

MCMILLAN BINCH LLP

Reasonable Expectation of Profit (REOP) in the GST Context

by Jamie M. Wilks

Taxation Law, Volume 14, No. 3, p. 42

Reasonable Expectation of Profit (REOP) in the GST Context

Jamie Wilks*

Introduction

In the wake of the companion decisions released by the Supreme Court of Canada in *Stewart v. The Queen*¹ and *Walls v. The Queen*² on May 23, 2002, and the consequential proposed amendment announced by the Department of Finance on October 31, 2003 to add section 3.1 to the of the *Income Tax Act (Canada)*,³ Reasonable Expectation of Profit ("REOP") is very much in the forefront of tax practitioners' minds. In fact, tax practitioners and private industry have raised substantial concerns with the REOP test in proposed section 3.1 of the ITA.

While understandably not having received the same degree of scrutiny as REOP in the income tax context, REOP in the Goods and Services Tax ("GST") context is problematic, despite its limited application. The statutory GST REOP test only applies to individuals in determining whether they are engaged in commercial activities as these terms are defined for GST purposes. This article questions whether the GST statutory concept of REOP achieves its intended policy objective and certain other policy objectives underlying Part IX of the *Excise Tax Act (Canada)*.⁴

Since the introduction of the GST Act on December 17, 1990, the GST Act has incorporated a REOP test to determine whether an "individual"⁵ engages in a "commercial activity"⁶ and can or should register for the GST. As a GST registrant, the individual would charge, collect and remit GST on taxable (other than zero-rated) supplies of property or services made in Canada in the course of that commercial activity and claim input tax credits ("ITCs") to recover GST payable on taxable inputs acquired for that activity. A commercial activity specifically excludes a business carried on, or an adventure or concern in the nature of trade engaged in, by an individual, a personal trust,⁷ or a partnership, all of the members of which are individuals (all of which are hereinafter referred to as "an individual" or "individuals") without a REOP. Furthermore, for GST purposes, to the extent that an activity involves making exempt supplies, it cannot be a commercial activity.

The REOP test is intended to restrict ITCs for a person not engaged in a commercial enterprise, but rather engaged in a personal activity or a hobby. This article questions whether the statutory concept of REOP achieves its intended policy objective and other policy objectives underlying the GST Act.

The GST Act is designed to put those engaged in commercial enterprises, whether for profit or not, on an equal competitive footing. One of the hallmarks of good tax policy, in an effective voluntary tax compliance regime, is the thrust towards tax simplification, wherever possible, to facilitate voluntary compliance. On both counts, we believe that the REOP test fails to achieve these intended policy objectives.

How did REOP evolve on the income tax side? What is REOP?

Before the Supreme Court of Canada released the companion decisions in *Stewart* and *Walls* on May 23, 2002, the courts had used REOP as a stand-alone "source of income" test to determine whether expenses may be deducted under section 9 of the ITA. All that changed with *Stewart* and *Walls* (at least until the Department of Finance proposed section 3.1 to amend the ITA on October 31, 2003), wherein the Supreme Court of Canada decided that where a taxpayer engaged in a commercial enterprise, in the absence of any personal or hobby element, there was a source of income and there was no need to resort to a REOP test. If an activity possibly has a personal or hobby element to it, then REOP can be one factor, although not necessarily a conclusive one, in determining whether a source of income exists. The Supreme Court of Canada concluded that REOP was not an independent source test.

The roots of the REOP test can be traced to certain *obiter* comments made by Mr. Justice Dickson of the Supreme Court of Canada in *Moldowan v. The Queen*.⁸ He said that in order to have a source of income under the ITA, a person must have a REOP. The criteria included: (i) the person's profit and loss experience, (ii) the person's training and experience, (iii) the person's plans for the intended

activities, and (iv) the viability of the enterprise generating a profit over time. GST Policy Statement P-176R⁹ incorporates these four criteria into the REOP test and expands on them. The test is one formed by objective criteria, as opposed to being governed by a subjective profit motive element.

Commercial Enterprises

As a general rule, a GST registrant can claim ITCs to recover GST payable on its taxable expenses to the extent that it incurs those expenses in furtherance of its commercial activity.¹⁰ REOP is not a factor in determining whether a person, other than an individual, engages in a commercial activity.

In fact, one purpose of the GST Act is to put for-profit and non-profit persons engaged in commercial enterprises on an equal competitive footing vis-à-vis GST. GST Policy Statement P-167R¹¹ states this policy objective clearly as follows:

The definition of business (and by extension, commercial activity) was structured to include not only those activities that are considered to be a business for income tax purposes, but also those activities undertaken without a profit motive that would stand in direct competition with activities of profit motivated enterprises. The exclusion of the profit test provides for a level playing field between profit and non-profit organizations that are essentially making the same type of supplies.

One way in which the GST Act is designed to put commercial enterprises in Canada on an equal footing is to require GST to be collected uniformly on the same type of taxable supplies, so that one enterprise does not gain an unfair competitive advantage over another by not charging and collecting GST to and from its customers. As a statutory requirement, REOP can be used to defeat this policy aim. The GST Act contains many examples of for-profits and non-profits, which are competing in the same type of commercial enterprise, as being treated in the same manner for GST purposes, that is, being engaged in taxable commercial activities. For example, charities producing, or buying and selling goods, or selling admissions to places of amusement for at least one dollar each, are considered to be engaged in commercial activities.¹² They may or should register¹³ for the GST and charge, collect and remit GST on their taxable (other than zero-rated)

supplies made in Canada. As GST registrants, they may generally claim ITCs on their taxable expenses to the extent that those expenses relate to their taxable commercial activities.

ITCs are intended:

- 1) to promote commercial activities by reducing expenses and the cost of capital on persons engaged in commercial enterprises; and
- 2) to level the playing field between enterprises engaged in commercial activities, whether for profit or not.

The application of the REOP requirement as a standard to determine whether an individual engages in a commercial activity, unfortunately, runs contrary to both these policy objectives.

What can happen in practice is that the Canada Revenue Agency ("CRA") could automatically disallow ITCs and net GST refunds claimed on GST returns by a registered individual where the individual's taxable revenues exceed taxable expenses, resulting in losses for that individual on the basis that the individual has no REOP. It seems rather arbitrary, discriminatory and unfair to treat an individual engaged in a commercial enterprise differently than any other type of person, including a non-profit, engaged in a similar activity by saddling the individual with the additional burden of discharging the onus of proving he or she has a REOP.

First, why should it make a difference whether an individual carries on business directly or through a corporation? If the activity is commercial in nature, then it should be considered a commercial activity (to the extent that exempt supplies are not made), regardless of whether it is carried on by the individual directly or through a corporation.

Second, a REOP test discourages entrepreneurial activities. As the story goes, the founder of Federal Express, Mr. Frederick W. Smith, submitted his Federal Express business plan to his MBA professor for an assignment. He received a poor mark on the assignment because his professor thought that it would never work. Despite many hardships, losses and teetering on the verge of bankruptcy early in its life cycle, Federal Express became a great success and is one of the largest courier companies in the world today and a Fortune 500 Company. Arguably,

Mr. Smith did not have, by an objective standard, a REOP when he started up the company. There was no doubt, however, that his company engaged in a commercial activity.

Third, the CRA does not need a statutory REOP test to remedy the mischief that it is intended to address. The real question is whether the individual engages in a commercial enterprise. A REOP test could still be used as a discretionary tool to determine whether the individual engages in a commercial activity and is entitled to register for the GST (and to claim ITCs). The recent Tax Court of Canada decision of *Carolyn Miller v. The Queen*¹⁴ is instructive in considering the problems with the REOP test.

In 1993, Ms. Miller retired from her long-term employment to devote all her attention and capital to her farm. She completed a course in therapeutic riding for people with disabilities. She obtained certification as a therapeutic riding instructor and began, in 1995, to operate a farm providing therapeutic riding operations. She had operated certain sideline businesses, which she terminated in 1997, when she decided that they weren't working. At that time, she decided to focus her efforts mainly on her therapeutic riding program and tourism business, where she thought that she could succeed. The CRA disallowed the ITCs she claimed for the 1995, 1996 and 1997 taxation years alleging that she had no REOP. During that period, her business expenses were about four times higher than her sales revenues. The Tax Court allowed Ms. Miller's appeal, finding that she had a REOP during this time period.

Fortunately, the decision went Ms. Miller's way, because it is obvious that she was engaged in a commercial enterprise. Where it is clear that Ms. Miller's activities, for which she claims the ITCs, have no personal or hobby element to them, she should be entitled to claim the ITCs. While there is no doubt that Ms. Miller engaged in a commercial enterprise, one could reasonably argue that she did not have a REOP when she carried on those side-line businesses. The Tax Court, however, had the benefit of hindsight in seeing how her operations turned around after she abandoned her unsuccessful side-line businesses.

As long as REOP remains a statutory standard for determining whether an individual carries on a commercial enterprise, the CRA can use it as a tool to second-guess the business judgment of

an individual so as to disallow ITCs and net GST refunds claimed. The fact of the matter is that many businesses don't succeed, despite *bona fide* best efforts on the part of individual entrepreneurs. There may be intervening economic circumstances beyond the control of the individual that adversely impact on the prospects for the business. In hindsight, the CRA may question whether the individual ever had a REOP and should be entitled to ITC claims. This unfortunate individual should not bear the additional cost of denied ITCs while continuing his or her business activities to recoup losses. The words of the Supreme Court of Canada in *Stewart* ring true in the GST context as well:

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 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.¹⁵

GST Simplification

The REOP requirement can create an additional layer of unnecessary analytical complexity in assessing whether a person is engaged in a commercial activity and should register for the GST and comply with the GST Act. Furthermore, other provisions in the GST Act incorporate the REOP requirement where, for the purposes of those provisions, determining whether an individual is engaged in a commercial activity is a relevant consideration.¹⁶

Parliament Should Repeal the REOP Requirement

Parliament should amend the GST Act to eliminate the REOP requirement because it undermines the aims of the GST Act on a number of counts. It discriminates unfairly against individuals who are engaged in commercial enterprises by denying them ITCs and net GST refund claims. It discriminates unfairly against businesses (whether operated for profit or not) that compete directly with those individuals, but which, unlike those individuals, must collect the 7% GST from their customers. It adds an additional, unnecessary layer of complexity to the GST regime that flies in the face of the regime's goal of being easily understandable so as to encourage voluntary GST compliance.¹⁷ Finally, Parliament does not need the REOP test to address the concern at which it is aimed.

The threshold question is whether the individual is engaged in a commercial enterprise. The subsidiary questions are whether the taxable expense for which the ITC is claimed is exclusively a personal expense or whether it is attributable to the individual's commercial enterprise, and in the latter case, to what extent. Existing provisions in the GST Act, specifically section 141.01, section 169 and other special ITC rules such as those found in subsection 199(2), are the appropriate legislative tools for determining an individual's ITC eligibility.

* *Jamie Wilks, McMillan Binch LLP, (416) 865-7804, jamie.wilks@mcmillanbinch.com.*

¹ 2002 DTC 6983 (SCC).

² 2002 DTC 6964 (SCC).

³ RSC 1985 (5th Supp.) c.1, as amended (the "ITA").

⁴ RSC 1985, c. E-15, Parts VIII and IX enacted by SC 1990, c. 45; as amended (the "GST Act"). All references below are to the provisions of the GST Act unless otherwise indicated.

⁵ Defined as a "natural person" under subsection 123(1).

⁶ Defined in subsection 123(1).

⁷ A "personal trust" is defined in subsection 123(1) as a testamentary trust, or an *inter vivos* trust that is a personal trust under subsection 248(1) of the ITA, all the beneficiaries (other than the contingent beneficiaries) of which are individuals, and all the contingent beneficiaries of which, if any, are individuals, charities or public institutions.

⁸ 77 DTC 5218 (SCC).

⁹ *Application of Profit Test to Carrying on a Business*, dated September 30, 1998.

¹⁰ Section 169.

¹¹ *Meaning of the First Part of the Definition of Business*, dated March 29, 2000.

¹² Section 1, paragraphs (d) and (e), Part V.1 of Schedule V to the GST Act.

¹³ Where it makes taxable supplies in Canada, a "small supplier" charity with less than \$250,000 annually in revenues from all sources has the option of whether to register for the GST. The small supplier rules for charities are set out in subsection 148.1(2).

¹⁴ 2002 DTC 1980 (TCC).

¹⁵ *Supra* note 1, at paragraph 55.

¹⁶ Subparagraph 141.1(2)(a)(iii) provides an exception to the sale of inventory or services being considered to be made in the course of commercial activities, where the inventory or services are sold by an individual in the course of a business or

an adventure or concern in the nature of trade, without a REOP. Paragraph (a), Section 9(2), Part I of Schedule V to the GST Act provides an exception to the exemption for the sale of land by an individual, where the land is held as "capital property used primarily in a business carried on by the individual ... with a" REOP.

¹⁷ When the Department of Finance announced on April 23, 1996 a major overhaul and reform of the GST, which, among many other amendments, introduced the Harmonized Sales Tax (HST) regime into the GST Act, its main selling point was that it would "streamline and simplify the operation of Canada's value-added tax system." Whether, in fact, those amendments ultimately achieved that stated goal is a dubious proposition at best.