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The Role of Intention in Distinguishing Employees from Independent Contractors

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PRÉCIS

Dans un revirement plutôt soudain par rapport à la jurisprudence, la Cour d'appel fédérale a indiqué que l'intention commune des parties devait jouer un rôle pour distinguer les employés des entrepreneurs indépendants dans les causes fiscales. Un examen de la jurisprudence indique qu'il y a de nombreuses questions sans réponse au sujet du rôle approprié de l'intention, et que l'intention ne joue pas nécessairement un rôle important dans les décisions sur la qualification. L'auteur soutient qu'il n'y a aucune justification pour tenir compte de l'intention et qu'il y a de nombreuses raisons pour lesquelles l'intention ne devrait pas être prise en considération. Cependant, si les tribunaux continuent de considérer l'intention comme pertinente pour faire la distinction entre employés et entrepreneurs indépendants, l'auteur maintient qu'ils devraient clarifier leurs raisons pour légitimer l'intention comme considération pertinente et fournir une orientation pour les causes subséquentes.

ABSTRACT

In a rather sudden shift in the case law, the Federal Court of Appeal has directed that the common intention of the parties should play a role in distinguishing employees from independent contractors in tax cases. A review of the case law shows that there are many unanswered questions about the appropriate role of intention, and that intention may not play a major role in characterization decisions. The author argues that there is no justification for considering intention and that there are many reasons why intention should not be considered. However, if the courts continue to consider intention to be relevant to the distinction between employees and independent contractors, the author maintains that they should make their reasons clear to legitimize intention as a relevant consideration and provide direction for subsequent cases.

KEYWORDS: EMPLOYEE ■ INDEPENDENT CONTRACTORS

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INTRODUCTION

The 2001 Supreme Court of Canada ruling in *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*[1] appeared to settle many of the unresolved issues relating to the legal test for distinguishing between employees and independent contractors. However, the reprieve was short-lived. The following year, the Federal Court of Appeal's decision in *Wolf v. Canada*[2] introduced a new element: the intention of parties with respect to the legal character of their relationship. The Federal Court of Appeal has continued to insist that intention is relevant, but has generally failed to give adequate direction about how this factor should affect the established legal test. In this article, I consider the role of intention in the employee-independent contractor test in relation to three pieces of legislation: the Income Tax Act (ITA),[3] the Employment Insurance Act (EIA),[4] and the Canada Pension Plan (CPP),[5] all of which are similar

1 2001 SCC 59.

2 2002 FCA 96.

3 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the ITA").

4 Employment Insurance Act, SC 1996, c. 23, as amended (herein referred to as "the EIA").

5 Canada Pension Plan, RSC 1985, c. C-8, as amended (herein referred to as "the CPP").

because they impose taxes (the latter two imposing payroll taxes) and are within the jurisdiction of the Tax Court of Canada and the Federal Court of Appeal.

A number of articles have considered the test for distinguishing between employees and independent contractors. Several older articles have surveyed the case law,[6] but, because of their vintage, these articles did not address the role of intention. More recent surveys of the jurisprudence have recognized the expanding importance of intention.[7] Timothy Clarke praised the change because it would "enable parties to govern their affairs more easily . . . without interference by the Courts or the Minister."[8] In his 2008 paper, Kurt Wintermute concluded that intention played a significant role, although there was a great deal of uncertainty at that time with respect to how intention was used.[9] Therefore, while there have been fairly comprehensive surveys of the case law before 2007, the literature has not yet addressed the appropriate role of intention. In this article, I endeavour to fill in this gap and to provide a review of the more recent cases.

I begin with an examination of the case law, which reveals that most, if not all, courts now mention intention as a factor. However, uncertainty still surrounds how intention is established and how it is used. I then argue that the intention of the parties with respect to the legal characterization of their relationship should not play a role in the legal test for distinguishing between employees and independent contractors. All of the reasons for considering intention are flawed, and there are countervailing arguments against considering intention.

6 See, for example, Alain Gaucher, "A Worker's Status as Employee or Independent Contractor," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 33:1-98; Brian J. Wilson, "Employment Status Under the Income Tax Act," in *Income Tax and Goods and Services Tax Planning for Executive and Employee Compensation and Retirement*, 1991 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1992), 2:1-61; Lara Friedlander, "What Has Tort Law Got To Do with It? Distinguishing Between Employees and Independent Contractors in the Federal Income Tax, Employment Insurance, and Canada Pension Plan Contexts" (2003) 51:4 *Canadian Tax Journal* 1467-1519; and Joanne E. Magee, "Whose Business Is It? Employees Versus Independent Contractors" (1997) 45:3 *Canadian Tax Journal* 584-603.

7 See, for example, Elizabeth J. Johnson and Jeffrey C. Johns, "Decisions Involving Legal Relationships: Partnership, Employee Versus Independent Contractor, and Agency (2010) 58, special supp. *Canadian Tax Journal* 149-73; Geoffrey A. Garland and Paul K. Grower, "Employee and Independent Contractor—Where Are We Now?" in *2004 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2004), 7:1-55; and Stuart Rudner, "Employee or Independent Contractor? Tax and Civil Courts Adopt Different Approaches in the Debate," Focus on Labour and Employment Law, *Lawyers Weekly*, September 10, 2010.

8 Timothy W. Clarke, "The Employee/Independent Contractor Conundrum," in *2004 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2004), 10:1-33, at 10:17.

9 Kurt G. Wintermute, "A Worker's Status as Employee or Independent Contractor: Recent Case Law, Trends, and Planning," in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008), 34:1-35, at 34:21.

THE CASE LAW

In this section, I review the case law to establish the framework in which the courts (particularly the lower courts) must operate with respect to the role of intention in distinguishing between employees and independent contractors. The section begins with a brief explanation of the relevance of the employee-independent contractor distinction. I then examine how intention has been established in the cases and explore the role of intention. Although developments in the law have made intention a factor, the role of intention is still uncertain.

The Relevance of the Employee-Independent Contractor Distinction

The employee-independent contractor distinction is relevant to a number of legal areas, all of which in large part depend on provincial common or civil law. The distinction is relevant under the ITA primarily because different provisions apply to employees, who earn employment income, and contractors, who earn business income.[10] If a worker is earning employment income rather than business income, fewer deductions are available, the employer must withhold and remit income tax, and the worker is not required to make instalment payments.[11] In addition, tax treaties may afford different treatment on the basis of the distinction.[12] Disputes often arise when the Canada Revenue Agency (CRA) disagrees with a worker with respect to his or her taxable income or the requirement that he or she make instalment payments, or when it argues that the recipient of the worker's services must withhold and remit tax.

The distinction is also relevant under the EIA because persons "employed in insurable employment"[13] and their employers are required to make contributions to the employment insurance system, and employees are able to obtain employment insurance benefits (as long as the other requirements are met).[14] Independent contractors are generally not required to make contributions and are not able to obtain employment insurance benefits. Disputes often arise because the government claims that the parties are in an employment relationship and have wrongfully neglected to make contributions. In these cases, the CRA usually makes a similar claim with respect to the CPP. Arguments also arise when workers become unemployed and the CRA disputes that they are employees entitled to employment insurance benefits.

Both employees and independent contractors must contribute to the CPP, but, as Lara Friedlander points out, the treatment of employees and independent contractors

10 Subdivision a of division B of part I of the ITA applies to employment income, while subdivision b of division B of part I applies to business income.

11 See Friedlander, supra note 6, at 1472-73 for a more detailed description of these distinctions.

12 This was the case in *Wolf*, supra note 2.

13 Supra note 4, section 67.

14 See Friedlander, supra note 6, at 1474-76 for a more detailed description.

is different.[15] There are different rules for calculating their respective contributions.[16] If an employment relationship exists, both the employee and the employer must make contributions, and the employer is required to withhold and remit the employee contributions along with its own.[17] Independent contractors, however, are responsible for remitting their own contributions directly to the government,[18] and these contributions are the equivalent of both the employer and the employee contributions.[19] Workers can receive retirement benefits from the CPP irrespective of whether they were employees or independent contractors.[20]

Although the recommendations in this article are limited to three areas of law, the courts have seldom distinguished cases on the basis of the area of law applied in a particular case. To a great extent, the courts draw on a single body of law concerning the employee and independent contractor distinction, regardless of the particular legal context (although the wisdom of this practice is not without question).[21]

Case Law on Establishing Intention

The courts have most often used the term "intention" in this context to mean the parties' intention concerning the legal characterization of their relationship as either employee-employer or independent contractors. It is also possible to consider the intention of the parties with respect to the terms of their agreement or other characteristics of their relationship; while this may be relevant to the employee-independent contractor distinction, the term "intention" is not generally used in this sense in the case law. In this article, I generally use the term "intention" to mean intention with respect to legal characterization, although there are a few noted exceptions.

The courts consider only mutual intention;[22] if mutual intention cannot be established, the courts have generally found intention to be irrelevant. In several instances, the courts have suggested that there must be a "clearly-expressed mutual intent"[23] for the intention to be relevant. However, in some cases the courts have examined

15 Ibid., at 1477-79.

16 Ibid., at 1478-79.

17 Ibid., at 1478-79.

18 CPP, section 10.

19 CPP, schedule.

20 Friedlander, supra note 6, at 1479.

21 Ibid.

22 See, for example, *Thompson v. MNR*, 2011 TCC 81; *Copper Creek Homes Inc. v. MNR*, 2011 TCC 570; *Heineke (Creative Staging Saskatchewan) v. MNR*, 2011 TCC 475; *Therrien v. MNR*, 2013 TCC 116 (cannot unilaterally change one's mind); *Bansal v. MNR*, 2010 TCC 340; and *Harold Isaac OP Sunrise Electrical v. MNR*, 2010 TCC 225.

23 *Copper Creek Homes*, supra note 22, at paragraph 24. See also *Twilley v. MNR*, 2009 TCC 524, at paragraph 10; and *Laperrière v. MNR*, 2007 TCC 252.

oral testimony,[24] and even conflicting evidence, to determine the mutual intention[25] before considering it in deciding the proper characterization of the relationship.

The term "common intention" (alternatively referred to as "mutual intention" by the courts) is used here to mean the common or mutual intention of the parties as determined by the courts through the examination of their relationship. This term can be contrasted with the term "asserted intention," which is used to describe the intention asserted by one or both of the parties, either in written or oral statements. "Shared asserted intention" is the term used when the parties assert the same intention. Asserted intention can be used by the courts to determine mutual intention, but it is common intention that is legally significant in determining employee or independent contractor status.

Shared asserted intention as expressed in written agreements has been an important factor in determining common intention, although in numerous recent cases the Tax Court has found a lack of common intention, despite the existence of a written agreement indicating an independent contractor relationship.[26] In a 2014 case, *Mallon v. MNR*, Miller J stated, "When determining the status of a working arrangement the message must be that the courts will look foremost to the actions and behaviour that define the relationship and determine whose business it is. Indeed, action and behaviour will determine intention, not the other way round."[27] It is likely that Miller J meant that objective evidence is necessary to prove common intention, not that intention itself is objective. In any event, Miller J clearly places little value on asserted intention.

Power imbalances and lack of knowledge have played a role in determining common intention. For example, in *Coloniale Maid Service Ltd. v. MNR*, an EIA case, the Tax Court judge pointed out that the workers showed "merely acquiescence—or grudging acceptance"[28] of the company's declaration of independent contractor status, and the workers acquiesced to this status in order to receive payment. The court appeared to proceed with its analysis, apparently without a finding of common intention, despite a signed statement that the workers were self-employed. Similarly, in *Powertrend Electric Ltd. v. MNR*, another EIA case, the Tax Court found no common intention because the worker agreed to be an independent contractor only to keep his job.[29] In a third EIA case, *1772887 Ontario Ltd. v. MNR*, the Tax Court made

24 See *Pichugin v. MNR*, 2011 TCC 16.

25 See, for example, *Smith v. MNR*, 2011 TCC 20; and *Persuader Court Agents Inc. v. MNR*, 2010 TCC 335.

26 *La Scala Conservatory of Music II v. MNR*, 2013 TCC 122; *Peterborough Youth Services v. MNR*, 2013 TCC 291; *Acanac Inc. v. MNR*, 2013 TCC 163; and *177398 Canada Ltd. v. MNR*, 2011 TCC 300.

27 *Mallon v. MNR*, 2014 TCC 14, at paragraph 15.

28 2010 TCC 115, at paragraph 31.

29 2011 TCC 361, at paragraph 20.

it clear that independent contractor status could not be imposed on the temporary and junior workers because they were "put in the position" of having to accept independent contractor status.[30] Therefore, it appears, at least in the EIA context, that when a worker is in a relatively weak position, a common intention may not be found, despite documentation that suggests otherwise.

In at least two EIA and CPP cases, the courts have used a worker's lack of knowledge to refute evidence of a common intention. In *Dean (Ana's Care & Home Support) v. Canada (National Revenue)*,[31] the Tax Court noted that the workers may not have understood the significance of a lack of source deductions, which led to a finding of no common intent. In *Oldham Robinson Integrated Technologies Inc. v. MNR*,[32] the Tax Court based its decision that there was no common intention on the worker's lack of understanding of the meaning of self-employment when entering into a verbal agreement. The power imbalance also played a role because the court noted that the worker did not argue about the status as a result of her fear of losing her job.[33] In at least one case, however, a party's failure to read the contract was not sufficient to dissuade the court from finding common intention.[34]

The courts assess the common intention that exists at the time that an agreement is made.[35] They have indicated that intention is not the same as aspiration or desire. Common intention of independent contractor status was found in one case despite a party's desire to become an employee in the future.[36] The Tax Court similarly rejected an argument of employee status on the basis of remorse and regret relating to independent contractor status where employee status would have meant compliance with goods and services tax (GST) legislation.[37]

A number of other factors have influenced findings of common intention. In *Butt v. MNR*, the court found that a worker entering into the contract through a personal company indicated an intention to form an independent contractor relationship.[38] Applying for a GST number[39] and reporting earnings as business income[40] have both supported an intention to be classified as an independent contractor. A failure to

30 2011 TCC 204, at paragraphs 146, 155, and 163.

31 2012 TCC 370.

32 2010 TCC 596.

33 Ibid., at paragraph 10.

34 *Integranuity Marketing Ltd. v. MNR*, 2012 TCC 4.

35 *Cavalier Land Ltd. v. MNR*, 2011 TCC 490; and *MAP v. MNR*, 2012 TCC 70.

36 *Prue v. MNR*, 2011 TCC 9.

37 *Wellbuilt General Contracting Ltd. v. MNR*, 2010 TCC 541. Similarly, see *Cavalier Land Ltd.*, supra note 35.

38 2013 TCC 284, at paragraph 16.

39 See, for example, *Maple Elect Zoltan v. MNR*, 2012 TCC 286.

40 See, for example, *Nightingale v. MNR*, 2012 TCC 218.

question a lack of source deductions,[41] the issuance of T5 slips,[42] the negotiation of a rate of pay that was higher than that of an employee,[43] and accepting responsibility for worker's compensation premiums[44] have supported findings of intention to be an independent contractor in various cases. However, in *SB Towing Inc. v. MNR*[45] the court found that the lack of GST registration could be attributed as much to inattention or negligence as to intention. Further, a worker's income tax return may not reflect an agreement reached one year earlier, according to the finding in *SIP Distribution Inc. v. MNR*.[46] While a number of factors have been used as objective evidence of subjective intention, their use is dependent on the facts.

Several factors have influenced courts in other cases to find a lack of common intention. A subsequent unilateral amendment to a contract to label the parties as independent contractors was viewed as an indication that intention was not clear at the time of the original contract.[47] In another case, where the worker did not turn her mind to the character of the relationship, no intention was found.[48] Despite an agreement that both parties would pay their own taxes, the court found a lack of common intention in *Young Tile Inc. v. MNR*.[49]

In *Poulin v. Canada*,[50] the Federal Court of Appeal suggested that a physical disability may result in an inability to form an intention:

> Given the applicant's physical condition and the consequences that result from employer status, I do not think it is reasonable to infer that the applicant intended to enter into a contract of employment with the three workers that would make him their employer.[51]

The court appears to suggest that the applicant could not reasonably have been considered to be an employer, presumably because he was a quadriplegic, with physical limitations described as "pathetic and heart-breaking."[52] This is particularly infuriating because the court does not seem to recognize the abilities of the

41 *Watzke v. MNR*, 2011 TCC 351.

42 *Kowalchuk v. MNR*, 2011 TCC 265.

43 Ibid.

44 Ibid.

45 2013 TCC 358.

46 2011 TCC 423, at paragraph 10.

47 *Marilake Education Centre Inc. v. MNR*, 2013 TCC 82.

48 *875527 Ontario Ltd. v. MNR*, 2012 TCC 214, at paragraph 11.

49 2012 TCC 383, at paragraphs 7, 10, and 15.

50 2003 FCA 50.

51 Ibid., at paragraph 30.

52 Ibid., at paragraph 2. For a critique of such language, see Tamara Larre, "Pity the Taxpayer: The Tax Exemption for Personal Injury Damages as a Disability Policy" (2007) 33:1 *Queen's Law Journal* 217-47.

applicant, even though it noted that after his accident he was employed half-time by the Canadian Museum of Civilization as a tourist guide or information officer. Courts would be sensible to eschew this line of reasoning in the future.

In a recent case, *177398 Canada Ltd v. MNR*, the Tax Court used other factors to at least partially justify a finding that there was no common intention, despite a written agreement indicating a shared intention of an independent contractor relationship.[53] The court decided that the contract's terms, including a full-time commitment with the company, an agreement not to compete, and the provision of a vehicle by the company, were more in keeping with employment, and this contributed to a finding of no common intention.[54] As is discussed below, one problem with this approach is that it does not coincide with the current two-step test for determining employee or independent contractor status, which establishes intention before applying judicially specified factors.

Case Law on the Role of Intention

In the past decade or so, there have been a large number of cases touching on the role of intention in distinguishing between employees and independent contractors. To make sense of these cases, it is necessary to examine the development of the law. In the survey below, I concentrate on the landmark decisions of *Wolf*,[55] *Royal Winnipeg Ballet v. MNR*,[56] and *1392644 Ontario Inc. (Connor Homes) v. Canada (National Revenue)*[57] but also consider the intervening cases. The review of cases since *Royal Winnipeg Ballet* is more comprehensive because these cases have not yet been reviewed extensively in the literature.

Cases Preceding Wolf v. Canada

The history of the test that distinguishes employees from independent contractors has been recounted on several occasions.[58] For the purposes of this article, it is sufficient to say that the four-in-one test, originating from Lord Wright's decision in *City of Montreal v. Montreal Locomotive Works Limited and Another*[59] and adopted in *Wiebe Door Services Ltd. v. MNR*,[60] was endorsed by the Supreme Court of Canada in the 2001 case of *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*, and this became the predominant test. It emphasized whether a service provider was performing

53 2013 TCC 177, at paragraph 86. Bowman J also interprets the comments in *Gagnon*, infra note 119, to suggest a similar approach: see *Lang v. MNR*, 2007 TCC 547, at paragraph 32.

54 *177398 Canada Ltd.*, supra note 53, at paragraph 86.

55 Supra note 2.

56 2006 FCA 87.

57 2013 FCA 85.

58 See, for example, Clarke, supra note 8; Friedlander, supra note 6; and Magee, supra note 6.

59 [1946] UKPC 44, at paragraph 17.

60 87 DTC 5025 (FCA).

services "as a person in business on his own account"[61] and considered four factors as especially relevant, although the list was non-exhaustive.[62] The four factors were control, ownership of equipment, degree of financial risk, and opportunity for profit.[63]

Before *Wolf v. Canada*, intention was not recognized as a factor in the employee-independent contractor distinction.[64] Courts focused primarily on the factors set out in *Wiebe Door*. In fact, in *Minister of National Revenue v. Standing* the Federal Court of Appeal stated, "There is no foundation in the case law for the proposition that such a relationship may exist merely because the parties choose to describe it to be so regardless of the surrounding circumstances when weighed in the light of the *Wiebe Door* test."[65]

Wolf v. Canada

The history of the role of intention begins with the Federal Court of Appeal's 2002 decision in *Wolf v. Canada*. The appellant had entered into an agreement with a Canadian corporation, Kirk-Mayer of Canada Ltd., agreeing to provide services to Canadair Limited as an "independent contractor." The case involved the question whether the appellant, a mechanical engineer resident in the United States but working in Canada, could be taxed by Canada. According to article XIV of the Canada-US income tax convention,[66] the state in which a taxpayer is not resident (in this case, Canada) can tax an independent contractor only if the individual has a fixed base in that state.[67] The taxpayer argued that he was an independent contractor and did not have a fixed base in Canada.

The Tax Court held that the appellant was an employee of Kirk-Mayer.[68] The three judges of the Federal Court of Appeal agreed with one another in result that the appellant was an independent contractor, but each authored a separate set of reasons. All of the judges appeared to consider the Civil Code of Québec[69] to be relevant in determining the status of the worker.

61 *Sagaz*, supra note 1, at paragraph 47.

62 Ibid., at paragraphs 47-48.

63 *Wiebe Door*, supra note 60.

64 The courts have mentioned intention in several cases: *Bradford v. MNR*, 88 DTC 1661 (TCC); and *SARA Consulting & Promotions Inc. v. MNR*, [2001] TCJ no. 773. See *Mayne Nickless Transport Inc. v. MNR*, [1999] TCJ no. 132, at paragraph 20.

65 *Minister of National Revenue v. Standing* (1992), 147 NR 238, at 239-40 (FCA).

66 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

67 *Wolf*, supra note 2, at paragraph 37. The article was deleted in 2007.

68 Ibid., at paragraph 32.

69 SQ 1991, c. 64.

Desjardins JA's decision did not promote an increased role for intention. After reviewing the decision in *Sagaz*, she applied the legal test. The first subheading considered was "the written contract." After discussing the duration of the contract, she noted that "[t]he terms of the written contract between Kirk-Mayer and the appellant will only be given weight if they properly reflect the relationship between the parties."[70] It seems from the discussion preceding the quotation, that Desjardins JA was examining the terms in the contract, rather than the parties' characterization of their relationship, to determine if these terms were consistent with the actual relationship. However, she then went on to quote a reference from *Standing v. Canada (MNR)*, which stated that the parties' characterization of their relationship lacked sufficient foundation.[71] She then examined the factors in *Wiebe Door*, concluding that they pointed to independent contractor status. Thus, the only reference in the decision to the intention of the parties in characterizing their relationship is contained in a (perhaps misplaced) quotation dismissing the relevance of the characterization in the contract.

The decisions of the two other Federal Court of Appeal judges in *Wolf* are viewed as endorsing the importance of the intention of the parties, although the comments on intention differ greatly. Décary JA made a bold statement: "I say, with great respect, that the courts, in their propensity to create artificial legal categories, have sometimes overlooked the very factor which is the essence of a contractual relationship, i.e. the intention of the parties."[72] These words, and the rest of the paragraph, appear to indicate that intention is significant when interpreting the contract.

Décary JA's judgment veered away from the longstanding jurisprudence by focusing on intention and failing to systematically consider the *Wiebe Door* factors (although control and autonomy were discussed), apparently because of freedom to contract and to determine one's own tax consequences. For example, Décary JA states that "[t]axpayers may arrange their affairs in such a lawful way as they wish. . . . When a contract is genuinely entered into as a contract for services and is performed as such, the common intention of the parties is clear and that should be the end of the search."[73]

However, there is some question whether his comments with respect to intention pertain to the terms or to the legal characterization.[74] Further, the reference to intention in the relevant Civil Code provisions[75] could be taken to limit the decision's

70 *Wolf*, supra note 2, at paragraph 71.

71 Ibid.

72 Ibid., at paragraph 117.

73 Ibid., at paragraph 119. See also paragraphs 118 and 120.

74 Décary JA's discussion appears to focus on intention with respect to the terms of the agreement that relate to control and subordination (ibid., at paragraphs 118 and 120). However, he does make reference to the stated intention of the parties with respect to characterization on at least one occasion in the judgment, when at paragraph 119 he refers to "what they say they are."

75 Ibid., at paragraph 117.

scope to the Code. It is also notable that he still supports as central the question whether a person is carrying on business on his or her own account.[76] Therefore, it seems that the focus on intention had not completely ousted the test endorsed by the Supreme Court in *Sagaz*.

The third set of reasons, written by Noël JA, limited the importance of intention, although it still had great potential to change the course of the law. In his four-paragraph judgment, Noël JA opined that in this particular case the characterization by the parties of their relationship "ought to be given great weight."[77] He acknowledged that the description of the relationship is "not usually determinative" but stated that "in a close case such as the present one, where the relevant factors point in both directions with equal force, the parties' contractual intent, and in particular their mutual understanding of the relationship cannot be disregarded."[78] It appears then that Noël JA viewed intention as a tie-breaker. However, later statements might suggest another test: "the manner in which the parties viewed their agreement must prevail unless they can be shown to have been mistaken as to the true nature of their relationship."[79] The latter half of Noël JA's reasons might therefore support a test that uses intention as a presumption, which can be rebutted if the parties' labelling of their relationship was mistaken. Here, the evidence was neutral at best, and therefore the Tax Court was wrong to disregard the understanding of the parties.[80]

The lack of congruency among the three sets of reasons (and even within them) has made the case particularly difficult to apply. Since two of the three judgments can be read to emphasize the intention of the parties with respect to the legal characterization of their relationship, it is not surprising that the courts subsequently adopted this idea and increasingly referred to intention.

Cases Following Wolf and Preceding Royal Winnipeg Ballet

Several points are interesting about the first few appellate cases that considered intention following *Wolf*. The court in *Poulin v. MNR* and *Le Livreur Plus Inc. v. Canada (Minister of National Revenue)*[81] considered only the points of Décary JA, and not those of his colleagues. The court in *Le Livreur Plus* also considered intention in addition to all of the *Wiebe Door* factors, even though Décary JA had not considered these factors. The court's decision in *D & J Driveway Inc. v. Canada (Minister of National Revenue)*[82] mentioned intention, but not the *Wolf* case, and intention did not appear to play an important role in the decision.

76 Ibid., at paragraph 119.

77 Ibid., at paragraph 122.

78 Ibid.

79 Ibid., at paragraph 124.

80 Ibid.

81 *Poulin*, supra note 50; *Le Livreur Plus*, 2004 FCA 68.

82 2003 FCA 453.

Royal Winnipeg Ballet v. MNR

After *Wolf*, the first case to discuss the role of intention in detail was the 2006 case of *Royal Winnipeg Ballet v. MNR*. The Tax Court had upheld the minister's ruling that three dancers were employees of the Royal Winnipeg Ballet, and thus the ballet company must make CPP and employment insurance contributions. The Tax Court judge stated that intention should serve as a tie-breaker in the event that the legal tests do not produce a result.[83] Two of the Federal Court of Appeal justices, Sharlow JA and Desjardins JA, overturned the Tax Court's decision, while Evans JA dissented.

Sharlow JA's review of the jurisprudence contained a summary of the *Wiebe Door* and *Sagaz* decisions, as well as the reasons of all three judges in *Wolf*.[84] She then considered the intention of the parties and pointed out that there was a common understanding among the parties that the dancers were not employees.[85] Sharlow JA was unsympathetic with the Tax Court judge's concern that giving intention great weight could allow employment insurance to become an optional program. She explained, "There is ample authority for the proposition that parties to a contract cannot change the legal nature of that contract merely by asserting that it is something else."[86] In one sense, this explanation was less than satisfactory because the Tax Court's concern was that paying heed to intention would change this proposition and allow an assertion to determine the legal nature of the contract. Sharlow JA may have meant to reaffirm the precedent that intention is not determinative. She points out that both in *Wiebe Door* and in *Wolf*, the courts examined the parties' relationship to determine if it was, in fact, the one that they intended to create.[87]

Sharlow JA disagreed with the Tax Court judge's reading of Noël JA's decision in *Wolf* as creating a tie-breaker role for intention.[88] To make her point, she did not consider Noël JA's judgment (which in my view does appear to incorporate a tie-breaker role at one point). Instead, she justified her position on the basis of *Montreal Locomotive*, which was cited at the end of Noël JA's judgment.[89] Since *Montreal Locomotive* does not mention intention, but looks to the terms of the agreement in determining the legal character of the parties' relationship, one may conclude that here, Sharlow JA is referring to intention in relation to the terms of the agreement. This approach could also be consistent with Décary JA's remarks in *Wolf*, which, as noted earlier, are ambiguous with respect to the meaning of intention. However, Sharlow JA was interpreting Noël JA's judgment, in which he clearly meant intention in the sense of legal characterization. Later in the judgment, Sharlow JA states that

83 Supra note 56, at paragraph 55, citing *Royal Winnipeg Ballet v. MNR*, 2004 TCC 390.

84 Supra note 56.

85 Ibid., at paragraph 64.

86 Ibid., at paragraph 56.

87 Ibid.

88 Ibid., at paragraph 57.

89 Ibid.

the label given by the parties to their relationship is not necessarily determinative.[90] However, she also later refers to "common intention as to most of the *terms* of their contract."[91] There is certainly some confusion about whether Sharlow JA's discussion of intention is referring to intention with respect to terms or intention with respect to legal characterization.

Sharlow JA appeared to rely on the principles of contract interpretation:

> One principle is that in interpreting a contract, what is sought is the common intention of the parties *rather than the adherence to the literal meaning of the words*. Another principle is that in interpreting a contract, the circumstances in which it was formed, the interpretation which has already been given to it by the parties or which it may have received, and usage, are all taken into account. The inescapable conclusion is that the evidence of the parties' understanding of their contract must always be examined and given appropriate weight.[92]

With respect, relying on contract interpretation to explain the process of determining the legal character of the relationship is problematic because these are two different exercises.

Sharlow JA concluded that the trial court judge should have considered the factors from *Wiebe Door* "in the light of"[93] the common intention that the dancers were independent contractors. As discussed later, this idea is repeated in subsequent cases, although its implications are still not clear.

Desjardins JA's concurring set of reasons in *Royal Winnipeg Ballet* did not say much about intention, although she did state that she "would not deprive the common law judge of the possibility of being made apprised of the intention of the parties so as to test such intention against objective factors and the surrounding circumstances of the case when he makes the final determination."[94] Later, she pointed out that judges must make sure that the circumstances in fact coincide with the label given by the parties.[95] She also commented that this exercise is similar to determining whether a relationship is one of partnership: it is necessary to look to objective evidence, not just to subjective intention.[96] As when determining whether a partnership relationship exists, it is not the interpretation of the contract, but the nature of the relationship, that must be determined.[97] Thus, unlike Sharlow JA's reasons, the reasons of Desjardins JA make the distinction between the two exercises clear.

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90 Ibid., at paragraphs 60-62.

91 Ibid., at paragraph 62 (emphasis added).

92 Ibid., at paragraph 60 (emphasis in original).

93 Ibid., at paragraph 64.

94 Ibid., at paragraph 71.

95 Ibid., at paragraph 72.

96 Ibid., at paragraphs 74-75.

97 Ibid., at paragraphs 78 and 79.

Desjardins JA saw value in allowing the common-law judge to look to numerous criteria in determining the legal nature of the relationship, and she agreed with Sharlow JA that intention should not be used only as a tie-breaker. She ends her reasons by leaving open the question whether the concept of the parties' intention is different under the civil law of Quebec.

One uncertainty that arises from the judgments of Sharlow JA and Desjardins JA is how, exactly, intention affects the analysis. While Sharlow JA stated that the other relevant factors should be examined "in the light of" the common intention, is it not clear what this actually means. Beyond citing *Wolf*, there is no commentary in the reasons explaining *why* intention with respect to legal characterization is relevant. In fact, Sharlow JA's reasoning is questionable in that she appears to use authorities that relate to the interpretation of a contract, which cannot be equated with the determination of the legal character of the parties' relationship.

In his dissenting judgment, Evans JA saw little role for intention in determining whether a person is an employee or an independent contractor. He pointed out that in the past courts "have attached little significance to the parties' understanding of the legal nature of their contract, or to their stated intention to enter into a particular kind of contract."[98] Instead, the legal character of a contract was determined on the basis of terms and conduct.[99] He observed that it is only recently that courts have weighted intention heavily in a number of employment insurance and CPP cases. He pointed out that the reasoning in these cases has relied, at least in part, on the Quebec Civil Code,[100] while this was the first common-law case that involved the role of intention.[101]

Evans JA gave several persuasive reasons for minimizing the role of intention. First, he pointed out that legal characterization is an inference of law, which "does not rest on the legal label attached to the agreement by the parties or on their purpose in entering into it."[102] He then distinguished between interpretation of the contract and legal characterization: "The intention of the parties is relevant to determining the terms of the transaction, not to its legal characterization, nor to whether the parties attained their ultimate objective."[103]

Evans JA, like Desjardins JA, used the legal characterization of a partnership as an analogy, though in a very different way. While Desjardins JA used the test for determining whether a partnership exists to make the point that looking to objective

98 Ibid., at paragraph 86.

99 Ibid.

100 Ibid., at paragraph 87.

101 Ibid., at paragraph 88.

102 Ibid., at paragraph 92.

103 Ibid.

evidence was necessary, Evans JA analogized the partnership test to the employee-independent contractor test and identified authorities that showed that declared intention carried little or no weight in determining legal characterization.[104]

Evans JA doubted the relevance of the parties' view of the legal characterization of their contract, and questioned how it would fit with the factors from *Wiebe Door*.[105] He also pointed out that the parties' view of the contract is self-serving.[106] Further, he commented that the parties may have differing bargaining powers, and that attributing weight to stated intention may adversely affect the more vulnerable party, who might be denied statutory rights (such as employment insurance benefits) as a result.[107] Finally, he observed that the legal characterization of the parties can have an impact on third parties, such as tort victims and the CRA,[108] stating that this result can "jeopardize"[109] the interests of third parties and "undermine non-voluntary protective statutory programs, such as EI and CPP."[110]

Evans JA concluded as follows: "In my opinion, the only significant role of the parties' stated intention or understanding about the legal nature of their contract is as part of the interpretative context in which the court views the contract in order to resolve ambiguities and fill in silences in its terms."[111] It is unfortunate that he does not explain this statement more fully. For example, does it mean that he would support the use of intention as a tie-breaker? Can the parties' label be used to fill in terms on which the agreement is silent, such as the supply of tools, which could affect the *Wiebe Door* analysis? Evans JA's strong statements up to this point in the judgment make it clear that he does not want intention to be given much weight, but this final statement raises the possibility of using intention in some circumstances.

Later arguments in this article against the use of intention incorporate many of Evans JA's points. Unlike the decisions advocating the use of intention, which provide few and weak reasons for introducing such a significant change in the law, the decision of Evans JA provides thoughtful and persuasive ideas.

Cases Following Royal Winnipeg Ballet

Following *Royal Winnipeg Ballet*, it could be expected that the cases would place significant weight on intention. In fact, Kurt Wintermute's study of the jurisprudence, which incorporates cases decided one year after the decision, showed that

104 Ibid., at paragraphs 93-94.

105 Ibid., at paragraph 98.

106 Ibid., at paragraph 99.

107 Ibid., at paragraphs 101-102.

108 Ibid., at paragraph 103.

109 Ibid.

110 Ibid.

111 Ibid., at paragraph 105.

the courts appeared to place increasing reliance on intention.[112] However, it remained unclear how intention should temper the analysis. As Bowman J stated in *Lang v. MNR*, "I doubt that it is possible to find one *ratio decidendi* that would apply to all three judgments."[113]

In *City Water International Inc. v. Canada*, the first Federal Court of Appeal case after *Royal Winnipeg Ballet*, the court considered whether the Tax Court judge should have placed greater weight on intention, given the reasons in *Royal Winnipeg Ballet*:

> In my analysis, since the relevant factors yield no clear result, greater emphasis should have been placed on the parties' intention by the Judge in this case. The Judge was required to consider the factors in light of the uncontradicted evidence, and to ask himself whether, on balance, the facts were consistent with the conclusion that the workers were persons in "business on their own account" . . . or were more consistent with the conclusion that the workers were employees.[114]

This excerpt is interesting in several respects. The first sentence appears to suggest that since the *Wiebe Door* factors did not lead to a conclusion, the judge should have given intention greater consideration. This could be interpreted to mean that intention should be used as a tie-breaker. However, in the second part of the paragraph, the court's comments are that the factors (presumably the *Wiebe Door* factors) should be considered "in the light of" the "uncontradicted evidence" (presumably of intention). This latter comment coincides with the decisions of Desjardins and Sharlow JJA in *Royal Winnipeg Ballet*. In reality, the court did not seem to perform its *Wiebe Door* analysis "in the light of" the common intention, since common intention was discussed only after the analysis of the other factors. In the end, the court concluded that the Tax Court had erred in not properly considering intention; had it done so, the result would have been a finding of an independent contractor relationship.

In a later case, *Combined Insurance Company of America v. Canada (National Revenue)*, the Federal Court of Appeal appeared to place great emphasis on the role of intention. The court summarized the case law as follows:

> 1. The relevant facts, including the parties' intent regarding the nature of their contractual relationship, must be looked at in the light of the factors in *Wiebe Door* . . . and in the light of any factor which may prove to be relevant in the particular circumstances of the case;

112 Supra note 9, at 34:21. Wintermute's research shows that when the parties' common intention was to have an independent contractor relationship, judges found there to be an independent contractor 57 percent of the time before *Wolf*, 71 percent of the time after *Wolf* and before *Royal Winnipeg Ballet*, and 89 percent of the time after *Royal Winnipeg Ballet*.

113 *Lang*, supra note 53, at paragraph 24.

114 2006 FCA 350, at paragraph 31.

2. There is no predetermined way of applying the relevant factors and their importance will depend on the circumstances and the particular facts of the case.[115]

The court later commented that the *Wiebe Door* factors were "at the very least useful guidelines."[116] This diminishment of the importance of the four-in-one test[117] would represent a major change in the jurisprudence, if it were adopted in later cases. In this case, however, the *Wiebe Door* factors appeared to play a major role, and the court concluded that they supported the intention to create an independent contractor relationship.[118]

In the next Federal Court of Appeal case, *Gagnon v. MNR*,[119] after stating that no evidence was provided with respect to intention, the court made the following statement: "However, the four criteria analyzed by the judge are relevant and helpful in ascertaining the intent of the parties to the contract and the legal nature of their relationship."[120] In a later Tax Court case, this was taken to mean that intention was given a prevalent role,[121] although intention was not mentioned in the remainder of *Gagnon*. It was also interpreted to mean that the *Wiebe Door* tests can assist in determining intention.[122]

In *Kilbride v. Canada*, the Federal Court of Appeal considered whether the taxpayer should have been denied business deductions under the ITA on the basis that he was an employee. What is interesting for the purposes of this discussion is that the Federal Court of Appeal appeared to support the use of intention as a tie-breaker: "This is not a close case where the *Wiebe Door* test is inconclusive, requiring the court to give greater weight to the intention of the parties."[123] This interpretation is inconsistent with the decisions of Desjardins and Sharlow JJA in *Royal Winnipeg Ballet*, although this case was cited later in the same paragraph.[124]

In the CPP and employment insurance case of *National Capital Outaouais Ski Team v. Canada*, the Federal Court of Appeal rejected the argument that it should look first to intention and that there was a presumption in favour of intention. The court observed that setting up a presumption in favour of intention would be contrary to the presumption in favour of the minister's assumption of facts in the area of the insurability of employment.[125] Assuming that a common test exists across all

115 2007 FCA 60, at paragraph 35.

116 Ibid., at paragraph 38.

117 See Bowman J in *Lang*, supra note 53, at paragraph 31.

118 *Combined Insurance Company of America*, supra note 115, at paragraph 72.

119 2007 FCA 33.

120 Ibid., at paragraph 5.

121 *Lang*, supra note 53, at paragraph 32.

122 Ibid.

123 2008 FCA 335, at paragraph 11.

124 Ibid.

125 2008 FCA 132, at paragraph 8.

areas of the law, this reasoning is somewhat problematic because similar presumptions would not exist in tort law, for example.[126] Another problem with the court's reasoning is that, as the judges acknowledge, there is a presumption in favour of the minister's assumed facts.[127] Such a presumption exists in income tax law as well.[128] This is the case no doubt because the person applying for insurance or disputing the CRA's position has better access than the minister to information that could rebut the presumption.[129] However, the legal characterization of a relationship is not a fact; it is a conclusion in law.[130] Therefore, there should be no presumption in favour of the minister's assumptions regarding the legal character of a relationship (although this point does not mean that there should instead be a presumption in favour of the parties' intention).

A few years later, the Federal Court of Appeal decided the case of *TBT Personnel Services Inc. v. Canada*. The issue was whether truck drivers working for the appellant (TBT) were employees and whether TBT should therefore have paid premiums under the CPP and EIA. Sharlow JA, for the court, summarized what *Wolf* and *Royal Winnipeg Ballet* held about the role of intention:

> [W]here there is evidence that the parties had a common intention as to the legal relationship between them, it is necessary to consider that evidence, but it is also necessary to consider the *Wiebe Door* factors to determine whether the facts are consistent with the parties' expressed intention.[131]

The court began its analysis with the key question: whether TBT engaged the drivers "as a person in business on his own account."[132] Thus, the intention of the parties did not appear to displace this central question.

Some of the drivers in *TBT Personnel Services* signed a written agreement, while others did not. The Tax Court judge had decided that only those drivers who had signed the agreement were independent contractors. Sharlow JA began by reviewing aspects of the contract that were relevant to the *Wiebe Door* factors, but then reviewed the intention clause, which indicated that the driver was an independent contractor:

126 This reasoning might give rise to the question whether the test should be the same across all areas of the law. See Friedlander, supra note 6.

127 *National Capital Outaouais Ski Team*, supra note 125, at paragraph 9.

128 *Canada v. Anchor Pointe Energy*, 2007 FCA 188, at paragraph 28; and Pooja Samtani and Justin Kutyan, "Reverse Onus: Time To Reconsider?" (2012) 2:4 *Canadian Tax Focus* 8-9, at 8.

129 *Anchor Pointe Energy*, supra note 128, at paragraph 35, citing *Orly Automobiles Inc. v. Canada*, 2005 FCA 425, at paragraph 20.

130 *Kopstein v. The Queen*, 2010 TCC 448, at paragraph 68; and *Strother v. The Queen*, 2011 TCC 251, at paragraphs 21-22.

131 *TBT Personnel Services Inc. v. Canada*, 2011 FCA 256, at paragraph 9.

132 Ibid., at paragraph 10.

> [S]uch intention clauses are relevant but not conclusive. The *Wiebe Door* factors must also be considered to determine whether the contractual intention suggested by the intention clauses is consistent with the remaining contractual terms and the manner in which the contractual relationship operated in fact.[133]

The *Wiebe Door* factors, in this case, supported a conclusion that the drivers who signed the agreements were employees, despite the intention clause. Thus, the intention clause did not affect the result. Sharlow JA upheld the Tax Court's decision that the drivers without a written agreement were employees.

To summarize the appellate-level law following *Royal Winnipeg Ballet*, the Federal Court of Appeal cases left questions about whether intention could still be used as a tie-breaker,[134] the way in which the *Wiebe Door* factors would be analyzed "in the light of" intention,[135] whether the principal focus of an inquiry is common intention rather than who runs the business,[136] and what difference intention makes to the analysis if it does not give rise to a presumption.[137]

In the Tax Court, perhaps the most notable case following *Royal Winnipeg Ballet* is *Lang v. MNR*,[138] in which Bowman J reviewed the existing case law and pointed out that the Supreme Court of Canada had not yet expressed its opinion about the proper role of intention.[139] Bowman J also highlighted the reasons of Evans JA in *Royal Winnipeg Ballet* and opined that the Supreme Court, if considering the employee-independent contractor test, would have to address Evans JA's reasons for de-emphasizing the importance of intention.[140] He pointed out that trial judges who ignored intention were often overruled, and therefore, while intention cannot be ignored, the weight to be attached to it had not yet been settled.[141] He concluded that there were four possible roles for intention:

> (a) Intent is determinative (*Royal Winnipeg Ballet*).
> (b) *Wiebe Door* is all that is needed and intent need not be considered (*Sagaz*, *Wiebe Door* and *Precision Gutters*).
> (c) The *Wiebe Door* test does not point conclusively in any direction and so intent is a tie-breaker (*Wolf* and *City Water*).
> (d) Common sense, instinct and a consultation with the man on the Clapham omnibus.[142]

133 Ibid., at paragraph 35.

134 *City Water International Inc.*, supra note 114; and *Kilbride*, supra note 123.

135 *Combined Insurance Company of America*, supra note 115.

136 *Gagnon*, supra note 119; and *Combined Insurance Company of America*, supra note 115.

137 *National Capital Outaouais Ski Team*, supra note 125.

138 *Lang*, supra note 53.

139 Ibid., at paragraph 33.

140 Ibid.

141 Ibid., at paragraph 34.

142 Ibid., at paragraph 36.

All four of these approaches led to the same conclusion in *Lang*.

A number of observations can be made about the other Tax Court decisions that arose after *Royal Winnipeg Ballet* and before *Connor Home*. In at least one case, the court described intention as very important.[143] However, in more cases the court seemed to downplay the role of common intention.[144] Frequently, the court found that the relationship was not as intended.[145] There were different approaches to the use of intention. Some cases added common intention to the list of *Wiebe Door* and other relevant factors.[146] In other cases, the idea of using common intention as a tie-breaker persisted,[147] similar to the ideas expressed in *City Water* and *Kilbride*. Despite *National Capital Outaouais Ski Team*, in at least one case it was suggested that common intention gives rise to a presumption.[148] While a number of judges reasoned that intention must be consistent with objective factors,[149] no direction was given about how the *Wiebe Door* factors should be examined in the light of intention. There was a need for additional clarity.[150]

1392644 Ontario Inc. (c.o.b. Connor Homes) v. MNR

The most recent direction from the Federal Court of Appeal is found in *Connor Homes*,[151] in which the court fortunately went some way toward clarifying the role of common intention. In this case, the issue was whether persons retained by Connor Homes to deliver foster and group home services were employees of Connor Homes, and thus engaged in pensionable and insurable employment under the CPP and EIA regimes, respectively. The Tax Court agreed with the minster that the workers were

143 *Wellbuilt General Contracting Ltd.*, supra note 37.

144 *Director of Labour Standards v. Acanac Inc.*, 2013 SKQB 21, at paragraph 54, stating "'on the ground' conduct may be more determinative of the true relationship"; *Wilford v. MNR*, 2011 TCC 6, at paragraph 19, stating that characterization "is a matter of law and not of private agreement."

145 *North Delta Real Hot Yoga Ltd. v. Canada (National Revenue)*, 2012 TCC 369; *A-1 Lumpers Inc. v. MNR*, 2012 TCC 243; *Samqo Transport v. MNR*, 2012 TCC 132; *Canadian Bio Pellet Inc. v. MNR*, 2011 TCC 406; *The Girls Gym of Canada Ltd. v. MNR*, 2011 TCC 312; *Steiner v. MNR*, 2011 TCC 146; *1770200 Ontario Inc. v. MNR*, 2011 TCC 65; *TBT Personnel Services*, supra note 131; and *Kilbride v. The Queen*, 2007 TCC 663; aff'd. 2008 FCA 335.

146 *Malleau v. MNR*, 2013 TCC 47; *Samqo Transport*, supra note 145; and *Seeislam Inc. o/p Truepath Logistics v. MNR*, 2010 TCC 243.

147 *Mehta v. MNR*, 2011 TCC 558; *Heineke*, supra note 22; *Integrated Automotive Group v. MNR*, 2011 TCC 468; *Sadden v. MNR*, 2011 TCC 450; *Southland Livestock Feeders Ltd. v. MNR*, 2011 TCC 209; *1772887 Ontario Ltd.*, supra note 30; *Aquazition 2007 Ltd. v. MNR*, 2011 TCC 77; and *Pichugin*, supra note 24.

148 *Maple Elect Zoltan*, supra note 39.

149 *Pro-Pharma Contract Selling Services Inc. v. MNR*, 2012 TCC 60; *MAP*, supra note 35; and *177398 Canada Ltd.* (2011), supra note 26.

150 This was also observed by Wintermute, supra note 9, at 34:20-21.

151 Supra note 57.

employees. One of the arguments made on appeal to the Federal Court of Appeal was that the Tax Court judge did not give appropriate weight to the contracts signed by the parties, which indicated a shared asserted intention to form an independent contractor relationship.

The judgment, for the court, was delivered by Mainville JA, who observed the difficulty of applying the employee-independent contractor test. After reviewing *Wiebe Door* and *Sagaz*, he observed that a "jurisprudential trend has emerged which affords substantial weight to the stated intention of the parties,"[152] citing *Wolf* and *Royal Winnipeg Ballet* but noting the criticism in *Lang*.

Mainville JA reviewed only the decision of Décary JA in *Wolf*, noting the substantial weight he afforded to intention and his comments that without unambiguous evidence to the contrary, the express intention of the parties should prevail, apparently on the basis of freedom to contract.[153] Mainville JA then summarized Sharlow JA's reasons in *Royal Winnipeg Ballet*, in which she directed that the *Wiebe Door* factors should be addressed, in light of the common intention, to see whether they are more consistent with an employment or an independent contractor relationship.[154] Mainville JA was careful to reiterate what Sharlow JA had also observed: the parties' declaration is not determinative.[155]

Mainville JA noted the difficulty in applying the decision in *Royal Winnipeg Ballet*,[156] and singled out two cases where a Tax Court judge had interpreted *Wolf* to mean that intention should prevail.[157] To counter these cases, Mainville JA used the dissenting judgment in *Royal Winnipeg Ballet*, in which Evans JA pointed out that, in the words of Mainville JA, "the parties' view of the legal nature of their contract is inevitably self-serving, the parties to the contract are often not in equal bargaining positions, and the legal characterization of a contract by the parties should not impact on third-parties relying on vicarious liability theories."[158] Mainville JA used Evans JA's dissent to limit the role of intention slightly, but not nearly to the extent advocated by Evans JA.

Mainville JA then justified the consideration of the common intention of the parties with freedom-to-contract principles:

> However, properly understood, the approach set out in *Royal Winnipeg Ballet* simply emphasises the well-know[n] principle that persons are entitled to organize their affairs and relationships as they best deem fit. The relationship of parties who enter into

152 Ibid., at paragraph 30.

153 Ibid., at paragraph 31.

154 Ibid., at paragraph 33.

155 Ibid.

156 Ibid., at paragraph 34.

157 Ibid., at paragraph 35.

158 Ibid.

> a contract is generally governed by that contract. Thus the parties may set out in a contract their respective duties and responsibilities, the financial terms of the services provided, and a large variety of other matters governing their relationship.[159]

Mainville JA then limited the impact of intention:

> However, the legal effect that results from that relationship, *i.e.* the legal effect of the contract, as creating an employer-employee or an independent contactor relationship, is not a matter which the parties can simply stipulate in the contract. In other words, it is insufficient to simply state in a contract that the services are provided as an independent contractor to make it so.[160]

While freedom to contract appeared to justify a consideration of common intention, the legal nature of the exercise reduced its weight. In further support of not permitting parties to determine their status, Mainville JA cited the "far reaching legal and practical ramifications"[161] in other areas of the law, and concluded that the legal status must "be grounded in a verifiable objective reality."[162] Concerns about the ability to manipulate the relationship, the legal nature of the question, and the far-reaching legal consequences dampened the effect of intention. These arguments are addressed later in the article. For now, it is sufficient to comment that a compromise appears to have been reached.

A novel, albeit minor, contribution of *Connor Homes* is its formulation of a two-stage approach. The first stage required a determination of the common intention of the parties.[163] The court did not state that intention must be mutual to be considered relevant, although it is likely that the courts will continue to consider mutuality to be a necessity. (Indeed, if freedom to contract was the impetus behind the increased focus on intention, it would make sense only to consider the *mutual* intention of the parties.) The decision also noted that the parties' behaviour could determine common intention, including behaviour with respect to invoices, GST registration status, and income tax filings.[164] The courts have not consistently given great weight to these factors,[165] and it will be interesting to see if the court's obiter comments will be seen as an endorsement for the placement of greater weight.

The second stage required the court "to ascertain whether an objective reality sustains the subjective intent of the parties."[166] In the words of Mainville JA,

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159 Ibid., at paragraph 36.

160 Ibid.

161 Ibid., at paragraph 37.

162 Ibid.

163 Ibid., at paragraph 39.

164 Ibid.

165 See, for example, *SB Towing*, supra note 45; and *SIP Distribution*, supra note 46.

166 *Connor Homes*, supra note 57, at paragraph 40.

> the parties' intent as well as the terms of the contract may also be taken into account since they colors [sic] the relationship. As noted in *Royal Winnipeg Ballet* at para. 64, the relevant factors must be considered "in the light of" the parties' intent.[167]

This is really nothing new—simply a restatement of Sharlow JA's judgment in *Royal Winnipeg Ballet*. Unfortunately, no examples are given concerning how intention may colour the relationship.

The language used in the next part of the paragraph does not support a presumption in favour of intention, but rather indicates that the *Wiebe Door* test must be used to determine whether a worker is an employee or independent contractor.[168] The court maintained that the "central question at issue remains whether the person who has been engaged to perform the services is, in actual fact, performing them as a person in business on his own account."[169] Depending on how the decision is interpreted in other cases, intention, as the consideration that colours the rest of the analysis, could displace control and the other factors as the most important consideration. Still, the court stated that "no particular factor is dominant and there is no set formula. The factors to consider will thus vary with the circumstances."[170]

The remainder of the judgment in *Connor Homes* may reflect a minor role for intention in practice. In applying its test, the court did not believe that the Tax Court's error in looking to intention last necessarily vitiated its decision.[171] The court noted a common intention that the parties were independent contractors, which characterization was contradicted by the evidence. There is nothing in the remainder of the court's analysis of control or other *Wiebe Door* factors to indicate that intention coloured the analysis and differentiated it from that of the lower court. One must therefore wonder whether intention will ever play a meaningful role if it does not lead to a presumption and the courts have not discovered a way to view the *Wiebe Door* factors in the light of the intention.

Cases Following Connor Homes

The Federal Court of Appeal has not ruled on the issue of employee-independent contractor status since *Connor Homes*, although it has heard nearly three dozen cases from lower courts. A review of these decisions reveals how *Connor Homes* has been interpreted and applied. The vast majority of the decisions have involved determining whether workers were engaged in insurable and pensionable income-earning activities under the EIA and CPP. Generally speaking, intention has not played as great a role as one might have expected.

167 Ibid., at paragraph 40.

168 Ibid.

169 Ibid., at paragraph 41.

170 Ibid.

171 Ibid., at paragraph 42.

While most of the signals indicating a minor role for intention after *Connor Homes* have been subtle, in two cases Miller J overtly disagreed with the increased focus on intention. In *Acanac Inc. v. MNR*, the workers argued that they were employees, while the company argued that the workers were independent contractors. Miller J was skeptical about placing emphasis on intention:

> Acanac clearly went so far as to have an Independent Contractor Agreement drawn up with independent contractor-like terms. Some might say this illustrates an intention to enter an independent contractor relationship: the more cynical may suggest the true intention does not necessarily go to the legal relationship, but to the result flowing from that: that is, no requirement to make source deductions. Frankly, this has always troubled me about putting any emphasis on the role of intention. Reliance on intention presumes those concerned have some intimate legal knowledge of the distinction between employment and independent contractor. With respect, in many cases, this is an unrealistic presumption.[172]

In *Mallon v. MNR*, the contract indicated that the worker was an independent contractor, but Miller J was again wary of placing undue weight on intention:

> This case highlights what is often at the root of these employee versus independent contractor cases, and that is that the involved parties believe they can choose to opt in or out of Employment Insurance. . . . If a worker wants independent contractor status, then with a stroke of a pen the worker has it. . . .
>
> This case also highlights the danger in placing too much reliance on intention in determining the appropriate relationship.[173]

Later in the same case, Miller J interpreted *Royal Winnipeg Ballet* to mean that "stated intention can be 'disregarded'"[174] and moved on to a detailed criticism of *Connor Homes*:

> With respect, turning what was, prior to the *Royal Winnipeg Ballet* case, a one-step approach into a two-step approach, requiring the second step to be an analysis through the "prism" of intention appears to place too great an emphasis on the factor of intention, that can so readily be manipulated with no regard for the true status of the working relationship, but more to the effect of avoiding source deductions.[175]

Miller J considered himself bound by the Federal Court of Appeal's approach, but found that the actions of the parties did not support the intentions expressed in the contract, and therefore found no common intention under the first stage. He then launched into a further criticism of the two-stage test:

172 *Acanac Inc.*, supra note 26, at paragraph 22.

173 *Mallon*, supra note 27, at paragraphs 11-12.

174 Ibid., at paragraph 14.

175 Ibid.

> I would suggest, with respect, the two step approach is backwards. First, determine the true nature of the working arrangement, through the traditional analysis, and as Justice Noël acknowledged in *Wolf v. The Queen*, if the answer is not definitive, consider the mutual intention. Or perhaps look to intention as just one of the traditional factors such as control, ownership of tools, chance of profit and risk of loss, limiting the analysis to one step. It has always troubled me that this factor received no mention in the Supreme Court of Canada leading case on this issue (*1671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*,) yet we now must analyze through the intention prism. As judges we attempt to set tests not just to provide useful guidance for our own analysis, but to provide a helpful roadmap to taxpayers or, in this case, employers and workers. When determining the status of a working arrangement the message must be that the courts will look foremost to the actions and behaviour that define the relationship and determine whose business it is. Indeed, action and behaviour will determine intention, not the other way round. . . . I proceed with caution when factoring intention into the analysis.[176]

It is therefore clear that at least one Tax Court judge is dissatisfied with the direction that the Federal Court of Appeal has taken and has advocated for a lesser role for intention.

A review of the cases seems to indicate that the focus has remained on whose business it is (the approach promoted in *Sagaz*), rather than intention.[177] Generally, the Tax Court has also recognized the two-stage approach in *Connor Homes*, with a few exceptions.[178] A surprisingly prevalent problem is a failure in many cases to clearly identify whether there was common intention.[179]

Two comments can be made about the recent cases that involve establishing common intention. First, the factors traditionally relevant under the *Wiebe Door* analysis have been viewed in at least one case after *Connor Homes* as being relevant to establishing intention.[180] This is not consistent with the two-stage approach in *Connor Homes*, under which the *Wiebe Door* factors should be considered in the second stage, following a determination of common intention. While the *Connor Homes* approach seems tidier, the reality is that other objective factors, such as the

176 Ibid., at paragraph 15.

177 See, for example, *Marilake*, supra note 47; and *York Region Sleep Disorders Centre Incorporated v. MNR*, 2013 TCC 108.

178 One notable exception is *3142774 Nova Scotia Ltd. v. MNR*, 2013 TCC 129, in which the court suggested that the *Wiebe Door* test is to be applied before looking to intention (if necessary), and then at paragraph 17 the court quoted *Connor Homes*, which promoted the inverse order of analysis. In another case, *Butt v. MNR*, supra note 38, the court appeared to deviate from *Connor Homes* by suggesting that since intention was clear, there was no need to examine the four-in-one test, though on a closer reading of the case, this may have been the result of a finding of a lack of direct contractual relationship.

179 *Guevera v. MNR*, 2013 TCC 193; *York Region Sleep Disorders Centre*, supra note 177; *Marilake*, supra note 47; and *Hann v. MNR*, 2013 TCC 359.

180 *177398 Canada Ltd.* (2013), supra note 53.

status claimed in income tax filings and GST registration, have often been considered to be evidence of common intention (although they have not always proved conclusive).[181] However, these factors tend to affect credibility because they can represent a verifiable expression of how a party views the relationship. The *Wiebe Door* factors, by comparison, are less likely to be an expression of subjective intent since even if the party has knowledge of the four-in-one test, the test does not set out a formula for determining legal status. For example, a high level of control in the relationship does not necessarily indicate that the parties intended to create an employment relationship. Using *Wiebe Door* factors to affect the finding of common intention is therefore problematic under the existing two-stage approach advocated in *Connor Homes*.

Second, the courts have found no common intention in many cases.[182] As shown in table 1, of the 29 instances in which the Tax Court has considered the legal character of a person or group since *Connor Homes*, either the court failed to find common intention or failed to make its finding on intention clear in over half of the cases.[183] In general, when the courts noted shared asserted intention, in writing or otherwise, that the parties acted as independent contractors, they have found a common intention to form such a relationship in 55 percent of the cases. Even when a signed agreement indicated a certain characterization, intention was often not a factor because no common intention was found in at least 8 instances.[184] To support a lack of common intention, the courts have referenced power imbalances (as a result of which one party had no choice but to sign the agreement),[185] lack of attention or knowledge,[186] and the *Wiebe Door* factors.[187] It seems that written expressions of intention may generally be of limited value because power imbalances and a lack of attention or knowledge are quite common.[188] However, in other cases the Tax Court stated that a lack of knowledge of the meaning of independent contractor did not matter[189] and viewed a worker's assertion as an illegitimate attempt to unilaterally change the

181 See *Connor Homes*, supra note 57, at paragraph 39.

182 *Pavao v. MNR*, 2013 TCC 305; *2177936 Ontario Ltd. v. MNR*, 2013 TCC 317; *La Scala*, *Peterborough Youth Services*, and *Acanac Inc.*, all supra note 26; and *177398 Canada Ltd.*, supra note 53.

183 The 29 instances are found in 22 cases, up to May 1, 2014. In two cases, multiple groups or individuals were assessed separately. The cases do not include two cases involving personal services businesses, in which intention was not found to be relevant.

184 *La Scala* (three groups of workers), *Peterborough Youth Services*, and *Acanac Inc.*, all supra note 26; *177398 Canada Ltd.*, supra note 53; and *SB Towing*, supra note 45 (two groups of workers).

185 *La Scala*, supra note 26, at paragraph 31.

186 *Peterborough Youth Services*, supra note 26.

187 See, for example, *177398 Canada Ltd.*, supra note 53; and *Gagnon*, supra note 119.

188 *Therrien*, supra note 22.

189 *Sandberg v. MNR*, 2013 TCC 301; and *Robertson Human Asset Management Inc. v. MNR*, 2014 TCC 23.

TABLE 1 Shared Asserted Intention Versus Common Intention

		Common intention					
		Independent contractor		Employee		None/unclear	
		No.	%	No.	%	No.	%
Shared asserted intention							
Independent contractor	22	12	55	0	0	10	45
Employee	0	0	0	0	0	0	0
None/unclear	7	2	29	0	0	5	71
Total	29	14	48	0	0	15	52

parties' common intention. In *Acanac Inc.*, Miller J did not specify which evidence he relied on in reaching the conclusion that there was no common intention, despite the presence of a signed statement of intention.

The role of intention was reduced in yet another way in the recent case of *Loving Home Care Services Ltd. v. MNR*.[190] Boyle J held that despite a shared asserted intention that the workers were independent contractors, common intention was of little importance because one party did not know what an independent contractor was:

> As a general principle, workers who are not informed and do not actually know or understand the differing possible characterizations of their work relationship can not make a very helpful self-characterization of the nature of the legal relationship they have taken on, and certainly not one that can much enlighten or inform the Court's objective consideration of the traditional *Sagaz/Wiebe Door* factors.
>
> In the circumstances of this case, the Court places little weight on the subjective intentions of the workers to characterize their work relationship as independent contractors.[191]

Boyle J takes a novel approach in considering a lack of knowledge. Rather than using a lack of knowledge to influence the finding of common intention, as had been done in the past, Boyle J used the factor to affect the weight of common intention. This approach is particularly persuasive where, as he suggests, the reason for considering common intention is that the parties have special insight into the legal characterization of their relationship. In this case, a lack of knowledge indicated that their intention was of little or no value. As is discussed later in this article, it is unclear whether special insight of the parties is in fact the reason that the courts have decided to consider intention.

To a great extent, the reasons in the most recent Tax Court decisions do not assign common intention a major role in the decision-making process. As noted above, in *Mallon* Miller J refers to the requirement set out by the Federal Court of Appeal

190 2014 TCC 71.

191 Ibid., at paragraphs 27-28.

that the *Wiebe Door* factors be assessed "through the intention prism."[192] In the vast majority of cases,[193] intention was initially discussed, but it was ignored during the *Wiebe Door* analysis; as a result, common intention does not appear to affect the characterization of the parties' relationship.[194] Either the courts did not think that it is important to the analysis or they did not know how to apply it. Unless the Federal Court of Appeal or the Supreme Court of Canada steps in to clarify the role of common intention at the second stage of the *Connor Homes* approach, the Tax Court may continue to be content to simply ignore intention at the second stage and essentially rely on *Wiebe Door*, as was the case before *Wolf*. I argue later in this article that this is not an unfortunate result.

The fact that a court's reasons do not reflect a major role for common intention does not necessarily mean that common intention does not affect its decision making. In his study of cases up to 2007, Kurt Wintermute observed that intention appeared to play an increasing role. While a robust comparison of his study to more recent cases is impossible because of a relatively small number of cases and a lack of appellate court decisions, a study of the 29 instances[195] in which the courts have considered the legal character of a person or group since *Connor Homes* does not appear to paint a similar picture. As shown in table 2, of the 24 instances in which either the parties had a shared asserted intention or the court found a common intention of an independent contractor relationship, only 7, or 29 percent, resulted in a finding of an independent contractor relationship.

Finally, a cursory review of non-tax cases, most of which involve wrongful dismissal, shows that intention is often not considered to be a factor, and *Connor Homes* has not been considered to be a leading case.[196] This raises the question whether there will be further divergence among areas of the law with respect to the employee-intendant contractor test.

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192 *Mallon*, supra note 27, at paragraph 15.

193 The two exceptions are the thinly reasoned *Vertzagias v. MNR*, 2013 TCC 219; and *Butt*, supra note 38.

194 See *Guevera*, supra note 179; *Therrien*, supra note 22; *3142774 Nova Scotia Ltd.*, supra note 178; *La Scala*, supra note 26; *Murray v. MNR*, 2013 TCC 220; *Niagara Gorge Jet Boating Ltd. v. MNR*, 2013 TCC 261; *Kouper-FKS Industries Inc. (Modes For Kids Sakes Ltée) v. MNR*, 2013 TCC 315; *Hann*, supra note 179; *SB Towing Inc.*, supra note 45; *Mallon*, supra note 27; and *Robertson Human Asset Management*, supra note 189.

195 See supra note 183.

196 See, for example, *R v. Chilliwack Cattle Sales Ltd.*, 2013 BCSC 1059 (the accused was charged under animal health legislation and regulations in relation to loading ill cattle); *Farmers of North America Inc. v. Bushell*, 2013 SKCA 108 (a wrongful dismissal case); *Hazel v. Rainy River First Nations*, 2013 OJ no. 4990 (ONSC) (a wrongful dismissal case); *Jacobs v. PHAT Training Inc.*, 2014 ABQB 100 (a case involving, among other things, wrongful dismissal); and *Ho v. WFG Securities of Canada Inc.*, 2014 ONSC 1791 (a wrongful dismissal case in which neither *Connor Homes* nor intention was mentioned as a relevant factor, although the parties' characterization appears to have been a factor).

TABLE 2 Shared Asserted Intention and Common Intention Versus Court's Characterization

		Result			
		Independent contractor		Employee	
		No.	%	No.	%
Shared asserted intention					
Independent contractor	22	5	23	17	77
Employee	0	0	0	0	0
None/unclear	7	4	57	3	43
Common intention					
Independent contractor	14	5	36	9	64
Employee	0	0	0	0	0
None/unclear	15	4	27	11	73
Shared asserted or common intention, independent contractor	24	7	29	17	71
All cases	29	9	31	20	69

A review of the cases therefore uncovers three unresolved questions that should be addressed by the Federal Court of Appeal:

1. Should the determination of common intention be affected by power imbalance, lack of knowledge, and the factors normally considered under *Wiebe Door*?
2. Should common intention be given more or less weight in some circumstances?
3. What does it mean to say that the second stage of analysis should be considered "in the light of" common intention?

Since *Connor Homes*, the Supreme Court of Canada denied leave to appeal in the case of *Pluri Vox Media Corp.*, *et al. v. Her Majesty the Queen*, *et al.*[197] on May 16, 2013, which is unfortunate because granting leave would have given the highest court an opportunity to clarify the role of intention. There are two reasons that the Supreme Court should consider granting leave in such a case. First, the court has yet to endorse the now prevailing, though sometimes criticized, view that common intention is an important aspect of the test. Second, even if common intention should play a role, the Supreme Court should address the previously identified unresolved issues. In the remainder of the article, I consider the ideal way for the Supreme Court to decide the issue, should it grant leave.

197 2013 CanLII 26764.

THE WAY FORWARD: HOW SHOULD THE COURTS DETERMINE AND USE INTENTION?

This section of the article is aimed at the Supreme Court and the Federal Court of Appeal, which have the power to refine and change the jurisprudence, although admittedly major changes are much more likely to come from the Supreme Court because the Federal Court of Appeal is less likely to overrule its own precedent. In this section, I consider how and whether the issue of intention should influence whether a worker is characterized as an employee or an independent contractor under the CPP, EIA, and ITA. I conclude that intention should play no role. However, given the trajectory of the case law, appellate courts (and the Federal Court of Appeal in particular) may decide that intention should play a role. Therefore, later in this section I explore the ways in which intention could fit into the employee-independent contractor test. Assuming that intention has any relevance, its appropriate role depends on the justification for its consideration.

The Argument Against the Relevance of Intention

Intention should not play a role in determining whether a worker is an employee or an independent contractor for two sets of reasons. The first set discredits any possible justifications for considering intention. The second set examines countervailing factors that favour either no role or a reduced role for intention. Together, these reasons create a strong case against any consideration of intention.

Discrediting the Justifications for Considering Intention

A review of the case law has revealed little explanation of the reasons for considering the intention of the parties. This is somewhat surprising, since the introduction of intention in *Wolf* represented a clear shift in the case law and also since the leading Supreme Court decision in *Sagaz* did not mention intention as a relevant consideration. Nonetheless, it is possible to extract some justifications for considering intention from the cases and to imagine other possible arguments in favour of this position. These arguments are each considered below.

While the Civil Code language was originally referenced in support of considering intention (and is perhaps the most persuasive justification for considering intention in *Wolf*), the test for determining whether a worker is an employee or an independent contractor within the jurisdiction of the Civil Code has essentially merged with the test for common-law jurisdictions after *Royal Winnipeg Ballet*.

Resolving Uncertainty

If common intention conclusively determines whether a relationship was one of employee and employer or independent contractor, much of the uncertainty surrounding the legal classification would be eradicated. There are legitimate concerns with the uncertainty created by the existing law, including the financial consequences of misclassification.[198] In general, courts have often been concerned with creating uncertainty in the area of tax law.[199]

If common intention were conclusive, uncertainty would be resolved only if common intention were easily determinable. However, case law has demonstrated that the parties often disagree about intention. Even if written agreements exist, the courts have favoured evidence that leads to a finding of a lack of common intention. Therefore, unless the courts are willing to recognize a written agreement as conclusive, the written agreement would not resolve uncertainty.

Further, to resolve uncertainty completely, the courts would have to agree that intention governs, which is something that they have not been prepared to do. No court has yet held that when common intention is clear, it dictates the legal result, and it is extremely unlikely that a court will ever make such a statement, given the countervailing considerations.

An increased role for intention does decrease uncertainty to some extent. However, the reasons against considering intention, set out below, present more important arguments than the reduction in uncertainty. In addition, there are other options for reducing uncertainty: parties can ask the CRA for rulings,[200] laws can be amended to eliminate the distinction between employees and independent contractors[201] or to introduce bright-line tests,[202] and settlement programs can be considered (as have been proposed in the United States).[203]

Promoting Freedom To Contract and Tax Planning

Décary JA's reasons in *Wolf* could be read to suggest that allowing people to choose to become independent contractors is desirable because they have given up benefits in return:[204] the worker "deliberately sacrifices security for freedom,"[205] and there is "better pay with less job security."[206] While this passage in *Wolf* may focus on control,

198 Clarke, supra note 8, at 10:5.

199 *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54; and *Mathew v. Canada*, 2005 SCC 55.

200 Clarke, supra note 8.

201 Friedlander, supra note 6, at 1514-16.

202 Ibid., at 1517-18.

203 Judson D. Stelter, "The IRS' Classification Settlement Program: Is It an Adequate Tool To Relieve Taxpayer Burden for Small Businesses that Have Misclassified Workers as Independent Contractors?" (2008) 56:2 *Cleveland State Law Review* 451-81, at 468. Stelter describes and critiques the Internal Revenue Service's classification settlement program, which, among other things, allows a "safe harbor" for certain employers who have had a reasonable basis for misclassifying employees as independent contractors (see page 461) and an early settlement program for partial relief when complete relief is unavailable (see page 469).

204 Supra note 2, at paragraph 118 and accompanying text.

205 Ibid.

206 Ibid.

rather than intention, it is nonetheless possible to advance an argument that it is fair for workers to be able to gain some of the advantages of independent contractor status because they have given up some of the important advantages of employment. However, it is inappropriate to view the consequences under the ITA, CPP, and EIA as part of a give-and-take negotiation because the government and members of society in general are not a part of the negotiation.

Décary JA's reasons include other passages connecting freedom to contract with the idea that intention should be considered.[207] Another case emphasising freedom-to-contract principles is *Capri Interiors Ltd. v. MNR*, in which the Tax Court, after quoting Décary JA's reasons for judgment in *Wolf*, stated:

> Thus, it seems to this Court that the pendulum has started to swing, so as to enable parties to govern their affairs more easily in relation to consulting work and so that they may more readily be able to categorize themselves, without interference by the Courts or the Minister, as independent contractors rather than employees working under contracts of service.[208]

Mainville JA's reasons in *Connor Homes* viewed the decision in *Royal Winnipeg Ballet* as being based on the freedom to contract,[209] although he recognized that the weight of intention needed to be limited.

Parties clearly should be able to negotiate consequences between themselves, which is an important aspect of the freedom to contract. However, this reasoning is incompatible with the situation at hand, in which third parties are involved. Ignoring intention with respect to legal characterization does not interfere with freedom to contract; ignoring intention does, justifiably, interfere with the freedom to determine legal results. One cannot "contract out" of the law. It is conceded, however, that this counterargument does not apply to some areas of the law, such as wrongful dismissal, where third-party interests are not relevant.

Similarly, it is possible to discredit the contention that ascertaining the common intention of the parties is the object of the exercise.[210] As noted by Desjardins JA[211] and Evans JA[212] in *Royal Winnipeg Ballet*, there is a distinction between contract interpretation and legal characterization. The focus of contract interpretation is the common intention of the parties, but this is not necessarily the focus of legal characterization.

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207 See ibid., at paragraph 119 and accompanying text.

208 2004 TCC 23, at paragraph 20.

209 *Connor Homes*, supra note 57, at paragraph 36.

210 See Sharlow JA's decision in *Royal Winnipeg Ballet*, supra note 56, at paragraph 59, citing Décary JA in *Wolf*, supra note 2, at paragraph 117.

211 Ibid., at paragraphs 78-79.

212 Ibid., at paragraph 92.

Another argument put forward by Décary JA is that recognizing the intention of the parties is consistent with the idea that there is a legitimate right to arrange one's affairs to minimize taxes.[213] This idea supports a position that parties can choose to form an independent contractor relationship to gain a tax advantage. However, it does not mean that the legal test for an independent contractor relationship does not need to be met. By analogy, parties can choose the legal form that they use (for example, a lease rather than a sale), but this does not mean that merely calling the transaction a lease is sufficient to make it a lease; the legal requirements of a lease must still be met. The question whether intention *should* play a role in the legal test will be explored further below. Assuming a consistent application of the test across different areas of the law, the other problem with the tax-planning argument is that it would change the law in other legal areas on the basis of tax law principles.

Recognizing Special Insight of the Parties

The intention of the parties might be considered relevant if the parties have special insight into the legal characterization of their relationship. If one or either of the parties has expertise that would allow the parties to determine the legal characterization of their relationship better than a judge, it is valid to consider the parties' characterization. However, it seems unlikely that this would often be the case. As Miller J pointed out, it is "an unrealistic presumption."[214] The courts have struggled to apply the test, and therefore it is difficult to conceive of circumstances in which the parties would be better suited to perform an appropriate legal analysis. Even if the parties seek legal advice, at most it could be said that their expertise is equal to that of judges.

Additional Reasons To Reduce or Eliminate the Role of Intention

To the extent that any of the justifications for considering intention are persuasive, I argue here that they are outweighed by a number of factors.

The Characterization of the Worker Is a Question of Law

In *Wilford v. MNR*, Weisman J stated that "a worker's status in a working relationship is a matter of law and not of private agreement."[215] Other judges, including Evans JA in *Royal Winnipeg Ballet*, have made similar statements:[216] "Whether a contract falls

213 Ibid., at paragraph 119. See also paragraphs 118 and 120.

214 *Acanac Inc.*, supra note 26, at paragraph 22.

215 *Wilford v. MNR*, supra note 144, at paragraph 19.

216 *Aquazition 2007 Ltd.*, supra note 147, at paragraph 16; *Canada Post Corp. v. Carroll and Workplace Health, Safety and Compensation Commission of New Brunswick, 2012 NBCA 18*, at paragraph 45, citing *Joey's Delivery Service v. New Brunswick (Workplace Health, Safety and Compensation Commission)*, 2001 NBCA 17; and *Wilford v. MNR*, supra note 144, at paragraph 19.

into a particular legal category is an inference of law, drawn from the terms of the agreement and the conduct of the parties. It does not rest on the legal label attached to the agreement."[217]

The statements above are interpretations of existing law in which the courts limited the role of intention. However, whether intention *should* play a role in a legal test cannot depend solely on the matter being a question of law. The legal test could incorporate intention as a factor. In fact, subjective intention is a factor in many areas of law, such as criminal law and intentional torts. What is different about these situations is that intention most often pertains to taking an action or producing a non-legal result. In other words, the law is most often concerned about the intention to deceive or harm someone, not the intention to commit a crime or tort. In the case of contract law, however, the intention to create a binding legal obligation is a prerequisite to the formation of a contract, and therefore intention with respect to legal consequences is relevant.[218] It is therefore possible that intention with respect to legal characterization (and thus legal consequences) could be a factor in the test for determining the legal character of a worker. The question is whether it makes sense to permit the parties to play a role in dictating these legal effects. The closest parallels exist in relation to other situations in which a contractual relationship has to be characterized. In these cases, as explained in *Joey's Delivery Service*,

> the law is concerned with what people actually do and not what they agreed to do. More importantly, the law will not blindly accept the classification label the parties have placed on their relationship. This follows from the equitable doctrine that form does not prevail over substance. For example, one cannot label a document a "lease" that in law is regarded a "licence." The nature of a working relationship is a legal problem that is to be resolved by legal analysis, not agreement.[219]

Intention, as reflected in the label placed on the relationship in the agreement, has little or no relevance to the categorization of a number of contractual legal relationships, such as the existence of a partnership[220] or the existence of a lease as opposed to a sale.[221] In these cases, the courts are concerned with the substance or true nature of the relationship. This raises the question whether there are special circumstances that justify permitting the parties to dictate or influence the characterization as an employee or independent contractor. On the basis of this discussion, the short answer is no. The justifications for considering intention are weak, and the reasons for not considering it are many.

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217 *Royal Winnipeg Ballet*, supra note 56, at paragraph 92.

218 Guenter Treitel, *The Law of Contract*, 11th ed. (London: Sweet & Maxwell, 2003), at 162.

219 *Joey's Delivery Service*, supra note 216, at paragraph 79.

220 *Rezek v. Canada*, 2005 FCA 227, at paragraph 80.

221 *W-5 Pins Ltd. v. Andrejcin*, 2005 SKCA 68, at paragraph 17.

Contrary to the Purpose of the Distinction in the Legislation

An important question is whether granting parties the opportunity to choose, or even influence, the legal characterization of their relationship is contrary to the purpose of the employee-independent contractor distinction in the legislation and the purpose of the regime as a whole. Lara Friedlander has examined the purposes of the legislation studied in this article,[222] and I rely on her work in the following analysis.

In the case of the ITA, Friedlander observes that the policy reason for distinguishing between employees and independent contractors is not entirely clear[223] but appears to be "largely one of administrative efficiency."[224] In fact, the Royal Commission on Taxation recommended abolishing the distinction because of the resulting unfairness.[225] The government's response to the report confirmed that the distinction would remain in place for administrative reasons; the record keeping by employees and the administrative work by the government to process the returns would be too onerous if employees were permitted to deduct expenses to the same extent that businesses are entitled to do so.[226] An employment credit has been introduced to recognize employment-related expenses,[227] although this only partially addresses fairness concerns.

While there certainly are equity grounds for arguing against the distinction in tax law, employees are generally less likely than independent contractors to incur large expenses relating to their work. According to the *Wiebe Door* factors, employees are less likely to control how work is done, own their own tools, or bear the risk of loss or profit personally, and these factors indicate that most employees incur relatively fewer expenses. In any event, the rules exist for an administrative reason. Such an administrative rule will have no effect if taxpayers can easily manipulate it. To permit such manipulation through subjective intention would be contrary to the purpose of the distinction because it would increase the administrative costs that the rule attempts to curtail. Further, if one looks to equity grounds, there is nothing to suggest that taxpayers with a common intention to be independent contractors are more likely to incur large work-related expenses. Therefore, considering intention does not support the purpose underlying the employee-independent contractor distinction under the ITA.

222 Friedlander, supra note 6.

223 Ibid., at 1481.

224 Ibid., at 1482.

225 Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen's Printer, 1966), at 284-85 and 290, cited in Friedlander, supra note 6, at 1482.

226 E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969), at 16, cited in Friedlander, supra note 6, at 1483.

227 ITA subsection 118(10).

An even stronger argument can be made against using common intention in the case of the EIA. Friedlander points out that the purpose of the legislation is to "protect people at risk of becoming unemployed."[228] She reports that there was perceived to be a risk (or moral hazard) that independent contractors could "create the conditions which permit collection of benefits."[229] Once the line was drawn between employees and independent contractors for benefits purposes, presumably it was concluded that the group that could benefit should fund the scheme, along with their employers, who would control the loss of employment.

A number of judges have commented on the problems with permitting people to opt in or out of employment insurance. For example, in *Royal Winnipeg Ballet*, the Tax Court stated the following:

> If "intention" was given the prominence the Supreme Court of Canada appears to have reserved for the control factor, there would be a risk that payors, employers, employees and independent contractors might view it as some endorsement of a right to opt in or out of the employment insurance scheme. It should be borne in mind this is not a voluntary program.[230]

If employment insurance were a voluntary program, it would not protect the most vulnerable. For example, the Tax Court has stated in an employment insurance and CPP case that giving too much weight to labels "would give true employers the ability to unjustly deprive their true employees of many benefits that have been legislated by Parliament and its provincial counterparts."[231]

There are two principal aspects of being an employee under the employment insurance scheme: the benefits if unemployed and the unavoidable premiums. Workers might see short-term advantages to being classified as independent contractors when they sign a contract, but may then change their minds and wish to be employees later on when the contract is terminated. Because of the subjective nature of intention, there is scope for manipulation, and courts have recently found a lack of common intention despite a written agreement indicating independent contractor status in situations where the worker was seeking employment insurance benefits.[232] If part of the reason for excluding independent contractors from benefits is the moral hazard or potential for manipulation, then allowing this type of manipulation seems to contradict the purpose of the distinction.

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228 Supra note 6, at 1484.

229 Canada, Commission of Inquiry on Unemployment Insurance, *Report* (Ottawa: Minister of Supply and Services, 1986), at 239, quoted in Friedlander, supra note 6, at 1484.

230 *Royal Winnipeg Ballet*, supra note 83, at paragraph 31. See also Miller J in *Mallon*, supra note 27, at paragraphs 11-12.

231 *Dynamex Canada Corp. v. MNR*, 2010 TCC 17, at paragraph 34.

232 *Peterborough Youth Services* and *Acanac Inc.*, both supra note 26; and *177398 Canada Ltd.*, supra note 53.

For employers, there is only a negative side to employment status: premiums. Therefore, there is a strong incentive to classify the relationship as something other than employment. Given the power and knowledge advantage of employers in most cases, permitting common intention to play a role in determining legal status is contrary to the purpose of the scheme because it will deny protection to those most vulnerable to unemployment.

Friedlander reports that the distinction between employees and independent contractors in relation to CPP is not great because they both must pay premiums, although the calculation and collection method varies.[233] The fact that employers must contribute to premiums is tied to the "general understanding that CPP contributions ought to be paid by both employers and employees."[234] Moreover, there is a "perception that employers ought to take some responsibility for financing the CPP."[235] This public perception is inconsistent with an opt-out regime.

Under the ITA, EIA, and CPP, considering intention appears to be contrary to the reasons for the distinctions that are based on working status. Although the test will be most at odds with these regimes if intention is given great weight, even assigning a lesser tie-breaking role to intention can influence outcomes and thus create conflict with the legislative purpose of the distinction.

Negative Implications for Third Parties

Judges have pointed out that third-party interests are at stake, and several distinct ideas are embedded in this language.[236] In some cases, third-party interests refer to government interests that lie at the heart of the legislation. For example, the Federal Court of Appeal has commented that "the State may have an interest in ensuring that laws establishing payroll taxes for employers and employees are complied with."[237] In other cases, third parties are tort victims.[238] Since third parties are, by definition, not part of the agreement, this argument can be used to defeat a freedom-to-contract justification for considering the intention of the parties.

Since the distinction between employees and independent contractors has, to a large extent, been consistent across many areas of the law, Mainville JA in *Connor Homes* points out that the ramifications of permitting parties to dictate their characterization is far-reaching:

> Because the employee-employer relationship has important and far reaching legal and practical ramifications extending to tort law (vicarious liability), to social programs (eligibility and financial contributions thereto), to labour relations (union status) and

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233 Friedlander, supra note 6, at 1485.

234 Ibid.

235 Ibid.

236 Evans JA uses the term in both senses in *Royal Winnipeg Ballet*, supra note 56, at paragraph 102.

237 *Grimard v. Canada*, 2009 FCA 47, at paragraph 34.

238 *Aquazition 2007 Ltd.*, supra note 147, at paragraph 17.

> to taxation (GST registration and status under the Income Tax Act), etc., the determination of whether a particular relationship is one of employee or of independent contractor cannot simply be left to be decided at the sole subjective discretion of the parties.[239]

While this argument was made in favour of limiting the role of intention, it seems that giving any role to intention should be avoided for the same reasons. However, if the courts distinguish the employee-independent contractor test across different areas of the law, the third-party-interest argument will not be relevant in some instances, such as wrongful dismissal cases.

Incentive To Characterize

Judges have made the point that there is often an incentive to characterize a relationship in order to gain certain advantages.[240] Granting parties the ability to characterize the relationship raises fairness issues because of the advantages that they may gain. In some cases, these advantages may be tempered by disadvantages. For example, in the case of employment insurance, workers will save premiums if they are characterized as independent contractors, but will not qualify for benefits if they later become unemployed. Nonetheless, there will be a temptation to manipulate the system to align one's position with what is perceived as most advantageous at the time. This manipulation may manifest as a written contractual term or in a subsequent argument that the term did not reflect a common intention when a party later tries to apply for benefits or gain certain tax advantages.

In cases under the ITA involving personal services businesses, the courts have made it clear that intention is not relevant when determining the status of a worker.[241] Personal services businesses are corporations that are treated as employees to ensure that they are not used to manipulate the tax system by gaining business treatment and favourable corporate tax rates for workers who would normally be employees.[242] Since the possibility of manipulation is great with personal services businesses, it makes sense that the courts have not considered intention to be relevant. This possibility also raises the question whether this reasoning should be extended to the employee-independent contractor test more generally: if manipulation of the test through stating intention can give rise to unfair advantage and is contrary to the purpose of the law, then should intention not be eliminated as a factor?

239 Supra note 57, at paragraph 37.

240 Evans JA's dissent in *Royal Winnipeg Ballet*, supra note 56, at paragraph 99, describes it as "inevitably self-serving." See also *Connor Homes*, supra note 57, at paragraph 35; and *Mallon*, supra note 27, at paragraph 14.

241 *G & J Muirhead Holdings Ltd. v. The Queen*, 2014 TCC 49, at paragraph 4; *Gomez Consulting Ltd. v. The Queen*, 2013 TCC 135, at paragraph 10; *609309 Alberta Ltd. v. The Queen*, 2010 TCC 166, at paragraph 23.

242 ITA paragraph 18(1)(p) and subsection 125(7) definition of a "personal services business."

Stated Intention Does Not Necessarily Reflect the Parties' True Intentions

Even if it could be argued that the parties' true intentions about the character of their relationship are relevant, there are a number of reasons why the stated intention in a contract may not reflect the parties' true desires about the nature of their relationship. First, one or both parties may not know the meaning and consequences of the terms "employee" or "contractor." Without this knowledge, it is difficult to attribute intention. Second, a party with little bargaining power, most often the service provider, may be coerced into signing an agreement with the service recipient to indicate a particular characterization.[243] If intention is given great weight, this might lead to a loss of benefits, including EIA benefits.[244] Both lack of knowledge and lack of bargaining power can also be used to rebut the freedom-to-contract and special insight arguments, as discussed above.

The Factors Point to Not Considering Intention

Many of the reasons for not considering intention have been used by the courts to limit the role of intention. However, since the analysis in this section shows that there is no persuasive reason to consider intention and there are many reasons not to do so, I take a stronger position: intention should not be considered relevant in determining whether a worker is an employee or independent contractor in ITA, CPP, and EIA cases. The disadvantages far outweigh any minimal benefit of considering intention.

Exploring the Options for Considering Intention

For the time being, the Tax Court must follow precedent and consider intention. Although it has been argued that intention should not be considered relevant to the employee-independent contractor characterization, I acknowledge that appellate courts may not share this point of view. The Federal Court of Appeal, in particular, may be uncomfortable with discarding intention as a factor now that the court has continued to insist on its relevance in a number of cases. Even the Supreme Court of Canada may be convinced that there is some value in considering intention in light of these cases. If appellate courts continue to consider intention to be relevant, what are the options for incorporating intention into the decision-making process? Most of the options discussed below have been advanced in one or more decisions following *Wolf*.

Tying the Role of Intention to the Reason for Considering Intention

Before considering the various options, it is necessary to explore why intention is relevant because this question may bear on the matter of how intention should be

243 Evans JA's dissent in *Royal Winnipeg Ballet*, supra note 56, at paragraphs 101-2.

244 Ibid.

used. Possible justifications, discussed above, included resolving uncertainty, promoting freedom to contract, and recognizing special insight of the parties. While I have argued that none of the reasons is sufficient to warrant considering intention, the courts may view them as having some merit.

If resolving uncertainty is the reason for considering intention, then intention should automatically govern the relationship, assuming that there are no countervailing factors. Of course, many factors against considering intention have been discussed above, which could justify intention playing a lesser role. At some point, though, the test offers no certainty, and the need to consider intention becomes questionable. If allowing parties to achieve some degree of certainty is the goal, then a clear shared intention should be necessary to show that the parties sought this certainty.

If freedom to contract and plan for taxes are used as justifications, the parties should be shown to have freely and knowingly agreed to a particular characterization. Therefore, power imbalance or lack of knowledge should either result in no common intention or result in common intention being irrelevant. Again, countervailing factors justify tempering the dominant role of intention.

If special insight of the parties into the legal characterization of their relationship is the reason for considering intention, then intention should be assigned differing weight in accordance with the knowledge and expertise of the parties. Since this factor is based on expertise and knowledge, the intention of one party, even if not shared by the other party, could be considered relevant. Special insight exists only when a party has insight that exceeds that of a judge regarding the application of the legal test for classifying the relationship.

If the courts state the justification for considering intention, the consideration of intention will be given legitimacy, and it will be easier for the courts to determine the appropriate role of intention.

Options for the Role of Intention

Common Intention Prevails

In a few cases,[245] it has been suggested that common intention is the dominant consideration. The Tax Court speculated that the Supreme Court may make common intention determinative:

> Following a review of the aggregate jurisprudence—including *Sagaz*—the Supreme Court of Canada might decide that under certain circumstances—such as the absence of coercion, sham or egregious disparity in bargaining power—the mutual intent of the parties to the working relationship could be determinative of status.[246]

245 *Kootenay Doukhobor Historical Society v. MNR*, 2010 TCC 256; *Wellbuilt General Contracting Ltd.*, supra note 37; and *Malleau*, supra note 146.

246 *Kootenay Doukhobor Historical Society*, supra note 245, at paragraph 28.

While this approach has the advantage of certainty, particularly when the common intention is clearly expressed by the parties at the time of the contract, it invites all of the criticisms already discussed in this section. Perhaps most importantly, it has the potential to destroy important aspects of the CPP, EIA, and ITA regimes that depend on maintaining the distinction between employees and independent contractors. Most courts seem to recognize the dangers of leaving the characterization in the hands of the parties, and therefore it seems unlikely that they would pursue this option.

An Additional Factor

In some cases, intention has been simply added to the factors from *Wiebe Door*.[247] This approach does not add certainty, but burdens the courts with considering another factor. If this approach is taken, direction should be given to the lower courts with respect to determining the appropriate weight to assign to intention. If freedom to contract and special insight of the parties are justifications for considering intention, then a lack of knowledge, a lack of special insight, and the existence of a power imbalance should dictate the assignment of lesser weight in the event of a finding of common intention. The danger with this approach is that it is difficult to ensure that intention is not given undue weight, thereby allowing the parties to control the legal result. Courts would be well advised to assert that certain factors (for example, control) are more important than intention.

Tie-Breaker

The option of using common intention as a tie-breaker, as has been suggested in a number of cases,[248] is convenient for courts and gives more clarity to the role of intention than many of the other options do. Unfortunately, it may give rise to the temptation to use intention as a tie-breaker without first undertaking a hard analysis; in fact, lower courts may feel that their judgments are safe from appeal if they use intention as a tie-breaker when the decision is otherwise very difficult. Using common intention as a tie-breaker does not allow courts to give lesser weight to common intention, for example, when knowledge is minimal or when the parties have no special insight. If intention is used only as a tie-breaker, the courts are faced with either finding no common intention or using common intention to determine the result of the case if the other factors are inconclusive.

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247 *Seeislam Inc.*, supra note 146; *Samqo Transport*, supra note 145; and *Malleau*, supra note 146.

248 *City Water International Inc.*, supra note 114; *Maliyar v. The Queen*, 2006 TCC 671; *Heineke*, supra note 22; *Integrated Automotive Group v. MNR*, 2011 TCC 468; *Sadden v. MNR*, 2011 TCC 450; *Southland Livestock Feeders Ltd. v. MNR*, 2011 TCC 209; *1772887 Ontario Ltd.*, supra note 30; *Kilbride v. Canada*, supra note 123; *Direct Care In-Home Health Services Inc. v. MNR*, 2005 TCC 173.

Presumption

If common intention gives rise to a presumption, as some cases suggest,[249] the results may be much the same as in the case of a tie-breaker. Common intention would play a role only if the result of the *Wiebe Door* analysis were unclear. However, by setting common intention up as a presumption, it may be even more likely that the courts will forgo a full *Wiebe Door* analysis and that common intention will be granted undue weight.

Intention Must Be Supported by Facts

Many cases declare that intention must be supported by the facts.[250] For example, in *Wilford v. MNR*, the court stated, "Such understandings will be given weight only if the terms and conditions of the parties' working relationship are congruent with their common intention, according to the *Wiebe Door* factors examined above."[251] Without a presumption in favour of intention, a tie-breaker role for intention, or even an instruction that intention should colour the objective factors, common intention would play no role in a decision. There would be no point in requiring a court to determine common intention.

Consider Objective Factors in Light of Intention

The current prevailing view is that it is necessary to consider objective factors in light of subjective intention.[252] In addition, some judges have stated that although intention must be supported by the facts, the facts must be considered in light of or through the prism of intention.[253] In other words, intention should colour the *Wiebe Door* analysis.[254] This approach potentially allows intention to play a greater role in decisions, but a review of the recent cases does not suggest that intention has affected the results. This may arise from a lack of comprehension concerning how intention colours the facts. It would be helpful if appellate courts could provide more guidance to lower courts on this matter.

Presumably, the reason behind viewing objective factors in light of common intention is that common intention can help fill in gaps in the evidence. As explained above, this can be rationalized only if both parties understand that certain expectations concerning the obligations of the parties flow from the use of a particular label.

249 *Vida Wellness Corporation (Vida Wellness Spa) v. MNR*, 2006 TCC 534; *Maple Elect Zoltan*, supra note 39.

250 See *TBT Personnel Services*, supra note 131; *York Region Sleep Disorders Centre*, supra note 177; *Therrien*, supra note 22; *La Scala*, supra note 26; and *Vida Wellness Corporation*, supra note 249.

251 *Wilford*, supra note 144, at paragraph 19.

252 *Connor Homes*, supra note 57, at paragraph 33; *City Water International Inc.*, supra note 114, at paragraph 31; and *Royal Winnipeg Ballet*, supra note 56, at paragraph 64.

253 *Mallon*, supra note 27, at paragraph 14.

254 *Connor Homes*, supra note 57, at paragraph 40.

It is difficult to make this leap since there is no checklist of requirements that must be present in an independent contractor or employment relationship, but merely a set of factors to be weighed.

No Obvious Role for Intention

There is no best approach for considering intention. If intention is to be considered, appellate courts should set out the justification for doing so. In this way, the underlying rationale can help to guide the use of intention.

CONCLUSION

Recently, the case law has evolved to consider the intention of the parties concerning the legal characterization of their relationship, despite a longstanding body of case law that did not take intention into account, concern by judges about the appropriateness of considering intention, and a lack of endorsement by the Supreme Court of Canada. The way in which intention will affect the analysis in practice is still unsettled.

Intention with respect to legal characterization should not play a role in determining whether a worker is an employee or an independent contractor in CPP, EIA, or ITA cases. There are no convincing reasons for considering intention and a number of valid arguments against its use. Should appellate courts continue to find a role for intention, they should make their reasoning clear so that it can be used to resolve issues relating to the determination and the role of intention.

Part of the reason for considering intention may be the difficulty of applying the *Wiebe Door* test, especially when coupled with a lack of understanding of the purpose of the distinction between employees and independent contractors under the ITA, EIA, and CPP (beyond administrative convenience). The bigger question is whether legislation should be amended to set out a new test or perhaps to eliminate the distinction.

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Rethinking RRIF Withdrawals: New Rates and Methodologies for New Realities

Moshe A. Milevsky*

PRÉCIS

Dans cet article, l'auteur se sert d'un cadre microéconomique pour examiner le barème de retraits du fonds enregistré de revenu de retraite (FERR) dans le cadre des taux d'intérêt actuels et des projections de l'espérance de vie. Il soutient que les réalités démographiques et économiques d'aujourd'hui exigent de revoir le barème pour qu'il demeure justifiable et juste. La méthodologie utilisée dans cet article diffère de celle d'autres arguments basés sur la politique (ou les probabilités) : l'auteur compare le barème de retraits prescrit à un barème de retraits optimal dans un modèle de cycle de vie de continuité de la consommation pour un retraité ayant une aversion pour le risque d'épuiser son actif avant sa mort. Il soutient que bien que le modèle de cycle de vie puisse justifier les taux de retrait du FERR en vigueur à la fin des années 1980 (une période où les taux d'intérêt étaient plus élevés et l'espérance de vie plus courte), un quart de siècle plus tard, le barème est périmé.

ABSTRACT

In this article, the author employs a microeconomic framework to examine the registered retirement income fund (RRIF) withdrawal schedule in the context of current interest rates and longevity projections. He argues that today's demographic and economic realities require that the schedule be revised to remain justifiable and fair. The methodology employed in this article differs from other policy-based (or probabilistic) arguments: the author compares the legislated withdrawal schedule with an optimal withdrawal schedule in a consumption-smoothing life cycle model (LCM) for a longevity risk-averse retiree. He argues that while the LCM might be able to justify the RRIF withdrawal rates in place during the late 1980s (a period with higher interest rates and lower longevity), a quarter of a century later the schedule has become outdated.

KEYWORDS: REGISTERED RETIREMENT INCOME FUND ■ RRIF ■ LIFE CYCLE MODEL ■ RETIREMENT

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CONTENTS

INTRODUCTION AND MOTIVATION

At the age of 71, all Canadians must begin withdrawing the money that they have accumulated in their tax-sheltered registered retirement savings plans (RRSPs) by (1) using the balance in the RRSP account to purchase a life annuity, (2) converting the RRSP to a registered retirement income fund (RRIF) and making yearly withdrawals in accordance with a rigid schedule, or (3) implementing a combination of (1) and (2).

Under the withdrawal rules, when a taxpayer reaches age 71 at least 7.38 percent of the value of the account at the outset of the year must be withdrawn before the end of the year. This required minimum distribution (RMD) rate increases with age, with the result that by the time that a taxpayer reaches age 85 at least 10.33 percent of the account value at the beginning of the year must be withdrawn. Once the taxpayer reaches age 95, the RMD rate is 20 percent for the remainder of the taxpayer's life.[1]

In the current economic environment, if Canadians want a risk-free location for their investments, they can expect to earn between 1 and 2 percent in nominal returns, or between 0 percent and a negative amount in real returns after inflation.[2] The high required RRIF withdrawal rates, coupled with low real returns on safe investments, mean that many RRIF accounts are depleted rapidly—just as Canadians must collectively plan for longer lifetimes. Not surprisingly, the current RMD rules are disliked[3] by the approximately 5 million Canadians who are above the age of 65 (the fastest-growing segment of the Canadian population, which is expected to double in the next 25 years), many of whom are faced with converting their RRSPs to RRIFs in the near term.[4]

1 The term "required minimum distribution (RMD) rate" is borrowed from the American lexicon because there is no comparable term in Canada, and the phrase "RRIF rate" is often confused with the investment or interest rate earned within the account.

2 This is certainly true after taxes. See, for example, Amin Mawani, Moshe Milevsky, and Josh Landzberg, "The Erosion of GIC Returns by Income Taxes and Inflation" (2004) 52:4 *Canadian Tax Journal* 1057-75.

3 See, for example, Fred Vettese, "Why Your TFSA Is Just What Your Over-Taxed RRIF Needs," *National Post*, August 13, 2014, as well as the recent "Conference for Advanced Life Underwriting: 2015 Federal Pre-Budget Submission," August 2014, available at www.calu.com.

4 Statistics Canada, *The Canadian Population in 2011: Age and Sex*, catalogue no. 98-311-X2011001 (Ottawa: Statistics Canada, May 2012).

In this article, I employ the life cycle model (LCM) of saving and consumption to argue that the current withdrawal rates are difficult to justify in today's environment of ultra-low interest rates and increasing human longevity. Current RMD rules force retirees—and especially those with low pension income—to decrease their wealth at a faster rate than prudence allows. For example, a 71-year-old retiree with $100,000 in his or her RRIF, earning a meager 1.5 percent nominal interest rate per year (at a generous bank) and adhering to the RMD rate schedule, would be left with only $7,878 in the account by the age of 95, and the required schedule of withdrawals would cause the rapid decline of the account between the ages of 71 and 95. In contrast, with a 6.5 percent interest rate (which is a relic of the past),[5] withdrawal amounts would be relatively stable, hovering between $7,000 and $8,000 for 25 years. (See appendix A for a comparison of the withdrawal schedules and the resulting cash flows, using interest rates of 1.5 and 6.5 percent.)

Defenders of the status quo might argue that RMD rates are red herrings since retirees are not required to consume the withdrawn funds, merely to withdraw them from the tax-protected shelter of the registered account. However, there is an element of forced spending if one carefully considers the tax implications. After withdrawing the funds, retirees must pay income tax on the withdrawals at their marginal tax rate. Yes, they can then use the (after-tax) funds to repurchase the same investments, which means that they then earn after-tax returns on these investments outside the tax shelter. However, this premature taxation twice impedes the growth of the portfolio: tax is initially due on the withdrawals and then again due on any gains in the non-registered account. Moreover, the (early and high) required withdrawals, when included in yearly income, may result in a clawback of old age security (OAS) under the provisions of the Income Tax Act, as well as a possible loss of the guaranteed income supplement (GIS).

The current RMD rules were announced in the 1992 federal budget in response to concerns (and consultations during the late 1980s) that under the rules then in place, "RRIFs cannot provide a life income for the substantial number of RRIF holders who can be expected to live beyond age 90."[6] The pre-1992 rules required that a RRIF holder withdraw a minimum amount each year equal to the start-of-year balance divided by "90 minus age"; in the year that the RRIF holder attained age 90, the full balance at the beginning of the year had to be withdrawn, with the result that the account was fully depleted in the year that the RRIF holder reached age 90. The current schedule for withdrawals, which provides for gradually increasing withdrawals from ages 71 to 94, followed by a 20 percent withdrawal rate for ages

5 According to the Bank of Canada, the average interest rate offered by chartered banks for a five-year fixed term was 1.5 percent per year in August 2013 and 6.5 percent per year in August 1968, the earliest year for which data are available. See Bank of Canada, Data and Statistics Office, "Chartered Bank Administered Interest Rates—5 Year Personal Fixed Term" (www.bankofcanada.ca/wp-content/uploads/2010/09/selected_historical_page47_48.pdf).

6 Canada, Department of Finance, 1992 Budget, Budget Papers, February 25, 1992, at 143.

95 and beyond, was intended to "permit RRIF withdrawals to extend over the remaining lifetime of the RRIF holder" and to "provide a basic level of protection from the effects of inflation."[7]

If the original intent of the regulations behind the RRIF and RMD rules was to (1) reasonably limit the deferral of income taxation, and (2) encourage retirees to spread their personal pension payments evenly over their remaining lifespan, then the main argument in this article is that this intention is not being fulfilled.

As in 1992, when the rules were last updated to reflect then-current realities, the RRIF withdrawal rates should be updated once again to account for current economic and demographic changes over time and perhaps be linked to an (annuity) index or economic-based formula that changes automatically with interest rates and market conditions.[8] In this article, I offer a methodology for considering proper spending rates. In the remainder of the article, I suggest an approach for rethinking RRIF RMD rates—namely, optimal spending rates in an economic LCM.

THE LIFE CYCLE MODEL AT RETIREMENT

The LCM concept is closely associated with the work of Franco Modigliani in the 1950s and 1960s,[9] although it can ultimately be traced back to the writing of Irving Fisher in the 1930s.[10] The LCM model starts with a theory that postulates how rational people save and spend their money as they age.[11] The main practical insight of the LCM is the idea that rational people choose to spread out or "smooth" their consumption over their lifetime, in accordance with their individual preferences for consuming now or later, and their attitudes toward all types of risk. Consumption smoothers strive to even out irregularities in their income by saving or borrowing to create a stable standard of living over time.

The following is a very simple example. If a consumption smoother (or LCM devotee) expects to live for only two years and earns $30,000 in year 1 and $10,000

7 Ibid.

8 The current RMD rules are not monolithic. For example, in 2008 in recognition of exceptional market conditions and their potential effect on retirement income streams for retirees, the government of Canada permitted a one-time reduction of 25 percent in the required minimum withdrawal for RRIF annuitants, including a tax-deductible recontribution allowance for annuitants who had already withdrawn the maximum. See Canada Revenue Agency, "Economic Statement—Proposed Measure for Annuitants of Registered Retirement Income Funds (Update)," December 9, 2008 (www.cra-arc.gc.ca/whtsnw/tms/rrf-fq-eng.html).

9 See, for example, Franco Modigliani, "Life Cycle, Individual Thrift, and the Wealth of Nations" (1986) 76:3 *American Economic Review* 297-313.

10 Irving Fisher, *The Theory of Interest, as Determined by Impatience To Spend Income and Opportunity To Invest It* (New York: Macmillan, 1930).

11 I refer the interested reader to Martin Browning and Thomas F. Crossley, "The Life-Cycle Model of Consumption and Saving" (2001) 15:3 *Journal of Economic Perspectives* 3-22. In this article, I simply offer my intuition and an overview.

in year 2, he or she would smooth this income by consuming $20,000 in each year, which means saving $10,000 (a third of the income) in year 1 and spending 100 percent more than the income in year 2.[12]

As its name suggests, the life cycle model is an idealized theory about the rational distribution of resources over a human lifetime. Whether or not people actually behave in a manner that is consistent with the LCM is an (open and controversial) empirical question.[13]

Regardless of people's behaviour, most economists agree that the LCM presents a reasonable framework for giving normative financial advice. Angus Deaton wrote, in a memorial tribute to Franco Modigliani, "As far as I am aware, no one has challenged the view that, if people were capable of it, they ought to plan their consumption, saving, and retirement according to the principles enunciated by Modigliani and Brumberg."[14]

How does the LCM help us in planning for spending in retirement? Within the context of retirement spending with uncertain lifespans (and in the absence of perfect annuity markets), the LCM suggests that rational consumption smoothers should balance the low probability risk of living a very long time against the utility (or enjoyment) of consuming earlier. In the 1960s, Menahem Yaari extended the LCM by focusing his attention on how it functions in the presence of longevity risk.[15] Yaari developed a mathematical representation of the LCM that advanced the work done by Franco Modigliani in the 1950s and the insights of Irving Fisher in the 1930s by taking longevity risk into account. Yaari described how a rational person would choose to spend his or her retirement both in the presence and in the absence of actuarial notes, which can roughly be thought of as pensions or life annuities. Since the Yaari model was developed, it has been put into operation and calibrated by many financial economists, including Lachance[16] and Milevsky and Huang.[17] As

12 Without getting into the mathematical details of the LCM, this very brief example assumes that both the individual's subjective discount rate and market interest rates are zero, and of course that the individual lives and earns income for only two periods (year 1 and year 2).

13 See Browning and Crossley, supra note 11, for a review of the evidence.

14 Angus Deaton, "Franco Modigliani and the Life Cycle Theory of Consumption," paper presented at the Convegno Internazionale Franco Modigliani, Accademia Nazionale dei Lincei, Rome, February 17, 2005 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=686475).

15 Menahem E. Yaari, "On the Consumer's Lifetime Allocation Process" (1964) 5:3 *International Economic Review* 304-17; and Menahem E. Yaari, "Uncertain Lifetime, Life Insurance, and the Theory of the Consumer" (1965) 32:2 *Review of Economic Studies* 137-50.

16 Marie-Eve Lachance, "Optimal Onset and Exhaustion of Retirement Savings in a Life-Cycle Model" (2012) 11:1 *Journal of Pension Economics and Finance* 21-52.

17 Moshe A. Milevsky and Huaxiong Huang, "Spending Retirement on Planet Vulcan: The Impact of Longevity Risk Aversion on Optimal Withdrawal Rates" (2011) 67:2 *Financial Analysts Journal* 45-58.

a result of this recent calibration work, explicit spending rates throughout retirement can now be easily obtained.[18]

Returning to the question of how pension income shapes the rational, consumption-smoothing behaviour of a retiree, one of the many insights from the LCM is that the amount of pre-existing pension annuity income should significantly affect the optimal spending and consumption plan. The basic concept is this: the more pre-existing pension income a retiree has, the more he or she can afford to withdraw from a RRIF. The retiree knows that in the event that he or she lives much longer than average, the pension income will still be there into his or her late 90s, and perhaps into centenarian territory.

A retiree's planned consumption will also depend, the LCM tells us, on his or her preference for consuming now as opposed to consuming later. It is obvious that advice or recommendations about withdrawal rates (and a mandatory RMD schedule) are meaningless without a better understanding of (1) the retiree's other income (what fraction is available as longevity-insured or pension income), (2) the retiree's longevity risk aversion (whether the retiree is concerned about the risk of living to an advanced age), and (3) the retiree's attitude toward financial and economic risks. Some retirees may not worry about a 5 percent chance of living to 100 or a 5 percent chance of losing 50 percent of his or her savings, while others are more risk-averse and will include these low-probability outcomes in their planning. In any event, risk attitudes are relevant because they affect consumption in retirement. They are especially important in a world in which true inflation-adjusted annuities (or actuarial notes, as Yaari terms them) are not available at reasonable prices.

I emphasize the importance and role of the LCM in personal financial decision making because it is central to this article, whose methodology differs from that of Robson and Laurin. These authors estimate probabilities of account depletion and the relevant RMD rates that would maintain the same probabilities as in 1992.[19] While this approach eliminates the need for a utility function or risk preferences, an insurance economist would argue that the probability of shortfall is an incomplete measure of risk. In other words, a schedule that maintains the same probability of hitting various account targets is not well grounded in economics—especially because it is related to exogenous income sources and attitudes to risk. Indeed, there

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18 An early attempt to embed the specifics of the Canadian RRSP in the LCM is evident in an article by Michael J. Daly, "The Role of Registered Retirement Savings Plans in a Life-Cycle Model" (1981) 14:3 *Canadian Journal of Economics* 409-21. A related article is Siu Fai Leung, "Uncertain Lifetime, the Theory of the Consumer, and the Life Cycle Hypothesis" (1994) 62:5 *Econometrica* 1233-39, in which the author proves the existence of an optimal depletion time in a deterministic interest LCM, which implies that it is rational to deplete savings in the presence of pension income. High withdrawal rates in and of themselves are not necessarily irrational.

19 William B.P. Robson and Alexandre Laurin, *Outliving Our Savings: Registered Retirement Income Funds Rules Need a Big Update*, C.D. Howe Institute E-Brief (Toronto: C.D. Howe Institute, June 4, 2014).

are many different curves that would lead to the same probabilities. How does one choose from among many curves?

Nevertheless, Robson and Laurin are making the same point that I am making in this article—using a different framework—which is that current RRIF withdrawal rates are too high and difficult to justify.

A NUMERICAL EXAMPLE

Models and nuanced differences aside, consider the case of a 70-year-old female retiree with $200,000 in her RRSP, which she anticipates converting next year into a RRIF. She has pre-existing pension income from the Canadian Pension Plan (CPP) and OAS/GIS, including a defined benefit pension, totalling $17,000 to $20,000 per year. I analyze both the high and the low cases side by side in table 1 to illustrate the impact of more or less pension income respectively. Note that this range of pension income is close to the estimates provided by Statistics Canada for retirees, rounded for convenience.[20]

The mortality rates are calibrated to the most recent actuarial values reported by the Office of the Chief Actuary, which I explain in more detail in the next section.

I assume that the real (after-inflation) interest rate available on safe investments is 1.5 percent per year—obviously higher rates may (or may not) be anticipated from holding riskier equity-based investments and mutual funds, but I assume that this retiree is a highly risk-averse investor who wants to smooth her total retirement spending.[21] One can also think of this as a risk-adjusted return.

Understanding Mortality

In terms of mortality table assumptions, the continuous time version of the LCM requires a parametric specification of the mortality curve in order to optimize utility. I used the Gompertz-Makeham (GM) law, which is quite common in actuarial finance research and was employed by Leung in the context of the LCM.[22] The GM law assumes that instantaneous mortality rates increase by a fixed percentage every year, starting at age 20 and ending in the late 90s. The free parameters available from the GM law can be calibrated to any mortality table (with a reasonably good fit).

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20 Median income for Canadian seniors from CPP was $7,000 (92 percent of Canadian seniors received CPP income in 2011), while median income from private pensions and RRSPs was $11,800 (63 percent of Canadian seniors had income from private pensions and RRSPs in 2011). See Employment and Social Development Canada, "Indicators of Well-Being in Canada: Financial Security—Retirement Income" (www4.hrsdc.gc.ca/.3ndic.1t.4r@-eng.jsp?iid=27). I would like to thank the editor for pointing out that median income among single seniors in 2010, using microdata from the survey of labour and income dynamics, was $22,625.

21 The LCM takes these assumptions as inputs, all of which can be easily changed and/or modified. Needless to say, different inputs will change the optimal spending and withdrawal rates. For example, with lower mortality rates and/or higher interest rates, the optimal LCM withdrawal and spending rates are higher.

22 Leung, supra note 18.

TABLE 1 Optimal RRIF Spending Rates in a Life Cycle Model: Different Levels of Pension Income and High Level of Risk Aversion

		2014 Parameters base case with $17,000 total pension income			2014 Parameters base case with $20,000 total pension income		
RRIF rates, %	Age	RRIF value, $	Optimal, %	Total spending, $	RRIF value, $	Optimal, %	Total spending, $
5.00[a]	70	200,000	4.95	26,902	200,000	5.09	30,194
7.38	71	193,215	5.13	26,865	192,938	5.28	30,153
7.48	72	186,365	5.27	26,824	185,817	5.43	30,107
7.85	75	165,484	5.88	26,673	164,129	6.04	29,938
8.75	80	129,826	7.15	26,290	127,197	7.48	29,508
13.62	90	59,556	12.78	24,612	55,235	13.80	27,625
20.00	95	29,307	20.02	22,945	25,160	22.86	25,754

[a] Withdrawal not required until age 71.

For this article, I calibrated the necessary curves to the Canadian mortality tables listed in the April 2014 report issued by the Office of the Chief Actuary.[23] For example, I (and the GM law) assumed that the life expectancy of a female at retirement age 65 (in the year 2014) is 23 years. The mortality rate at age 70 is 11/1000, at age 75 is 18/1000, and at age 80 is 31/1000. These calibration[24] points coincide with values reported in the above-mentioned April 2014 report.[25] I ran various cases with other mortality rates, which I will address later.

Results Under $20,000 Pension Income

According to the LCM, a financial economist would advise this retiree to consume a total of $30,194 at her current age of 70: this optimal spending would smooth her resources over her remaining life cycle, accounting for risk preferences. The $30,194 would be composed of $20,000 in pension income and $10,194 from the RRIF portfolio. Note that this smooth spending rate leads to an annualized optimal withdrawal rate from the RRIF of 5.09 percent at age 70. When the retiree reaches the age of 71, the financial economist would advocate a slightly lower optimal spending rate of $30,153 per year, $20,000 of which would be sourced from pensions and $10,153 of which would be sourced from the investment portfolio. This requires an optimal withdrawal rate from the RRIF of 5.28 percent (and the exercise

23 Office of the Superintendent of Financial Institutions Canada, Office of the Chief Actuary, *Mortality Projections for Social Security Programs in Canada*, Actuarial Study no. 12 (Ottawa: Office of the Superintendent of Financial Institutions Canada, April 2014).

24 For those interested in the actuarial details, the GM law is driven by three parameters (λ, m, and b). The exact functional form is available in basic actuarial textbooks or the paper by Milevsky and Huang, supra note 17, for example. In this study, having calibrated to age 65 to 100 of the Canadian 2014 tables, I estimated that ($\lambda = 0$, $m = 92$, and $b = 9.5$), which induces relevant q_x values at any age.

25 Supra note 23, at table 5.

can be repeated for each following year). The 5.28 percent is lower than the mandated 7.38 percent, which is displayed in the far left column of table 1. Comparing column 1 to column 4 is really the main point of this article.

The optimal spending rate (in the LCM world) minus the yearly income from the CPP or defined benefit pension leads to the optimal withdrawal rate from the RRIF. Think of the RRIF withdrawal rate or amount as providing the means of meeting the smoothed consumption that must be sourced from the RRIF. This is how an economist would determine the appropriate amount to withdraw from a RRIF (in the absence of tax frictions).

As noted above, the smoothing process continues each year, and the optimal withdrawal rates increase slowly to 6.04 percent at age 75, 7.48 percent at age 80, and 13.80 percent at age 90. The optimal rates increase with age; the key is to notice that the LCM-derived rates are lower than the RMDs until age 90. Notice how the optimal rates converge with the mandated rates only at very advanced ages. At the lower pension income of $17,000, the optimal rates are lower than the mandated rates until age 95. The results of the corresponding account values—assuming a deterministic return, since all assets are invested in risk-free assets—are displayed in table 1.

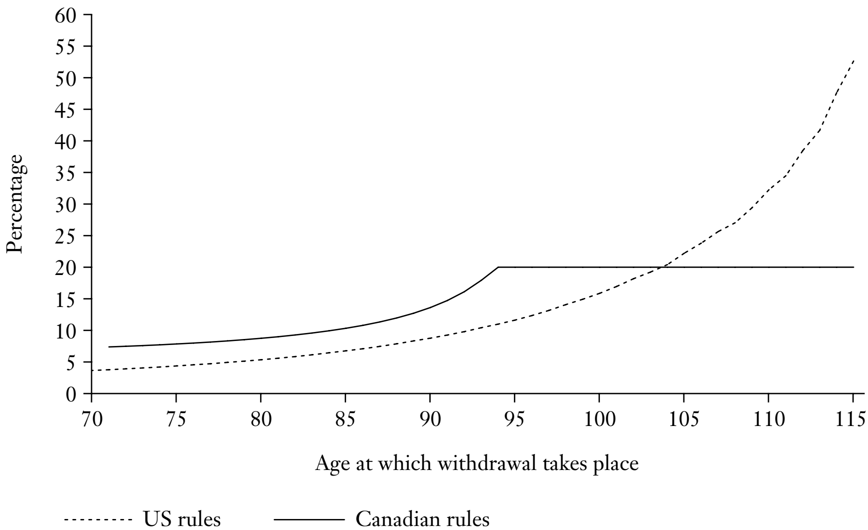
In terms of sensitivity analysis, I offer the following initial comparison points. If, for example, the 70-year-old retiree had a pension income of $15,000 (instead of the $17,000 or $20,000 displayed in table 1), her optimal withdrawal rate at the age of 75 would be even lower (5.72 percent). Therefore, a lower level of exogenous pension income, all else being equal, induces a lower optimal RRIF spending rate. Likewise, if, instead of a 1.5 percent real interest rate, I assumed a 3 percent real rate (with all other parameters in table 1 being the same), then the age 75 optimal withdrawal rate (under a lower $10,000 pension) would be 6.11 percent. Finally, if the retiree were a man with a life expectancy at retirement of 20 years (instead of 23), then the optimal age 75 withdrawal rate (again, under a lower $10,000 pension) would be 5.94 percent.

When one uses different parameter values in the LCM, most of the resulting numbers are lower than the required RRIF rates for retirees between the ages of 70 and 100. They are uniformly lower for all age ranges when pension income is lower than approximately $15,000 per year. The main point is that regardless of the exact parameters and values used for exogenous pension income, gender, or safe returns (within reason), it is very difficult to justify current RRIF withdrawal rates.

Interestingly, the financial economists who conducted a recent study in the United States using a similar LCM but working with US RMDs, which for the most part are lower than the Canadian RRIF withdrawal rates, claimed that in the United States the RMDs are more reasonable guideposts for withdrawals than the rules of thumb followed by the financial planning profession.[26] Figure 1 compares US and

26 See Wei Sun and Anthony Webb, "Should Households Base Asset Decumulation Strategies on Required Minimum Distribution Tables?" (2013) 38:4 *Geneva Papers on Risk and Insurance: Issues and Practice* 729-52, where the authors compare the US RMD to the so-called 4 percent Bengen rule for "safe" portfolio withdrawal rates in retirement. In this article, the authors argue that RMDs are better than 4 percent instead of arguing for the optimality of the RMD schedule.

FIGURE 1 RMD Factor: Percentage of Tax-Sheltered Account That Must Be Withdrawn



Canadian RMD rates. Notice that it is only at age 105 that US rates exceed the Canadian values. For the first 35 years of retirement, the Canadian RMD values are higher, which might be yet another indication of the constraints imposed by the current RMD values.

A caveat in these models is that the LCM has been calibrated assuming a risk-averse retiree who prefers to invest in safe cash assets.[27] Retirees who (1) are unhealthy with much higher mortality, (2) are more tolerant of investment risk, and/or (3) prefer not to delay their consumption would select a different path and schedule for their RRIF withdrawals.

In fact, in a Canadian study investigating wealth and spending patterns in retirement, Kevin Milligan claimed that some Canadians were actually withdrawing more than the mandated amount from their RRIF.[28] Clearly not everyone in Canada finds the current RMD schedule "constraints-binding," in the language of economics. The point here, again, is to argue for a reduction in rates—especially in the age 70-to-90 range—as opposed to justifying a particular number or schedule.

Table 2 provides an alternative case, in which the pension income is set to $10,000 (instead of $20,000), mainly for comparison with earlier periods, when CPP

27 In the language of economics, the coefficient of relative risk aversion was set equal to a value of 8, which would induce the retiree to allocate her entire RRIF to risk-free assets.

28 Kevin Milligan, "Life-Cycle Asset Accumulation and Allocation in Canada" (2005) 38:3 *Canadian Journal of Economics* 1057-1106, at 1088 and note 22.

TABLE 2 Optimal RRIF Spending Rates in a Life Cycle Model: $10,000 Pension Income with High Level of Risk Aversion

		2014 Parameters Real rate = 1.50% Retirement life expectancy 23 yrs.			1992 Parameters Real rate = 4.00% Retirement life expectancy 17 yrs.		
RRIF rates, %	Age	RRIF value, $	Optimal, %	Total spending, $	RRIF value, $	Optimal, %	Total spending, $
5.00[a]	70	200,000	4.55	19,110	200,000	7.07	24,100
7.38	71	193,960	4.69	19,080	194,240	7.27	24,070
7.48	72	187,860	4.84	19,050	188,330	7.45	24,000
7.85	75	169,200	5.27	18,950	169,610	8.06	23,700
8.75	80	137,128	6.35	18,675	135,480	9.63	23,000
13.62	90	72,073	10.38	17,484	61,600	16.31	20,050
20.00	95	42,124	14.96	16,300	28,500	25.61	17,300

[a] Withdrawal not required until age 71.

plus OAS/GIS income levels were lower than they are today. As explained earlier, lower pension income results in lower optimal withdrawal rates.

As a comparison, however, one can re-create the same exercise, using early 1990s real interest rates (which are much higher, at 4 percent) and demographic assumptions (which fix life expectancy at 17 years, as opposed to 23 years, at retirement). With these inputs, which reflect the demographic and economic realities of the day, not surprisingly the optimal withdrawal rates are much higher—and coincidentally closer to the current RRIF RMD rates. These inputs are listed in the last three columns of table 2.

For example, when a retiree is 71 (under 1992 parameter values), an LCM-wielding financial economist would suggest a 7.27 percent withdrawal rate, compared with the 7.38 percent required by law. When the retiree reaches 90, the optimal withdrawal rate would be 16.31 percent, which is actually a few percentage points higher than the mandated 13.62 percent. Therefore, whereas Ottawa would have been generous in the early 1990s in using the financial economic LCM as a benchmark for RMDs, allowing retirees to take RRIF balances into income and spreading RRIF withdrawals over a (comparatively) shorter collective lifespan in retirement, this generosity evaporated by 2014 (assuming the same $10,000 pension income), but not as a result of any deliberate policy change. Note that even with the higher ($20,000) pension income reported in table 1, the RMD constraint is binding.

CONCLUSION

What are the consequences if the current RMD schedule is maintained? There are two implications of note. First, Canadians over age 65 form the fastest-growing segment of the population. In addition, longevity for these Canadians is increasing and will continue to increase at a more rapid pace than for the rest of the population. Recent projections suggest that Canadians will continue to have one of the highest life expectancies in the world, along with the residents of Japan, France, Switzerland, Italy, and Australia.[29] Ultimately, the current RMD schedule, if maintained, will affect a subset of the Canadian population that is growing more quickly both in terms of population numbers and in terms of expected longevity than any other group. Second, if the retirees of today and tomorrow are required to make withdrawals and pay tax on RRIF income at rates that can be expected to deplete private wealth quickly, it is also reasonable to assume that some of the costs faced by this population (such as health and long-term care) will be shifted to federal and provincial governments because retirees will be unable to fund these expenditures themselves.

In sum, I have examined the RMDs from RRIFs in the context of current interest rates and increasing longevity. The methodology is economically based, and it compares the current required RRIF RMD schedule with an optimal withdrawal schedule from a consumption-smoothing LCM for risk-averse retirees. The RMD schedule is also evaluated by modelling the outcomes if current withdrawal rates were applied to the economic and demographic conditions prevailing in the early 1990s, when these rates were designed. Under those conditions, the rates were easier to justify.

Unlike Robson and Laurin,[30] I am not arguing that required withdrawals should be abolished or that they should begin later than they currently do; both of these possibilities would have cascading implications for the entire pension system. The main contribution of this article is to illustrate that (1) an LCM can be used to determine optimal RMD values on the basis of observable economic and demographic variables, and (2) optimal withdrawal rates are lower than the required rates for most retirees with middle and lower pension incomes.

29 See *Mortality Projections for Social Security Programs in Canada*, supra note 23.

30 Supra note 19.

APPENDIX A Simple RRIF Trajectory Assuming Two Different Investment Rates

		Earning 1.5%		Earning 6.5%	
RRIF withdrawal, %	Age	RRIF withdrawal	End of year RRIF value	RRIF withdrawal	End of year RRIF value
		dollars			
7.38	71	7,380	94,120	7,380	99,120
7.48	72	7,040	88,492	7,414	98,149
7.59	73	6,717	83,102	7,449	97,079
7.71	74	6,407	77,942	7,485	95,904
7.85	75	6,118	72,993	7,528	94,609
7.99	76	5,832	68,255	7,559	93,200
8.15	77	5,563	63,716	7,596	91,662
8.33	78	5,308	59,364	7,635	89,985
8.53	79	5,064	55,191	7,676	88,158
8.75	80	4,829	51,190	7,714	86,174
8.99	81	4,602	47,356	7,747	84,029
9.27	82	4,390	43,676	7,789	81,701
9.58	83	4,184	40,147	7,827	79,185
9.93	84	3,987	36,763	7,863	76,469
10.33	85	3,798	33,517	7,899	73,540
10.79	86	3,616	30,403	7,935	70,385
11.33	87	3,445	27,414	7,975	66,985
11.96	88	3,279	24,547	8,011	63,328
12.71	89	3,120	21,795	8,049	59,395
13.62	90	2,968	19,153	8,090	55,166
14.73	91	2,821	16,619	8,126	50,626
16.12	92	2,679	14,190	8,161	45,756
17.92	93	2,543	11,860	8,199	40,531
20.00	94	2,372	9,666	8,106	35,059
20.00	95	1,933	7,878	7,012	30,326
20.00	96	1,576	6,420	6,065	26,232
20.00	97	1,284	5,232	5,246	22,691
20.00	98	1,046	4,264	4,538	19,627
20.00	99	853	3,476	3,925	16,978
20.00	100	695	2,833	3,396	14,686

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Policy Forum: Piecemeal Tax Reform Ideas for Canada—Lessons from Principles and Practice

Robin Boadway*

PRÉCIS

La structure de base du régime fiscal des particuliers et des sociétés au Canada s'inspire de principes qui étaient répandus au moment du rapport Carter. Ces principes incluent l'imposition fondée sur la capacité de payer, qui repose sur l'imposition du revenu global comme base idéale, accompagnée d'un impôt des sociétés conçu pour retenir l'impôt à la source sur le revenu des actionnaires dans le but d'empêcher sa mise à l'abri illimitée au sein des sociétés. Diverses réformes fragmentaires ont eu lieu depuis lors, dont bon nombre déplacent la base du côté de la consommation personnelle. Cependant, des vestiges de l'approche d'imposition du revenu global demeurent, comme une structure à taux uniforme et une assiette d'impôt des sociétés qui est censée refléter le revenu de l'actionnaire.

Les idées sur l'impôt optimal et les circonstances économiques ont évolué considérablement depuis le rapport Carter. Au commencement, le revenu global comme base idéale était contesté par une taxe à la consommation progressive. Cette idée a par la suite été supplantée par une approche mettant l'accent sur le bien-être individuel ou l'« assistantialisme ». Cette dernière a été contestée dernièrement par les idées d'égalité des chances, qui mettent l'accent sur les occasions dont profitent les contribuables, plutôt que sur les résultats qu'ils obtiennent. En outre, l'impôt des sociétés est de plus en plus perçu comme une façon d'imposer les superprofits des sociétés, plutôt que de retenir l'impôt à la source sur le revenu des actionnaires.

L'auteur parcourt la littérature qui a façonné ces changements et certaines des pratiques qui ont émergé dans d'autres pays. Parmi les principaux éléments de cette littérature, il y a les récentes commissions sur la réforme fiscale au Royaume-Uni, aux États-Unis et en Australie, qui sont toutes pertinentes pour le Canada. Au nombre des pratiques novatrices, notons les régimes d'imposition différenciée instaurés dans les pays nordiques et les régimes d'imposition des superprofits, tels que la déduction pour fonds propres des sociétés et l'impôt sur les bénéfices tirés des ressources. L'auteur puise dans ces idées et pratiques afin de faire des recommandations en vue d'une réforme fiscale au Canada.

* Emeritus Professor of Economics, Queen's University, Kingston (email: boadwayr@econ.queensu.ca). This article is based on a talk given at the Deloitte Centre for Tax Education and Research 2013 Tax Policy Research Symposium, June 20, 2013. I am grateful to the organizers and participants for insightful reactions, and to Kevin Milligan for helpful comments on a previous draft.

ABSTRACT

The basic structure of the Canadian personal and corporate tax system is informed by principles that were prevalent at the time of the Carter report. These principles include taxation based on the ability to pay, which supports comprehensive income taxation as the ideal base, accompanied by a corporate tax designed to withhold shareholders' income at source to prevent unlimited sheltering within corporations. Various piecemeal reforms have occurred since then, many of which move the base toward personal consumption. Yet, vestiges of the comprehensive income approach remain, such as a single-rate structure and a corporate tax base that is meant to reflect shareholder income.

Ideas about optimal tax design and economic circumstances have evolved considerably since the Carter report. Initially, comprehensive income as an ideal base was challenged by progressive consumption taxation. This was later supplanted by an approach that emphasized individual well-being or welfarism. This in turn has recently been challenged by equality-of-opportunity ideas, which emphasize the opportunities that taxpayers enjoy, rather than the outcomes that they achieve. Additionally, the corporate tax has increasingly come to be seen as a device for taxing corporate rents, rather than for withholding shareholders' income at source.

The author recounts the literature that has informed these changes and some of the practices that have emerged in other countries. Key elements of the literature include recent tax reform commissions in the United Kingdom, the United States, and Australia, each of which has relevance for Canada. Innovative practices include the dual income tax systems introduced in the Nordic countries and rent tax systems, such as the allowance for corporate equity and the resource rent tax. The author draws on these ideas and practices to offer some recommendations for tax reform in Canada.

KEYWORDS: CARTER COMMISSION ■ TAX POLICY ■ TAX REFORM ■ INDIVIDUAL INCOME TAXES ■ CORPORATE INCOME TAXES ■ PROGRESSIVE TAXES

CONTENTS

INTRODUCTION

The Canadian tax system has evolved considerably since the early postwar period, but it is still anchored in the ideas of that time. These ideas were synthesized in Musgrave's famous public finance treatise and formed the basis of two influential tax policy reports: the report of the Royal Commission on Taxation of Profits and Income in the United Kingdom and the report of the Royal Commission on Taxation (Carter report) in Canada.[1] The recommendations in these reports flowed from the notion that comprehensive income was the ideal tax base, and all else followed from that. Two ideas were paramount: all sources of income should be fully included in the personal tax base, and the corporate income tax should serve as a withholding tax to ensure that shareholders could not use a corporation as a vehicle for avoiding personal tax.

The Carter report recommendations were never fully implemented, and the Canadian tax system never achieved the comprehensive income tax ideal. As time has gone by, gradual reforms of the system have moved it further away from the ideal. Nonetheless, comprehensive income taxation continued to inform the policy debate, and movements away from the ideal (such as sheltering returns on retirement savings from taxation) were considered to be justifiable exceptions. The idea of the corporate tax as a withholding device persisted. The base of this tax has always been shareholders' income, and it has continued to be accompanied by devices to integrate it with the personal tax to return the taxes that had been withheld from shareholders at the corporate level. The imperfections of these integration measures were highlighted by the Mintz report,[2] but the role of the corporate tax was not questioned.

In light of the distance that the system has strayed from the ideal, it is odd that the comprehensive income tax has continued to be the underlying principle of taxation. This is particularly evident with the introduction and prominence of the goods and services tax (GST) and the harmonized sales tax (HST), which as consumption-based taxes contradict the comprehensive tax ideal. What is more evident is that the persistence of the comprehensive income tax ideal has been overtaken by both ideas and circumstances. The purpose of this article is to recount the evolution of ideas and circumstances, and to describe how this evolution has found its way into recent important tax policy proposals in the United Kingdom, the United States, and Australia. No such fundamental rethinking of tax policy has taken place in Canada, but some of the recent themes can be readily adapted to Canadian circumstances.

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1 Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959); United Kingdom, *Royal Commission on the Taxation of Profits and Income: Final Report* (London: HMSO, 1955); and Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) ("the Carter report").

2 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) ("the Mintz report").

THE EVOLUTION OF TAX PRINCIPLES AND PRACTICES

There has been a parallel evolution of circumstances, tax policy ideas, and practices. Nations like Canada now face economic settings that are very different from those encountered decades ago, and this constrains tax choices. International openness and competitiveness have increased dramatically, and capital and skilled labour are highly mobile. Labour markets have transformed as skills have improved and as labour participation rates for women have risen. Employment and earnings have become more volatile, and the composition of industries has changed, with the decline of agriculture and manufacturing and the expansion of finance, services, and resource industries. At the macroeconomic level, recurring problems of public indebtedness and growing demographic changes put pressure on public finances. At the same time, the cost of public services is rising owing to their labour intensiveness. There has been a significant rise in inequality, whose determinants are not fully understood. In addition, views of tax policy should be influenced by a less well-recognized feature of modern industrialized economies: the growing importance of rents in the economic system, whether as a result of knowledge or informational advantages, industry concentration, or fixed factors such as resources.

At the same time, tax policies have changed. Most countries have adopted value-added (sales) taxation (VAT). Combined with the increasing use of capital income-sheltering schemes, especially but not exclusively in relation to retirement savings, the overall tax system has come to be based more on consumption than on income. Even those countries, such as the United Kingdom and the Nordic countries, that include most capital income in their bases do so at preferential rates. As discussed further below, the Canadian system is arguably now very close to a progressive consumption tax system. Tax systems, income and sales taxes combined, have also become less progressive, especially in the upper half of the income distribution. In Canada, the decentralization of revenue raising to the provinces has contributed to this situation. At the lower end of the income distribution, the innovation of the refundable tax credits and the continued provision of universal public services have mitigated the reduction in progressivity, although transfers to the poor at the provincial level have faded. Notably, inheritance and wealth taxes have faded, and in Canada these taxes disappeared soon after they were devolved to the provinces.

The evolution of ideas is significant and ongoing, and it will be discussed in more detail below. The longstanding paradigm of the first half of the 20th century—going back to the German economist Schanz[3] at the end of the 19th century—was that taxes should be based on the ability to pay, as reflected in comprehensive income, and that progressivity relied on the notion of equal sacrifice. The Carter report proposed a nuanced version of the ability-to-pay rationale by distinguishing between

3 George von Schanz, "Der Einkommensbegriff und die Einkommensteuergesetze" (1896) 13 *FinanzArchiv* 1-87.

discretionary and non-discretionary income. Non-discretionary income represented the amount of income that was required for the necessities of life and should be taxed at a lower rate than income that was not required for these necessities. The comprehensive income paradigm was challenged by Kaldor,[4] who suggested that taxing persons on the basis of their consumption (what they took from society) was fairer than taxing them on the basis of their income (what they contributed). A direct consumption or expenditure tax, whose base is income less savings, could achieve this result in a progressive way. The expenditure tax conditioned the ability-to-pay approach on the basis of the manner in which taxpayers chose to use their income.

A fundamentally different perspective on tax design—and the one that is currently dominant—was introduced by the optimal tax literature in the 1970s with the seminal work of Mirrlees.[5] The approach is inherently mathematical and formal, but underlying it are ideas that distinguish it from the ability-to pay approach and its extensions. The ultimate objective of the tax system is to extract tax revenues from taxpayers according to how well off they are, and how well off a person is depends conceptually on a utility function that respects individual preferences. Noteworthy consequences of this approach, referred to as welfarism or (loosely as) utilitarianism, are as follows.

First, the ideal tax base depends on the form of preferences over goods and services consumed today, those consumed in future periods, and leisure. Thus, the structure of preferences determines whether differential tax rates should apply to different goods, or whether a uniform tax should apply. Preferences also determine the tax treatment of present versus future consumption—that is, the taxation or non-taxation of capital income. Ability to pay alone is not relevant; how the ability to pay is exercised by spending and savings decisions is. Second, the degree of progressivity is determined by the concavity of utility—that is, how rapidly the marginal utility of income diminishes with income. Third, the utilitarian analysis assumes that well-being is comparable interpersonally, an assumption that typically deems persons to have identical preferences. Finally, unlike equal sacrifice approaches associated with the ability to pay, welfarism is consequentialist in the sense that policies are judged by their final outcomes, regardless of where people start. Following Rawls,[6] this implies that the productive capacities of taxpayers are effectively regarded as common property available for redistribution to those who are less well endowed.

Welfarism has recently been called into question, as is discussed in more detail below. Some criticisms are fundamental, such as the argument that welfare cannot be meaningfully measured and compared across persons, especially when they have

4 Nicholas Kaldor, *An Expenditure Tax* (London: Allen & Unwin, 1955).

5 James A. Mirrlees, "An Exploration in the Theory of Optimum Income Taxation" (1971) 38:2 *Review of Economic Studies* 175-208.

6 John Rawls, *A Theory of Justice* (Cambridge, MA: Belknap Press of Harvard University Press, 1971).

very different preferences and therefore make very different choices in similar circumstances. This criticism leads some scholars, such as Fleurbaey and Maniquet, and Sen, to propose that tax policy be based on measures of resource availability, perhaps akin to the ability to pay, or the equality of opportunity in the case of Roemer.[7] Others argue that consequentialism is unsatisfactory since it gives the state licence to engage in excessive redistribution, a criticism recently voiced by Feldstein.[8] There are also objections to welfarism on the basis of behavioural economics, which suggest that basing policy on revealed preferences may lead to unsound outcomes. Finally, some observers object to normative approaches per se, and argue that they should be tempered by political economy considerations. Political constraints can certainly be demanding: consider the difficulty of enacting revenue-neutral tax reforms when some persons gain and other persons lose, or the challenge of undoing preferential and distortionary tax policies that generate rent for some taxpayers. A convincing case can nevertheless be made that normative tax prescription, unfettered by political constraints, is a sensible approach.[9]

Despite these concerns, welfarism remains the prevailing approach to tax policy proposals. Recent influential reform proposals have been heavily, even exclusively, influenced by the utilitarian or welfarist perspective, as represented by the optimal income taxation approach. Three important tax policy reviews include the President's Advisory Panel on Tax Reform in the United States, the Mirrlees review in the United Kingdom, and the Henry report in Australia.[10] Of the three, the Mirrlees review is the most thorough. Though nominally devoted to UK tax reform, its key policy recommendations for the major tax types (personal, corporate, sales, inheritance, and property) are relevant for other Organisation for Economic Co-operation and Development (OECD) countries, including Canada. It consists of two substantial volumes, one a series of tax-specific research studies, each written jointly by an

7 Marc Fleurbaey and François Maniquet, *A Theory of Fairness and Social Welfare* (Cambridge, UK: Cambridge University Press, 2011); Amartya K. Sen, *Commodities and Capabilities* (Amsterdam: North-Holland, 1985); John E. Roemer, *Equality of Opportunity* (Cambridge, MA: Harvard University Press, 1998).

8 Martin Feldstein, "The Mirrlees Review" (2012) 50:3 *Journal of Economic Literature* 781-90.

9 The case for ignoring political constraints in normative policy analysis is made in Robin Boadway, "The Role of Public Choice Considerations in Normative Public Economics," in Stanley L. Winer and Hirofumi Shibata, eds., *Political Economy and Public Finance: The Role of Political Economy in the Theory and Practice of Public Economics* (Cheltenham, UK: Edward Elgar, 2002), 47-68.

10 United States, President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: President's Advisory Panel on Federal Tax Reform, 2005); James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011) ("the Mirrlees review"); Australia, Department of the Treasury, *Australia's Future Tax System* (Canberra: Commonwealth of Australia, 2010) ("the Henry report").

international scholar, a UK scholar, and a UK practitioner, and the other a report written on behalf of a committee chaired by the Nobel laureate, Sir James Mirrlees. The research deployed state-of-the-art optimal tax analysis backed up by formidable empirical analysis of the effect of taxation on household decision making over the life cycle. Its proposals include fundamental reforms to personal and corporate taxation, some of which are suitable for Canada, as discussed later. There is considerable overlap between the ideas in the president's panel and those in the Henry report. Of particular interest for Canada in the Henry report is the proposal for a resource rent tax (RRT) for the mining sector. An RRT is one of several ways of levying an efficient tax that is designed to capture a share of natural resource rents for the public sector.

The question to be explored in the following sections is what these evolutions of ideas and practices suggest for tax policy in Canada. A detailed summary of this evolution precedes a discussion of the policy implications for the Canadian tax system.

A SELECTIVE HISTORY OF MAJOR TAX POLICY REPORTS

The sequence of tax policy reports over the postwar period illustrates the way in which thinking about tax policy has evolved. Three are singled out as representative.

The Starting Point: The Carter Report

The Carter report, following its precursor in the United Kingdom, the Royal Commission on the Taxation of Profits and Income, represents the culmination of a long tradition of advocating the comprehensive income tax ideal. Comprehensive income aggregates income from all sources, including labour, capital, and property, and can equivalently be defined by means of an individual's budget constraint as the sum of consumption and additions to wealth through saving. Comprehensive income represents a taxpayer's command over resources: it is the maximum amount that can be consumed while keeping wealth intact. It is taken to be an index of the ability to pay taxes, and it is divorced from actual decision making. Unlike the welfarist alternative, it does not profess to measure well-being; rather, it is a measure of potential consumption and as such is in principle objective.

The comprehensive income approach uses personal income taxation as the appropriate tax form. Carter therefore focused largely on income taxation as the relevant tax base, setting aside indirect sales taxation as unnecessary.

The choice of a rate structure is more problematic since it requires some judgment about how much potential consumption should be given up by different taxpayers. It is tempting to appeal to the classical notion of equal sacrifice, but this notion is traditionally rooted in utilitarianism. The Carter prescription was innovative, and its innovation was to distinguish between necessary and discretionary consumption, with only the latter being worthy of taxation. Of course, this distinction is not sufficient to characterize the full rate structure to be applied to discretionary expenditure. It is not entirely clear what underlying principles should inform the progressivity of the comprehensive income tax—that is, how much potential consumption should be sacrificed by various income groups. This issue was not satisfactorily resolved. What was important was that a single rate structure should apply to aggregate comprehensive income, whatever its source. As Carter put it, "a buck is a buck."

Comprehensive income taxation is an ideal. Its practical shortcomings are daunting since it requires the measurement of all forms of income, which is especially problematic for asset income. Some income takes an imputed form, such as the imputed return on housing and other consumer durables. Income from personal business assets is particularly hard to measure since it requires estimating the costs of earning income, such as depreciation. This problem is even more difficult for human capital. Other forms of income, such as capital gains, accrue without being reflected in market transactions. The best that can be done is to include capital gains as income when they are realized, rather than when they accrue. Changes in wealth can also occur if assets are given away. Unless donations are regarded as consumption, comprehensive income should be reduced by the full amount of a donation. The proper treatment of asset income also requires that only real income, and not a nominal income, be included, which gives rise to complicated methods of indexation for inflation.

The prescription of comprehensive income taxation in the Carter report involved a natural role for corporate taxation. Because capital gains cannot be taxed unless they are realized, the taxation of shareholder income can be postponed while capital gains accumulate by retaining profits in a corporation. Corporate taxation can counteract this accumulation by taxing shareholder income at the corporate level as it is earned, and providing a credit for corporate taxes paid when the funds are paid out to the shareholders. The Carter report recommended an intricate form of personal-corporate tax integration involving a dividend tax credit system based on corporate taxes that have actually been paid on the relevant shares. This system was prohibitively difficult to implement because of the difficulty of associating the flow of past corporate tax payments with the flow of future dividend payments and the complications that arise from different forms of dividends, such as intercorporate dividends; the need to distinguish domestic from foreign shareholders; and the changing tax status of corporations. In practice, integration could be approximated only by dividend tax credit and preferential capital gains provisions that use uniform rates, rather than rates that are tied to corporate taxes that have actually been paid.

Of note for the Canadian case is that the withholding rationale for corporate taxation also applies to foreign shareholders who would otherwise escape taxation on income earned in Canada. Of course, this rationale fails to address how international income should be taxed, but these considerations take us too far afield.

Many implementation issues (apart from measurement) apply to comprehensive income taxation, and many of these also apply to tax bases, which are considered below. One is the treatment of the family, both cohabitating spouses and children. Potential consumption can be defined at either the individual or the family level, but the issue then becomes what rate structure to use. In the spirit of Carter, this involves identifying the level of non-discretionary income at the family level. Another issue is how to deal with fluctuating income, which can lead to unfair tax treatment among taxpayers with different degrees of income volatility. In principle, this matter can be addressed by a system of income averaging over time, something that is clearly feasible with today's tax-collecting technology.

A final concern involves the treatment of inheritances. The idea of comprehensive income presumably implies that inheritances represent an addition to wealth that should be included in comprehensive income. The treatment of bequests from the donor's point of view is not as clear. If a bequest is treated as an act of consumption, this consumption cancels out the loss in wealth, and therefore the donor faces no tax consequences. In this case, the bequest gives rise to consumption benefits both for the donor and for the inheritor, a form of double counting that some may find objectionable.[11] If a bequest is not treated as an act of consumption, the reduction in wealth should reduce the donor's comprehensive income. The taxation of inheritances combined with the deduction for bequests would make bequest taxation a wash.

The principles of the Carter report are important because they form the basis for some aspects of the Canadian tax system and continue to inform policy. All forms of taxable income are aggregated into a single base, and a common rate structure is applied. Of course, the base is not comprehensive since some forms of capital income are exempt. The corporate tax is designed to be a withholding tax in accordance with the thinking of Carter, albeit imperfectly. The base is shareholder income (for both domestic corporations and foreign corporations operating in Canada), and the corporate tax is integrated with the personal tax through the dividend tax credit and the preferential treatment of capital gains. The tax base for unincorporated business income is defined in a similar way in accordance with comprehensive income principles. Though the base strays from the comprehensive income tax ideal, reforms are judged through the prism of this ideal.

The Progressive Consumption Tax Alternative

A seemingly simple alternative to potential consumption as a direct tax base is actual consumption, although its practical consequences would be much more profound. The idea is typically attributed to Kaldor,[12] who had proposed personal consumption or expenditure taxation in his minority report to the Royal Commission on the Taxation of Profits and Income.[13] However, it had its classical precursors in Mill,

11 This matter is discussed in detail in Robin Boadway, Emma Chamberlain, and Carl Emmerson, "Taxation of Wealth and Wealth Transfers," in James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, eds., *Dimensions of Tax Design: The Mirrlees Review* (Oxford: Oxford University Press, 2010), 737-814. This is one of the background research papers prepared for the Mirrlees review.

12 Supra note 4.

13 Supra note 1.

Pigou, and Fisher.[14] Kaldor's argument was a straightforward extension of the command-over-resources approach of comprehensive income: taxpayers should be taxed according to what they take out of the economy (consumption) rather than what they contribute (income). Instead of taxing a person's income, the base would be income less changes in wealth (saving). Being a direct tax levied on individuals, a progressive rate structure could be applied, and in principle any degree of progressivity could be chosen, thus undercutting any equity concerns about favouring high-income persons, whose savings tend to be higher than those of low-income persons.

Detailed policy versions of Kaldor's proposal appeared in the US Treasury blueprints and the Meade report.[15] Similar Canadian proposals also came from the Economic Council of Canada and the Macdonald commission.[16] These proposals were all similar, and I focus here on the Meade report. The rationale for consumption taxation began to take on a more utilitarian form. Consumption taxation was viewed as more equitable than comprehensive income taxation, both horizontally between persons with different saving habits and different income volatility, and over the lifetime because consumption is more stable than income. Consumption taxation might also be more efficient since, by taxing capital income at substantial rates, it discourages the choice of future over current consumption, although partly at the expense of higher tax rates on labour supply. The most powerful arguments are administrative. By eliminating savings from taxation, the problems of measuring and indexing asset income are avoided. Moreover, because the need to use corporate taxation for withholding is eliminated, it can be devoted to other tasks, such as taxing rents. From a political economy point of view, greater progressivity can arguably be achieved without including capital income in the tax base, given the responsiveness of capital income to taxation at higher income levels.

It is instructive to outline the exact tax design proposals of the Meade report. They consist of three main elements: the personal tax base, the corporate tax base, and the inheritance tax. (As in the Carter report, sales taxes are unexamined.)

14 John Stuart Mill, *Principles of Political Economy: With Some of Their Applications to Social Philosophy* (London: Parker, 1848); Arthur C. Pigou, *A Study in Public Finance* (London: Macmillan, 1928); and Irving Fisher, "The Double Taxation of Savings" (1938) 29:1 *American Economic Review* 16-33. Fisher's arguments have recently been summarized in John B. Shoven and John Whalley, "Irving Fisher's Spendings (Consumption) Tax in Retrospect" (2005) 64:1 *American Journal of Economics and Sociology* 215-35.

15 United States, Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington, DC: Department of the Treasury, 1977); Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (London: Allen & Unwin, 1978) ("the Meade report").

16 Canada, *Royal Commission on the Economic Union and Development Prospects for Canada, Report* (Ottawa: Supply and Services, 1985) ("the Macdonald commission"); Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Supply and Services, 1987).

The personal tax base differs from comprehensive income as a result of the treatment of assets and capital income, and this treatment takes three different forms, depending on the type of asset. Some assets, such as consumer durables and selected financial assets, are treated on a tax-prepaid basis. Their acquisition (or disposal) is not deductible from income, and their asset income is tax-exempt. To use the terminology of the Mirrlees review, their treatment is "TEE": savings are out of after-tax income (T), asset income is tax-exempt (E), and sales of assets are tax-exempt (E). Other assets, such as savings for retirement, are treated on a registered basis, or "EET": the purchase is tax-deductible (E), asset income accumulates tax-free while the asset is held (E), and principal and accumulated asset returns are taxed on disposition (T). A final set of assets are taxed on a cash flow basis; these assets include human capital accumulation (forgone earnings are implicitly deductible along with tuition and other costs, and increased earnings are taxed) and personal businesses (input purchases are deducted, and sales are taxed on a cash accounting basis). The intent is for the present value of the tax base to be equivalent to consumption, although, as the Mirrlees review emphasized, this is not accomplished for tax-prepaid savings. The various tax treatments of assets reflect the fact that income is difficult to measure for some assets. In addition, the ability of the taxpayer to choose how financial assets are treated allows self-averaging to smooth tax liabilities over the life cycle.

The corporate tax base proposed was cash flow: sales less all purchases, both current and capital, on a cash basis. Since persons were not liable for capital income taxation, there was no need for withholding at the corporate level. Rather than simply abolishing the corporate tax, it would instead be used to tax pure profits or rents, and a cash flow corporate tax roughly accomplishes that. I say "roughly" because cash flow taxation taxes any returns to risk, while allowing a deduction for risky losses. The integrity of the cash flow tax allows full loss offsetting or, equivalently, the carrying forward of losses with interest.

Some aspects of cash flow taxation are worth noting. First, as long as corporations are risk-neutral, cash flow taxation has no effect on investment or other choices. Risk-averse corporations might even be encouraged to invest since under a cash flow tax the government effectively shares the risk. Second, the pure form of cash flow taxation includes only real transactions. However, the Meade report suggested that the tax could either be restricted to real cash flows (the R base) or it could include financial cash flows as well (the R+F base) to tax rents in the financial sector. Third, it is necessary to consider whether the integration of the corporate and the personal tax is necessary, especially given the complexity. The case for integration is that some rents are taxed at the personal level to the extent that shareholders hold their assets in registered form, under which all asset returns are taxed on withdrawal. Because not all rents are taxed at the personal level, however, to provide credit would simply undo the purpose of the corporate tax. Since it is not practically feasible to distinguish the two cases, the case for integration is diminished.

The final element of the Meade report's consumption tax agenda is a cumulative progressive inheritance tax on inheritors. This is a contentious proposal, and no strong justification was given for it. Implicit was the idea that inheritances represent a windfall source of income to inheritors, which finances consumption and ought to be taxed. No consideration was given to the standing of bequests to donors and its implication for their tax treatment.

The Mirrlees Review: The Welfarist Reincarnation of Meade

The Mirrlees review represents the conquest of tax policy analysis by the optimal taxation approach. It is based on state-of-the art optimal income tax principles backed by detailed empirical analysis and enunciated in detailed background research by well-known international scholars. Unlike its Carter and Meade precursors, the review covers the entire tax system. It is the ultimate welfarist blueprint for a revenue- and distribution-neutral tax reform. Some of the same ideas are found in the president's panel and the Henry report, but they are not presented nearly as comprehensively.

The Mirrlees review was set up to mark the 30th anniversary of the Meade report, and (coincidentally or not) its prescriptions for direct taxation were similar. At the personal level, its authors argued for a modern variant of the Meade progressive expenditure tax scheme. Some assets, particularly bonds and consumer durables, would be treated as tax-prepaid (TEE). Saving for retirement would be registered (EET). However, for shares held in firms a new treatment called "TtE" was devised. Instead of capital income going untaxed, as in tax-prepaid assets, only a normal rate of return would be exempt; above-normal returns, including rents, would be taxed. Returns to risk would be taxed as well, although negative returns would be exempt. This approach was presumably motivated by the desire to tax the unexpectedly high returns of a buoyant stock market, but the feasibility of administering this system was not addressed.

Corporate and personal businesses would also face a rent-type tax, as advocated in the Meade report, but instead of a simple cash flow version, a so-called allowance for corporate equity (ACE) was proposed. This system allows a deduction for both debt and equity finance and can be designed to be equivalent to a cash flow tax in present-value terms.[17] The ACE system had been proposed for Europe by the Institute for Fiscal Studies and was since adopted in Belgium, Italy, Croatia, and Brazil.[18]

The Mirrlees review, like the Meade report, contained recommendations for a progressive inheritance tax on inheritors' lifetime receipts, although its arguments were couched in terms of equality of opportunity rather than utilitarianism. But the Mirrlees review went beyond the Meade report in many other ways. It recognized the role of a separate system of transfers to less well off persons, but proposed that the

17 This was demonstrated by Robin Boadway and Neil Bruce, "A General Proposition on the Design of a Neutral Business Tax" (1984) 24:2 *Journal of Public Economics* 231-9; and Stephen R. Bond and Michael P. Devereux, "On the Design of a Neutral Business Tax Under Uncertainty" (1995) 58:1 *Journal of Public Economics* 57-71.

18 Institute for Fiscal Studies, Capital Tax Group, *Equity for Companies: A Corporation Tax for the 1990s: A Report of the IFS Capital Tax Group*, IFS Commentary no. 26 (London: IFS, 1991). International experience with the ACE system has been summarized in Alexander Klemm, "Allowances for Corporate Equity in Practice" (2007) 53:2 *CESifo Economic Studies* 229-62.

tax and transfer system, including refundable tax credits analogous to Canada's working income tax benefit (WITB), should be integrated to avoid precipitous increases in marginal tax rates. Following recent optimal income tax analysis, it put particular emphasis on participation tax rates—that is, on the sum of taxes incurred and transfers lost when taxpayers choose to participate in the labour market. Its own research identified situations in which participation was particularly responsive to the tax-transfer system, including secondary earners in families with small children and workers near retirement age. It also drew on optimal tax principles, particularly the Atkinson and Stiglitz theorem and its recent generalization by Laroque and Kaplow,[19] and its own empirical work to recommend eliminating all special exemptions in the VAT, while changing the income tax rate structure to maintain distribution neutrality. Finally, it recommended changing the property tax to a land valuation tax and adjusting excise taxes to take proper account of road congestion and carbon pricing.

Despite this ambitious set of recommendations, there were a few blind spots in the Mirrlees report. Given the self-imposed constraint of distribution neutrality, no position is taken on the optimal progressivity of the tax system. This has been an active area in optimal taxation research, and is highly relevant to policy, given the current rancour about growing income and wealth inequality. Although much emphasis is placed on harmonizing taxes and transfers, no attention is paid to the social insurance role of the tax-transfer system, particularly unemployment insurance. This would have been timely, given the volatility of earnings and employment, and the anxiety created by the recent "great recession." Also missing is consideration of taxation of the family and the tax treatment of human capital accumulation. There is no discussion of multijurisdictional tax issues, despite the devolution of taxation powers to the Scottish Parliament and the debate over the Scottish independence referendum.

Finally, two major issues are left incomplete, and these are relevant for my later discussion. One is the taxation of capital income. The Mirrlees review opted for a system that is very similar to the system advocated in the Meade report wherein most capital income is sheltered from tax. The exception is above-normal capital income, which is taxed on share ownership (TtE), retirement savings (EET), and personal business income (ACE). All normal returns to saving are tax-free, which is oddly inconsistent with the advice contained in the background research papers. The paper by Banks and Diamond[20] in particular makes a cogent case for taxing capital income, albeit at a rate that is lower than the tax on earnings.

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19 Anthony B. Atkinson and Joseph E. Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation" (1976) 6:1 *Journal of Public Economics* 55-75; Guy Laroque, "Indirect Taxation Is Superfluous Under Separability and Taste Homogeneity: A Simple Proof" (2005) 87:1 *Economics Letters* 141-44; and Louis Kaplow, "On the Desirability of Commodity Taxation Even When Income Taxation Is Not Optimal" (2006) 90:6 *Journal of Public Economics* 1235-50.

20 James Banks and Peter Diamond, "The Base for Direct Taxation," in *Dimensions of Tax Design*, supra note 11, 548-648.

The second issue is natural resources taxation, particularly the taxation of offshore North Sea petroleum. This form of taxation would be a significant, albeit temporary, source of tax revenue for Scotland in the event of independence, and is currently a source of UK tax revenues, but it is not discussed in the Mirrlees review.

Non-renewable resource taxation was treated in detail in the Henry report in Australia.[21] The report contained recommendations to impose a rent tax on the mining industry, and proposed an RRT, following the analysis of Garnaut and Clunies-Ross.[22] Like the ACE, the RRT is a cash flow equivalent tax. Consider a resource project that involves some initial investment in exploration and development, and then produces a revenue stream as the resource is extracted. Cash flows are initially negative and are put into an account that increases at a risk-free interest rate each year. Once the value of the account becomes positive, cash flows are fully taxable throughout the life of the project. In effect, negative cash flows are carried forward at a risk-free interest rate until they are offset by positive cash flows. As long as all negative cash flows are eventually offset, the tax is equivalent to a cash flow tax. For firms that wind up before negative cash flows have been offset by positive ones, a tax refund is required so that the tax remains neutral with respect to a firm's decisions. This refundability of losses of firms that have been wound up is important because a significant proportion of new resource firms never become profitable. (Governments apparently find it difficult to refund losses of firms that wind up, although this is the practice in Norway.)

The RRT was implemented in the mining industry by the Australian federal government despite considerable opposition from the mining industries. It applies alongside state-level mining taxes. It could equally well be used in other non-renewable resource industries, such as oil and gas.

HAS THE WELFARIST APPROACH BEEN TAKEN TOO FAR?

The Mirrlees review was dominated by welfarist or utilitarian thinking, which is not surprising, given Mirrlees's seminal role in developing optimal income taxation. The analytical underpinnings of the Mirrlees review rely on some key results from optimal tax theory. These include the Atkinson-Stiglitz theorem supporting a uniform VAT, with its important generalization by Kaplow and Laroque; the production efficiency theorem of Diamond and Mirrlees,[23] which further favours the VAT form; the role of job market participation subsidies, such as the WITB, emphasized by

21 *Australia's Future Tax System*, supra note 10.

22 Ross Garnaut and Anthony Clunies-Ross, "Uncertainty, Risk Aversion and the Taxing of Natural Resource Projects" (1975) 85:338 *Economic Journal* 272-87.

23 Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production I: Production Efficiency" (1971) 61:1 American *Economic Review* 8-27.

Diamond and Saez;[24] the integration of taxes and benefits into a single progressive tax-transfer system with positive marginal income tax rates throughout the income distribution; and the design of efficient rent-based business taxation. There were also important insights into optimal progressivity, based on utilitarian logic that is constrained by incentive effects, and into the desirability of taxing capital income. Although these ideas formed part of the background studies of the Mirrlees review, they were not drawn on in the final report.

As mentioned, the Mirrlees review, along with the president's panel in the United States, culminated a fundamental shift from the ability-to-pay principles of the Carter report to the exercise of the ability to pay through consumption choices in the Meade report, to the utility-based social welfare approach. In other words, it represented a shift from the opportunities provided to taxpayers by command over resources to a consequentialist approach in which individual choices are relevant. The ability-to-pay approach puts little emphasis on how taxpayers choose to use the resources at their disposal: two persons with similar opportunities are treated the same way. The welfarist approach puts all the emphasis on ex post consequentialism—that is, outcomes actually achieved, rather than ex ante opportunities. Kaplow has provided a vigorous defence of welfarism as the sole criterion for public economics choices, and has offered the same advice for legal decision making in Kaplow and Shavell.[25] Adler is also worth considering in this regard.[26] The question is this: has welfarism been taken too far?

The basic argument for welfarism is that it is based on individuals' own evaluations of their well-being as reflected in their revealed preferences or inferred by other indirect means. To override this individualism seems to be improper per se and, as Kaplow argues, it can lead to Pareto-inferior policies. However, respecting individual preferences is not sufficient for public policy. Interpersonal comparisons of welfare are required as well. Formally, these comparison are made by representing individual preferences in a utility function and aggregating utilities into a social welfare function. The optimal tax literature makes this seem elementary by assuming that individual utility functions are the same, and therefore comparable across individuals. All that is required, then, is a presumption about the rate at which marginal utility of income diminishes, or about "the aversion to inequality," as it is called technically. The conceptual meaning of this process of measuring and aggregating utility is not clear, apart from its analytical convenience. Kaplow apparently takes

24 Peter A. Diamond, "Income Taxation with Fixed Hours of Work" (1980) 13:1 *Journal of Public Economics* 101-10; Emmanuel Saez, "Optimal Income Transfer Programs: Intensive Versus Extensive Labor Supply Responses" (2002) 117:3 *Quarterly Journal of Economics* 1039-73.

25 Louis Kaplow, *The Theory of Taxation and Public Economics* (Princeton, NJ: Princeton University Press, 2008); Louis Kaplow and Stephen Shavell, *Fairness Versus Welfare* (Cambridge, MA: Harvard University Press, 2002).

26 Matthew D. Adler, *Well-Being and Fair Distribution: Beyond Cost-Benefit Analysis* (New York: Oxford University Press, 2012).

the view common to classical utilitarians that utility can in principle be measured scientifically.[27] Others recognize that an important value judgment is required, although who makes it is not clear. As Arrow showed long ago,[28] arriving at a social consensus about social orderings is a very difficult task.

Public economists are increasingly recognizing that there are significant difficulties with the welfarist approach, and that there are alternatives worth considering that typically go back to command-over-resources ideas. Concerns with welfarism are discussed in the following sections.

Preference Heterogeneity

If individual preferences differ, interpersonal welfare comparisons are difficult. Two persons with the same opportunities may make different choices. Some of these choices, such as the choice of clothing colour, are inconsequential. Others are more fundamental, especially if all we can observe are final outcomes; these choices include labour-leisure, occupation, saving, and risk taking.

One way to address this issue is the equality-of-opportunity approach of Roemer, and Fleurbaey and Maniquet.[29] These authors suppose that individuals differ in two types of characteristics: those they have no control over, such as native ability, and those they do have control over, such as preferences. The authors propose the principle of compensation, whereby individuals ought to be compensated for characteristics that they do not control, and the principle of responsibility, whereby individuals should not be rewarded or penalized for characteristics that they do control. This seemingly attractive approach encounters difficulties, however. It is not clear how to identify characteristics that individuals control. While preferences are the standard example, Roemer himself recognizes that preferences can be conditioned by socioeconomic circumstances. More fundamentally, it turns out that the principles of compensation and responsibility conflict: they cannot both be satisfied at the same time.

Nonetheless, there is something appealing about neither rewarding nor penalizing persons' choices as a way of addressing preference heterogeneity. This is essentially what the ability-to-pay approach did.

Equality of Opportunity

The notion of equality of opportunity is often used in a distinct sense in policy discourse. It refers to the ideal of giving everyone an equal starting point in life so that success is determined by merit rather than by luck. Equality of opportunity in this sense is referred to in section 36(1) of the Canadian constitution, which commits

27 Kaplow, supra note 25, at 376-77.

28 Kenneth J. Arrow, *Social Choice and Individual Values* (New York: Wiley, 1951).

29 Roemer, and Fleurbaey and Maniquet, supra note 7.

the government of Canada and the provincial governments to "promoting equal opportunities for the well-being of Canadians." The precise meaning of these words is unclear. They could mean simply that persons should be able to make the best of their abilities through access to education, training, and labour market opportunities, unfettered by socio-economic and other constraints. They might also be more pro-active and call for society to invest resources in equalizing abilities through education and training. Whatever perspective is adopted, the idea of equality of opportunity informs the tax policy that applies to education.

Behavioural Issues

Welfarism relies on revealed preferences for gauging individual well-being, but, as the recent literature on behavioural economics makes clear, this approach may be unreliable. Individuals make decisions that even they know are not in their long-term interest and live to regret it. The sources of these inappropriate decisions have been widely studied,[30] and they are particularly important in some areas of relevance to tax policy. One is the tendency to save too little for one's retirement. Another concerns consumption choices, including diet and addictive substances, combined with lifestyle choices that lead to health problems. Finally, present-biased preferences can lead to scant effort in the field of education and work, which has long-term consequences. Government intervention in the face of these behavioural problems is controversial. The apparent paternalism can be softened by adopting nudge policies that induce consumers to make appropriate decisions.[31]

Which Preferences Count?

Strictly speaking, utilitarian-based social welfare should count all sources of individual utility, but this is clearly problematic. The well-being of one person may be affected by the income or consumption of another. This might cause an excess labour supply as everyone tries in vain to be above average. Should the government respond with policies to dampen labour supply, as a pure welfarist would presumably argue? Along the same lines, one may simply dislike the colour of one's neighbour's house. Should interdependent utility of this type be counted in social welfare (despite the obvious difficulties in measuring such avarice)?

A particularly relevant example concerns voluntary transfers, such as bequests or donations to charity. From a strict welfarist point of view, voluntary transfers give rise to two benefits: one to the recipient and, by revealed preference, one to the donor. This leads some observers to argue that bequests should be subsidized, as

30 See, for example, the summary in William J. Congdon, Jeffrey R. Kling, and Sendhil Mullainathan, *Policy and Choice: Public Finance Through the Lens of Behavioral Economics* (Washington, DC: Brookings Institution, 2011).

31 Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (New Haven, CT: Yale University Press, 2008).

well as taxed in the hands of recipients.[32] Others, including Mirrlees, argue that this double counting of benefits is unreasonable.[33] Other purely altruistic benefits are not counted, so why should the altruistic benefits of bequests be counted just because a transfer has occurred? Moreover, if altruistic benefits from bequests are included, what about other intrafamily transfers, such as child care, which could give rise to multiple altruistic benefits in large families? Some argue, perhaps fancifully, that if bequests give double benefits, so does saving because it constitutes a voluntary transfer from one's "current self" to one's "future self." Finally, if government transfers to the poor satisfy the altruism of well off taxpayers, one should count the benefits both to the transfer recipients and to the well off taxpayers. Since that is unlikely to be agreed on, voluntary transfers should not be double counted either. This has potentially important policy implications: because bequests make the donor worse off, a tax credit should be given. Interestingly, the authors of the Mirrlees review struggled with this idea, and in the end eschewed welfarism in the case of bequests, opting instead for equality of opportunity as the guiding criterion for inheritance taxation.

Consequentialism

As mentioned earlier, some of the consequentialist implications of the welfarist approach have been criticized by Feldstein in his commentary on the Mirrlees review.[34] Under strict welfarism, individuals' initial situations are irrelevant in judging social outcomes, implying that society can effectively exercise property rights over all productive skills, subject of course to incentive constraints. Rawls[35] famously justifies this position on ethical grounds, arguing that if everyone imagined being in an "original position" before skills have been assigned, they would agree to a consequentialist social contract. Feldstein, following Nozick,[36] takes issue with this and argues that individuals should have a prior ownership right in their own human capital. The implications of assigning property rights to one's own skills for tax-transfer policy are not clear, except that redistribution would presumably be heavily muted. How much depends on formulating the circumstances in which individual

32 Louis Kaplow, "A Framework for Assessing Estate and Gift Taxation," in William G. Gale, James R. Hines, and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Washington, DC: Brookings Institution, 2001), 164-204; Ivan Werning and Emmanuel Farhi, "Progressive Estate Taxation" (2010) 125:2 *Quarterly Journal of Economics* 635-73.

33 Peter J. Hammond, "Altruism," in John Eatwell, Murray Milgate, and Peter Newman, eds., *The New Palgrave: A Dictionary of Economics*, 1st ed. (London: Palgrave Macmillan, 1987), 85-87; Peter Diamond, "Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences" (2006) 90:4 *Journal of Public Economics* 897-919; and James A. Mirrlees, "Taxation of Gifts and Bequests," unpublished slides for a talk at the Centenary of James Meade Conference, 2007.

34 Feldstein, supra note 8.

35 Rawls, supra note 6.

36 Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974).

property rights should be violated. In a democracy, these things are presumably resolved by coming to a social consensus, which varies from nation to nation.

FROM THEORY TO PRACTICE: REFORMING THE CANADIAN TAX-TRANSFER SYSTEM

As the above discussion shows, welfarism provides a powerful basis for tax design but has some shortcomings. It has difficulty dealing with preference heterogeneity and, if taken literally, leads to unpalatable policy prescriptions. Given the important value judgments involved, this is not surprising. It is wise to adopt an eclectic approach, complementing welfarism with other principles when appropriate, such as equality of opportunity or neutrality with respect to preference differences.

Before turning to concrete policy recommendations, it is worth summarizing where piecemeal reform has taken us in the past several decades and also reviewing some key initiatives from abroad.

Important Tax Policy Innovations in Canada

In this section, I focus on significant structural policy changes, rather than the small targeted tax reforms of the past few years. Several key reforms have moved the tax system closer to a consumption-based one, to one that is more progressive at the bottom and less progressive at the top, to a more decentralized and more harmonized system, and to one with lower corporate tax rates applied to roughly the same tax base. The following list summarizes these changes.

- *Refundable tax credits and the flattening of the rate structure.* The replacement of personal deductions with credits and the introduction of refundability, initially with the GST credits and child tax credits and subsequently with the WITB and educational tax credits, essentially turned the system into a limited negative income tax system. Such a system allows the federal government to contribute to redistribution at the bottom end of the income distribution, especially since refundable tax credits themselves are income-tested. Unfortunately, provincial transfers to the poor have fallen in real terms since the early 1990s. At the same time, the income tax rate structure has flattened out considerably at both the federal and the provincial levels, leading to less redistribution at the top. This phenomenon has occurred over the same period as pre-tax income inequality has been rising.
- *Vehicles for sheltering saving.* A number of tax-sheltering vehicles have been introduced over the years, including registered retirement savings plans (RRSPs), registered pension plans (RPPs), the Canada Pension Plan, the Quebec Pension Plan, and most recently tax-free savings accounts (TFSAs). Along with the tax-free status of imputed rent on owner-occupied housing and the implicit sheltering of the returns to human capital, most asset income can now be tax-sheltered. The Department of Finance has estimated that with the introduction of TFSAs, up to 90 percent of taxpayers will be able to shelter all

of their capital income by 2030.[37] This estimate was corroborated by Milligan, who finds that when the TFSA system matures, only 2 percent of families will have taxable assets if TFSA opportunities are fully exploited.[38] This brings the personal tax system remarkably close to a progressive consumption tax system, except in the case of the highest income taxpayers and those taxpayers (such as the elderly) who have not exploited their TFSA and RRSP opportunities. This has implications for both the progressivity of the income tax and the design of the corporate tax, as suggested below.

- *Corporate tax initiatives.* Corporate tax rates have fallen dramatically in Canada, as in many other OECD countries. There has been some broadening of the corporate tax base, following the recommendations of the Mintz report, but the basic structure remains a tax on shareholder income. Integration provisions through the dividend tax credit and preferential capital gains taxation remain in place, reflecting the view of the corporate tax as a withholding tax. Integration is imperfect, however: shareholder income in sheltered assets obtains no relief, while tax relief is given whether or not corporate tax has actually been paid.
- *Tax decentralization and harmonization.* Canada's income tax system has gradually become as decentralized as any system in any federation in the world. The bases of both the personal and corporate taxes remain highly harmonized, but provinces have been given leeway to choose their own rate structures and credits within limits. Gradually, many provincial rate structures have become less progressive, no doubt as a result of the pressures of tax competition, with Alberta adopting a linear progressive tax (flat tax) system.[39] Considerable progress has been made in harmonizing sales taxes through the HST, with participating provinces having discretion over their own rates. This further consolidates the move to consumption-based taxation. An extremely important innovation that has facilitated harmonization and tax administration more generally has been the institution of the Canada Revenue Agency (CRA). Arguably, the HST would not have been administratively feasible without a single tax-administering authority.

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37 Canada, Department of Finance, "Tax-Free Savings Accounts: A Profile of Account Holders," in *Tax Expenditures and Evaluations 2012* (Ottawa: Department of Finance, 2013), 31-45.

38 Kevin Milligan, "Policy Forum: The Tax-Free Savings Account—Introduction and Simulations of Potential Revenue Costs" (2012) 60:2 *Canadian Tax Journal* 355-60.

39 Milligan and Smart have recently studied the taxation of high incomes in the Canadian provinces. They find that the responsiveness of top income earners to increases in provincial top tax rates is quite high. Despite this fact, five provinces have recently raised their top tax rates. See Kevin Milligan and Michael Smart, "Provincial Taxation of High Incomes: What Are the Impacts on Equity and Tax Revenue?" paper presented at the IRPP-CLSRN conference "Inequality in Canada: Driving Forces, Outcomes and Policy," held in Ottawa, February 24-25, 2014 (http://faculty.arts.ubc.ca/kmilligan/research/taxation-federation.htm).

- *Human capital incentives for post-secondary education.* A variety of tax measures have been introduced to shelter savings for post-secondary education (registered education savings plans and Canada learning bonds), to provide credit for education costs (education and textbook tax credits), and to assist persons from low-income families in financing post-secondary education through loans and grants (Canada education savings grants, Canada student grants) and loans (Canada student loans). Some of these programs have their provincial equivalents.
- *Elimination of inheritance taxation.* One of the casualties of the post-war realignment of tax responsibilities between the federal government and the provinces was the inheritance tax. Not long after it was devolved to the provinces, it was eliminated—a classic example of tax competition in action. There is nothing in principle to prevent the federal government from reinstating inheritance taxation.

Other reforms have been significant, but they are beyond the scope of this discussion. These reforms might include the institution of market value property taxation and the limited introduction of provincial carbon taxes. There have also been some instances of provincial non-renewable resource taxes adopting a rent tax form. Overall, the Canadian tax system approximates progressive consumption taxation, but with vestiges of comprehensive income and equality-of-opportunity elements, and with progressivity compromised.

Some Relevant Tax Policy Innovations Abroad

Recent tax reform initiatives in several countries have included some interesting approaches that Canada could learn from. Many of these initiatives draw on the current taxation literature and on tax commission reports. Perhaps the most wide-ranging is the Nordic dual income tax that was originally applied in Denmark, Finland, Norway, and Sweden; variants are used in Germany, Switzerland, and the United Kingdom. Simply put, labour earnings and transfers are taxed according to a progressive rate structure, while capital income bears a uniform rate, typically that of the lowest earnings tax bracket. The uniform rate facilitates withholding by financial institutions and integration with the corporate tax, whose rate is the same as the capital income tax rate. By separating earnings and capital income taxation, the dual income tax both enables the taxation of capital income in an administratively feasible way and gives full freedom to tailor the progressivity of the earnings tax without being constrained by the more elastic capital income tax base. Notably, the dual income tax is often accompanied by inheritance or wealth tax systems to address the issue of wealth inequality.

A number of countries have chosen to move to a rent-based corporate tax system instead of using shareholder income as the base. Most of these countries have adopted an ACE form of tax since it represents the simplest transition from the traditional system. Countries that have used the ACE system include Belgium, Brazil, Croatia, and Italy, and others are contemplating its use. There is growing recognition that considerable rents accrue to the corporate sector, something that has been documented in studies of the revenue cost of shifting to an ACE system.[40]

Some countries have adopted rent tax regimes for non-renewable natural resources. These include the Australian mining tax, which takes the RRT form, and Norwegian offshore petroleum taxation, a form of cash flow tax. Other cash flow equivalent taxation applies selectively: in the oil sands in Alberta and mining operations in British Columbia, for example. In addition, the auctioning of natural resource rights, as in the Alberta oil and gas industry, provides a complementary way for governments to obtain a share of resource rents. Three things distinguish the Norwegian case from most others, all of which require political self-discipline. First, full refundability is offered to resource firms that incur losses, including those that are never profitable and eventually go out of business. Second, the rate of rent tax is well over 90 percent, no doubt partly resulting from the fact that a Norwegian public firm dominates the offshore industry. Third, the resource revenues are put into a sovereign wealth fund, the proceeds are invested in foreign assets, and only the capital income is spent. This goes a long way toward mitigating the Dutch disease in Norway.

Other more specific measures also have promise. Various countries harmonize their systems of taxation and stand-alone transfers, including the United Kingdom. Others, including federations such as Spain, Germany, and Australia, harmonize elements of their transfer systems, such as unemployment insurance and welfare. Many countries maintain inheritance tax systems, although their role as revenue raisers has diminished. Their existence, however, provides a base on which to build. Carbon-pricing schemes are deployed in various places, either cap-and-trade systems, as in the European Union, or carbon tax systems, as in British Columbia and until recently in Australia. Efforts, especially by the OECD, continue to address international tax avoidance through international agreements and protocols, and there are ongoing attempts to restrain corruption through natural resource reporting protocols.

TAX REFORM PROSPECTS FOR CANADA

There is currently little enthusiasm for comprehensive tax reform in Canada or for the establishment of a tax reform commission. This is regrettable because Canada's tax system is founded on outdated principles. Nonetheless, piecemeal reforms based on widely accepted principles are possible, and these would improve efficiency, equity, and administrative ease without sacrificing revenues. These reforms would build on the successful piecemeal reforms of the past and on innovative thinking about the objectives of the tax system. They would also reinstate some fairness in the tax-transfer system, which has been left to languish in recent years. The following discussion draws on previous work concerning various aspects of tax-transfer

40 Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note SDN/11/11 (Washington, DC: IMF, May 3, 2011).

reform in Canada.[41] These views are purposely presented without taking into account supposed political constraints.

Some key objectives inform these proposals. The fairness of the tax-transfer system would be prioritized by focusing on those at the lower end of the income distribution and worrying less about middle- and upper-income persons. The social insurance function could also be improved, and egregious increases in wealth inequality could be addressed. These fairness concerns reflect a desire to mitigate the consequences of luck, both good and bad, as determinants of economic outcomes. This approach would be complemented by using more efficient tax instruments, especially for the business tax system, which can be designed as an efficient system whose main purpose is to capture a share of the rents generated by the private sector. The personal tax-transfer system could also be reformed to minimize the amount of revenue needed to achieve the desired degree of fairness. Finally, federal-provincial tax-transfer harmonization should be reinforced to protect the overall equity of the fiscal system.

These principles can be translated into the following proposed tax reform priorities.

Tax Reform Priorities I: Individual Income Tax

The personal income tax is a hybrid system that taxes income in name only. A significant proportion of asset income is sheltered through RPPs, RRSPs, TFSAs, and the exclusion of imputed income on housing and other consumer durables. The asset income that is taxed also benefits from the dividend tax credit and the partial capital gains exemption, as well as special treatment applying to personal businesses. Otherwise, the common individual rate structure applies, and progressivity is also influenced by various credits and deductions, some of which are refundable.

Some measures that would improve the fairness of the tax system, especially for those at the bottom end of it, include the following:

- *Refundability of tax credits.* Make all tax credits refundable and let them vanish with income. Income-tested refundable tax credits would enhance targeting in a revenue-neutral manner. This would convert the income tax system into

41 Robin Boadway, "Rethinking Tax-Transfer Policy for 21st Century Canada," in Fred Gorbet and Andrew Sharpe eds., *New Directions for Intelligent Government in Canada: Papers in Honour of Ian Stewart* (Ottawa: Centre for the Study of Living Standards, 2011), 163-203; Robin Boadway and Jean-Denis Garon, "The Design of Employment Insurance in a Federation," in Keith G. Banting and Jon Medow, eds., *Making EI Work: Research from the Mowat Centre Employment Insurance Task Force* (Kingston, ON and Montreal: Queen's University, School of Policy Studies, and McGill-Queen's University Press, 2012), 119-55; Robin Boadway and Katherine Cuff, "The Recent Evolution of Tax-Transfer Policies," in Keith G. Banting and John Myles, eds., *Inequality and the Fading of Redistributive Politics* (Vancouver: UBC Press, 2013), 335-58; and Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada* (Toronto: Mowat Centre, April 2014).

a proper negative income tax, and go some way toward establishing a basic income for all Canadians. As it stands, persons who are not taxpayers rely largely on provincial social assistance, which puts them well below the poverty line.

- *Tax treatment of capital income.* The breadth of asset income sheltering has reached the point at which most taxpayers (up to 90 percent by 2030, according to the Department of Finance, or even more, according to Milligan)[42] can shelter all of their savings, if they choose to do so, leaving the capital income tax as largely a tax on upper-income taxpayers. This approach is reasonable, but further reforms could enhance the fairness of the overall system. First, drawing on experience in the United Kingdom and several European countries, the treatment of taxable capital income could be based on a rate schedule that is separate from that of earnings. Canada could adopt the so-called Nordic system, wherein a uniform tax rate applies to unsheltered capital income. This would reduce the incentive for tax planning. More important, removing capital income from the standard income base would allow the government to choose the progressivity of the earnings tax structure, unfettered by concerns arising from the responsiveness of reported capital income at high income levels. (Of course, taxpayers would have to be discouraged from converting earnings into capital income artificially). Second, the dividend tax credit and the preferential treatment of capital gains could be eliminated, as proposed in Boadway and Tremblay.[43] These measures are in place mainly as integration devices, as was observed in the Mintz report. However, as such they are faulty. Evidence suggests that the corporate tax is largely shifted to labour, so giving credit to shareholders for it is largely a windfall. In addition, there is no relationship between the dividend tax credit and the payment of corporate taxes. Moreover, the dividend tax credit does not apply to sheltered share income. This change will complement the proposal below to change the corporate tax to a rent-based tax, and it will both partly recoup the revenue loss from that reform and enhance the fairness of the tax system.
- *Equality of opportunity agenda I.* The personal tax system largely addresses fairness based on ex post outcomes, as in the welfarist tradition. But it also includes elements that contribute to fairness in ex ante prospects, particularly the tax treatment of post-secondary education costs. (Of course, most of the equality-of-opportunity agenda is on the expenditure side of public policy, especially the provision of universal education and health care and some social services.) This includes registered education savings plans and education tax credits, as well as non-tax programs, such as income-tested student grants and loans. These

42 Department of Finance, supra note 37; and Milligan, supra note 38. An issue remains concerning how to deal with persons who neglect to shelter their savings to the extent permissible. To the extent that these persons earn relatively low income, some unfairness remains.

43 Boadway and Tremblay, supra note 41.

programs are useful as far as they go, but their benefits are spread thinly and go disproportionately to students from wealthier families. Accessibility problems resulting from financial constraints are much more a concern of low-income families, which have less wealth to begin with and more difficulty borrowing to finance post-secondary education. Moreover, existing programs are not well designed to address the social insurance dimension of post-secondary education, given the uninsurable riskiness of success in education, as well as in subsequent employment. These fairness and insurance issues can be mitigated by better targeting grant and tax credit programs, and by converting programs like the Canada student loan program and its provincial counterparts into an income-contingent loan system delivered alongside the income tax.

- *Equality of opportunity agenda II.* A more ambitious reform of personal taxation involves the treatment of bequests. In Canada, bequests trigger a realization of capital gains on an estate, but there is no tax on bequests or inheritances per se (the conceptual issues faced by welfarism in dealing with bequests have been discussed earlier). A reasonable alternative, adopted by the Mirrlees review, invokes equality of opportunity. Donors would neither be penalized nor rewarded for making bequests, but inheritances would be treated as windfall gains to inheritors. The Mirrlees review, following the earlier Meade report, advocated a progressive cumulative lifetime inheritance tax, separate from the income tax and focusing on large estates. Such a tax would be an important complement to the favourable treatment of capital income in a dual income tax system, and it would also mitigate concerns recently expressed by Piketty that wealth inequality tends to grow in normal times.[44] This would be a major reform for Canada, but one that deserves to be on the agenda.
- *Smaller personal tax reforms.* There are endless possibilities for personal tax reform, but a few that fit with normative principles could be mentioned. One reform would be to reinstate general income averaging so that taxpayers with fluctuating incomes are treated fairly. This is particularly important for persons who move in and out of employment: for taxpayers whose employment income fluctuates, the need for averaging is perhaps less pressing since there are now only four income tax brackets with tax rates that differ relatively little. The details of precisely how to apply general averaging would have to be worked out, but technically it is feasible and in principle desirable.

  Second, as the Mirrlees review emphasized, personal taxation should not discourage participation in the workforce by those groups whose participation is highly responsive to participation tax rates. The Mirrlees review singled out second earners in families with small children and taxpayers near normal retirement age. More generally, the participation of secondary earners in any family is more elastic than that of primary earners, which suggests that family

44 Thomas Piketty, *Capital in the Twenty-First Century* (Cambridge, MA: Belknap Press of Harvard University Press, 2014).

income splitting would unduly discourage participation, apart from the fairness concerns that it would entail.[45] In the case of retirement age taxpayers, participation concerns involve coordinating the tax and transfer systems. The same can be said for encouraging the participation of the unemployed, to which I briefly return below.

Finally, the progressivity of the personal tax rate structure deserves a second look. As income tax devolves more and more to the provinces and they have more discretion over the progressivity of their share, not surprisingly there are competitive pressures for provinces to flatten their rate structures. The federal government then assumes greater responsibility for preserving tax equity. Despite concerns about the elasticity of taxable income at the top of the income distribution[46] and the limited potential for revenue raising at the very top, there is scope for increasing the progressivity of the rate structure. This is especially true under a dual income tax system, in which progressivity applies selectively to earnings.

Tax Reform Priorities II: Corporate Income Tax

The existing corporate tax is designed to be a tax on shareholder income, reflecting its prevailing rationale as a withholding device for the personal income tax. This tax is complemented by the dividend tax credit and preferential treatment of capital gains as mechanisms for crediting Canadian shareholders for corporate taxes withheld on their behalf. This approach to corporate taxation has outlived its relevance. In today's global economy, with interdependent capital markets, evidence suggests that corporate taxes levied at source are largely shifted to labour rather than being borne by shareholders. Providing relief is unnecessary. Moreover, since a high proportion of shareholder income is now sheltered from personal tax, the rationale for withholding disappears. There is one exception: the corporate tax applied to foreign corporations operating in Canada can still be a mechanism for transferring tax revenues from foreign to Canadian treasuries, assuming that foreign governments allow tax crediting, although the number that do so is dwindling. One other disadvantage of the current tax is that as long as full integration does not apply, the interest deductibility provision of corporate taxation encourages excessive leverage and favours firms that are able to finance with debt.

These concerns have stimulated arguments for abandoning the withholding rationale and substituting the collection of rents or above-normal profits. This is not as dramatic a change in the corporate tax as it may seem to be, since shareholder income already includes rents as well as normal shareholder profits (adjusted for risk). A rent-based corporate tax is highly compatible with a personal tax system that

45 See the analysis in Henrik Jacobsen Kleven, Claus Thustrup Kreiner, and Emmanuel Saez, "The Optimal Income Taxation of Couples" (2009) 77:2 *Econometrica* 537-60.

46 For example, see Canada, Department of Finance, "The Response of Individuals to Changes in Marginal Income Tax Rates," in *Tax Expenditures and Evaluations 2010* (Ottawa: Department of Finance, 2010), 45-65; and Milligan and Smart, supra note 39.

shelters most shareholder income. Moreover, there is no compelling need to integrate a rent-based corporate tax with personal income, which would be very difficult to do in any case.

The idea of the corporate tax as a tax on rents has been in the literature at least since Brown.[47] Brown was the first to recognize that a cash flow tax was virtually equivalent to a tax on rents, which would otherwise be virtually directly immeasurable. (Rents are the difference between revenues and all imputed current and capital user costs measured on an accrual basis and indexed for inflation. Cash flow is simply receipts less expenditures for both capital and current inputs measured on a cash basis. The present value of cash flows equals the present value of rents.) As mentioned above, the authors of the Meade report advocated changing the corporate tax to a cash flow tax to accompany the reform of the personal income tax into a personal direct consumption tax by effectively sheltering all saving.

A cash flow tax is neutral with respect to a corporation's choices only if refundability of all losses is allowed.[48] With rare exceptions, governments seem unwilling to allow refundability, but the equivalent effect can be achieved if losses can be carried forward at the risk-free interest rate, and if all losses are eventually recouped, even if a firm winds up. (The risk-free interest rate is appropriate as long as there is no risk that the government will renege on the promise to make good on the tax losses.) There are various systems that are equivalent to a cash flow tax. In one variant proposed by Boadway and Bruce,[49] firms in a loss position postpone their deductions for costs and carry them forward with risk-free interest. The ACE system puts this into operation in a simple way. Another variant, epitomized by the RRT used in Australia, allows negative cash flows to be carried forward with risk-free interest.

The ACE system could readily be adopted in Canada with minimal reform of the existing system. The main change would involve allowing corporations to deduct the normal cost associated with their equity financing as well as interest on debt.[50] When taxable income is negative, these deductions would be carried forward at the risk-free interest rate. This system has the advantage of removing the various distortions of the existing corporate tax system, including the disincentive to invest; excessive leverage; and discrimination against small, growing, and risky firms. The same ACE treatment would apply not only to corporations but also to unincorporated businesses. It would apply to both domestic and foreign corporations, and to all sectors. The hope is that foreign tax-crediting arrangements would still apply (mainly in the United States), given that the reform makes tax crediting less onerous for foreign governments.

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47 E. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essay in Honor of Alvin H. Hansen* (New York: Norton, 1948).

48 Strictly speaking, a cash flow tax is neutral with respect to investment only if firms are risk-neutral. Cash flow taxation allows the government to share firms' risks, and this can actually increase risk taking.

49 Boadway and Bruce, supra note 17.

50 For more details, see Boadway and Tremblay, supra note 41.

The move to a rent-based corporate tax presumes that there are sufficient rents in the system to warrant the tax. There can be little doubt about that. In some concentrated industries, such as the financial sector, rents are likely. Sectors with fixed factors, such as all resource industries, can have significant rents. But, more generally, rents are a fact of modern economies. Even in competitive industries, there are liable to be inframarginal investments yielding rents because of locational, informational, or other advantages. Rents also accrue to protected intellectual property, and presumably one would not want to tax them fully for fear of undoing the incentive to invest. It is arguable that preferential treatment should be given to intellectual property rents, at least those that are exploited domestically.[51]

Some issues remain in the event of such a reform. A rent-based corporate tax would do little to address the issue of profit shifting, which induces corporate tax competition. This would require a more coordinated international approach. However, a rent tax would be less susceptible to ordinary corporate tax competition because a normal rate of return to investment would not be taxed. A rent tax would, however, lead to a loss of revenue in the absence of increases in the tax rate. Boadway and Tremblay argue that this revenue loss could be offset by two accompanying reforms.[52] First, the dividend tax credit and preferential treatment of capital gains could be eliminated. Second, the deductibility of provincial resource taxes could be eliminated. This serves mainly to reduce federal resource tax revenue, while at the same time introducing a source of inefficiency into the taxation of resource industries.

Tax Reform Priorities III: The Tax-Transfer Nexus

Some transfers to low-income persons are delivered through the income tax, mainly through refundable tax credits. However, the majority are delivered through stand-alone programs. Several things distinguish these transfer programs from the refundable tax credits.

First, unlike the income tax system, which operates by means of taxpayer self-reporting, most stand-alone transfers are administered by means of ex ante application and screening for eligibility criteria, such as disability, financial need, or involuntary job loss.

Second, some transfer programs for individuals who are not employed are conditional on the recipients actively searching for work and accepting suitable job offers. Program administration is thus an important element of these transfers. The integrity and generosity of disability assistance and employment insurance (EI) depend on sound administration and compliance.

51 The case for offering preferential corporate tax rates on income generated by intellectual property is made in Nick Pantaleo, Finn Poschmann, and Scott Wilkie, *Improving the Tax Treatment of Intellectual Property Income in Canada*, C.D. Howe Institute Commentary no. 379 (Toronto: C.D. Howe Institute, April 2013).

52 Boadway and Tremblay, supra note 41.

Third, there are many different types of transfer programs, each catering to a particular type of disadvantage. Some are social-insurance-type programs that protect workers from unexpected shocks, such as job loss or injury. Others are programs for individuals whose need is more permanent. The heterogeneity of need associated with stand-alone transfer programs makes it difficult to apply standard welfaristic arguments.

Finally, some programs (such as EI and transfers to the elderly) are legislated and administered by the federal government, while others (such as social assistance, disability assistance, and workers' compensation) are provincial. Although the effective delivery of these programs may require decentralization, interprovincial fiscal competition can compromise fairness for the poorest persons in the economy, and can complicate the harmonization of programs delivered by the two levels of government. Indeed, casual observation indicates that citizens whose transfers are primarily federal (the elderly, children, and the temporarily unemployed) have been much more successful in avoiding poverty than those who rely on provincial governments (welfare and disability assistance recipients).

The multiplicity of transfer systems results in considerable movement of persons from one category to another—for example, from working to unemployed, from EI recipient to welfare recipient, and so on. This movement can be very disruptive because of the time and information involved in applying for each program and the change in transfers that this can entail. Moving between federal and provincial programs can be particularly problematic because these programs are managed by separate agencies. There is no agency such as the CRA that oversees transfers.

This state of affairs and the experience of other federations, such as Australia, Germany, and Spain, suggest several directions for reform, none of which will be easy as a result of the divided jurisdictions. Here the focus is mainly on EI and welfare. Disability assistance is also in dire need, but fixing it is no mystery. Payments are woefully inadequate owing to both need and deservedness, but the political will does not exist at the provincial level. The federal government could make a much more meaningful contribution to the income of the disabled by using a refundable tax credit whose eligibility is coordinated with provincial disability assistance schemes. EI and welfare require more fundamental rethinking.

EI is not an insurance program in the usual sense. Contributions are mandatory and bear no relation to expected benefits, and EI benefits are only vaguely related to contributions. The program is better seen as a social insurance program that fills a vacuum created by the absence of private unemployment insurance, and it is particularly valuable to the workers who are least able to self-insure. Its role in providing insurance to low-income vulnerable workers could be better recognized in its design. Another problem with EI is that its main focus is on workers who are temporarily unemployed. Such a focus favours industries that have a relatively high incidence of temporary layoffs, such as seasonal industries. It does not serve the needs of workers who face structural unemployment, including displaced workers who face both a long period of unemployment and a permanent loss of earnings. For these workers, the transition from EI to welfare can be both painful and cumbersome.

Several significant revisions to EI and welfare could help address some of these problems. First, EI financing could be changed from contributory to general revenue financing to improve fairness. Second, EI benefits could move to a two-tier system. The first tier would continue to be based on replacement income, reflecting the insurance aspects of the program, while a second tier would apply to workers who have exhausted their first-tier eligibility and would be needs-based. First-tier eligibility could be relaxed to reflect the difficulty that new workers now face in accumulating the minimum hours of work. The two-tier system would smooth the transition from temporary to long-term unemployment status. Provincial welfare assistance would then constitute the third tier, and would include both those who have exhausted their first two tiers of benefits and those who have never succeeded in becoming eligible. Ideally, there would be cooperative administration of second-tier EI and welfare to ease the transition. Both EI and social assistance would continue to be administered by ex ante screening and continued monitoring for compliance with job search activities.

In addition, some reforms to welfare could enhance job market participation and self-insurance incentives. Rules restricting earnings and asset holdings could be relaxed considerably to encourage part-time work and some self-insurance capability. Eligibility rules for WITB could be loosened so that more part-time low-income workers are eligible. Ideally, welfare rates could be considerably improved, and rigid monitoring could be enforced to mitigate incentive problems. It may be difficult for the provinces to improve their welfare rates independently, but, as mentioned, the federal government could contribute to the basic income of welfare recipients by expanding refundable tax credits.

CONCLUDING COMMENTS

Ideas about tax reform have evolved considerably since the days of the Carter report. Many countries have begun to experiment with major tax reforms, and others have initiated important studies on taxation. Canada's tax system is built on foundations that were outlined five decades ago in the Carter report, whose main building blocks consist of the comprehensive income tax ideal backed up by a corporate tax on shareholders' income that is designed to serve a withholding purpose. I have recounted the evolution of ideas about reform of the tax-transfer system and what they imply for policy design. I have then speculated about lessons for Canada and proposed some broad reforms for the tax-transfer system. These reforms are feasible and mirror some of the best practices elsewhere in the world.

My discussion of Canadian reforms has necessarily been selective. Space limitations prevent me from considering some important areas of the tax-transfer system that are candidates for reform. A major concern for Canada is the federal-provincial dimension, and particularly the manner in which the decentralization of the Canadian revenue system, while motivated by the intention to contribute to accountability, has led to some major concerns. Many of these concerns stem from the large horizontal imbalances created by provincial natural resource revenues and the inability to cope with these by means of equalization. In addition, the few provincial governments that obtain the bulk of the resource revenues seem intent on using them now to build their provincial economies, rather than saving them for future generations. This both exacerbates the Dutch disease in provinces that rely on manufacturing and other tradable production and intensifies interprovincial fiscal and redistribution competition. As discussed elsewhere, this is an issue of profound policy importance in Canada, and one that has implications for tax policy.[53]

Another issue of growing concern is the role of carbon taxation. National carbon taxation could yield a double dividend. It would encourage economizing on carbon use by reducing demand for carbon-using products and inducing abatement technologies. At the same time, it would provide substantial tax revenue for the federal government that could be used to reduce personal and corporate tax rates. Of course, a key problem with carbon taxation is that the major beneficiaries of reduced carbon use are future generations and persons in other countries. It takes considerable national will not to act as an international free rider.

Finally, the issue of family taxation remains vexing, and the welfarist approach can be of only limited value in resolving it. Family taxation raises difficult issues of how to compare the well-being and/or opportunities of persons according to their family circumstances and relatively standard incentive effects. It also involves social policy issues about the importance of the family and the implications of family policy for fertility. Simple solutions, such as income splitting, are unlikely to provide a satisfactory solution.

53 Robin Boadway, Serge Coulombe, and Jean-François Tremblay, "The Dutch Disease and the Canadian Economy: Challenges for Policy-Makers," in Keith G. Banting, Richard P. Chaykowski, and Stephen Lehrer, eds., *Thinking Outside the Box: Essays in Honour of Thomas J. Courchene* (Kingston, ON: Queen's University, School of Policy Studies, forthcoming); and Robin Boadway, Serge Coulombe, and Jean-François Tremblay, "Canadian Policy Prescriptions for Dutch Disease" (2013) 3 *IRPP Insight* 1-27.

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International Tax Planning

Co-Editors: Michael Maikawa and Ken Buttenham*

The Canadian Tax Foundation welcomes Ken Buttenham as the new co-editor of the journal's International Tax Planning feature. Mr. Buttenham is a partner with PricewaterhouseCoopers LLP, Toronto. He graduated with an accounting degree from the University of Waterloo and is a member of the Canadian Institute of Chartered Accountants. Mr. Buttenham practises mainly in the area of inbound international tax and provides advice to large multinational corporations. He regularly assists Canadian multinational groups with the acquisition, structuring, reorganization, and financing of their foreign affiliates. He also assists foreign multinational groups with the acquisition and structuring of their Canadian investments.

The Foundation gratefully acknowledges the contribution of Pierre Bourgeois of PricewaterhouseCoopers LLP, Montreal, who is retiring as the co-editor of the International Tax Planning feature. Mr. Bourgeois's dedication to ensuring the timeliness, technical accuracy, and readability of the feature's articles has contributed greatly to the continued popularity of the feature. On behalf of the journal's readers, the Foundation extends its warmest thanks to Mr. Bourgeois for his exemplary service as co-editor since 2010.

TREATY SHOPPING AND BASE EROSION AND PROFIT SHIFTING ACTION 6

*Gwendolyn Watson***

As part of action 6 of the base erosion and profit shifting (BEPS) initiatives, the Organisation for Economic Co-operation and Development (OECD) is considering alternatives to address "improper uses" of tax treaties, including treaty shopping. In September 2014, the OECD released a report in which it proposed to revise the model convention to include a limitation-on-benefits provision and a new general anti-abuse rule in response to treaty-shopping concerns. Before BEPS, Canada started its own treaty-shopping consultation, and, in the 2014 federal budget, Canada proposed to adopt a domestic anti-treaty-shopping rule. However, in August 2014, Canada announced that instead of proceeding with this domestic solution, it would wait for further work by the OECD as part of the BEPS initiatives. Consequently, it is expected that Canada will reconsider the domestic anti-treaty-shopping rule in light of the OECD final BEPS recommendations, which are expected

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in September 2015, and that these recommendations may play a greater role in the direction that Canada may ultimately take.

Because the various treaty-shopping initiatives are ongoing, this topic is divided into two articles. In this article, the author discusses the treaty-shopping proposals in the September 2014 OECD report and the 2014 federal budget, and provides some comments on the direction that Canada may ultimately take to counter treaty shopping. The final treaty-shopping recommendations made by the OECD and ensuing developments in the Canadian context will be discussed in a subsequent article.

KEYWORDS: INTERNATIONAL TAXATION ■ TAX TREATIES ■ TREATY SHOPPING ■ OECD ■ BASE EROSION AND PROFIT SHIFTING ■ LIMITATION ON BENEFITS

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Personal Tax Planning

Co-Editors: Pearl E. Schusheim* and Gena Katz**

MARRIAGE BREAKDOWN: A PRACTICAL REVIEW OF INCOME TAX CONSIDERATIONS

*Andrew Bateman****

A tax adviser often will, and in the author's view always should, actively participate in structuring a settlement in respect of the breakdown of a marriage or common-law relationship. The process of legally ending a marriage can give rise to a wide range of income tax considerations related to, among other things, (1) support payments, (2) property division, and (3) tax liability risks. The author provides a practical review of these topics and selected considerations that arise under the Income Tax Act.

KEYWORDS: DIVORCE ■ TAX LIABILITY ■ MATRIMONIAL PROPERTY ■ SPOUSE ■ SUPPORT ■ TRUSTS

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Planification fiscale personnelle

Co-rédactrices : Pearl E. Schusheim* et Gena Katz**

Échec du mariage : un aperçu pratique des considérations fiscales

*Andrew Bateman****

Il est fréquent qu'un conseiller fiscal participe activement — et, selon nous, il devrait toujours le faire — à la structuration d'un règlement à la suite de l'échec d'un mariage ou d'une union de fait. Mettre légalement fin à un mariage peut entraîner une vaste gamme de considérations fiscales concernant, entre autres : 1) la pension alimentaire; 2) le partage des biens; et 3) les risques de dette fiscale. L'auteur donne un aperçu pratique de ces sujets et de certaines considérations découlant de la Loi de l'impôt sur le revenu.

MOTS-CLÉS : DIVORCE ■ DETTE FISCALE ■ BIEN MATRIMONIAL ■ ÉPOUX ■ CONJOINT ■ PENSION ALIMENTAIRE ■ FIDUCIE

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Corporate Tax Planning

Co-Editors: Derek G. Alty,* Brian Carr,** Michael R. Smith,*** and Christopher J. Steeves****

THE CORPORATE CAPITAL STRUCTURE: THIN CAPITALIZATION AND THE "RECHARACTERIZATION" RULES IN PARAGRAPHS 247(2)(b) AND (d)

Derek G. Alty and Brian M. Studniberg******

Most Canadian corporations and their shareholders choose an appropriate capital structure on the basis of a number of factors, including tax. Shareholders of a taxable corporation often prefer external and internal intragroup debt. Assuming that the capital structure of a corporation includes internal debt rather than equity, the authors consider the circumstances under which Canada's transfer-pricing recharacterization rules might permit the recharacterization of interest when the corporation is otherwise compliant with Canada's thin capitalization rules.

The authors address the history of paragraphs 247(2)(b) and (d) of the Income Tax Act, the applicable interpretive approach, the views of the Canada Revenue Agency (CRA), and the potential interaction between the thin capitalization rules and the recharacterization rules. As a result of an appropriately purposive interpretation of the thin capitalization rules and the relieving nature of Canada's tax treaties, the types of situations that the CRA would find most concerning are more appropriately dealt with by means of the general anti-avoidance rule than by recharacterizing a taxpayer's debt as equity. The recharacterization rules require an analysis of whether the transaction or series giving rise to the taxpayer's debt can reasonably be considered not to have been entered into primarily for bona fide purposes, other than to obtain the interest deduction.

The analysis of the relevant factors in a non-arm's-length context is by no means straightforward. Some caution is called for before recharacterizing the taxpayer's debt as equity under Canada's transfer-pricing rules, and the CRA has exercised such caution

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in the past. There are a number of cases before the Tax Court that raise the application of paragraphs 247(2)(b) and (d), and it will be interesting to see how the court addresses these rules.

KEYWORDS: TRANSFER PRICING ■ RECHARACTERIZATION ■ THIN CAPITALIZATION ■ DEBT-EQUITY ■ STATUTORY INTERPRETATION ■ TAX TREATY

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Selected US Tax Developments

Co-Editors: Peter A. Glicklich* and Michael J. Miller**

UPDATE ON US CORPORATE INVERSIONS

*Candice Turner****

The author describes some of the history and recent developments affecting US corporate inversions, transactions in which US corporations are acquired by foreign corporations for shares. She explores in particular Notice 2014-52, which will stop "cash-box" inversions and slow others, and which will ring-fence the historical earnings of an inverted corporation's existing controlled foreign corporations (CFCs) and will double-tax the structures commonly used to decontrol a former CFC. Surprisingly, the notice did not grandfather pending transactions, but some of the new rules may stretch the government's regulatory authority too far.

KEYWORDS: INTERNATIONAL TAXATION ■ CORPORATE REORGANIZATIONS ■ CROSS-BORDER ■ TAX REGULATIONS ■ CONTROLLED FOREIGN CORPORATION

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Current Tax Reading

Co-Editors: Bev Dahlby, Tim Edgar, Jinyan Li, and Alan Macnaughton*

The Canadian Tax Foundation gratefully acknowledges the contribution of Bev Dahlby, who is retiring from his position as co-editor of Current Tax Reading. Professor Dahlby joined the feature as co-editor in 2011. Drawing on his wealth of research experience on the efficiency effects of taxation and fiscal federalism, as well as his work as a policy adviser, he wrote many valuable and insightful reviews of the current literature on the economics of taxation. On behalf of the Canadian Tax Journal*'s readers, the Foundation extends its warmest thanks for his work on the feature.*

Ian W.H. Perry, Dirk Heine, Eliza Lis, and Shanjun Li, *Getting Energy Prices Right: From Principle to Practice* (Washington, DC: International Monetary Fund, 2014), 183 pages, ISBN 978-1-48438-857-0

Increasing concerns about the environmental impacts of fossil fuels, as well as the fiscal pressures on governments in the aftermath of the global financial crisis, have pushed the taxation of fossil fuels up the policy agenda. Since the work of A.C. Pigou, economists have advocated for the imposition of excise taxes on goods that have harmful externalities, so that their prices reflect the true social costs of production and consumption. Although the authors of this volume caution that much work needs to be done to fill in the data gaps, they provide policy advice that ranges from the general principle of imposing corrective taxes to detailed computations of the appropriate tax rates for 156 countries. It is an ambitious undertaking, to say the least.

Following a brief introduction and summary, in chapter 2 the authors provide an overview of the fossil fuel consumption patterns across countries; the emissions of carbon dioxide (CO_2), sulphur dioxide (SO_2), nitrogen oxide (NO_2), and fine particles ($PM_{2.5}$) from burning fossil fuels; statistics on road congestion and traffic deaths; and excise tax rates on motor fuels in Organisation for Economic Co-operation (OECD) countries in 2010. It will not surprise most readers to learn that Canada and the United States have among the lowest excise taxes on gasoline (approximately $0.28 and $0.11 per litre, respectively) while Mexico provides a $0.13 per litre subsidy (all

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figures are in 2010 US dollars). The authors note that many developing countries subsidize fossil fuel consumption (to the extent of $490 million in 2011). These subsidies promote excessive consumption of fuel and aggravate environmental damage. They are also regressive because only 3 percent of the subsidy accrues to the bottom 20 percent of the income distribution in developing countries.

Chapter 3 makes the case for carbon pricing. Taxing fossil fuels makes carbon-free sources of power generation (such as wind, solar, and hydro) more competitive, creates incentives to reduce emissions intensity by shifting from coal to natural gas or nuclear power, creates incentives to adopt energy-saving technologies, and reduces transportation and home and industry heating demands. Although other policies, such as subsidies for renewables and the regulation of efficiency standards for buildings and appliances, could also be adopted, only carbon pricing uses all of these adjustment mechanisms in reducing environmental damage. Furthermore, the revenues generated by fuel taxes can be used to reduce distortionary income and payroll taxes, thereby increasing incentives to work, save, and invest. Selective tax cuts can also help to alleviate adverse distributional effects of fuel taxes in developed countries. Although emission-trading systems (ETSs) can also be effective mechanisms for putting a price on CO_2 emissions, the authors clearly favour fuel taxes because of the difficulty in establishing the appropriate cap on emissions and because price volatility reduces incentives for investment in clean technology. (In recent years, carbon prices in European trading systems have fluctuated between €5 per ton and €30 per ton.) With regard to the congestion and non-CO_2 emissions from the transportation sector, the authors acknowledge that

> the ideal fiscal system for motor vehicle transport would involve charging motorists for each kilometer driven, and the charge would be scaled according to factors affecting the congestion, accident, local pollution, and possible road damage costs imposed on others by that kilometer driven, and a fuel tax component would be retained to address carbon emissions.[1]

But until the widespread adoption of metering technologies that are based on the global positioning system, taxing fuels remains the best way to reduce road congestion and non-carbon emissions.

Chapter 4 contains a survey of the measurement of the environmental damage caused by fossil fuel use. The most disappointing aspect of the book is that the literature on marginal damage caused by CO_2 emissions is not reviewed in detail. This is a complex and controversial topic, with major differences in the estimates based on the discount rate that is applied to the damage from future climate changes, the status of global warming, and the geographic region where these changes occur; however, the marginal damage from emitting an additional ton of carbon into the atmosphere is the crucial variable in determining the appropriate carbon taxes. Unfortunately, the

1 At 49.

authors simply adopt $35 per ton *for illustrative purposes*, noting that the appropriate carbon tax is roughly proportional to the marginal damage. While the lack of detailed discussion of the marginal damage from CO_2 emissions is regrettable, it is offset by a very detailed treatment of the theory and the empirical evidence concerning the marginal damage from local air pollution from fossil fuels. Computations of damage from local air pollution depend on the amount of the pollutants inhaled by the population, which in turn depends on such factors as population densities; wind patterns; the mortality risks of the population, which varies with the age and health of the population; and the dollar value of increased health care costs and loss of life. The discussion in this chapter is particularly interesting because of the importance of coal-fired power generation in China and China's emerging concerns about the health problems associated with the emissions.

In chapter 5, the authors provide estimates of the congestion, accident, and road damage costs from automobile transportation. For congestion costs, the authors use 60 percent of the average market wage to value time spent on long automobile journeys, which is based on the average after-tax wages rate. Because of the income differences among the 156 countries in the study, there are substantial differences in the cost of congestion. For example, China's estimated congestion cost is $0.05 per kilometer, compared with $0.064 per kilometer in the United States; although travel delays in China are on average higher than in the United States, the value of time lost in congestion in China is much lower. The value of time lost in congestion is the most important component of congestion costs because increased fuel use from stop-and-go traffic adds only about 5 percent to the overall congestion costs. Obviously, traffic congestion is a local phenomenon, and the authors use city-level data bases on traffic congestion to determine country averages. This may lead to underestimates of the costs in some urban areas and gross overestimates in small urban centres and rural areas. Local variations in congestion costs have implications for the level of government that should be responsible for these charges, a subject that is ignored in this study.

The authors bring the theoretical frameworks for calculating external damages and the data on these costs together in chapter 6 to estimate the corrective taxes for coal, natural gas, gasoline, and diesel fuel, as well as the additional revenues that governments could gain from imposing these taxes and the health and environmental benefits that would be achieved. For coal, the carbon component of the corrective tax is $3.30 per gigajoule (GJ), or 66 percent of the average world price of coal in 2010, based on the illustrative $35 per ton marginal damage figure adopted by the authors. The carbon component of the corrective coal tax is assumed to be the same for all countries because it is based on the global damage caused by climate change. The local pollution component, based on emissions of SO_2, NO_2, and $PM_{2.5}$, brings the total tax to an average of $5.00 per GJ in Canada.[2] The corrective taxes for coal

2 These and other figures are taken from the data base that can be downloaded from the IMF website at http://www.imf.org/external/pubs/ft/survey/so/2014/pol073114a.htm.

are \$4 per GJ for Mexico and \$8.70 per GJ for the United States. There are even larger variations among countries that are not signatories to the North American Free Trade Agreement: \$57 per GJ for Bulgaria, \$33 per GJ for Ukraine, \$22 per GJ for Israel, and \$15 per GJ for China. These figures indicate that the local pollution costs from coal-fired power generation are substantially higher than the marginal damage from CO_2 emissions, unless the marginal damage is well over \$100 per ton. The taxes on coal would create strong incentives to adopt control technologies that are estimated to reduce local pollution damages, and therefore the non-carbon component of the corrective taxes, by 75 percent. They would also create an incentive for switching to cleaner fuels, most notably natural gas for power generation.

The CO_2 emission from natural gas is 55 percent of that for coal per GJ of energy, and the corresponding corrective carbon tax for natural gas is \$2 per GJ. Local area pollution costs are also lower with natural gas, and the total corrective tax for natural gas in Canada is estimated at \$2.21 for power generation and \$2.10 for domestic home heating. To put the latter tax rate in perspective, residential consumers in Calgary are paying about \$4.50 per GJ for natural gas. Therefore, the corrective tax would represent a 45 percent increase in the price of natural gas for homeowners, assuming full forward shifting of the tax. Overcoming the backlash from imposing this level of tax on the price of home heating would be a major challenge for policy makers. As in the case of coal, there are variations in the corrective taxes for natural gas for power generation across countries with, for example, a \$2 per GJ tax for Mexico and a \$3.10 per GJ tax for the United States. A tax that is 50 percent higher in the United States than in Canada would undoubtedly raise alarms over the competitiveness of the US utilities, and perhaps industry in general, as a result of higher US electricity prices. For China, the corrective tax for natural gas used in power generation is estimated as \$3.20 per GJ, which corresponds to the much lower level of local pollution damage from natural gas than from coal. Regardless whether these taxes are adopted in China, a switch from coal to natural gas would bring huge health and environmental benefits to the Chinese population.

The estimated corrective gasoline excise tax for Canada is \$0.55 per litre. The carbon component is only \$0.08 per litre or 15 percent of the total corrective tax. However, the congestion component is \$0.38 or 70 percent of the total corrective tax, while accidents represent 11 percent, and local air pollution 4 percent, of the total tax. The corrective gasoline tax for the United States is estimated to be lower than in Canada, at \$0.43 per litre because congestion costs are estimated to be higher in Canada than in the United States, although the accident cost component is lower. The authors' calculations also indicate that the corrective tax on diesel fuel in Canada should be higher than on gasoline, at \$0.64 per litre. The current excise taxes on gasoline in many European countries, such as Germany and the United Kingdom, exceed the estimated corrective taxes by about 30 percent.

The authors also estimate the increase in tax revenues that could be achieved if countries implemented the corrective fuel taxes, assuming that the price elasticities of demand for fuel is 0.50. For Canada, they estimate that the additional revenue would be equivalent to 1.4 percent of the gross domestic product, or approximately

Cdn $26.5 billion. More than half of this additional revenue would come from the taxes on gasoline and diesel fuel. This fiscal dividend could be used to increase spending, lower taxes, or reduce debt. The corrective fuel taxes would also reduce energy-related CO_2 emissions by 15.4 percent in Canada, 22.3 percent in the United States, and a whopping 34 percent in China.

There are many caveats and potential refinements to the methodology and data that the authors have used to calculate the corrective fuel taxes and their effects on revenues. However, the main findings in the report—that coal prices are significantly below their true social cost in terms of CO_2 emission and local air pollution; that CO_2 and local air pollution from natural gas are modest compared with CO_2 pollution and local air pollution from coal, although the corrective tax rate would still be relatively high; and that higher motor fuel taxes are warranted in North America, mainly to reflect the costs of traffic congestion, accidents, and local air pollution—are likely to be amenable to further refinements in data and methodology. This report is a major contribution to applied environmental policy and significantly advances the case for higher fuel taxation in Canada and most other countries.

B.D.

Tamara Larre, "Misguided Inferences? The Use of Expressio Unius To Interpret Tax Law" (2014) 51:3 *Alberta Law Review* 497-524

In this article, Larre provides a thorough review and critique of the use of the canon of statutory interpretation *expressio unius est exclusio alterius* in Canadian income tax case law. Commonly translated as "implied exclusion," this Latin maxim may be invoked to support an inference that the failure of legislation to include a reference to a particular item is deliberate. As Larre emphasizes, implied exclusion should be distinguished from *generalia specialibus non derogant*, another canon of statutory interpretation. Commonly translated as "implied exception," this Latin maxim may be invoked to support the priority of a specific legislative provision over a more general provision when two such provisions conflict. Larre argues that these two canons of statutory interpretation have often been confused in Canadian income tax case law. More importantly, she also argues that even when invoked correctly, the canons have all too often been relied on as an intellectual shortcut to justify a desired result and avoid the difficulties of a textual, contextual, and purposive approach to interpretation.

Larre's case analysis is organized on the basis of two general categories that have been identified by Ruth Sullivan[3] as involving an implied exclusion argument. One category consists of instances in which the legislative drafter fails to include comparable items in an enumerated legislative list. Another category consists of instances in

3 Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed. (Markham, ON: LexisNexis, 2008), at 244.

which the legislative drafter fails to follow a particular pattern of reference. If items are left off a list or otherwise excluded, Larre suggests that implied exclusion reasoning is equivalent to a textual reading of the Income Tax Act[4] when a single provision is at issue. She argues that in these instances a purposive analysis should be considered to determine whether the purpose of the provision would be better served by extending it to the particular item that is excluded. When the question is whether a general provision should be applied in light of a specific provision that nearly applies to an item, Larre argues that a textual, contextual, and purposive analysis should be undertaken for both provisions. With a handful of exceptions, her review of the relevant case law reveals a failure to integrate the canon of implied exclusion with a deeper inquiry into context and purpose. Moreover, she finds that implied exception is all too often invoked when implied exclusion would be correct. She offers a series of considerations for interpreters in an effort to integrate the canon of implied exclusion with a textual, contextual, and purposive interpretative approach, while also distinguishing between implied exclusion and implied exception.

With instances of non-parallel drafting, Larre's review of the relevant case law reveals a somewhat clearer willingness to engage in a textual, contextual, and purposive interpretive exercise, rather than relying on implied exclusion to conclude that the difference in drafting suggests a difference of application. She suggests that the complex nature of the Act requires the kind of deeper analysis associated with a textual, contextual, and purposive interpretive exercise, rather than the simple assumptions that the drafter has knowledge of every provision and non-parallel drafting is intended to signal a difference of application. Again, she provides a set of considerations that can guide courts in integrating implied exclusion argumentation with the deeper interpretive exercise she argues is critical to a coherent interpretation of the Act.

T.E.

Nick Pantaleo, Finn Poschmann, and Scott Wilkie, *Improving the Tax Treatment of Intellectual Property Income in Canada*, C.D. Howe Institute Commentary no. 379 (Toronto: C.D. Howe Institute, April 2013), 20 pages, available at www.cdhowe.org/pdf/commentary_379.pdf

Preferential income tax treatment for revenue attributable to a range of intellectual property appears to have become the latest fashionable policy idea intended to attract the location of what are perceived to be desirable, and mobile, economic activities focused on the exploitation and commercialization of research and development (R & D). Tax preferences for eligible expenditures have long been provided to encourage the undertaking of basic R & D by businesses and are referred to in some of the

4 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

literature as "push factors."[5] The provision of preferential treatment for revenue from intellectual property is perhaps a logical extension of these standard tax preferences, focused on encouraging the commercial development and exploitation of the fruits of basic research by businesses. Tax preferences with this focus are referred to in some of the literature as "pull factors,"[6] and recent legislative initiatives by some continental European countries, as well as the United Kingdom, are colloquially referred to as "patent box regimes."[7]

Despite a generous set of tax preferences for expenses associated with basic R & D, Canadian-based businesses continue to underinvest in R & D relative to businesses based in other countries. Given this underinvestment and the current interest in patent box regimes, it is perhaps not surprising that the adoption of such a regime in Canada is seen by some as an appealing policy initiative. The co-authors of this C.D. Howe commentary, two senior Canadian tax practitioners (Pantaleo and Wilkie) and the vice-president for research at the C.D. Howe Institute (Poschmann), articulate two principal arguments in support. One is a standard tax competition argument focused on an increasing mobility of the location of R & D activities, including the exploitation of developed or acquired intellectual property. The other argument focuses on spillover effects that are supposedly associated with the location of activities intended to commercialize R & D. This argument is particularly important since it suggests a targeted tax preference for associated revenue rather than a reduction in Canada's general corporate tax rate, which tends to be seen as a more desirable policy instrument in the sense that it can attract mobile business activities generally. The authors develop their two arguments for the adoption of a patent box regime in Canada in a largely speculative manner. They canvass related empirical evidence for the preferential income tax treatment of expenses incurred for basic R & D and attempt to extrapolate this evidence to activities intended to develop, exploit, and commercialize the product of basic R & D.

Even accepting the authors' somewhat sweeping case for a patent box regime, the Canadian context presents a unique consideration that they acknowledge but, unfortunately, do not address in detail. Because of subparagraph 95(2)(a)(ii), Canada arguably has one of the most generous residence-country exemption systems in the world for repatriated foreign earnings. Very broadly, this provision allows a range

5 See, for example, Kenneth J. McKenzie, *Giving with One Hand, Taking Away with the Other: Canada's Tax System and Research and Development*, C.D. Howe Institute Commentary no. 240 (Toronto: C.D. Howe Institute, October 2006). See also Mark Parsons, *Rewarding Innovation: Improving Federal Tax Support for Business R&D in Canada*, C.D. Howe Institute Commentary no. 334 (Toronto: C.D. Howe Institute, September 2011).

6 Ibid.

7 United Kingdom, HM Treasury and HM Revenue & Customs, *Consultation on the Patent Box* (London: HM Treasury and HM Revenue & Customs, June 2011), reviewed in this feature (2011) 59:4 *Canadian Tax Journal* 915-36, at 915-17.

of tax-deductible payments to be made by a foreign affiliate of a Canadian corporation to another foreign affiliate and maintain exempt surplus status, provided that the payment is associated with the earning of active business income in a treaty country. Such status also requires that the intermediate foreign affiliate be resident in a treaty country and therefore able to include the amount received in its exempt surplus, which can be repatriated to the Canadian corporation free of Canadian corporate income tax. Although an exemption may be justified when a substantial level of corporate income tax might be expected to be paid to the country of residence of the intermediate foreign affiliate, this is often not the case as a result of Canada's extensive treaty network, which includes some countries that apply low tax rates on the relevant revenue. This generous exempt surplus treatment for intragroup payments, including payments for intellectual property, means that Canada operates a de facto patent box regime that seems to be quite competitive with the formal patent box regimes of other countries, both in the sense that the applicable tax rate is at most minimal and in the sense that the availability of preferential treatment is largely unconstrained by any targeting requirements that are a feature of formal regimes.

The authors' brief review of some data regarding the transfer of Canadian patents internationally can be interpreted as consistent with Canada's generous exempt surplus system. As the authors note, the data show a consistent increase over the course of the past three decades in the number of Canadian patents transferred internationally. They suggest that this trend could be consistent with either a non-tax or a tax motivation, although the fact that the destinations of the transferred patents have been shifting to tax havens and patent box jurisdictions is more consistent with a tax motivation. The authors prefer the adoption of a patent box regime as a policy instrument to arrest the outflow of Canadian patents. In fact, they recommend the adoption of a federal tax rate of 7.5 percent, which is one-half of the current federal rate of corporate income tax. This lower rate would be limited to qualifying income, which would require that all, or substantially all, enumerated revenue streams be associated with the continuing commercial exploitation of intellectual property in Canada. The authors do not, however, provide any detail about how they arrive at this preferential rate. Presumably, the rate available under a patent box regime would have to be less than that otherwise available through tax-driven structuring intended to maximize the benefits of Canadian exempt surplus treatment. It is notable therefore that the authors suggest that a patent box regime would be desirable primarily because of a saving in compliance costs associated with the de facto regime, which can be obtained currently through tax structuring.

Extrapolating from UK projections of the revenue cost of a patent box regime, the authors estimate that the steady state annual federal revenue loss from the adoption of such a regime in Canada would be approximately $1 billion. They suggest that some of this loss could be offset by gains attributable to spillover effects captured by a suitably targeted patent box regime. They also suggest that a reduction in the amount of existing preferences for eligible R & D expenses could mitigate the revenue loss. They do not indicate, however, what treatment would be applied to payments for intellectual property that are ineligible for patent box treatment. One obvious possibility would be taxation at the general corporate tax rate, when the payments are received either directly or indirectly through an intermediate foreign affiliate. In the case of ineligible payments received indirectly, current taxation would require revision of the existing exempt surplus and foreign accrual property income legislation, but could provide a measure of additional revenue.

T.E.

Daniel N. Shaviro, *Fixing US International Taxation* (New York: Oxford University Press, 2014), 223 pages, ISBN 978-0-19-935975-2

The title of this book is somewhat misleading, at least to the extent that it suggests a review and analysis of the entire set of US rules governing the taxation of income from inbound and outbound direct investment, as well as inbound and outbound portfolio investment. The book actually focuses almost exclusively on the US deferral with foreign tax credit system for the taxation of business income from outbound direct investment. Although all other major OECD countries have adopted exemption systems for this particular type of cross-border income, the United States remains deadlocked over the reform alternatives of exemption and current taxation with foreign tax credits. Shaviro, a professor and prolific author at the New York University School of Law, presents a compelling national welfare argument as the basis for breaking out of the deadlock. There is, however, almost no consideration of the US interest as a capital-importing source country and only the briefest mention of the OECD base erosion and profit-shifting (BEPS) initiative.[8] The US controlled foreign corporation (CFC) rules in subpart F of the Internal Revenue Code and sourcing rules generally are discussed as second-order design details within the context of the basic rule choice for the treatment of business income from outbound direct investment. Yet even with a somewhat narrow focus, Shaviro provides much in his analysis that is relevant to exemption systems, and his book should be of interest for non-US readers.

Shaviro articulates a national welfare argument for the repeal of the US foreign tax credit system. In terms of incentive effects, he emphasizes that a credit for foreign taxes provides a 100 percent marginal reimbursement rate up to the amount of the foreign tax credit limit when the reimbursement rate drops to zero. Within the bounds of the limit, US multinational corporations (MNCs) are thus insensitive to the payment of foreign taxes. Shaviro argues that from a national welfare perspective foreign taxes are no different from any other expense of a US MNC since taxes

8 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), reviewed in this feature (2013) 61:2 *Canadian Tax Journal* 541-62, at 546-47; and Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

paid to a foreign government do not add to US national welfare. The provision of a deduction for foreign taxes, consistent with the treatment of other expenses, would ensure the same incentive effect. In this respect, he observes that an exemption system is in fact an implicit deductibility system for foreign taxes, albeit with a zero tax rate in the residence country. This national welfare argument in favour of repealing the foreign tax credit exists in addition to a perceived unnecessary compliance and administrative cost associated with the foreign tax credit system. Shaviro's principal argument is unique to the US foreign tax credit system, since there are considerable administrative and compliance costs associated with the definition of the boundaries of exempt treatment under an exemption system.

Shaviro similarly reviews the deterrent effects of deferral, with the primary such effect being the lockout of foreign earnings to avoid US tax on repatriation. He spends some time reviewing the new view of dividend taxation, which in the cross-border context posits that a repatriation tax would be irrelevant under certain conditions and the behaviour of US MNCs would be unaffected. However, he acknowledges that the required conditions for the new view are absent, and the US repatriation tax induces a lockout effect. This effect exists in addition to the same effect attributable to differences in corporate tax rates, which is arguably a much more substantial cause of lockout that persists under exemption systems.

Shaviro characterizes the US deferral with foreign tax credit system as an "iron box" because any attempt to improve the incentive associated with one of these features exacerbates the deterrents of the other. For example, the elimination of deferral would address the lockout effect but would make US MNCs less sensitive to the payment of foreign taxes up to the foreign tax credit limit. However, the elimination of or the placement of restrictions on the availability of foreign tax credits would reduce the marginal reimbursement rate at the cost of exacerbating the lockout effect of deferral. This dilemma leads Shaviro to his principal policy recommendation—that is, current US taxation of foreign-source business income of US MNCs at a positive tax rate that is less than the general corporate rate imposed on US-source income. He correctly observes that in principle there is no policy reason why the residence country rate on such income must be zero, as it is under exemption. Indeed, he argues that the optimal rate is likely to be positive, although it is probably lower than the full US rate on domestic-source income because of the overwhelming empirical evidence that outbound direct investment complements domestic investment, rather than substitutes for it. His policy recommendation includes the elimination of foreign tax credits in favour of the deductibility of foreign taxes, with a much lower marginal reimbursement rate as a function of the low rate applied to business income from outbound direct investment.

The elimination of both deferral and foreign tax credits would permit US policy makers to break free of the iron box. As Shaviro recognizes, however, a critical empirical issue for his proposal is the choice of a positive tax rate on business income from outbound direct investment. In the absence of any such evidence, he can only speculate on the upper and lower boundaries of the desired rate. At the lower boundary would be a minimalist rate of a few percentage points. As Shaviro observes, this approach is characteristic of some existing exemption systems, as well as a recently proposed system of exemption in the United States, that require a minimal inclusion of 5 percent of repatriated earnings. The resulting minimal tax rate is usually justified as a means to wash out the misallocation of expenses against domestic-source income. At the higher rate boundary, he tentatively suggests a rate in the 8 to 10 percent range, with his preferred minimal rate being 5 percent. He recognizes that in addition to the state of empirical ignorance regarding this necessary rate choice, US treaty obligations may constrain the range of choice because of the standard requirement to provide relief for source-country taxes in the form of either exemption or foreign tax credits. In the event of adoption of his preferred move to the current taxation of business income from outbound direct investment with deductibility of foreign taxes, Shaviro briefly makes the case for the need of a transitional tax on locked-out foreign earnings.

In his final chapter, Shaviro canvasses a range of second-order policy issues that do not require the adoption of his recommended alternative to the US deferral with foreign tax credit system. The more interesting and problematic of these issues, highlighted by the OECD's BEPS project, is the use of tax havens as vehicles for income shifting. Shaviro observes that low levels of foreign taxes suggest both shifting of income out of source countries and shifting of domestic income out of the United States by US MNCs, which he refers to as a "tagging issue." Shaviro argues that US policy makers should want to address the latter but not necessarily the former, since avoidance of foreign taxes is the correct incentive for US MNCs assessed in terms of national welfare. However, an inability to distinguish between the type of income being shifted leaves the extension of the CFC rules to tax all tax haven income, using some form of minimal tax requirement. Shaviro considers alternatives such as a US minimum tax on accrued earnings without regard to deferral, but he concludes that these alternatives are complex and not entirely satisfactory. He suggests limiting the CFC rules to passive income, with deflected business income from source countries addressed only in extreme cases of shell affiliates.

Interestingly, Shaviro also suggests following what he considers to be the practice of exemption countries of taxing royalties in full, although this is a formality for some countries, including Canada. He prefers full taxation to the practice under the US deferral with credit system, which allows foreign taxes to shelter royalty income through mixing income and credits. Shaviro would also apply current taxation to income from foreign portfolio investment generally with deductibility only for foreign taxes. This recommendation is consistent with his emphasis on deductibility rather than creditability and is premised on the empirical assumption that such investment is mobile and therefore substitutes for domestic investment, albeit there remains a well-recognized home country bias. Finally, Shaviro would reduce corporate residence electivity by moving beyond an exclusive reliance on place of incorporation under US tax law to the adoption of a central management and control alternative test. He also provides brief discussions concerning interest expense allocation rules and the use of formulary apportionment as an overlay on sourcing results, rather than an arm's-length transfer-pricing inquiry.

Two chapters following an introduction describe the current US international tax rules and the associated policy issues. Shaviro's policy recommendations are first developed in this context and are more fully articulated in two chapters that critique the academic policy literature, which he labels "the battle of the acronyms." Readers may be familiar with much of this literature and the well-known standards of capital-export neutrality, capital-import neutrality, national neutrality, capital ownership neutrality, and national ownership neutrality. It has long been recognized that the kind of analysis found in this literature is of limited use because of its tendency to focus narrowly on a single behavioural margin. Shaviro's critique of this literature is thus of more academic than practical interest. In fact, this portion of the book is much more important for its provision of a broad conceptual framework for his policy recommendations and, in particular, his use of the literature on the efficiency cost of funds as the basis for the imposition of a positive residence-country tax rate on income from outbound direct investment. The final chapter also includes some discussion of movement to a progressive consumption tax or conduit treatment of all business entities as fundamental reforms in the cross-border context. Because practical policy considerations constrain either alternative, the discussion is similarly of academic interest only.

T.E.

Michael Blackwell, *Do the Haves Come Out Ahead in Tax Litigation? An Empirical Study of the Dynamics of Tax Appeals in the UK*, Oxford University Centre for Business Taxation Working Paper 13/20 (Oxford: Oxford University Centre for Business Taxation, November 2013), 33 pages, available at www.sbs.ox.ac.uk/ideas-impact/tax/publications/working-papers

This paper adds to the empirical legal literature on tax litigation and is particularly important for its focus on the United Kingdom, where only Blackwell has explored this type of research.[9] The focus of the analysis is a data set, compiled by the author, of UK tax appeals from decisions of the special commissioners during the period 1981-2009. Blackwell categorizes tax litigants, including Her Majesty's Revenue and Customs (HMRC), as either "repeat players" or "one-shotters."[10] The former category consists of HMRC and large corporate taxpayers. The latter category consists of individuals and small businesses. As a repeat player, HMRC is seen to have an advantage over individuals and small businesses that is attributable to factors such as specialized expertise, economies of scale, and bargaining credibility. HMRC is also seen to be concerned with the precedential value of a case and not just its outcome.

9 See Michael Blackwell, "Variation in the Outcomes of Tax Appeals Between Special Commissioners: An Empirical Study" [2013] no. 2 *British Tax Review* 154-74.

10 This conceptual framework is based on Marc Galanter, "Why the Haves Come out Ahead: Speculations on the Limits of Legal Change" (1974) 9:1 *Law and Society Review* 95-160.

Because large corporate taxpayers are repeat players, the advantaged position of HMRC may be reduced in litigation against these taxpayers, who may also enjoy an advantaged position because of a strong bargaining position associated with the size of their contribution to the revenue.

Blackwell statistically tests six different hypotheses that are posited to follow from the categorization of taxpayers as either repeat players or one-shotters and HMRC as a repeat player. Although the results are not always statistically significant, he finds that the majority of appeals are decided in favour of the Crown, but this finding is more attributable to taxpayers appealing cases in which they have low prospects of success than to the Crown being overly cautious about which cases it appeals. He also finds that permission to appeal tends to screen out unmeritorious appeals, with the effect being most pronounced at the House of Lords, where permission is difficult to obtain and taxpayers win the majority of their appeals. The identity of Crown counsel is found to have no effect on outcomes, while the identity of counsel for taxpayers is found to have an effect. Perhaps somewhat surprisingly, this effect is found to be more attributable to aggressiveness and risk aversion of legal advice than it is to quality of argumentation. Finally, Blackwell finds that HMRC is more likely to appeal losses against large corporate taxpayers than against individuals, while large corporate taxpayers are also more likely to appeal losses against the Crown. The first finding is particularly interesting, given the recent controversy in the United Kingdom surrounding the perceived preferential treatment of certain large corporate taxpayers, including Vodafone and Goldman Sachs.

T.E.

Allison Christians, "Avoidance, Evasion, and Taxpayer Morality"
(2014) 44:1 *Washington University Journal of Law and Policy* 39-59

Lee A. Sheppard, "Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges" (2014) 44:1 *Washington University Journal of Law and Policy* 61-78

On April 1, 2013, Washington University School of Law held a colloquium, "Conceptualizing a New Institutional Framework for International Taxation." This issue of the *Washington University Journal of Law and Policy* includes an edited transcript of the remarks of participants at the colloquium along with these two articles. A third article in the issue was reviewed previously in this feature.[11]

The author of the first article, Allison Christians, is the holder of the H. Heward Stikeman Chair in Tax Law at McGill University. She argues that the political gains

11 Adam H. Rosenzweig, "An Antigua Gambling Model for the International Tax Regime" (2014) 44:1 *Washington University Journal of Law and Policy* 79-101, reviewed in this feature (2014) 62:3 *Canadian Tax Journal* 907-26, at 909-13.

realized by the conflation of international tax evasion and international tax avoidance by tax justice and civil society groups come with significant potential costs. These groups have arguably performed an important public service by exposing both evasion and avoidance to the light of popular policy discourse, but, as Christians observes, they have used the rhetoric of morality to equate the two, which avoids a necessary engagement with a very different analysis of the legal obligations of taxpayers. Christians suggests that an implicit premise of this course of action is that the difference between illegal tax evasion and legal tax avoidance cannot be properly articulated within the law. Punishment is then meted out randomly on the basis of judgments about taxpayer behaviour in the court of public opinion rather than within the sphere of deliberative law making. She argues that a convincing case can be made that governments have the required tools within the legal system to control behaviour that is considered to be inappropriate and that following this course of action, with its admittedly messy exercise in legal line drawing, ultimately leads to a more coherent system characterized by a greater consistency of application monitored through judicial review.

Christians emphasizes, however, that the political work of tax justice and civil society groups is most effective as a complement to the law-making process when it is focused on the need for transparency to enable the public monitoring of legislation. She calls for an increased challenge of two systemic tax governance traditions. One is the disproportionate influence of well-resourced special interest groups in both domestic national settings and the international setting through the OECD. The other is the confidentiality that is accorded to taxpayer information. Christians suggests that interest group behaviour can be monitored more effectively by demanding greater accountability and public access to information regarding the interaction of government officials and private sector actors and lobbyists. She believes that these initiatives would be most effective in the context of the OECD's tax policy work. With respect to confidentiality of taxpayer information, Christians acknowledges that there is a case for favouring confidentiality over public disclosure for individuals, but she believes that the same argument does not extend to corporations. She concludes that the international tax evasion and tax avoidance problem could motivate governments to reform tax disclosure laws in the direction that she suggests.

The author of the second article, Lee Sheppard, is well known to many readers as a contributing editor at Tax Analysts, publisher of *Tax Notes International* and *Tax Notes*. In fact, this article is a version of an earlier article published in *Tax Notes International*.[12] Sheppard argues that the OECD BEPS initiative, which is intended to preserve the existing international tax consensus, may actually upset it in the long run. More particularly, Sheppard asserts that US multinationals will have to pay more

12 Lee A. Sheppard, "The Twilight of the International Consensus" (2013) 72:1 *Tax Notes International* 7-12.

tax to source countries as a result of the BEPS initiative, but the national legislative product of this initiative will ultimately prove untenable, leading to an inevitable move to a system of formulary apportionment based on sales. She develops her argument through a survey of the issues that are the focus of BEPS, while speculating on the political considerations that will constrain any fundamental rethinking of the existing international tax consensus.

T.E.

Antony Ting, "iTax—Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] no. 1 *British Tax Review* 40-71

Ting uses the tax-driven structuring of Apple's European operations as a case study of profit shifting by multinational enterprises (MNEs) that, in the extreme, results in the non-taxation of cross-border income by source and residence countries (referred to as "double non-taxation"). The structure used by Apple was the subject of recent US congressional hearings, which revealed that Apple had successfully avoided US$44 billion in taxes from 2009 to 2012. These hearings in the United States also focused on the cross-border tax planning of Microsoft and Hewlett-Packard, while the House of Commons Public Accounts Committee in the United Kingdom held hearings investigating the tax planning of US-based MNEs Google, Amazon, and Starbucks as their planning affected UK-source jurisdiction to tax. The author selected Apple's structured tax planning as an illustrative case study both for its simplicity and for the wealth of information revealed by the US congressional hearings into the role of the United States as the country of residence of Apple's parent corporation and the effect on European and Asian countries as source countries providing markets for Apple's sales. Ting uses the label "iTax" in the title of the article to refer to the cross-border tax structure implemented by Apple for its European and Asian market sales, with the "i" branding the kind of innovation that is frequently characteristic of Apple's products. The label also refers, however, to what he believes is a need for innovative policy thinking to address the double non-taxation issue illustrated by the Apple case study.

After providing a brief description of Apple's tax structure, Ting reviews in some detail the features of the relevant income tax systems that, in combination, provided the double non-taxation result. Some of these features are unique to the US income tax system and are the focus of tax planning by US-based MNEs only; but some are also found in the income tax systems of other countries and are exploited by MNEs based in these countries, including Canada. A unique feature of the Apple structure is the use of holding corporations incorporated in Ireland but managed in the United States. Under US tax law, which uses a place-of-incorporation test exclusively to determine corporate residence, the fact that the Irish-incorporated holding companies were managed from the United States does not make them resident in the United States. Under Irish tax law during the relevant period, the same holding companies were not considered to be resident in Ireland because Irish law used a test of central management and control exclusively to determine corporate residence. The holding companies were thus neither resident in the United States nor resident in Ireland. The Irish government has since changed its law to provide that a corporation incorporated in Ireland is considered Irish-resident if its central management and control is exercised from another country.

Before this change in Irish law, the inconsistency in the US and Irish corporate residence rules ensured that royalty and licensing income payable from Apple subsidiaries in Europe and Asia was not subject to any residence-country tax. Deductibility of the payments in computing source-country tax by these subsidiaries also ensured that any source-country tax was avoided, while the use of a cost-sharing agreement for R & D projects entered into between Apple's US parent corporation and the Irish holding companies resulted in a disproportionate amount of the royalty and licensing payments accruing to the companies. Limited application of the US CFC rules, along with the check-the-box regime for entity classification purposes under US law, meant that the payments were not taxable to Apple's US parent currently as passive income deflected from its subsidiaries in Europe and Asia to the Irish holding companies.

Ting emphasizes that the US government has for some time, and somewhat transparently, accepted the kind of tax-driven structuring used by Apple and other US-based MNEs, with the apparent goal of enhancing US welfare at the expense of source-country tax jurisdictions. Indeed, other capital-exporting countries, including Canada, have adopted similar positions with similar effects through their domestic tax law for similar reasons. Countries also appear willing to accept erosion of their source tax bases to compete for desirable inbound investment. This policy status quo was upset, of course, by tax justice and civil society organizations based primarily in the United Kingdom. By exposing a range of tax-structured cross-border investments to public scrutiny, the associated policy issue became a political issue that was amplified by government budget constraints caused by the need to bail out the financial sector in the wake of the financial crisis of 2007-9. The resulting political imperative led to the initiation of the BEPS project by the OECD, as mandated by the G-20 group of countries. In addition, the European Commission recently opened investigations into the transfer-pricing arrangements of Apple, Starbucks, and Fiat Finance and Trade to determine whether they constitute prohibited state aid provided by Ireland, the Netherlands, and Luxembourg, respectively.

Although Ting embeds his analysis in the BEPS project, the timing of the publication of this article did not permit a detailed analysis of any of the results of that project, which are only now becoming available in the form of discussion documents that address various aspects of BEPS. Ting does offer some interesting policy thinking that could be followed by both residence and source countries, assuming that they are committed to addressing the double non-taxation issue that is often the result of cross-border tax planning. For residence countries, his suggested policy initiatives are somewhat standard and will presumably be the focus of the OECD BEPS project to some extent. In particular, he suggests that CFC legislation be extended to require current recognition of business income that is deflected as a tax-deductible payment to a low-tax third country. For the United States uniquely, this policy initiative would require the repeal or substantial revision of the check-the-box regime for entity classification in a cross-border context. He also suggests that cost-sharing agreements for intangibles be strengthened to prevent profit shifting. For source countries, Ting recommends a country-by-country income-reporting requirement for MNEs, which is an idea that has received considerable recent approbation. A more provocative proposal from a source-country perspective is Ting's suggestion that the conventional separate-entity approach to intragroup transactions be ignored in certain circumstances. Unfortunately, he does not provide much guidance concerning these circumstances, indicating only that the holy grail of "economic substance" could be invoked in the name of the prevention of BEPS.

T.E.

Chloe Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone Versus Worldwide Approach" (2014) 6:1 *World Tax Journal* 40-76

The allocation of interest expense deductions as a base erosion technique is the focus of action item 4 of the OECD BEPS project.[13] The Department of Finance has been active in recent budgets on this policy front, introducing the foreign affiliate dumping rules in section 212.3, while also amending the thin capitalization rules in subsections 18(4) to (8). Other countries have similarly been legislatively active, but, as Burnett observes, no international consensus has emerged regarding a best practice approach to restricting interest expense deductions in a cross-border context. She suggests that the wide variety of legislative approaches results in high compliance costs and potential double taxation as well as double non-taxation. She provides a useful conceptual framework for assessing various approaches. Burnett argues that a "worldwide ratio approach" to the limitation of interest expense deductions is the best practice approach that countries should be moving toward.

Burnett defines a worldwide ratio approach as an interest expense allocation method that "considers the total third-party debt of the multinational group and compares this to, or allocates it amongst, the subsidiaries in the multinational's various jurisdictions."[14] As she points out, this approach can be implemented by limiting debt at the subsidiary level, both intragroup and third-party, to the amount of third-party leverage of the multinational group, with a denial of interest deductions on the excess. Alternatively, the same result can be realized by ignoring intragroup debt

13 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), action 4, "Limit Base Erosion Via Interest Deductions and Other Financial Payments."

14 At 42.

and explicitly allocating third-party debt of the multinational group among the group members in proportion to the third-party leverage ratio of the group. Burnett asserts that the allowable interest rate can be determined either by using a standard transfer-pricing analysis or by extending the worldwide ratio approach to use the multinational group's average interest rate on third-party debt, with interest expense accounted for after netting out the interest income of the group. She contrasts the worldwide ratio approach with what she refers to as a "stand-alone approach," which sets the permissible debt allocation level using a standard transfer-pricing inquiry focused on how much debt a group member could otherwise borrow if it were a stand-alone entity, rather than a member of the particular multinational group. A third approach used by some countries, and characteristic of Canada's thin capitalization rules, is to set a fixed maximum leverage ratio independent of either the actual leverage ratio of a particular multinational group or a hypothetical leverage capacity assessed on the basis of the unique facts of a group member.

Burnett rejects a fixed ratio approach as an unnecessarily blunt limitation that suffers from problems of overinclusiveness and underinclusiveness. She does not believe that the presumed compliance and administrative cost savings associated with such an approach justify its poor targeting. She argues that a worldwide ratio approach is theoretically preferable on the basis of three propositions. One proposition, which is empirical, is that intragroup debt is a close or perfect substitute for equity and can be readily substituted to take advantage of differences in tax treatment. A second proposition, which is also empirical, is that a multinational group's choice of location of its third-party debt is responsive to tax considerations. The third proposition, which is more normative in content, is that a multinational group should have the same leverage and interest rate throughout the jurisdictions in which it operates. Burnett suggests that a stand-alone approach is defensible only if a multinational group member has an identifiable arm's-length amount of debt, and an intragroup loan has an identifiable arm's-length price. She criticizes this proposition because of the substantial tax-electivity that it provides for multinational groups through selective leveraging up of group members to the maximum justifiable debt. As she emphasizes, this "could standard" means that the potential leverage for particular group members can be higher than the group's third-party leverage ratio, given the observed phenomenon of spare debt capacity and the wide range of positions that are plausible under the proposition that a multinational group member has a unique arm's-length amount of debt and an arm's-length price.

Burnett concludes that a worldwide ratio approach is not only theoretically justifiable but also administratively feasible, drawing on the examples of the debt allocation limitations in Australia, Germany, and New Zealand as legislative templates. She recognizes, however, that inconsistent financial accounting standards create an important practical problem. This inconsistency is significant because of the need to use financial accounting standards as the basis for measuring debt-to-asset ratios. She also usefully reviews some of the transitional issues that tax policy makers would need to address in moving to a worldwide ratio approach.

T.E.

Wolfgang Schön, "International Taxation of Risk"
(2014) 68:6/7 *Bulletin for International Taxation* 280-94

In this article, Schön draws on the extensive theoretical literature on taxation and risk taking to critically examine the focus on the allocation of risk as a basis for the allocation of the income of MNEs among taxing jurisdictions. He suggests that this literature highlights three principal reasons why tax policy makers would be interested in the taxation of risky investments as a source of revenue, after allowing for the recognition of losses. First, standard limitations-on-loss recognition result in asymmetric taxation of gains and losses, where gains are taxed in full. Second, economic rents may be disguised as returns to risk taking. Third, investors who are risk-averse demand a premium for bearing undiversifiable risk. Schön argues that in the international context MNEs may defensibly shift risk from a high-tax to a low-tax jurisdiction to moderate the impact of asymmetric gain and loss recognition. In principle therefore intragroup risk-transfer transactions should be respected for tax purposes. In this respect, Schön asserts that the focus of transfer-pricing practice on risk-bearing capacity is sensible as a proxy for the shift of the full upside and downside associated with a risky investment. He argues, however, that a focus on the control of risk is largely irrelevant in determining whether an intragroup transfer of risk should be respected, since a divergence between risk bearing and control of risk is commonly observed in dealings between independent parties as the transfer-pricing standard.

Schön then argues that the important tax policy distinction between risk transfer or allocation, on the one hand, and profit shifting by MNEs, on the other, can be found in the transfer of intangibles and the intragroup charging of risk premiums. With transfers of intangibles (including cost contribution arrangements), the ex ante approach of attempting to determine the adequacy of consideration provided by group members inevitably fails in the presence of asymmetric information on the part of MNEs and tax administrators. The asymmetric information leads to undervaluation, which hides the misallocation of economic rents as defensible allocations of returns to risk taking. Schön concludes that this type of profit shifting can be addressed only by adopting an ex post adjustment for tax purposes, using, for example, a commensurate-with-income standard. With risk premium, he suggests that the separate-entity approach to income allocation among MNE group members should be rejected by ignoring any intragroup charges that take this form. The basis for this proposition is the fact that the shareholders of a parent corporation in a corporate group bear any undiversifiable risk associated with group investments. In contrast to an otherwise general relevance of risk allocation for income allocation purposes under the arm's-length standard, Schön observes that proposals to extend source-country taxing jurisdiction to any inbound sales or services would make risk allocation generally irrelevant, which is the case with the current menu of income apportionment formulas offered in the literature.

T.E.

Michael Devereux and Rita de la Feria, *Designing and Implementing a Destination-Based Corporate Tax*, Oxford University Centre for Business Taxation Working Paper 14/07 (Oxford University Centre for Business Taxation, May 2014), 22 pages, available at www.sbs.ox.ac.uk/ideas-impact/tax/publications/working-papers

In much of the tax policy literature, a cash flow corporate tax is regarded as the preferred reform alternative to existing corporate income tax systems. By providing immediate expensing of all expenses, a cash flow corporate tax taxes economic rents only—that is, returns to capital in excess of (1) normal or time-value returns and (2) returns for bearing undiversifiable risk. The extensive literature advocating a cash flow corporate tax tends to focus on two principal design issues. One is the use of an allowable deduction for imputed returns on corporate equity as an alternative to the current expensing of capital expenses. The other is the tax treatment of corporate returns to shareholders and corporate creditors. These design features are characteristically fleshed out in an entirely domestic context. In the cross-border context, some of the policy literature suggests the adoption of a destination basis rather than the continued use of residence and source jurisdiction to tax. In this respect, a corporate cash flow tax would operate similarly to a value-added tax (VAT) or a goods and services tax (GST). An important difference, however, between consumption taxes and a cash flow corporate tax is the treatment of labour costs, which are deductible under a cash flow corporate tax but are not deductible under VAT and GST systems. This paper fills an important gap in the literature by addressing in detail the legal and practical implementation issues associated with the use of a destination-based jurisdiction to tax.

The authors argue that the country of destination, as the nexus for taxing jurisdiction, could be identified under a cash flow corporate tax much more easily than under VAT and GST systems. Because VATs and GSTs are consumption taxes, these systems must use a range of proxies to identify the place of consumption. In contrast, a cash flow corporate tax is unconcerned with the identification of the place of consumption, since it is a tax on corporate profits and could be based largely on the single proxy of customer location to identify the country of destination. This single-proxy approach would be modified only in limited circumstances involving the provision of some services. Administratively, the authors suggest that a clearing-house approach proposed for EU VAT purposes could be modified for corporate cash flow purposes. This approach is necessary to establish appropriate enforcement of the destination basis and to ensure that countries in which goods and services originate are not in the position of providing rebates to producers and service providers because of the deductibility of labour costs in computing corporate profit.

The authors provide some discussion about the normative argument for adoption of the destination basis as the exclusive determinant of taxing jurisdiction, but their principal focus is the practical enforcement issues raised by a cash flow corporate tax applied in this manner. Ultimately, the case for a cash flow corporate tax depends on its efficiency properties, which are commonly emphasized in the policy literature.

The destination basis can be seen to realize many of the same standard efficiency properties. It is notable therefore that much of the same fundamental rethinking of jurisdiction to tax and enforcement addressed by Devereux and de la Feria is evident in the literature discussing a system of formulary apportionment of corporate income earned in a cross-border context. In particular, such a system invariably relies on the same taxing nexus, the location of sales, as one of the elements in apportionment formulas. Presumably, the authors do not discuss this obvious reform alternative to a destination-based corporate cash flow tax because of the efficiency properties of the latter, which are assumed to make it the best reform choice.

T.E.

Francis Weyzig, "The Capital Structure of Large Firms and the Use of Dutch Financing Entities" (2014) 35:2 *Fiscal Studies* 139-64

The use of Dutch holding companies as tax-advantaged conduit entities is well known. Weyzig seeks to empirically test the relationship between the use of Dutch holding companies and the degrees of leverage of large firms at both the consolidated and the subsidiary level throughout the European Union. More particularly, the author empirically tests the use of Dutch special purpose entities (SPEs) to avoid non-resident interest withholding tax. Dutch SPEs are tax-advantaged in this respect because of the inapplicability of non-resident interest withholding tax on their issued debt. Dutch SPEs can therefore be used as issuing vehicles for the publicly traded debt of an MNE held by non-resident tax-exempt investors who cannot make use of a foreign tax credit in their home jurisdiction for withholding tax at source. In addition, Dutch SPEs can be used by an MNE to avoid non-resident interest withholding tax that would otherwise apply on intragroup loans made directly by a non-EU group member to an EU subsidiary. This result is realized by interposing the Dutch SPE between the EU subsidiary borrower and a non-EU group lender in a back-to-back intragroup loan structure. Interest payments from EU subsidiaries to the Dutch SPE can benefit from the inapplicability of non-resident withholding taxes on interest paid between EU group members, while the interest receipts can be paid by the Dutch SPE to a non-EU group member without any Dutch non-resident interest withholding tax.

Weyzig defines a Dutch SPE in a manner that is consistent with the definition used for Dutch information-reporting purposes. This definition includes a Dutch-resident enterprise in which non-residents hold a direct or indirect participating interest and whose objective is the receipt of funds to be channelled to non-residents. The author tests four hypotheses using a constructed data set for the 1997-2005 period, consisting of 365 firm-year observations for 82 firms and 2,493 country-year observations based on 9,371 underlying subsidiary-year observations. He finds that the use of publicly issued debt at the firm level is associated with 13 percent higher debt financing relative to equity and that the use of a Dutch SPE is associated with yet higher debt financing. At the subsidiary level, the author finds that EU subsidiaries of large multinational firms are more leveraged, and that the use of Dutch

SPEs is again associated with yet higher levels of subsidiary leverage. However, the sensitivity of subsidiary leverage to host country statutory tax rates is found to be relatively low, which the author suggests is indirect evidence that large firms are more likely to shift debt from low-tax affiliates to subsidiaries in most or all EU countries, facilitated by the use of Dutch SPEs. An obvious policy lesson offered by the author is the need to consider uniform EU withholding taxes on interest payments to non-EU debtholders.

T.E.

Joseph J. Thorndike, *Their Fair Share: Taxing the Rich in the Age of FDR* (Washington, DC: Urban Institute Press, 2013), 349 pages, ISBN 978-0-87766-771-1

Ajay K. Mehrotra, *Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation 1877-1929* (New York: Cambridge University Press, 2013), 427 pages, ISBN 978-1-107-04392-3

These two books are examples of tax history at its finest. Ideally, they should be read together since each describes a different period in US tax history that saw the foundations laid for the modern fiscal state. Common themes are readily apparent, the most prominent of which is an emphasis on the income tax as a policy instrument to allocate a progressively greater tax burden to the wealthy but without necessarily seeking to redistribute wealth in any significant manner. Both authors emphasize the contested and historically contingent nature of events. They also emphasize some unintended consequences, such as the rejection of a national sales tax, the absence of which continues to be a defining feature of the US fiscal system.

Thorndike argues that the modern US fiscal regime originated in a series of policy decisions made during the Great Depression and the Second World War that have had lasting importance for the US state and society. The story is a familiar one of how the income tax, which was originally a class-based tax, became a mass tax as a result of the revenue imperative of the Second World War. However, Thorndike paints a rich picture of this development, emphasizing the role of ideas and political institutions in the transformation. Particularly interesting is his portrait of President Roosevelt's moralistic approach to tax policy, which was focused on the fiscal responsibilities of wealthy Americans. This attitude was reflected in a categorical rejection of a national sales tax as a wartime revenue measure. The different approaches of a set of lawyers and economists in the Roosevelt administration are another of Thorndike's themes. The New Deal lawyers, on the one hand, focused on tax avoidance and the need to raise rates at the highest income levels. The New Deal economists, on the other hand, viewed this approach as being too narrowly progressive and preferred to extend the income tax to the middle class, which would allow cuts to regressive consumption taxes as a means of realizing a measure of progressivity throughout the income scale.

Mehrotra's narrative unfolds during the late 19th and early 20th centuries, which saw populist and progressive movements to replace what was seen as an outdated tax system consisting of customs duties and excise taxes at the federal level and property taxes at the state level. Mehrotra characterizes this system as one of "indirect, hidden, disaggregated, and partisan duties and regressive excise taxes,"[15] which was replaced with a "professionally administered, graduated tax system"[16] with the income tax as its centrepiece. Driven by a new view of an activist state within a changed industrial society, the concept of ability to pay was championed by some leading public finance economists, including Edwin Seligman, as the conceptual basis for a freshly conceived tax system. Mehrotra argues that even though the New Deal and the Second World War were seminal events in the development of the modern US fiscal state, the developments of that era were ultimately built on the accomplishments of the late 19th and early 20th centuries.

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15 At 7.

16 Ibid.