The Joint Committee on Taxation of
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February 19, 2004

Mr. Brian Ernewein
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Department of Finance Canada
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Dear Mr. Ernewein:

Re: October 31, 2003 Draft Proposals Regarding the Deductibility of Interest and Other Expenses

We are pleased to submit our comments on the October 31, 2003 Draft Proposals Regarding the Deductibility of Interest and Other Expenses ("Draft Proposals").

For the reasons discussed in our submission, we are of the view that the Draft Proposals would introduce a fundamental change to the *Income Tax Act* which goes well beyond the case law and administrative practice prior to recent court decisions. We are concerned that the proposals could be used to disallow losses resulting from wholly-legitimate business expenses the deductibility of which would not have been an issue under prior case law or administrative practice. They would create significant issues with respect to the treatment of investments in securities. In our view, fundamental changes such as those contained in the Draft Proposals are not necessary to deal with what we understand to be the principal areas of concern to Finance.

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At your invitation, we have also commented on the difference between the Draft Proposals and the alternative approach of defining "income" as meaning "net income" where used in the various "purpose tests" in the Act. While in our view such a change would avoid some of the issues under the test in the Draft Proposals, we are concerned that a blanket amendment of this sort could lead to results that are inappropriate and contrary to current administrative practice.

We appreciate the opportunity to participate in this process and your willingness to discuss these matters with us. We hope that you will find these comments useful. As you will see in our submission, our view is that, if any changes are made, they should be targeted to the specific areas of concern to Finance. We would be happy to elaborate or give you further thoughts on this or any other matter relating to our submission.

Yours truly,

Paul B Hickey Brian Carr

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CICA –CBA Joint Committee on Taxation

Submission on the October 31, 2003 Draft Proposals
Regarding the Deductibility of Interest and Other Expenses

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1. INTRODUCTION

In the February 18, 2003 federal budget, it was stated that amendments to the *Income Tax Act* were necessary because recent court decisions could lead to inappropriate results that would not have been generally expected under prior law and practice. On October 31, 2003, the Department of Finance released Draft Proposals Regarding the Deductibility of Interest and Other Expenses ("Draft Proposals"). The technical notes to the Draft Proposals state that the purpose of the proposals is to "clarify" the existing law.

In our view, the Draft Proposals are much more than a simple "clarification" which restores the prior law. They would apply in circumstances which are well beyond the prior case law and administrative practice. There are significant concerns with respect to the treatment of investments in securities. We are also concerned about the lack of grandfathering.

In our view, fundamental changes such as those contained in the Draft Proposals are not necessary to deal with what we understand to be the principal concerns of the Department of Finance.

These matters are discussed below. In addition, we consider the difference between introducing the test in the Draft Proposals and the alternative approach of defining "income" as meaning "net income" where used in the various "purpose tests" in the Act. While in our view such a change would avoid some of the issues under the test in the Draft Proposals, we are concerned that a blanket amendment to change the definition of income to mean net income could adversely affect taxpayers in unintended and inappropriate ways.

2. THE DRAFT PROPOSALS GO BEYOND PRIOR CASE LAW AND ADMINISTRATIVE PRACTICE

Under the Draft Proposals, a taxpayer's loss for a year from a business or property will not be deductible against other income unless, in that year, it is reasonable to expect that the taxpayer will realize a cumulative net profit over the whole period that the taxpayer carries on (and is likely to carry on) the business or holds (and is likely to hold) the income-producing property.

This test for the deductibility of losses goes far beyond the law as it was applied by the Canada Revenue Agency before the recent court decisions. Two elements of the test are of particular concern, and will result in the inappropriate denial of losses realized by wholly-commercial undertakings: the requirement to test for the profit expectation each year in which a loss is realized, and the use of *cumulative* profit or loss results from the time the business commenced or the property was acquired.

These and other matters are discussed below.

(a) Requirement to Test in Each Loss Year

Because of the requirement to test in each year in which a loss is realized, the Draft Proposals could apply to deny losses from a *bona fide*, wholly-commercial undertaking which has become unsuccessful and is possibly being terminated. This would be so notwithstanding that individual expenses qualify for deduction, and would have qualified prior to the recent court decisions. Thus, the Draft Proposals constitute a fundamental change in policy.

Interest provides one example of this problem with the Draft Proposals. The deductibility of interest is determined under paragraph 20(1)(c). In the ordinary course, this determination is not revisited unless there is a change in use. If losses subsequently arise from the deduction of the interest, this does not affect the deductibility of the interest. The losses are deductible because there is no overriding rule similar to the Draft Proposals.

Another example is provided by capital cost allowance claims. CCA is allowed on capital property acquired for the purpose of gaining or producing income (Reg. 1102(1)(c)). As long as the use of the property does not change, CCA can continue to be claimed, whether or not losses are realized from the undertaking (subject to the leasing and rental property rules).

Under the Draft Proposals, an overriding test would be applied in each future year in which a loss arises because of the deduction of interest or capital cost allowance (or other amounts). The Draft Proposals impose a requirement to test in each year whether there is a reasonable expectation of a cumulative profit from a venture over the entire period during which it has been, and can reasonably be expected to be carried on. Thus, if borrowed money is used or depreciable property is acquired in a previous year, losses from the deductibility of interest or capital cost allowance may be denied in a subsequent year if the related business is unsuccessful and, in that subsequent year, it is not reasonable to expect that accumulated net losses to date will be recouped. This denial of deductibility would apply not only to losses from the deduction of interest and capital cost allowance, but also to losses from other expenses that the taxpayer is committed to pay, such as lease payments, salaries, franchise fees, and other recurring expenses.

The annual testing in respect of losses also penalizes a taxpayer on the termination of a business. In this case, there may be no expectation of either a future profit or a cumulative profit, but from a commercial point of view the taxpayer has no choice but to incur certain costs. These may include costs of terminating contractual arrangements such as employee severance costs, as well as mothballing costs, reclamation costs and the other costs of terminating a business. The taxpayer may well have on-going interest costs relating to the existing financing for the business or the funding of closing-down costs. To deny such legitimate commercial losses represents a fundamental change in the Canadian system of business taxation.

The concern with the annual testing in respect of losses exists for *all* business ventures. Specifically, it exists where a fully-informed, sophisticated taxpayer has acted on a rational basis and with a reasonable expectation of profit (as opposed to a capital gain) at the outset, but for some reason that expectation is not borne out. This may occur as a result of circumstances beyond the control of the taxpayer. Examples could be a change in political or regulatory regime or catastrophic national or world events.

The annual testing in the Draft Proposals is inconsistent with the policy underlying section 20.1 of the Act. That section deems borrowed money to be used for the purpose of earning income from a business or property and permits continued interest deductibility even though the source of income has disappeared. The section expressly contemplates the situation where there can be no reasonable expectation of future profit from the business or property because the business or property has ceased to exist or has been sold and ensures that interest deductibility will continue in these circumstances. Section 20.1 was introduced to overcome an acknowledged inequity in the Act. Without this provision, taxpayers would be less inclined to take business and investment risks. The direction of the Draft Proposals is completely contrary to and inconsistent with this tax policy objective.

(b) Requirement for Cumulative Profit

As noted above, under the Draft Proposals, the test for recognition of losses is whether, on a year-by-year basis, it is reasonable to expect that the taxpayer will realize a cumulative net profit over the whole period that the taxpayer carries on (and is likely to carry on) the business or holds (and is likely to hold) the income-producing property. Thus the cumulative profit or loss that the taxpayer has realized in prior years is taken into account as well as expected future profit or loss.

This approach is not consistent with how business and investment decisions are made. Most business persons and investors do not necessarily know how long they will carry on a particular business or hold a particular investment. The decision to continue a business or to hold an investment depends on an assessment, at a particular time, of the profits that will be generated in the future. What has happened in the past may be useful information in assessing what profits are likely to be generated in the future, but the decision to continue in a venture or in an investment depends on whether, on a forward-looking basis, a greater return can be obtained elsewhere. Thus, where a taxpayer owns a business and realizes a loss, his or her decision to continue the business will depend on the taxpayer's own financial criteria, which may mean recouping only some of the losses incurred to date. Under the Draft Proposals, the test is whether the business can be expected to more than recoup *all* of the prior losses of the business so as to earn a positive cumulative overall profit. This test is artificial and lacks commerciality.

A further problem with a test that is based on the past is that it can result in different treatment of taxpayers who are in the same current economic position. For example, two taxpayers could own the identical business or property and finance it in the same way, but could be in different tax positions if their historical cumulative net profit or loss positions are different. In our view, taxpayers' losses should not be treated differently where the objective expectations for the future profitability of the business or property are the same.

The cumulative profit test can be more easily satisfied by taxpayers who have greater financial resources. Assume that two taxpayers have the same reasonable expectations of profit at the outset of their ventures (businesses or property acquisitions). Both suffer losses. Profits are expected again in the future. One taxpayer has sufficient financial resources to remain in his or her venture for the long term and ultimately earn a cumulative profit. The other taxpayer, who has fewer financial resources, is expected to remain in his or her venture for a shorter period and to only partially recoup his or her losses. Thus, any further losses incurred by the second taxpayer will not be deductible. Again, in our view, the losses of such taxpayers should not be treated differently. (This example can also be considered a further illustration of the inappropriateness of the annual testing in respect of losses.)

(c) <u>Effect of Change in Law on Commercial Decisions</u>

In view of the concerns identified above, the Draft Proposals can be expected to adversely affect decisions made with respect to commercial activities. One effect is that entrepreneurship will be discouraged. An entrepreneur who wishes to start a new venture must make commitments in doing so. He or she may have to borrow money, hire employees, rent or buy equipment and premises. If one of the consequences of a failure of the venture is the risk that losses from fulfilling or settling those commitments will not be deductible against the entrepreneur's income from other sources, there will be a significant disincentive for the entrepreneur to make the commitments and take the risk that the venture will not succeed. Lenders to the entrepreneur will also be less willing to finance the venture if there is a greater risk that the entrepreneur will not be able to carry the loan because interest on it may have to be paid out of after-tax dollars. Prospective investors in the entrepreneur's venture will also be less likely to invest if they perceive a risk that they will not be able to write off the financing costs of their investment if the investment should prove unsuccessful.

The Draft Proposals will also inhibit restructurings of corporations in financial difficulty. Where a corporation is in financial difficulty, it will be less likely that lenders and other stakeholders will be able to restructure the corporation where there is a concern that current or future losses from the corporation's business will not be deductible against its future income.

3. <u>INVESTMENTS IN EQUITIES</u>

The Department of Finance Press Release on the Draft Proposals stated: "These measures will reaffirm many current practices that support the deductibility of interest, including those relating to the deductibility of interest on money borrowed to purchase common shares." Based on this Press Release and on our subsequent discussions with you, we understand that you do not expect there to be any change in the administrative practice of

Canada Revenue Agency (CRA) in this area. In our view, this does not satisfy the concerns that taxpayers have in this area.

CRA's position on interest deductibility is stated in Interpretation Bulletin IT-533, but this Bulletin deals only with the application of paragraph 20(1)(c), which is not affected by the Draft Proposals. The Draft Proposals assume that the interest is deductible under paragraph 20(1)(c) and deal only with the recognition of any resulting loss. Under the proposals, such loss will be deductible only where it is reasonable to expect that the taxpayer will realize a cumulative profit from the shares for the period that the shares can reasonably be expected to be held. There is no guidance from CRA as to when these requirements will be considered to be met. It is one thing to conclude that, at the time shares are acquired, there is a reasonable expectation that the shareholder will receive dividends. It is another thing to conclude each year that, for the full period throughout which the shares are held, it is reasonable to expect that the cumulative amount of the dividends will exceed the cumulative carrying costs of the shares.

The wording of the Draft Proposals does not suggest that share investments should be treated differently from investments in other property. For example, the Draft Proposals do not provide any legal basis for distinguishing between investments in common shares and investments in real estate. Even if CRA adopts a favourable administrative practice in dealing with share investments, in our view this area is too important and affects too many taxpayers – both sophisticated and unsophisticated – to be left to be dealt with by administrative practice, especially where the legal basis for it is not apparent.

We recognize that, prior to the decision of the Supreme Court of Canada in *Ludco v. The Queen*, 2001 DTC 5055, the law may not have been clear with respect to the deductibility of interest on borrowed money used to acquire shares. In our view, however, if changes are made relating to the deduction of interest or of losses arising because of the deduction of interest, CRA, taxpayers and the courts should be given better guidance as to how the rules are to apply with respect to interest on money borrowed to acquire shares and other securities.

4. FURTHER CONCERNS

In addition to the major concerns identified above, we have the following concerns with the Draft Proposals, some of which are of a more technical nature. We think that these concerns cannot be addressed by minor changes to the Draft Proposals.

(a) Meaning of "Profit"

The technical notes included with the Draft Proposals state that "profit" is intended to mean "profit determined in accordance with generally accepted commercial principles" without any more guidance. The use of the word "profit" excludes the various provisions of the Act which override generally accepted commercial principles. The use of an accounting concept of profit means that certain amounts that are included in income by virtue of particular provisions in the Act will not be taken into account in applying the REOP test. Examples include the gross-up for dividends on shares held by individuals, the deemed interest accrual on prescribed debt obligations, FAPI of a controlled foreign affiliate, and income from a partnership, trust or foreign investment entity (FIE). It is inappropriate not to recognize such income for the purpose of computing "profit", given that the income is subject to tax.

(b) Uncertainty of REOP Determination

Projections of revenue and expenses can be quite speculative. Hence, the Draft Proposals are likely to result in many disputes between taxpayers and the CCRA as to whether a cumulative profit can reasonably be expected in particular situations.

In *Stewart v. The Queen*, 2002 DTC 6969, the Supreme Court of Canada raised legitimate concerns with a general REOP test:

> [T]he reasonable expectation of profit test is imprecise, causing an unfortunate degree of uncertainty for taxpayers. As well, the nature of the test has encouraged a hindsight assessment of the business judgment of taxpayers in order to deny losses incurred in *bona fide*, albeit unsuccessful, commercial ventures.

The Supreme Court of Canada has clearly indicated that it does not consider it appropriate for the courts to be called upon to second guess the business decisions of taxpayers.

(c) No Continuity Rules

The Act contains numerous provisions which provide for continuity of a taxpayer's position under certain circumstances. The Draft Proposals do not include any continuity provisions, and so inappropriate results can occur.

For example, if Aco borrows money to purchase property X, but expects to amalgamate with related corporation Bco, the loss from Aco's interest expense prior to the amalgamation should be deductible even though its investment in property X may not be expected to yield a profit to Aco over Aco's expected holding period of the property up to the amalgamation.

Other examples are as follows: (1) If Aco borrows money to purchase the shares of Xco, but expects to amalgamate with Xco, the loss from Aco's interest expense prior to the amalgamation should be deductible even though its investment in Xco may not be expected to yield a profit to Aco over Aco's expected holding period of the shares. (2) If Aco borrows money to purchase the shares of Xco and Xco later amalgamates with Yco, Aco's interest deductibility prior to the amalgamation should not be determined solely by reference to the period that it holds the shares of Xco.

(d) Sourcing Issues

The Draft Proposals apply on a source-by-source basis. It is not always clear what is to be considered a source for this purpose. For example, if a taxpayer buys shares with borrowed money and then buys more identical shares with non-borrowed funds, it is not clear whether there is one source or two. A further problem with applying the loss denial rule on a source-by-source basis is that this can lead to unequal treatment of taxpayers who are in the same economic position. If Taxpayer A acquires property X and property Y and leverages the acquisition of both of them on a 50% debt, 50% equity basis, he or she may be able to demonstrate a reasonable expectation of cumulative net profit from both properties. By contrast, if Taxpayer B acquires identical property, but funds the acquisition of property X with all debt and property Y with all equity, he or she may not have a sufficient profitability expectation in respect of property X to be able to deduct losses on property X against income from property Y. In our view, there should be no difference and it is unreasonable to require taxpayers to structure their affairs to avoid technical issues such as this.

The Draft Proposals would create new issues with respect to allocation of income and expense to a source. These issues are often academic under the current state of the law. Under the Draft Proposals, however, it would be necessary to more precisely trace or link borrowed money to specific business or property sources. For example, if a corporation earns income from various sources (such as an operating business and holdings of subsidiaries) and borrows (or has borrowed) money to return capital, the borrowing will have to be allocated to a particular source in order to apply the cumulative profit test.

In practice, most taxpayers have not and would not normally keep their financial records on a property-by-property basis. The record keeping that would be required to be able to comply with the Draft Proposals would be onerous. For example, taxpayers with a portfolio of investments in securities would have to keep records in order to establish the extent to which their investments are funded with either borrowed or non-borrowed funds (including gains realized on other investments). Furthermore, as a practical matter, such allocation has never been necessary in the past and it is unreasonable to expect that taxpayers will have the records to make such an allocation when the Draft Proposals commence to apply.

(e) No Recognition of Denied Losses

The technical notes to the Draft Proposals state that, where a taxpayer has expenses that exceed the revenue generated by an investment, it would be inappropriate to tax any amount of that revenue. Because the Draft Proposals do not include any carryover mechanism, the excess expenses cannot be applied to revenue of other years. For fairness, taxpayers should be permitted to apply denied losses to revenue in other years in which expenses do not exceed revenue, as well as to capital gains.

5. REOP VS. PURPOSE OF EARNING NET INCOME

At our recent meeting, you invited us to comment on the difference between the REOP test in the Draft Proposals and the various purpose tests under the Act, assuming "income" were defined as "net income." In addition to commenting on these differences, we have identified concerns with making this change to the purpose tests.

(a) Difference between REOP and Purpose Test

In our view, a purpose test (whether based on income or net income) is significantly different from the REOP test as formulated in the Draft Proposals.

Whereas the Draft Proposals require all the circumstances to be reviewed each year, the existing purpose test does not necessarily require this. For example, the test for interest deductibility is initially applied when the borrowed money is used and not when the interest expense is incurred. This deductibility is revisited only if there is a change in use. The Draft Proposals require an examination of the circumstances each year that the interest expense is incurred.

(b) Concern with Modifying Purpose Tests to Refer to Net Income

While modifying the purpose tests to refer to net income would avoid a number of the problems identified with the Draft Proposals, we are concerned that, unless an amendment to define income as meaning net income is clearly focused, it could be interpreted as making a fundamental change which could affect taxpayers in unexpected and inappropriate ways.

There are four principal areas where a purpose test is used in the Act and Regulations:

1. paragraph 18(1)(a) provides that an outlay or expense is not deductible except to the extent that it was made or incurred for the purpose of gaining or producing income from a business or property,
2. paragraph 1102(1)(c) of the Regulations provides that an asset is not a depreciable property eligible for capital cost allowance unless it was acquired for the purpose of gaining or producing income,
3. the definition of "eligible capital expenditure" in subsection 14(5) refers to a capital outlay or expense made or incurred in respect of a business for the purpose of gaining or producing income from the business, and
4. paragraph 20(1)(c) refers to borrowed money used for the purpose of earning income from a business or property and to an amount payable for property acquired for the purpose of gaining or producing income from the property or from a business.

(i) Paragraph 18(1)(a)

At present, there is an overlap between subsection 9(1) and paragraphs 18(1)(a) and (h) of the Act. This was pointed out in *Symes v. The Queen*, 94 D.T.C. 6001 (S.C.C.). In that case it was stated that "profit" under subsection 9(1) is a business concept which refers to "well accepted principles of business (or accounting) practice" or "well accepted principles of commercial trading". In the Court's view, such principles "would generally operate to prohibit the deduction of expenses which lack an income earning purpose, or which are personal expenses, just as much as paragraphs 18(1)(a) and (h) operate expressly to prohibit such deductions." We are concerned that, if paragraph 18(1)(a) is amended to refer to net income, there may be a change to that relationship which results in a more restrictive test for deductibility of business expenses.

For example, we are concerned that a change to paragraph 18(1)(a) to refer to net income could be construed as imposing a new, forward-looking test requiring a direct relationship between the expense and the earning of net income in the future, so that the deductibility of closing-down costs of a business could be affected. We note that CRA has accepted that, under the current law, paragraph 18(1)(a) does not preclude deductibility of expenses of this nature: see Memo 9810067—Deductibility of Legal Fees (May 6, 1998), Memo 9700547 – Deduction of terminal loss from resource profits (July 17, 1997), Ruling 2000-0039873 – Sublease. There is also support for this in the case law: see *Poulin v. The Queen*, 94 DTC 1674, reversed on other grounds: 96 DTC 6477. We are concerned with the potential impact on this position, which accords with a common-sense commercial view of what constitutes a normal business expense, of an amendment to paragraph 18(1)(a) to refer to net income.

(ii) Depreciable Property and Eligible Capital Expenses

In our view, the definition of depreciable property and eligible capital expenditure should also be read together with subsection 9(1) and paragraph 18(1)(a). The existing restrictions with respect to leasing properties and rental properties and the recapture provisions in the Act deal appropriately with the over deduction of capital cost allowance. The treatment of eligible capital expenditures is similar. For that reason, we are of the view that a change to the definition of depreciable property or eligible capital property should not be made. A change to the definition to refer to a purpose of earning net income could inappropriately change the types of properties and expenditures that qualify under these definitions.

(iii) Interest Deductibility

We are also of the view that a blanket amendment to define income as meaning net income for the purposes of paragraph 20(1)(c) could be interpreted as limiting the scope of the provision to something narrower than what is permitted under prior case law and current administrative practice.

One area of particular concern is with respect to the deductibility of borrowed money used to acquire common shares and other equity securities. At the 1981 Annual Conference of the Canadian Tax Foundation, the Department was asked whether it had any guidelines as to the situations, if any, where a taxpayer will be denied an interest deduction in respect of funds borrowed to purchase common shares. The response was as follows:

> Normally the Department considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that the potential return to the common shareholder may exceed his borrowing cost. It is conceivable that in certain fact situations it would be quite unreasonable to expect a potential return in excess of the borrowing costs related to such shares. We do not have any guidelines that might be used to isolate such situations and feel each situation must be dealt with on the basis of the facts involved.

This comment was repeated a number of times, including at the 1987 Corporate Management Tax Conference of the Canadian Tax Foundation. The above statement suggests that, if there were a net income test in paragraph 20(1)(c), CRA could continue to maintain its administrative practice in the area, but its stated position is not, in fact, very clear because it includes a warning that, depending on the circumstances, CRA may take the position that interest is not deductible on the basis that it is “quite unreasonable” to expect a positive net return. While we acknowledge that taxpayers have lived with this uncertainty for many years, we are concerned that a blanket amendment which purports to limit the application of paragraph 20(1)(c) could affect the treatment of share investments.

6. LACK OF GRANDFATHERING

The absence of grandfathering in the Draft Proposals is a significant concern. Taxpayers have entered into business ventures or other transactions in reliance on the tax law as it was understood at the time (including publicly announced changes). In many cases, they have made long-term commitments based on that law. It is unfair to change the law without providing reasonable grandfathering to such taxpayers. In this regard, not only would the Draft Proposals alter the current law, they would amount to a significant tightening of the law as it was understood by taxpayers and their advisors prior to the recent Supreme Court of Canada decisions, as has been demonstrated in this submission.

While we hope that Finance will decide not to proceed with the Draft Proposals as they are now framed, our concern about grandfathering is equally applicable to any amendments that may be introduced in their place. We think it is essential that such amendments include adequate grandfathering protection for taxpayers.

7. A FUNDAMENTAL CHANGE IN THE LAW IS NOT WARRANTED

By adding an overriding REOP test for the deductibility of losses from any source, the Draft Proposals would make a fundamental change to the scheme of the Act. In our view, such a change is not necessary in order to cover what we understand to be the areas of concern to Finance.

It would appear that the objective of the Draft Proposals is to prevent taxpayers from deducting losses from an activity once it is objectively unreasonable to expect that the activity will be profitable on a cumulative basis. This could occur where:

1. there is a personal or hobby element to the activity,
2. the taxpayer does not devote the necessary time or resources, or lacks the necessary commitment, background or organization, etc., to carry out the activity in a commercial fashion, or
3. the motivation is, at least in part, a return in the form of a capital gain.

In *Stewart*, it was held that "in order to determine whether a particular activity constitutes a source of income, the taxpayer must show that he or she intends to carry on that activity in pursuit of profit…". The Court also said that, while a REOP test is not appropriate where there was no personal or hobby element to the taxpayer's activities, it could be a factor where there is a suspicion that the taxpayer's activity is a hobby or personal endeavour rather than a business. The Court also said:

> It should also be noted that the source of income assessment is not a purely subjective inquiry. Although in order for an activity to be classified as commercial in nature, the taxpayer must have the subjective intention to profit, in addition, as stated in Moldowan, this determination should be made by looking at a variety of objective factors. Thus, in expanded form, the first stage of the above test can be restated as follows: "Does the taxpayer intend to carry on an activity for profit and is there evidence to support that intention?" This requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour.
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> The overall assessment to be made is whether or not the taxpayer is carrying on the activity in a commercial manner. However, this assessment should not be used to second-guess the business judgment of the taxpayer. It is the commercial nature of the taxpayer's activity which must be evaluated, not his or her business acumen.

In our view, this is the appropriate test to apply in the first two circumstances referred to above, namely where there is a personal or hobby element to the taxpayer's activities or the activities are otherwise not carried out in a commercial fashion.

With respect to the purpose of realizing a capital gain, the Court in *Stewart* said that "the motivation of capital gains accords with the ordinary business person's understanding of 'pursuit of profit', and may be taken into account in determining whether the taxpayer's activity is commercial in nature." We agree that this is an appropriate consideration in evaluating the commerciality of an activity when determining whether a taxpayer has a source of income.

If Finance is concerned about the deduction of losses from a particular kind of an activity not carried on with a reasonable expectation of profit because the motivation is to realize a capital gain, the concern should be dealt with in a focused amendment which does not alter the treatment of other activities under the Act (such as investments in common shares). However, any such amendment should be based upon tax policy reasons that support why certain activities should be treated differently than other activities.

8. CONCLUSION – ANY AMENDMENT SHOULD BE FOCUSED

For the reasons discussed above, we are of the view that the Draft Proposals are unnecessarily broad and uncertain in their application. They will deny losses incurred in *bona fide* commercial undertakings. A blanket amendment to define income as meaning net income could also have a destabilizing effect. In our view, if Finance considers that amendments are required to deal with policy concerns raised by recent case law, such amendments should be clearly focused on the specific areas of concern to Finance. Furthermore, it should be made clear that any such amendment does not limit the deductibility of interest on borrowed money used to purchase shares or other securities.

While in our view the existing provisions of the Act and the case law thereunder impose the appropriate tests for deductibility where an activity has a personal or hobby element or is otherwise not carried out in a commercial fashion, we recognize that the recent case law has suggested that the motivation to earn a capital gain can be used to support interest deductibility. If this is the tax policy concern to Finance, we are of the view that it should be dealt with through an amendment which targets only the specific types of capital property that give rise to the concern.

We can think of two ways in which this might be accomplished. One possibility would be to introduce an overriding rule that, where interest would otherwise be deductible because the borrowed money is used for the purpose of earning income from a type of property of concern, the deduction is restricted unless the borrowed money is used for the purpose of earning net income (excluding capital gains) from the property (or from the business in which the property is used). Where the interest deductibility is restricted, it would be deductible only against income or capital gains from the same source. Another alternative could be to provide that, where interest is deductible on borrowed money used to earn income from a type of property of concern, but not for the purpose of earning net income, any interest-related losses of the taxpayer during the holding period would be recaptured and included in ordinary income (up to the amount of any capital gain otherwise determined) on the ultimate sale of the property.