying the two-part test in *Stewart*: that a commercial activity is undertaken for profit. The justice held that "unless there is some reason to question this assumption in the circumstances of a particular case, an activity that is on its face clearly a commercial activity as opposed to a personal undertaking is considered a source of income."

Owen J stated that, in *Paletta*, Noël CJ had "found that because the evidence revealed that there was no pursuit of profit notwithstanding the apparently commercial nature of the transactions there could not be a business source of income." Owen J also stated, however, that Noël CJ was not proposing an additional layer of inquiry into whether a commercial activity was in pursuit of profit. I would respectfully disagree with Owen J in this regard: the effect of *Paletta* was precisely to raise the prospect of further enquiry. By reading in a factual exception to the direct application of the original two-part test in *Stewart*, *Paletta* opened the door to additional layers of inquiry not supported by the approach taken in *Stewart* and *Walls*. This eventually resulted in the FCA's problematic rephrasing of *Stewart* in *Brown* (see Friedlan and Friedlan's article in the April 2024 issue of *Tax for the Owner-Manager*).

In *Chad*, Sommerfeldt J noted that several passages in *Stewart* "might possibly be read, in the context of a commercial activity with no personal element, as not requiring any inquiry into a taxpayer's intention to pursue a profit." The justice also noted, however, that "those passages seem to be at odds with other passages . . . that indicate that there can be no source of income without an intention to pursue a profit." Sommerfeldt J stated that, as a trial judge, it "behoove[d]" him to apply the interpretation of *Stewart* as set out by the FCA in *Paletta* and *Brown*. He went on to state that, even if the two cases do not precisely coincide on all points, both of them "emphasize that, to be a source of income, there must be an intention to profit."

Accordingly, Sommerfeldt J held that, although the appellant's FX activities did not have a personal element, the appellant still had to produce objective evidence that, in participating in those activities, he was pursuing a profit (although profit did not need to be his predominant intention). Sommerfeldt J reviewed both subjective and objective evidence regarding the appellant's intention to profit. The court noted the fact that the profit realized by the appellant did not exceed the fee charged by the FX broker and that the FX trading activities of the appellant did not result in a net profit as would be computed under section 9 of the ITA. Accordingly, the TCC held that the FX trading activities of the appellant, despite appearing commercial, were not conducted with a view to profit and were not "clearly commercial." Sommerfeldt J also found that the appellant's intention in implementing the FX trading was to incur a loss for 2011. Accordingly, the court held that the FX activities were not a source of income.

Because the TCC's source-of-income holding was sufficient to dispose of the appeal, Sommerfeldt J declined to make a finding with respect to the GAAR and method-of-accounting arguments.

In *Walls*, the SCC applied the two-part test in *Stewart* without considering whether the commerciality was supported by an intention to profit. This is an important point, because *Walls* dealt with a partnership set up as a "tax shelter" that could only give rise to financial advantage by way of "tax refunds as a result of claiming the inevitable losses from the arrangement." The SCC had rejected the argument that the storage park held by the partnership was not a source of income because the storage park's activities were self-evidently "commercial in nature, and there was no evidence of any element of personal use." The court had held, further, that the fact that the activities of the partnerships were "clearly motivated by tax considerations" did not detract from the commercial nature of the partnership's activities.

Although the paired trades in *Chad* were mostly offsetting, they were not completely offsetting: a small (gross) profit was realized when the gains legs were closed out in the taxpayer's 2012 taxation year, although that profit did not end up being sufficient to cover the fees charged by the FX broker.

A faithful reading of the *Walls* case supports the position that where the activities involve no personal or hobby elements, the test in *Stewart* should be applied without consideration of whether the activities were "conducted with a

view to profit," even when the transactions are tax-motivated. The activities in *Walls*, *Paletta*, and *Chad* were all commercial in nature, without the presence of personal or hobby elements, but they were tax-motivated. In *Paletta*, the FCA distinguished that case from *Walls* on the basis that *Paletta* was similar to *Moloney (M.) v. The Queen* (92 DTC 6570 (FCA)). In *Walls*, the SCC had stated that, in *Moloney*, "the taxpayer was not engaged in a commercial activity, but instead was involved in a sham" (paragraph 21 of the decision). With respect, the FCA's distinguishing of *Paletta* from *Walls* on the basis of *Moloney* was not justified, given the factual findings of the trial judge in *Paletta*.

Regarding tax motivation, there may be a possible distinction between the facts in *Walls* and those in *Paletta*. Although the transactions in *Walls* were tax-motivated, the underlying business operated by the partnership was held to be "commercial in nature." In *Paletta*, on the other hand, the TCC found that the transactions (though commercial in nature) had only one purpose: to generate tax losses.

To the extent that *Paletta* is consistent with *Walls*, reconciling the cases would require that a tax-motivated (though not exclusively tax-motivated) transaction with no personal or hobby elements be exempt from inquiries into pursuit of profit but that a transaction without personal or hobby elements (but motivated *exclusively* by tax considerations) not be so exempt. It might be possible to conclude that any distinction between the two cases hinges on the presence of the contemplation of an anticipated possibility of profit in one case but not in the other. I note that, in *Chad*, it is not clear whether the factual findings support an inference that there was no anticipated possibility *at all* of profit.

With due respect, my view is that the FCA decision in *Paletta* is not consistent with the SCC decisions in *Stewart* and *Walls* and that, therefore, the decision in *Chad*, which relies on the decision in *Paletta,* is also not consistent with those SCC decisions.

It is very important to note that the SCC stated in *Walls* (paragraph 22)—reiterating the caution stated in *Stewart* (paragraph 65)—that, "given the specific anti-avoidance provisions in the Act, courts should not be quick to embellish its provisions in response to tax avoidance concerns." In my view, that is precisely what was done by the FCA in *Paletta*.

*Chad* has been appealed to the FCA, and it would be a welcome development if the FCA could clarify the source-of-income test in a way that preserves and follows the remedial purpose of the SCC decisions in *Stewart* and *Walls* (namely, the purpose of limiting questions about "pursuit of profit" to situations that involve some personal or hobby element). Without such clarity, taxpayers will be left to contend with muddled case law rife with subtle nuances and uncertainty, raising the prospect of frequent and contentious litigation on source-of-income issues.

*Philip Friedlan*
Friedlan Law, Richmond Hill, ON
philip.friedlan@friedlanlaw.com

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