Applying the Canadian “reasonable expectation of profit” test to a section 80M(1)(d) reportable arrangement

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Abstract
A section 80M(1)(d) reportable arrangement is defined in the Income Tax Act 58 of 1962, as amended, and contains the reasonable expectation of a pre-tax profit requirement. Such an arrangement must be reported to the Commissioner of the South African Revenue Service within 60 days. Failure to do so can result in a R1 million penalty. It is submitted that this requirement is subjective because of a lack of indigenous litigation and implementation guidelines. The Canadian reasonable expectation of profit (REOP) test may be of value to formulate objective standards against which to apply the section 80M(1)(d) reportable arrangement.

Key words
Canada tax; Deductible expense; IAS; Income; Personal expense; Profit; Pursuit of profit; Reasonable expectation of profit; Reportable arrangement; Section 80M(1)(d); Source of income; Subjective interpretation; Tax benefit

1 Introduction
A reportable arrangement is defined in the Income Tax Act 58 of 1962, as amended, (the Act) as any arrangement contemplated in section 80M. In terms of the disclosure obligation of section 80O, such an arrangement must be reported to the Commissioner of the South African Revenue Service (SARS) within 60 days.

The first reportable arrangements provisions were introduced to the Act by section 76A which came into effect on 1 March 2005. Section 76A was repealed on 1 April 2008 and replaced with a new Part IIB, inserted into the Act by section 6(1) of the Revenue Laws Second Amendment Act 21 of 2006. Part IIB contains sections 80M to 80T and applies to any arrangement entered into with effect from 1 April 2008.

According to a media release issued by SARS, the main purpose of the new reportable arrangements provisions is to counter tax abuse more speedily (SARS 2008). SARS also stated that the number of transactions previously reported (under the former section 76A) was disappointing. In addition, some taxpayers raised technical points to avoid reporting or restructured their transactions to avoid the triggers for reporting. As such, when SARS adopted the new General Anti-Avoidance Rule (GAAR) in 2006, it afforded them the opportunity to also revise the reportable arrangements legislation (SARS 2006).

SARS believed that this new early-warning system (in the form of sections
80M to 80T) would reduce the delays that occurred between the conclusion of transactions, the submission of the related annual return, the assessment issued by SARS and any resulting audit that might take place (SARS 2008).

Sections 80M(1) and (2) identify arrangements considered to be reportable to the Commissioner of SARS, while section 80N(1) contains a list of arrangements specifically excluded from the reportable arrangements provisions. Reportable arrangements can be classified into two categories. One category is contained in section 80M(2) and refers to hybrid equity instruments, hybrid debt instruments and any arrangement identified by the Minister of Finance by a notice in the Government Gazette as an arrangement which is likely to result in any undue tax benefit.

The other category is contained in section 80M(1) and relates to arrangements that result in a tax benefit (as stated in the introductory requirement of section 80M(1)) and meet the requirements of one of five scenarios found in sections 80M(1)(a) to (e). One such scenario is the reasonable expectation of a pre-tax profit requirement as contained in section 80M(1)(d), which is the focal point of this article. A section 80M(1)(d) reportable arrangement must meet the following requirements:

1. An arrangement (as defined) is entered into;
2. A tax benefit (as defined) is or will be derived or is assumed to be derived;
3. By any participant (as defined) by virtue of that arrangement; and
4. The arrangement does not result in a reasonable expectation of a pre-tax profit for any participant.

The “reasonable expectation of a pre-tax profit” (section 80M(1)(d)) is a concept that was introduced to the Act for the first time on 1 April 2008. The Act, however, does not define this concept. In addition, it has not appeared in South African law and has never been considered by our courts.

The term “reasonable expectation” has been considered by our courts on a few occasions when determining whether a loss suffered by letting immovable property is an allowable deduction in terms of section 11(a). The principle that rental losses do not qualify as a deduction unless there is a reasonable expectation of realising a profit is found, *inter alia*, in *ITC 561* (13 SATC 313), *ITC 1292* (41 SATC 163) and *ITC 1367* (45 SATC 39). These court cases, however, only refer to the specific instances of rental losses and do not provide objective guidelines applicable to any other arrangement.

Furthermore, SARS has not issued any guidelines or an Interpretation Note on the application of section 80M(1)(d). Owing to the lack of indigenous litigation and implementation guidelines, the legislation and court cases of other countries must therefore be considered.

In the Reportable Arrangements Guide (SARS 2005), the international tax position is referred to regarding tax disclosure requirements. One of the countries specifically mentioned in this guide is Canada, owing to its well-developed reportable transaction legislation in the form of tax shelter rules. Furthermore, Canada is the only country that contains an even remotely similar requirement to South Africa’s “reasonable expectation of a pre-tax profit”. Section 248(1) of the Canadian Income Tax Act (the ITA) prohibits the deduction of personal and living expenses and refers to a “reasonable expectation of profit” (REOP) test in determining whether or not an expense is for business or private purposes. This test is long established, resting on almost 70 years of research and court cases which helped Canadian taxpayers to formulate objective standards...
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against which to apply their REOP test.

When referring to the income tax decisions of foreign courts, De Koker (2008:25.5) cautions that one should always bear in mind that they may be based upon a differently worded statute from the statute under consideration. However, they may be most valuable and may very well influence South African courts, particularly when they deal with a point of law that also occurs in the South African Act. Clegg and Stretch (2008:2.4.2) also emphasise that even though the judgments of the courts of other countries are not binding on South African courts, they are of significance because they do have persuasive value. Such judgments are often quoted in the courts of the Republic and are sometimes even applied. As such, the Canadian REOP test can be of value in assisting South African taxpayers to formulate objective standards against which to apply the section 80M(1)(d) reasonable expectation of a pre-tax profit requirement.

2 Objective of the study

It is submitted that any interpretation of the meaning of the section 80M(1)(d) reasonable expectation of a pre-tax profit requirement will be subjective because there are no objective factors identified in South Africa for use by South African taxpayers. The objective of this article is to examine the REOP test in Canada in order to determine its possible application to a section 80M(1)(d) reportable arrangement. Consideration will be given to the following:

- The article commences with the legislative history and development of the REOP test, in light of the fact that courts often refer to the legislative history of a statutory provision.
- The evolvement of Canada’s “source of income” rules is then addressed because the REOP test must be applied in order to determine a source of income.
- Various practical problems surrounding the application of the REOP test are then discussed since these same problems are likely to be encountered by South African courts.
- Lastly, the article lists some of the objective factors that have been identified by Canadian courts to assist in the application of the REOP test.

3 Research method

The analysis of the Canadian REOP test can be done with reference to previously published data. A non-empirical research method was therefore adopted. This method entails a literature review of Canadian statutory laws, court decisions and published articles and textbooks.

4 The Canadian REOP test

The Canadian income tax system is largely based on the “source of income” rule – a fundamental assumption that only gains and losses that flow from a source of income are to be taken into account to determine a taxpayer’s income and resulting tax.

The Interpretation Bulletin IT-334R2, Miscellaneous Receipts, issued by the Canada Revenue Agency (CRA) states that in order for any activity or pursuit to be regarded as a source of income, there must be a REOP. Where such an expectation does not exist, neither amounts received nor expenses incurred are included in the income tax calculation (CRA 1992).

A judicial doctrine is thus relied upon to identify a source of income by testing for a REOP. The legislative history and development of the REOP test will be examined in the next section.
4.1 The legislative history and development of the REOP test

The REOP test was developed as part of the “personal and living” expenses provisions of the Canadian tax laws. The first reference to personal and living expenses is found in Canada’s first income tax legislation – the Income War Tax Act (IWTA). Paragraph 6(f) was introduced to the IWTA in 1927, thereby disallowing the deduction of personal or living expenses. The rationale for this prohibition is explained in the case of Maurice Samson v. MNR (1943:64):

“It is obvious that the determination of what the taxable income of a taxpayer shall be cannot depend upon or be left to the taxpayer’s own choice”.

Two court cases were instrumental in the development of the REOP test. The first of these was the Commissioner of Internal Revenue v. Field (1933:877-878), where the US Circuit Court of Appeals determined that:

“if the right to deduct losses under the statute required that profit appear to the court to be possible, that requirement would be quite general and would be applicable to any enterprise, whether it was farming, manufacturing, or promotion of any character. We may not, in this way, foredoom any business venture.”

The same case made another important point [at paragraph 878]:

“... we think the respondent embarked in these enterprises with the expectation of making profits; at least he did so, with an earnest and honest intention” [own emphasis].

A few years later, the case of Hatch v. MNR (1938:98) found that a venture operated in good faith for profit constituted a business. It is clear from the above two cases that the courts considered the genuineness of the taxpayer’s intention to generate a profit and not whether they had, realistically speaking, a reasonable expectation to do so.

The IWTA was amended in 1939 to add the requirement that the taxpayer had to have a good-faith intention to earn profits as well as a reasonable expectation of doing so. This amendment came in the form of the inclusion of the definition of “personal and living expenses”. Subparagraph 2(r)(i) was added which defined “personal and living expenses” in order to include

“the expenses of properties maintained by any person for the use or benefit of any taxpayer or any person connected with him by blood relationship, marriage or adoption, and not maintained in connection with a business carried on bona fide for a profit and not maintained with a reasonable expectation of profit” [own emphasis].

Thus the concept of a REOP test was first introduced to Canadian tax law in 1939 during the second reading of the IWTA Amendment Bill in the House of Commons (Canada House of Commons 1939). The Minister of National Revenue explained the introduction of the test as follows:

“The effect of this section is to make it impossible for taxpayers to deduct as a business expense ... the expenses of properties ... not maintained in connection with a business carried on bona fide for profit, and not maintained with a reasonable expectation of profit” [own emphasis].

In 1948, the IWTA was replaced by the ITA and the definition of “personal and living expenses” was reworded. This definition is now contained in section 248(1) of the ITA and reads as follows:

“the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or adoption, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit” [own emphasis].

The new definition effected two distinct changes, namely the deletion of the words “bona fide” and the requirement to test for a REOP (the conjunction “and” changed to “or”). Prior to this change, the taxpayer had
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to demonstrate that he or she was conducting a business with a bona fide profit motive and that he or she had a reasonable expectation to generate a profit from that business.

The case of McLaughlin Executor v. MNR (1952) contained two compelling arguments as to why the change in wording was confusing. Firstly, the new either/or test makes the wording of “reasonable expectation” questionable, as presumably, the required profit motive would always be present where there was a REOP. Secondly, the deletion of bona fide was probably intended to make the test stricter so that an actual profit was required. However, the deletion rendered the first profit criterion redundant, since these situations are presumably covered by the second REOP criterion.

Fien (1995:1292) suggests that a REOP is an inherent ingredient of a business. He logically questions why the need exists to include the words “for profit” or “with a reasonable expectation of profit” in the definition of personal or living expenses.

Since the REOP test must be applied in order to determine a “source” of income, the next section will address the evolvement of Canada’s source rules.

4.2 The evolvement of Canada’s “source of income” rules

The “source” concept was initially derived from the English taxation statutes (Arnold, Edgar & Li 1993:49). Section 3 of the IWTA defined “income” to include

“the annual net profit from a trade or commercial or financial or other business ... and also the annual profit or gain from any other source”.

Paragraph 3(a) of the ITA defines the calculation of income for the year as an attempt to

“determine the total of all amounts, each of which is the taxpayer’s income for the year (other than a taxable capital gain) from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer’s income for the year from each office, employment, business and property”.

Since the ITA contains no other definition of “source”, common law principles are applied to define a source. In Nathan v. Federal Commissioner of Taxation (1918:189), the word “source” was not viewed as a legal concept, but something which a practical person would regard as a real source of income. The Canadian courts have also referred to a source as an originating cause of receipts (The Queen v. Kuhl et al 1974:6032). Traditionally, the courts have referred to a source as that which “bears the fruit of the tree” (Front & Simcoe Ltd v. MNR 60 DTC 1081:1087).

According to Hansen, Rendall and Krishna (1978:142), income, as stated in conformity with the source concept, is characterised by the following attributes:

- recurring on a periodic basis;
- proceeding from a productive source; and
- representing the creation of new wealth.

Fien (1995:1296) states that the concept of a business, as determined from early case law, was consistent with this notion of source and that it involves two components, namely

i) the pursuit of profit (or, in other words, intention); and
ii) habitual activity (or, in other words, behaviour).

Because the ITA refers to “business” in the income definition, it is necessary to ascertain what the meaning of “business” is. A “business” is defined in section 248(1) of the ITA, so as to include a profession, calling, trade, manufacture or undertaking of any kind whatsoever and an adventure or concern in the nature of trade. A business
does not, however, include an office or employment.

The time the business was started is an important point to consider because a taxpayer must carry on a business in the fiscal period during which the expense was incurred. To this end, the CRA issued the Interpretation Bulletin IT-364, Commencement of Business Operations, providing guidelines on when a business is considered to have started (CRA 1977). Briefly, the guidelines are as follows:

☐ A business commences whenever some significant activity is undertaken that is a regular part of the income-earning process in that type of business or is an essential preliminary to normal operations;

☐ There must be a fairly specific concept of the type of activity to be carried on; and

☐ A sufficient organisational structure must be assembled to undertake at least the essential preliminaries.

Until the 1970s, the existence of a source did not appear to be dependent on a REOP (Fien 1995:1296). The income tax cases that dealt with losses from farming activities (commonly referred to as the “hobby farm” cases) only started referring to the source issue in the early seventies. One earlier case, J.S. Stewart v. MNR (1964:5338), which concerned the raising of dogs for use in a display advertising business, did suggest the REOP as a condition for the existence of a business. The court stated that the business had to be carried out in good faith with a reasonable expectation of generating a profit. Later, in O. Dorfman v. MNR (1972:154), the following judgment was made which confirmed this earlier decision:

“The words ‘source of income’ are used in the sense of a business, employment, or property from which a net profit might reasonably be expected to come”.

Thereafter, two Federal Court decisions came to different conclusions regarding the significance of the REOP concept. In James v. MNR (1973:5341-5342), REOP was only one of the indicia to be employed in determining whether or not a taxpayer in a given taxation year was in the business of farming. However, in D.A. Holley v. MNR (1973:542), the court found that profit, or the reasonable expectation of it, was inseparable from the basics of business. In this instance, the court clearly did not accept that the REOP was only one of the indicia to be considered in each case. Fien (1995:299) suggests that the above cases might well have been the springboard to the CRA’s adoption of a broadly-based REOP test.

These differing court decisions were followed by years of court cases in which the emphasis of the REOP test continued to shift. Then, in 1977, the landmark Supreme Court case of Moldowan v. The Queen (1977) affirmed the status of the REOP test. In this case, the taxpayer had a horse-racing activity (which was considered to be a business) as well as a farm that suffered losses. The court had to decide whether the taxpayer’s farming was his chief source of income, in order for him to be permitted to fully deduct his losses. The Supreme Court stated the following (at paragraph 5215):

“Although originally disputed, it is now accepted that in order to have a “source of income” the taxpayer must have a profit or a reasonable expectation of profit. Source of income, thus, is an equivalent term to business” [own emphasis].

The Tax Court of Canada (Knight v. MNR 1993:1259) confirmed the Moldowan findings, stating the following:

“To have a source of income, a taxpayer must have a profit or a reasonable expectation of profit. Source of income, therefore, is an equivalent term to business” [own emphasis].

Thus, it was affirmed that a “source of income” was an equivalent term to...
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“business”. The carrying on of a business therefore presupposed a REOP. Note that the deductibility of a private or living expense remained unchanged when the IWTA was replaced by the ITA in 1948. The prohibition of a private or living expense is now contained in section 18(1)(h) of the ITA and reads as follows:

“In computing the income of a taxpayer from a business or property no deduction shall be made in respect of personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer’s business.”

To summarise: In order for an incurred expense to be deductible, it must be a business expense (and not a private or living expense). In addition, for an activity to qualify as a business, there must be a source of income. In order to prove a source of income, the taxpayer must have a reasonable expectation of generating a profit from that activity. The deductibility of an expense can be illustrated as follows (see figure 1):

Figure 1: The deductibility of an expense – the Moldowan approach

<table>
<thead>
<tr>
<th>Expense incurred</th>
<th>Reasonable expectation of profit</th>
<th>Source of income</th>
<th>Business</th>
<th>Deductible</th>
</tr>
</thead>
</table>

However, many Canadian taxpayers regard the REOP test as an unjust test because it was the CRA’s favoured weapon in rejecting money-losing ventures as legitimate tax deductions (Reasonable expectation of profit 2002). According to Fien (1995:1288), there is little historical justification for the test because it can produce inconsistent and unjust results. The next paragraph will explore some of the flaws inherent in the REOP test.

4.3 Practical problems when applying the REOP test

The REOP test was typically used by the CRA in hindsight to deny losses and expenses incurred in a large number of unprofitable but bona fide commercial ventures. Since the test is highly uncertain in its application to any given situation, it caused a high volume of tax litigation (Tax & Trusts E-Newsletter 2002:19).

In the Moldowan case, the Supreme Court stated (at paragraph 5215) that the REOP was an objective determination to be made from all the facts. In addition, the Tax Court of Canada stated the following in Kerr & Forbes v. MNR (1984:1095):

“The existence of a reasonable expectation of profit is not to be determined by the presence of subjective hopes or aspirations, no matter how genuine or deep-felt they may be. The issue is to be decided by objective testing” [own emphasis].

Moreover, the Federal Court of Canada (W. Chequer v. The Queen 1988:259) confirmed the objective test by stating the following:

“The reasonableness of the expectation must be viewed objectively and cannot merely consist of an expectation that the taxpayer in good faith entertains the effect that a profit will eventually be realised” [own emphasis].

It is clear, then, that the courts intended (at least since the Moldowan case) for the REOP test to be an objective one. In 1995, the CRA issued the Interpretation Bulletin IT-504R2, Visual Artists and Writers, to provide the criteria that the CRA considers relevant in determining whether artists and writers have a REOP (CRA 1995). It states that any undertaking or activity of a taxpayer that results in profits or has a
reasonable prospect of profits would be viewed as the carrying on of a business.

In the bulletin, the CRA emphasises that the REOP test is an objective determination to be made from all the facts. It acknowledges that the relevant factors to be considered in making such a determination will differ according to the nature and extent of the activity or undertaking. The CRA also acknowledges that it is possible that a taxpayer may not realise a profit during his or her lifetime but may still have a REOP.

Despite the fact that the CRA and courts have established objective factors for consideration, the vague language of the REOP test has left the door wide open for subjective and inconsistent interpretation. Some of these anomalies are explored in the following sections.

4.3.1 Meaning of profit

The first question to arise is what is meant by “profit”. The REOP test is a common law concept developed by the courts. But, according to Fien (1995:1304), the Canadian common law has no regime of calculating income or profit. Thus, in applying the REOP test, accounting principles must be used in determining a profit.

Canada has its own set of Generally Accepted Accounting Principles (GAAP) that regulates its accounting rules and provisions. It should be noted that Canada has not yet adopted the International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) provisions, but according to the Canadian Institute of Chartered Accountants (CICA), the implementation process is underway. Mandatory adoption of IFRS relating to fiscal years beginning on or after 1 January 2011 applies to any Canadian company that qualifies as a publicly accountable enterprise4 (CICA 2009). Private enterprises and not-for-profit organisations will be permitted to adopt IFRS, but are not required to do so.

Thus, in order to determine the meaning of profit, the IAS definition applies. An accounting “profit or loss” is defined in the IAS 1, Presentation of Financial Statements (IASB 2008), as the total of income less expenses, excluding the components of other comprehensive income.

“Other comprehensive income”, in turn, is also defined in IAS 1, and comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRS provisions. The components of other comprehensive income include

a) changes in revaluation surplus;

b) actuarial gains and losses on defined benefit plans;

c) gains and losses arising from translating the financial statements of a foreign operation;

d) gains and losses on remeasuring available-for-sale financial assets; and

e) the effective portion of gains and losses on hedging instruments in a cash flow hedge.

A recent Canadian Tax Court case further expounded on the meaning of “profit” for income tax purposes. In BBM Canada v. Canada (Minister of National Revenue) (2008), the court considered the meaning of the term “profit” in a variety of contexts. The court examined the ordinary commercial meaning of profit found in various dictionaries and found that these definitions did not make express reference to an activity related to commerce or business.

Section 9(1) of the ITA states that a taxpayer’s income for a taxation year from a business or property is the taxpayer’s profit from that business or property for the year. Although the term “profit” is not
defined in the ITA, the court interpreted it in the *BBM Canada* case (at paragraph 24) to mean the difference between the receipts in a period and the expenditures laid out to earn those receipts. It further found that the commercial and accounting definition of “profit” concurred.

As previously stated, income is based on the source rule. If no source can be identified, then an amount is excluded from the tax calculation. In addition, income (as defined by the ITA) does not include capital gains from the disposal of property. In other words, capital gains are not regarded to be derived from a source. Thus the potential to generate capital gains does not create a source. A prospect of generating a profit other than an expectation of a capital gain must therefore exist.

Furthermore, the Supreme Court stated that the capacity for profit is to be determined after taking into account any capital allowances (*Moldowan v. The Queen* 1977). In the case of assets that are subject to accelerated write-off rates, the CRA deems it appropriate to amortise the cost of the asset under GAAP to determine whether an activity has a REOP (*Fien* 1995:1304).

### 4.3.2 Commercial profit

Fien (1995:1304) is of the opinion that recent (at that stage) Canadian case law has tilted in the direction of first identifying a commercial profit in order for there to be a source. According to this line of thinking, the prospect of tax savings is in itself not sufficient to qualify as a source. *Moloney v. The Queen* (1992:6570) confirmed this view by stating that in order for an activity to qualify as a business (and thus a source of income) it “must not only be one engaged in by the taxpayer with a reasonable expectation of profit, but that profit must be anticipated to flow from the activity itself rather than exclusively from the provisions of the taxing statute”.

Therefore, not only must a taxpayer prove a REOP, but his or her profit must also fulfill the “commercial” criterion in order for it to qualify as a source.

#### 4.3.3 How much profit?

In formulating the REOP test, neither the courts nor the CRA has stated the amount of profit that will be deemed sufficient. When one considers the losses incurred during the past or the amount of capital or time invested in an activity, how much profit must be anticipated in order to pass the REOP test?

In *Queen v. Matthews* (1974:6197), the court suggested that the prospect of only a few revenue-generating years over a period even longer than a lifetime did not necessarily preclude the existence of a business. The court also pointed out that the term “reasonable expectation of profit” was not synonymous with the “expectation of a reasonable profit”.

Thus, it is not the anticipated profit that must be reasonable, only the expectation thereof. This viewpoint further exacerbates the problem of determining the amount of profit. After all, how does one determine what a reasonable profit is for each specific activity or business venture? Furthermore, is the taxpayer’s expectation assessed on an objective basis, or will subjective expectations also be relevant? Even the CRA is ambiguous in its *Interpretation Bulletin IT-504R2, Visual Artists and Writers* (CRA 1995), acknowledging the fact that even though a taxpayer may not realise a profit during his or her lifetime, he or she still could have a reasonable expectation of profit. It is evident that there is no clear answer to this dilemma.

#### 4.3.4 Proportion of profit to risk

In high-risk, high-return industries such as the mining industry, there is a slim chance of generating a huge profit. Obviously, these types of taxpayers face an uphill
battle to prove a REOP at the outset of their ventures. It has been held in various Canadian court cases that the venture’s ability to produce large revenues could justify the undertaking of large risks and losses (Fien 1995:1305).

Once profits have been earned, it is easy, in hindsight, to prove that an activity was a business from the outset. Conversely, if a business failed to generate profits, it is difficult, in hindsight, to prove that the activity had any REOP. In the case of Belec v. The Queen (1995:123), it was stated quite succinctly that the CRA should not be able to say to a taxpayer:

“the fact that you lost money ... proves that you did not have a reasonable expectation of profit, but as soon as you earn some money, it proves that you now have such an expectation”.

Clearly, there is a need to objectively test for REOP in high-risk industries, while making allowance for the fact that it may take a number of years before a profit might reasonably be expected.

4.3.5 Financing
In the Moldowan case, one of the factors identified by the court to determine the REOP, was the capability of the venture, as capitalised, to show a profit after charging a capital cost allowance (see paragraph 4.3.1). The success of a business venture often depends on the manner in which the taxpayer has financed the business. For example, it may be highly geared, or there may be other external factors, such as market interest rates.

Fien (1995:1306) questions the extent to which a source for income tax purposes should depend on the debt-to-equity ratio; or, phrased differently, why should a bona fide commercial venture as a source depend on whether the owner capitalises it with his or her own funds or with borrowed funds?

Another practical implication is the manner in which financing is structured, where each way has a dramatic effect on the entity’s bottom line. Consider a partnership, for example. The revenue projections for the partnership will differ greatly if the partners finance themselves externally (and contribute capital to the partnership) as opposed to a situation in which the partnership is financed internally. At what level should the REOP test be applied? Is it at the partnership level or at the partner level?

4.3.6 Annual test
Although the REOP test is applied annually, it applies to the entire period that the taxpayer can reasonably be expected to carry on the business (Cannon & Silverman 2004:23). This raises the question of whether or not a cumulative profit has to be proven. A taxpayer could have a reasonable expectation of realising a cumulative profit in the year it commences with the business, but may cease to have such an expectation in a subsequent year. Does this then imply that the taxpayer has failed the REOP test?

Consider the following practical example (Cannon & Silverman 2004:24): A taxpayer acquires a business in year one and incurs substantial losses in years one to four. The taxpayer may reasonably expect the tide to turn and the business to become profitable in year five. However, if the expected hold period is not sufficiently long to allow prior year losses to be recouped, the taxpayer may not have a reasonable expectation of a cumulative profit in year five. He thus fails the REOP test and the CRA will disallow the deduction of his business losses.

A further implication of the annual test is when a taxpayer considers disposing of or discontinuing a business (Cannon & Silverman 2004:24). The period during which the taxpayer is reasonably expected to carry on the business is used in the REOP test. If the taxpayer no longer expects to carry on the business, the relevant period for applying the test may
be shortened accordingly.

4.3.7 Subsidiaries
Consider the scenario in which a business is carried on through various operating subsidiaries. Suppose, for example, that the parent company owns four subsidiaries. One of the subsidiaries is operating at a loss, or to state it differently, without a reasonable expectation of generating a profit. The parent company allows the unprofitable subsidiary to carry on business because it supports the other subsidiaries’ businesses. The other three subsidiaries are all earning profits. So, from a group perspective, the consolidated companies are profitable. But, at what level should the REOP test be applied?

Cannon and Silverman (2004:24) state that the REOP test is applied on an entity-by-entity basis. Thus, an unprofitable subsidiary may not be entitled to claim losses, despite the fact that it is a member of a profitable group.

4.3.8 An alternative test
Owing to the confusion and litigation caused by the REOP test, the need for an alternative test was soon realised. It seemed, in 2002, that the Supreme Court of Canada had “finally driven a stake through the heart of the REOP test” (Tax & Trusts E-Newsletter 2002:19). In two landmark cases, Stewart v. Canada (2002) and Walls v. Canada (2002), a simple two-stage approach was established to determine whether a taxpayer had a source of income:

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

The facts of the Stewart case are, briefly, as follows: the taxpayer had purchased four condominium units as rental properties. All the units were highly leveraged. The developer’s projections contemplated negative cash flows and tax deductions for ten years, with the prospect of a gain at the end. The taxpayer’s interest expenses exceeded his rental income and the losses claimed consisted primarily of interest expenses.

The CRA disallowed these losses on the basis that the taxpayer had no REOP, and therefore no source of income. However, the Supreme Court of Canada allowed the deduction, based on the two-step approach cited above. It was found that the taxpayer had borrowed money to engage in a bona fide investment from which he had a reasonable expectation of income. The court considered the anticipated gain in assessing the commerciality of the venture. Consequently, the interest expense was deductible.

The court emphasised that the pursuit of profit analysis is only required where a personal or hobby element exists. Should this analysis be required, the REOP is one factor for consideration. However, a REOP is not the only factor and it is by no means conclusive (Tax & Trusts E-Newsletter 2002:19).

To summarise: Based on the Stewart approach, in order for an incurred expense to be deductible, it must be a business or property expense (and not a private or living expense). For an activity to qualify as a business, there must be a source of income. In order to prove a source of income, the taxpayer must prove that he or she had undertaken an activity in pursuit of profit. The deductibility of an expense can be illustrated as follows (see figure 2):
However, this pursuit-of-profit test did not replace the REOP test and was certainly never included in Canadian legislation. As such, the REOP test has remained and still requires clarification.

Fien (1995:1310) submits that the appropriate test for the existence of a “source” ought not to be whether there is a REOP, but whether the taxpayer can establish the following:

1. His predominant intention is to make a commercial profit in the activity, and
2. The activity is carried out in accordance with objective standards of businesslike behaviour.

Fien’s (1995) test recognises the importance of a taxpayer’s intention, but also requires that the intention is substantiated by the taxpayer’s conduct. In order to constitute a business, there must be a requisite amount of effort and commitment to further the activity’s profit-making prospects (Fien 1995:1310).

A further benefit of this test is that it does not expose the CRA to any material risk. Fien (1995:1311) argues that the requirement of predominant intention to profit favours the CRA where there is an ambiguous motive, as the requirement of a commercial profit excludes expenditures incurred merely to effect a tax reduction.

The evidentiary burden on the taxpayer under this proposed test was confirmed by Lorentz v. MNR (1985:132), where the following was stated:

“[The taxpayer] must place evidence before the Court from which it can be objectively concluded that his conduct was that which could be expected of a reasonably prudent person becoming involved in a commercial undertaking designed to extract profit.”

It is unfortunate that this test was never submitted to or adopted by the courts because it would have shifted the focus to the taxpayer’s conduct and away from his or her business judgement. Certainly, it would have been far less subjective than the so-called “objective” REOP test.

4.4 **Objective factors to be used in applying the REOP test**

Table 1 lists a number of objective factors identified and used by the Canadian courts in the application of the REOP test (Informative Tax 2009:6–8). This article does not seek to elaborate on the criteria listed in the table.

<table>
<thead>
<tr>
<th>General factors</th>
<th>Detailed elements</th>
</tr>
</thead>
</table>
| Manner in which the activity is operated | ✓ Activity operated in a manner similar to comparable profitable businesses
| | ✓ Activity operation in a business-like manner
| | ✓ Activity held out to community as a business
| | ✓ Unsuccessful methods discontinued and new ones adopted
| | ✓ Formal books and records maintained
| | ✓ Separate bank account maintained
| | ✓ Record-keeping system can determine segment profits and relevant costs
| | ✓ Detailed non-financial records maintained
| | ✓ Operating methods changed to improve profitability |
5 Conclusion

Any participant in a section 80M(1)(d) reportable arrangement who fails to comply with the disclosure obligation of section 80O shall be liable to a penalty of R1 million in terms of section 80S. It is therefore of the utmost importance that taxpayers and tax planners fully understand the precise meaning of the reasonable expectation of a pre-tax profit requirement as contained in section 80M(1)(d).

However, the interpretation of the South African section 80M(1)(d) reasonable expectation of a pre-tax profit requirement remains subjective because of the lack of indigenous litigation and objective guidelines. As such, the Canadian REOP test, which is a long-established test with numerous objective criteria, was analysed in order to determine its possible application to a section 80M(1)(d) reportable arrangement.

The Canadian income tax system is based on the “source of income” rule. As noted in this article, in order for any activity or pursuit to be regarded as a source of income, there must be a REOP. The REOP test is thus a judicial doctrine that identifies a source of income. The test was developed as part of the “personal and living” expenses provisions of the Canadian tax laws. The definition of “personal and...
“living” expenses refers to expenses incurred in connection with a business that is not maintained with a reasonable expectation of profit. The development of this definition from its initial wording in the IWTA until its current format in the ITA was discussed in this article.

The source concept was subsequently analysed because it was not defined in the ITA. It was found that a “source” is the originating cause of receipts. “Business” is a term defined in the ITA and it was concluded that the concept of business was consistent with the concept of source. It was noted that in earlier case law, it did not appear that the REOP test was a condition precedent to the existence of a source.

There appears to be a lack of consensus on the significance of the REOP test, with some courts considering it to be only one of many indicia which determine a business. The landmark case of Moldowan affirmed the status of the test and held that in order to have a source of income, the taxpayer must have a REOP. It was further established that a source of income was equivalent to a business. It was therefore determined that in order for an incurred expense to be deductible, it had to be a business expense. And in order for an activity to qualify as a business, there had to be a source of income which was proven by having a REOP.

Despite the fact that the REOP test is referred to as an objective standard, the reality is that the terminology is highly subjective. Some of the anomalies encountered by Canadian taxpayers were explored – these included the meaning of profit, commercial profit, the amount of profit, the proportion of profit to risk, financing, the annual test and subsidiaries.

Owing to the confusion and litigation caused by the REOP test, the need for an alternative test was soon realised. The Stewart case gave rise to a two-step approach in determining whether or not a taxpayer had a source of income. It was determined that in order for an incurred expense to be deductible, it had to be a business expense. And in order for an activity to qualify as a business, there had to be a source of income which was proven by the pursuit of profit. This alternative test however, was never submitted to or adopted by the courts.

Lastly, a number of objective factors to be used in the application of the REOP test were listed. Some of these objective factors included the manner in which the activity was operated, the expertise of the taxpayer, the history of income or loss, time and effort expended by the taxpayer and his or her financial status.

The rules of interpretation determine that a statute may be viewed in the context of comparative and international law. Granted, foreign case law (and thus the Canadian REOP test) is not binding on our courts. But, provided the REOP test does not violate the principles and the jurisprudence of our common law, it may be of considerable assistance and of persuasive value in shedding light on how other legal systems (most notably that of Canada) deal with the subjective interpretation of a “reasonable expectation of a profit” concept.

Both the South African Act and the Canadian ITA contain a similar “reasonable expectation of profit” requirement. As such, the Canadian court cases (and Canadian REOP test) are relevant when interpreting a section 80M(1)(d) reportable arrangement since the Canadian REOP test deals with language similar to that in the South African Act\(^5\). It is therefore submitted that South African courts may apply the Canadian REOP test to a section 80M(1)(d) reportable arrangement.
Applying the Canadian “REOP” test to a section 80M(1)(d) reportable arrangement

Endnotes:

1 According to the media release, fewer than 150 transactions, most of them involving well-known hybrid instruments, were reported during the 25 months the legislation was in force.

2 The new GAAR was introduced in the form of sections 80A to 80L of the Act on 2 November 2006.

3 This requirement is applicable whether the projected business is intended to be a continuing one or is to be a single transaction in the form of an adventure in the nature of trade.

4 According to CICA’s Guide to IFRS in Canada, a publicly accountable enterprise is defined as an entity, other than a not-for-profit organisation, or a government or other entity in the public sector that:
   i) has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market; or
   ii) holds assets in a fiduciary capacity for a broad group of outsiders as one of its ordinary businesses.

5 This principle that foreign cases were relevant when they were dealing with language similar to that in the South African Act was established by Watermeyer CJ in Joffe & Co v CIR (1946:165).

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