Canada v Craig, 2012 SCC 43

SCC overrules its earlier decision regarding the test for subsection 31(1) limitation on loss deductions from farming activities.

[PLEASE READ THE COMMENTS FOLLOWING THIS POST RE AMENDMENTS IN BUDGET 2013]

Canada v Craig, 2012 SCC 43

At issue was what factors one considers when determining whether farming and some other source of income constitutes a "chief source of income", thereby avoiding the loss limitation in section 31 of the ITA.

The Court held that the approach it proposed to the application of Subsection 31(1) in *Moldowan v. The Queen*, 1977 CanLII 5 (SCC), was incorrect. The SCC revisited that decision and held that since subsection 31(1) provides two distinct exceptions to the loss deduction, the judge made rule in *Moldowan* which had the effect of reading one exception out of the legislation could not stand.

The taxpayer's primary source of income was intended to be, and in fact was, his professional income from law practice. In addition to income from investments and gains from stock options, the taxpayer also bought, sold, trained, and maintained horses for racing.

The horse racing business had some profitable years, but also suffered some significant losses. The Minister reassessed on the basis of *Moldowan* and limited the losses to that allowed by 31(1)(a). The taxpayer's appeal was granted by the TCC, and this was upheld by the FCA, on the basis of *Gunn v. Canada*, 2006 FCA 281 (CanLII), 2006 FCA 281, on the finding that the combination of the horse-racing business and his law practice constituted the taxpayer's chief source of income.

Section 31(1)(*a*) provides that, where a taxpayer's chief source of income is neither farming nor a combination of farming and some other source of income, the taxpayer's deductible farm loss is limited to $8,750 annually, the relevant portions of which read:

> 31. (1) Where a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income, . . . the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be a total of
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> (a) the lesser of
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> (i) the amount by which the total of the taxpayer's losses for the year, determined without reference to this section and before making any deduction under section 37 or 37.1, from all farming businesses carried on by the taxpayer exceeds the total of the

> taxpayer's incomes for the year, so determined from all such businesses, and
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> (ii) $2,500 plus the lesser of
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> (A) 1/2 of the amount by which the amount determined under subparagraph 31(1)(a)(i) exceeds $2,500, and
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> (B) $6,250, and

The provision allows for two exceptions to its loss deduction limitation. The first is where farming is the taxpayer's chief source of income. The second is where the taxpayer's chief source of income is a combination of farming and some other source of income.

The court said that one must take a contextual approach and cannot resign to simply adding up two sources of income. One must consider the capital invested in the farming business and in the second source of income; the relative amounts of income from each of the two sources of income; the time spent on each of the two sources of income; and the taxpayer's ordinary mode of living, farming history, and future intentions and expectations (including actual and potential profitability) when dealing with subsection 31(1). If the foregoing factors have the tendency to show that the taxpayer places significant emphasis on both the farming and the non-farming sources of income, there is no reason to hold that a combination of the two should not constitute a chief source of income, and meeting the requirements of one of the exemptions to 31(1).

The Court stated at paragraph 41 that "as long as the taxpayer devotes considerable time and resources to the farming business, the fact that another source of income produces greater income than the farm does not mean that such a combination is not a chief source of income for the taxpayer."

The court noted that although both endeavours must be significant ones for the taxpayer, they need not be connected and farming need not be the primary source of income. The Court stated at paragraph 39:

> I see nothing in the words or context in s. 31(1) to support the proposition that farming must be the predominant source of income when viewed in combination with another source, in order to avoid the loss deduction limitation of the section. It is also not possible to relegate s. 31(1) to applying only to "hobby" or "gentleman" farmers because, for a loss to be deductable at all, farming must be a source of income. A taxpayer who is engaged in farming in a non-commercial manner, with no profit or intention to profit, does not have a source of income from farming and therefore no loss for income tax purposes, limited or not (*Stewart v. Canada*, 2002 SCC 46 (CanLII), 2002 SCC 46, [2002] 2 S.C.R. 645, at paras. 51-54).

When considering the factors, not every one of them need be significant. In making the factual determination needed, the court considering a taxpayer's activities must consider at all the

factors together, and determine whether the taxpayer places significant emphasis on each of the farming business and other earning activity. If the taxpayer does so, the combination will constitute a chief source of income and avoid the loss deduction limitation in 31(1).

This interpretation is consistent with the ITA's general policy that unless there are specific exceptions, a taxpayer may offset losses from one business or source of income against profits from another without limitation.

In this case the taxpayer's activities constituted a business (not a hobby), and the taxpayer devoted a significant amount of capital and a very significant part of his daily work routine to the farming business, and was an active member of and contributor to the community of standard?bred racing.

The new two-step test for subsection 31(1) is:

1. Is there a farming business such that it forms a source of income from which losses may be deducted as oppose to a hobby or personal endeavour? Look to the test in *Stewart v. Canada,* 2002 SCC 46: Is the farming operation being run in a "commercial manner" such that there is no personal or hobby element to the operations, or (if there is a personal or hobby element) undertaken in a sufficiently commercial manner in accordance with objective standards of business-like behaviour. If so, it is a business.
2. Is the taxpayer limited in claiming the losses of the farming business against another source of income? The limitation applies unless (a) the farming operation is the chief source of income for the taxpayer, or (b) the farming operation and another source of income is the chief source of income for the taxpayer. In considering (b) one must consider the following factors together: (i) the amount of capital invested in farming and the other source of income; (ii) the income from each of the two sources of income; (iii) the time spent on the two sources of income; and (iv) the taxpayer's ordinary mode of living, farming history and future intentions and expectations.

COMMENT

From Budget 2013 (Economic Action Plan 2013) Annex 2

Restricted Farm Losses

The restricted farm loss (RFL) rules apply to taxpayers who have incurred a loss from farming, unless their chief source of income for a taxation year is farming or a combination of farming and some other source of income. The RFL rules limit the deduction of farm losses to a maximum of $8,750 annually ($2,500 plus ½ of the next $12,500). Farm losses incurred in a year in excess of that limit can be carried forward for 20 years to be claimed against farming income.

The RFL rules were introduced in 1951. In 1977, the Supreme Court of Canada in *Moldowan v. The Queen*, [1978] 1 SCR 480, interpreted the chief source of income test in the RFL rules. The Court held that farming that results in a loss could satisfy the chief source of income test (and

the RFL rules would therefore not apply) if farming is the taxpayer's chief source of income in combination with a non-farming source of income that is a subordinate source or a side-line employment or business. The *Moldowan* decision is consistent with the purpose of the chief source of income test, which is to ensure that taxpayers for whom farming is not the principal occupation are limited in their ability to deduct farm losses from their nonfarm income.

In 2012, in *The Queen v. Craig*, 2012 SCC 43, the Supreme Court overruled *Moldowan* by holding that the particular taxpayer could meet the chief source of income test even though his primary source of income was practicing law, and farming (i.e., horse racing) was a subordinate source of income. In effect, the Court established a test that permits the full deduction of farming losses where a taxpayer places significant emphasis on both farming and non-farming sources of income, even if farming is subordinate to the other source of income.

To restore the intended policy of the RFL rules, Budget 2013 proposes to amend them to codify the chief source of income test as interpreted in *Moldowan*. This amendment will clarify that a taxpayer's other sources of income must be subordinate to farming in order for farming losses to be fully deductible against income from those other sources.

Recognizing that the deductible limit under the RFL rules has not been increased since 1988, Budget 2013 also proposes to increase the RFL limit to $17,500 of deductible farm losses annually ($2,500 plus ½ of the next $30,000).

These measures will apply to taxation years that end on or after Budget Day.