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Management Services, Personal Motives, and the Pursuit of Profit

Brown v. Canada: How the FCA Evolved the Source-of-Income Test and Applied Its Decision in Paletta

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In *Brown v. Canada, 2022 FCA 200,* the Federal Court *of Appeal restated the source-of-income test and applied the test to the taxpayer's management services activity. The FCA focused on the nature of the activity and clarified that, in situations where the activity lacks any personal element, the test requires courts to consider still whether the taxpayer aims to generate profit by engaging in the activity. Brown evolves the source-of-income test and attempts avoid a regression to the pre-Stewart era and uncertainty.*

Key Insights

Brown v. Canada[1] offers three key insights.

1. Personal motives for an activity will not inherently transform the activity into a personal endeavour. The nature of the activity, not the reason behind the decision to engage in it, constitutes the key factor.

2. Even when the activity **lacks** a personal element, the Court will consider whether the taxpayer aims to generate profit by engaging in the activity. However, the FCA does not intend to return to disputes about reasonable expectation of profit or taxpayer business acumen.

3. To comply with the FCA's guidance in Brown and avoid reverting to pre-Stewart uncertainty, courts should reject CRA and DoJ arguments that attack an activity's commercial nature unless the activity cannot create profit or loss, similar to the Tax Court's finding in *Paletta.*

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Background

Darrell Brown and Lyudmila Bezpala were a married couple.

Darrell and Lyudmila planned to open an art gallery in Toronto's Yorkville neighbourhood. Darrell and Lyudmila incorporated a numbered company to manage the gallery ("218 Inc."). Darrell owned 51%, and Lyudmila owned 49% of the common shares.

Darrell and Lyudmila hoped to open the art gallery in 2010. And they expected 218 Inc. to incur losses for the first five years. Darrell arranged for 218 Inc. to receive financing from Rotveil Technologies to provide 218 Inc. with the financial stability it needed in the early years. Lyudmila's brother was Rotveil's principal.

Bezpala-Brown Gallery ("BBG") opened in September 2010. But in 2010, Lyudmila became ill and could not carry out her BBG responsibilities because of her illness. In 2011, Rotveil stopped lending money to 218 Inc., and Darrell started contributing more time to BBG.

In January 2011, 218 Inc. passed a resolution to retain Darrell to provide management services. Darrell and 218 Inc. agreed that: (1) Darrell would receive a management fee equal to 20% of the amount by which BBG's annual revenue exceeded $100,000; and (2) Darrell would have the right to enter into a five-year management services contract to recoup losses if 218 Inc.'s revenue did not exceed $100,000 and did not pay Darrell any management fees ("the revenue-sharing agreement").

As expected, BBG experienced startup losses in 2011, 2012, and 2013. Darrell claimed non-capital losses of $90,696, $115,200, and $113,932, respectively.

The CRA audited and denied Darrell's non-capital losses, adopting the position Darrell's management service activity was not a source of income. The CRA held that Mr. Brown's services to 218 Inc. did not constitute a source of income because it was a personal activity.

The CRA attempted to justify its position by arguing that Darrell's choice to engage in the activity was due to his spouse's illness and inability to fulfill her BBG duties. In simple terms, Darrell decided to do the work for personal reasons. Also, the CRA took the position that Darrell did not carry out the activity in a sufficiently commercial manner to constitute a source of business and did not show his predominant intention was to profit from the activity.

CRA issued notices of reassessment denying Darrell's non-capital losses.

Darrell appealed the notices of reassessment to the Tax Court of Canada.[2]

The TCC's Decision

The TCC dismissed Darrell's appeal.

The TCC determined that Darrell's personal motivation influenced his decision to participate in the activity, thus classifying the activity as a personal endeavour.

Additionally, the TCC determined that Darrell did not provide the management services in a sufficiently commercial manner, mainly due to the terms of his compensation agreement. As a result, the TCC found the activity was not a source of business income.

> [T]he Court finds that Mr. Brown only began providing management services because of Mrs. Brown's health issues.[3]
>
> ...
>
> [A] businessperson would not have accepted to be compensated for his services as Mr. Brown did.[4]

Darrell appealed the TCC's decision to the Federal Court of Appeal.

The FCA's Decision

The FCA allowed Darrell's appeal.

It held the TCC erred when it found that Darrell's motive for providing the management services transformed the activity into a personal endeavour.

The FCA explained that *Stewart v. Canada*[5] requires us to focus on the activity itself, regardless of the reasons for carrying it out. The first question is whether the activity inherently involves a personal aspect. If so, then Stewart requires the decision-maker to assess whether the taxpayer is carrying out the activity in a sufficiently commercial matter. When considering activities with **no personal element**, the FCA in Brown turned to its decision in *Canada v. Paletta*[6] to explain the correct next step.

In Paletta, the FCA examined whether the taxpayer's activity (i.e., the straddle transactions) was a source of income. In Paletta, the courts found the nature of the activity made it impossible to generate any profit or loss; the taxpayer undertook the activity to create tax losses. This finding was important and had a significant impact on the decision. If an activity cannot generate profit or loss, it cannot fit within section 9 of the ITA.

After examining *Paletta,* the FCA in Brown restated the source of income test 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" (Stewart, at para. 60).
>
> 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.

After restating the source-of-income test this way, the FCA applied it to the facts in *Brown*.

Does the Activity Have a Personal Element?

In *Brown*, Mr. Brown's activity was providing management services. The Crown and TCC focussed on Mr. Brown's motives for providing the management services, i.e., Lyudmila's illness. However, the FCA held that when the Crown and TCC adopted this approach, they misinterpreted *Stewart* and erred in law. What truly matters is the activity itself, not the reason behind engaging in it.

Justice Webb pointed out there is always some personal incentive behind engaging in an activity, but this does not necessarily mean the activity is personal.

> Applying [the TCC's] logic to an intergenerational transfer of a business, whenever the next generation takes over an endeavour from their parents as a result of their parents' inability to continue the endeavor, the analysis to determine if the next generation is carrying on the activity in a sufficiently commercial manner to qualify as a source of income would be triggered. However, simply because a child takes over an endeavor from his or her parent because that parent is not able to continue conducting that endeavor should not result in a finding that there is a personal element to the endeavor that the child is now undertaking.[7]
>
> A person's personal motivation or reason for conducting an activity cannot, in and of itself, result in there being a personal or hobby element to the activity. It is possible to find a personal reason why any person is carrying on a particular activity. For example, a person may be motivated to conduct a particular activity to generate money to fund his or her personal lifestyle or because they are personally motivated to provide better services or products than are currently available in the marketplace.[8]

The Crown did not present an argument that the activity itself had a personal element. The FCA held the activity in Brown did not contain a personal element and considered the second part of the restated test, i.e., whether the taxpayer was carrying on the activity to pursue profit.

Before looking into this question, the FCA made a point to highlight the different conditional questions that come up when the activity includes a personal element compared to when it doesn't.

> The presence of a personal element in the activity in question will trigger the inquiry into the predominant intention of the taxpayer. **Absent a personal element in the activity, the question is whether the taxpayer is pursuing profit in undertaking the activity in question, not whether this was his predominant intention.** If the evidence establishes that profit is not being pursued, then the taxpayer is not carrying on a business (Paletta, at paragraph 39).[9]

[emphasis added]

Was the Taxpayer Carrying on the Activity to Pursue Profit?

The Crown argued Darrell was not carrying on the management services to pursue profit. To support its position, the Crown emphasized that Darrell and 218 Inc. did not enter into a formal agreement that would require 218 Inc. to repay Mr. Brown's expenses. In general terms, the Crown argued that, without a reimbursement agreement, Darrell was not pursuing profit.

The FCA cited the parties' revenue-sharing agreement to show the link between Mr. Brown's management services activity, the BBG's business and revenue, and Mr. Brown's pursuit of profit.

The Crown's and the TCC's expressions of doubt regarding Mr. Brown's decision to agree to the revenue-sharing model, considering the financial state of 218 Inc., and the likelihood of Darrell profiting from his management services activity, were not enough to support the conclusion that Darrell was not actively seeking profit by providing the management services to 218 Inc.

The FCA rejected the CRA's argument and explained the CRA misinterpreted the correct question. It seems the Tax Court made a similar mistake.

> The question … is whether, in providing the management services, he was pursuing profit, n**ot whether he had a reasonable expectation of profit or whether a different business model could have been chosen.**[10]

[emphasis added]

[intentionally blank]

In contrast to *Paletta*, there was no evidence in Brown to indicate the purpose of the activity was anything other than the pursuit of profit from the activity. Therefore, the FCA held it is likely that Darrell was in pursuit of profit in providing the management services.

> There is also no allegation in the Reply filed by the Crown in the Tax Court that the arrangement between Mr. Brown and the numbered company was a sham. Therefore, there is no allegation that the contract between Mr. Brown and the numbered company did not reflect the obligations of the parties.[11]
>
> ...
>
> As a result, in my view, there is no basis to conclude that Mr. Brown was not in pursuit of profit in providing the management services to the numbered company and, therefore, on the balance of probabilities, he was in pursuit of profit in providing these management services.[12]

Final Remarks

The FCA's decision in *Paletta* surprised many in the tax community, leading to a moment of surprise and concern.

Brown gives stakeholders more guidance to correctly setting out and applying the source-of-income test in this post-*Stewart* and *Paletta* era. The FCA's restatement of the source of income test is a sensible way to reconcile the caselaw and the relevant provisions in the ITA. Now, the judiciary is responsible for strictly applying this restated test and remaining within its boundaries in future cases. We do not anticipate that this will be a simple task.

To uphold the FCA's guidance in Brown and avoid regressing to pre-Stewart times, the courts must reject arguments that attack an activity's commercial nature unless (1) the activity, in and of itself, has a personal aspect; or (2) the activity lacks the inherent capability to generate profit or loss, similar to TCC's finding in the *Paletta* case.

In general, we expect *Brown* will help reduce the scope of disputes and make them more targeted than otherwise. Brown represents a positive development for taxpayers and legal counsel engaged in these tax disputes.

[1] 2022 FCA 200.
[2] 2020 TCC 123.
[3] *Ibid.* at para 34.
[4] *Ibid.* at para 37.
[5] 2002 SCC 46.
[6] 2002 FCA 86.
[7] *Supra* note 1 at paragraph 28.
[8] *Supra* note 1 at paragraph 29.
[9] *Supra* note 1 at paragraph 35.
[10] *Supra* note 1 at paragraph 38.
[11] *Supra* note 1 at paragraph 43.
[12] *Supra* note 1 at paragraph 45.

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