CANADIAN TAX JOURNAL

REVUE FISCALE CANADIENNE

PEER-REVIEWED ARTICLES

Income Tax Disputes Involving Loss Years: Pitfalls, Foibles, and Possible Reforms *Michael H. Lubetsky*

Subsidies and Value-Added Tax: A Comparative Study of Law and Practice in Canada and the European Union *Robert F. van Brederode and Simon B. Thang*

Suing the Canada Revenue Agency in Tort *Amir A. Fazel*

SYMPOSIUM

Re-Imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar *Jinyan Li, J. Scott Wilkie, and Graeme Cooper*

An Introduction and a Tribute *J. Scott Wilkie*

The Income Tax in an Uncertain World: Pillar, Symbol, and Instrument *Richard M. Bird*

Rationalizing the Canadian Income Tax System *Robin Boadway*

Navigating Disruption: The Politics of Business Tax Reform as Two-Level Game *Geoffrey Hale*

The Future of the Progressive Personal Income Tax: How High Can It Go? *Kevin Milligan*

A Supplemental Expenditure Tax for Canada *Victor Thuronyi*

Extrajurisdictional Taxation: Canada and UNCLOS Article 82 *Micah Burch*

FEATURES

Finances of the Nation: Tax Expenditures in Canada—Historical Estimates and Analysis *John Lester*

Current Cases: (FCA) Canada (National Revenue) v. Cameco Corporation; (TCC) Morissette c. La Reine *John Sorensen, Ouvedi Rama Naiken, and Michael D. Templeton*

Personal Tax Planning / Planification fiscale personnelle : Donation of Private Company Shares / Don d'actions d'une société privée *Brian Janzen*

Corporate Tax Planning: Canadian Inbound Investment After the MLI *Nelson Whitmore and Owen Strychun*

Current Tax Reading *Alan Macnaughton and Jinyan Li*

■ CANADIAN TAX JOURNAL EDITORIAL BOARD/ COMITÉ DE RÉDACTION DE LA REVUE FISCALE CANADIENNE

■ Editors/Rédacteurs en chef

Alan Macnaughton
University of Waterloo

Kevin Milligan
University of British Columbia

Daniel Sandler
EY Law LLP

■ Practitioners/Fiscalistes

Brian J. Arnold
Tax Consultant, Toronto

Thomas A. Bauer
Bennett Jones LLP, Toronto

Stephen W. Bowman
Bennett Jones LLP, Toronto

C. Anne Calverley
Dentons Canada LLP, Calgary

R. Ian Crosbie
Davies Ward Phillips & Vineberg LLP, Toronto

Cy M. Fien
Fillmore Riley LLP, Winnipeg

James P. Fuller
Fenwick & West LLP, Mountain View, CA

Edwin C. Harris
McInnes Cooper, Halifax

William I. Innes
Rueter Scargall Bennett LLP, Toronto

Brent Perry
Felesky Flynn LLP, Calgary

Scott Jeffery
KPMG LLP, Vancouver

Howard J. Kellough
Davis LLP, Vancouver

Heather Kerr
Ernst & Young LLP/Couzin Taylor LLP, Toronto

Edwin G. Kroft
Blake Cassels & Graydon LLP, Vancouver

Elaine Marchand
Banque Nationale du Canada, Montréal

Janice McCart
Blake Cassels & Graydon LLP, Toronto

Thomas E. McDonnell
Toronto

Matias Milet
Osler Hoskin & Harcourt LLP, Toronto

W. Jack Millar
Millar Kreklewetz LLP, Toronto

Michael J. O'Connor
Sunlife Financial Inc., Toronto

François Vincent
KPMG Law LLP, Chicago

■ University Faculty/Universitaires

Reuven Avi-Yonah
University of Michigan

Richard M. Bird
University of Toronto

Robin W. Boadway
Queen's University

Neil Brooks
York University

Arthur Cockfield
Queen's University

Graeme Cooper
University of Sydney

Bev G. Dahlby
University of Calgary

James B. Davies
University of Western Ontario

David G. Duff
University of British Columbia

Judith Freedman
Oxford University

Vijay Jog
Carleton University

Jonathan R. Kesselman
Simon Fraser University

Kenneth J. Klassen
University of Waterloo

Gilles N. Larin
Université de Sherbrooke

Amin Mawani
York University

Jack Mintz
University of Calgary

Martha O'Brien
University of Victoria

Suzanne Paquette
Université Laval

Abigail Payne
McMaster University

Michael R. Veall
McMaster University

CPA

CHARTERED
PROFESSIONAL
ACCOUNTANTS
CANADA

COMPTABLES
PROFESSIONNELS
AGRÉÉS
CANADA

Technical insights for the changing tax landscape

Commodity Tax Symposium

October 23-24, 2019 | Ottawa, Ontario

cpacanada.ca/cts

CRA UPDATES

PST & QST

GST/HST

INDIRECT TAX

CRITICAL ISSUES

Join tomorrow's tax leaders

MASTER OF TAXATION

REACH BEYOND

In addition to strong technical competencies, the MTax program prepares graduates for roles as high performing members of the tax community.

Next class starts in September – apply now!

EXPERT FACULTY > UNPARALLELED LEARNING EXPERIENCE

learn ... develop ... experience

All classes held in downtown Toronto

WATERLOO EMPOWERS STUDENTS
TO GO BEYOND. LEARN MORE.

The MTax advantage.

mtax.ca

UNIVERSITY OF
WATERLOO

CO16411

www.ctf.ca/www.fcf-ctf.ca

BRIAN CARR

With this issue of the journal, we say farewell to Brian Carr, who is stepping down as co-editor after many years of dedicated service. The Canadian Tax Foundation, its membership, and Brian's co-editors extend their deepest thanks to him for the astute guidance that he has provided since being appointed co-editor of the journal in 2009. Brian has served the journal in various capacities, not only as co-editor and member of the journal's Editorial Board but also, for many years, as co-editor of its Corporate Tax Planning feature, a role that he continues to fulfill. Brian's varied contribution to the continuing prestige of our flagship publication cannot be overstated.

Avec ce dernier numéro sous sa gouverne, Brian Carr nous quitte après avoir agi pendant plusieurs années à titre de co-rédacteur de la *Revue fiscale canadienne*. La Fondation canadienne de fiscalité et ses membres ainsi que les co-rédacteurs de la *Revue* lui offrent leurs sincères remerciements pour les loyaux services qu'il a rendus depuis sa nomination en 2009. Brian a contribué à la *Revue* de diverses façons, non seulement à titre de co-rédacteur ou de membre du comité éditorial de la *Revue*, mais aussi à titre de co-rédacteur de la chronique Corporate Tax Planning, rôle qu'il continue d'occuper. On ne peut trop insister sur les diverses contributions de Brian à notre prestigieuse publication phare.

DANIEL SANDLER

With this issue, we welcome Daniel Sandler as co-editor of the *Canadian Tax Journal*. Daniel is the managing partner of tax law services at EY Law LLP, Toronto, and he is the head of the firm's national tax litigation practice. Before joining EY Law LLP as a partner in 2008, Daniel was a professor for 13 years at the Faculty of Law, The University of Western Ontario, where he taught tax law. Daniel has served as a consultant to the Organisation for Economic Co-operation and Development, the auditor-general of Canada, and the Technical Committee on Business Taxation. He has written several books and numerous articles, and he has spoken and taught worldwide on various aspects of tax law and policy.

Dans ce numéro, nous accueillons Daniel Sandler à titre de co-rédacteur de la *Revue fiscale canadienne*. Daniel est associé directeur des services juridiques du droit fiscal chez EY Law LLP à Toronto ainsi que directeur national du litige fiscal pour la firme. Avant de rejoindre EY Law LLP à titre d'associé en 2008, Daniel a été professeur de droit fiscal à la faculté de droit de l'Université Western en Ontario pendant 13 ans. Daniel a également joué le rôle de conseiller auprès de l'Organisation de coopération et de développement économiques, du Bureau du vérificateur général du Canada et du Comité technique de la fiscalité des entreprises. Il a rédigé plusieurs livres et de nombreux articles. Enfin, Daniel a été conférencier dans plusieurs pays et il a enseigné une panoplie d'aspects du droit fiscal et de la politique fiscale.

CALL FOR BOOK PROPOSALS

The Canadian Tax Foundation, an independent, not-for-profit research and educational organization, is seeking proposals for books in the areas of taxation and public finance.

Since its inception in 1945, the Foundation has published many books and articles on a wide range of subjects within its areas of interest. The Foundation seeks proposals for research projects that will

- result in a book on a single topic of interest in the area of taxation or public finance;
- be undertaken by an experienced researcher who has expertise in an area of taxation or public finance; and
- be carried out within a time frame that is reasonable, given the nature of the project.

Projects selected by the Foundation may qualify for its full or partial financial support of the research and for its underwriting of the publication costs. The Foundation retains the absolute right at its sole discretion to choose whether to support a given proposal or to publish a project.

Interested parties should send a brief written outline of a proposal, for initial consideration by the Foundation, to:

Heather Evans
Executive Director and Chief Executive Officer
Canadian Tax Foundation / Fondation canadienne de fiscalité
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
hevans@ctf.ca

For further information, please contact the director, as indicated above, or the co-chairs of the Canadian Tax Foundation Research Committee:

Janette Pantry
c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

Kim Brooks
c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

APPEL DE PROPOSITIONS DE LIVRES

La Fondation canadienne de fiscalité (FCF) / Canadian Tax Foundation, un organisme sans but lucratif indépendant de recherche et à caractère éducatif, souhaite recevoir des propositions de livres dans les domaines de la fiscalité et des finances publiques.

Depuis sa fondation en 1945, la FCF a publié de nombreux livres et articles sur divers sujets dans ses champs d'intérêt. La FCF souhaite obtenir des propositions de projets de recherche qui :

- mèneront à la rédaction d'un livre sur un sujet unique d'intérêt en fiscalité ou en finances publiques;
- seront dirigés par un chercheur chevronné ayant une expertise dans un domaine de la fiscalité ou des finances publiques;
- seront effectués dans un délai raisonnable, compte tenu de la nature du projet.

Les projets qui seront sélectionnés par la FCF pourront être partiellement ou totalement admissibles à une aide financière pour la recherche et les frais de publication. La FCF se réserve le droit absolu, et à sa seule discrétion, d'appuyer une proposition particulière ou de publier un projet.

Toute personne intéressée doit faire parvenir un bref sommaire de la proposition pour examen initial par la FCF à :

Heather Evans
Directrice exécutive et chef de la direction
Canadian Tax Foundation / Fondation canadienne de fiscalité
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
hevans@ctf.ca

Pour plus d'information, veuillez communiquer avec le directeur, tel qu'il est mentionné plus haut, ou avec les co-présidentes du comité de recherche de la Fondation canadienne de fiscalité :

Janette Pantry
a/s Canadian Tax Foundation / Fondation canadienne de fiscalité

Kim Brooks
a/s Canadian Tax Foundation / Fondation canadienne de fiscalité

■ RECENT AND UPCOMING EVENTS*

■ ACTIVITÉS RÉCENTES ET À VENIR*

PRAIRIE PROVINCES TAX CONFERENCE AND LIVE WEBCAST

May 27-28, 2019, Calgary

SÉMINAIRE TECHNIQUE — LES FIDUCIES

Le 11 septembre 2019, Québec

BRITISH COLUMBIA TAX CONFERENCE AND LIVE WEBCAST

September 16-17, 2019, Vancouver

SÉMINAIRE TECHNIQUE — ORGANISMES DE BIENFAISANCE

Le 24 septembre 2019, Montréal

WOMEN IN TAX: BE BOLD, BE YOU

September 25, Vancouver

MIDI-CONFÉRENCE — JEUNES FISCALISTES: RÈGLES ANTI-ÉVITEMMENT

Le 18 octobre 2019, Québec

ONTARIO TAX CONFERENCE AND LIVE WEBCAST

October 28-29, 2019, Toronto

ATLANTIC PROVINCES TAX CONFERENCE

November 1-2, 2019, Halifax

MIDI-CONFÉRENCE — JEUNES FISCALISTES: IMMOBILIER ET CONSIDÉRATIONS EN TAXES DE VENTE

Le 22 novembre 2019, Québec

SEVENTY-FIRST ANNUAL TAX CONFERENCE (2019)

December 1-3, 2019, Montreal

* For further details on upcoming events, please visit the Canadian Tax Foundation website at www.ctf.ca. / Pour plus de renseignements, veuillez consulter le site Web de la Fondation à www.fcf-ctf.ca.

Disclaimer. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication. Opinions expressed by individual writers are not necessarily endorsed by the Canadian Tax Foundation and its members.

Photocopying and reprinting. Permission to photocopy or reprint any part of this publication for distribution must be applied for in writing to permissions@ctf.ca.

Advertising. Inquiries relating to advertisements should be directed to Christine Escalante, e-mail: cescalante@ctf.ca.

Exonération de responsabilité. Le contenu de cette publication ne doit être interprété d'aucune façon comme un avis ou une opinion. L'abonné ou le lecteur ne devrait pas fonder ses décisions sur le contenu de cette publication sans envisager une consultation professionnelle appropriée. L'éditeur et les auteurs réfutent toute responsabilité envers toute personne, qu'elle soit abonnée ou non, relativement à toute conséquence résultant d'actes ou omissions faits en fonction du contenu de la présente publication. Les opinions exprimées par les auteurs particuliers ne sont pas nécessairement appuyées par la Fondation canadienne de fiscalité et ses membres.

Photocopie et réimpression. L'autorisation de photocopier ou de réimprimer toute portion de cette publication à des fins de distribution devra être obtenue en adressant une demande écrite à permissions@ctf.ca.

Annonces publicitaires. Toutes demandes concernant les annonces publicitaires devront être adressées à Christine Escalante, courriel : cescalante@ctf.ca.

Canadian Tax Journal

Published four times per year

Price: \$75 per copy (plus applicable taxes)

Subscription rate: \$275 per year (plus applicable taxes)

(HST registration no. R-106867260)

Canadian Tax Foundation

145 Wellington Street West

Suite 1400

Toronto, Canada M5J 1H8

Telephone: 416-599-0283

Toll Free: 1-877-733-0283

Facsimile: 416-599-9283

Internet: www.ctf.ca

2019, vol. 67, no. 3

(Issued October 2019)

ISSN 0008-5111

Printed in Canada

6,900 09-19

Revue fiscale canadienne

Publiée quatre fois l'an

Prix : 75 \$ l'exemplaire (taxes en sus)

Abonnement : 275 \$ par an (taxes en sus)

(Numéro d'enregistrement de TVH :

R-106867260)

La Fondation canadienne de fiscalité

1250, boul. René-Lévesque ouest

Bureau 2935

Montréal (Québec) H3B 4W8

Téléphone : 514-939-6323

Télécopieur : 514-939-7353

Internet : www.fcf-ctf.ca

2019, vol. 67, n° 3

(publication : octobre 2019)

ISSN 0008-5111

Imprimée au Canada

6,900 09-19

Canadian Tax Journal

Revue fiscale canadienne

PEER-REVIEWED ARTICLES

- 499 Income Tax Disputes Involving Loss Years: Pitfalls, Foibles, and Possible Reforms** MICHAEL H. LUBETSKY
- 533 Subsidies and Value-Added Tax: A Comparative Study of Law and Practice in Canada and the European Union** ROBERT F. VAN BREDERODE
AND SIMON B. THANG
- 581 Suing the Canada Revenue Agency in Tort** AMIR A. FAZEL

SYMPOSIUM

- 613 Re-Imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar** JINYAN LI, J. SCOTT WILKIE, AND
GRAEME COOPER
- 615 An Introduction and a Tribute** J. SCOTT WILKIE
- 623 The Income Tax in an Uncertain World: Pillar, Symbol, and Instrument** RICHARD M. BIRD
- 643 Rationalizing the Canadian Income Tax System** ROBIN BOADWAY
- 667 Navigating Disruption: The Politics of Business Tax Reform as Two-Level Game** GEOFFREY HALE
- 693 The Future of the Progressive Personal Income Tax: How High Can It Go?** KEVIN MILLIGAN
- 711 A Supplemental Expenditure Tax for Canada** VICTOR THURONYI
- 729 Extranational Taxation: Canada and UNCLOS Article 82** MICAH BURCH

FEATURES

- 755 Finances of the Nation: Tax Expenditures in Canada—Historical Estimates and Analysis** JOHN LESTER

- 775 Current Cases:** (FCA) Canada (National Revenue) v.
 Cameco Corporation; (TCC) Morissette c.
 La Reine JOHN SORENSEN, OUVEDI RAMA NAIKEN, AND
 MICHAEL D. TEMPLETON
- 789 Personal Tax Planning:** Donation of Private Company Shares BRIAN JANZEN
- 809 Planification fiscale personnelle :** Don d'actions d'une
 société privée BRIAN JANZEN
- 831 Corporate Tax Planning:** Canadian Inbound Investment
 After the MLI NELSON WHITMORE AND OWEN STRYCHUN
- 881 Current Tax Reading** ALAN MACNAUGHTON AND JINYAN LI

■ CANADIAN TAX JOURNAL

The *Canadian Tax Journal* publishes research in, and informed comment on, taxation and public finance, with particular relevance to Canada. To this end, the journal invites interested parties to submit manuscripts for possible publication as peer-reviewed articles, and it especially welcomes work that contributes to the analysis, design, and implementation of tax policies.

Articles may be written in English or French and should present an original analysis of the topic. Submitted work, or any substantial part or version thereof, must not have been previously published, either in print or online, and it must not be submitted or scheduled for publication elsewhere. The journal welcomes shorter submissions (from 4,000 to 8,000 words) focused on specific topics as well as longer submissions (to a maximum of 20,000 words) that analyze issues in depth.

Submitted articles are subject to a double-blind peer review; authors' identities are not known to reviewers, and reviewers' identities are not known to authors. (Non-peer-reviewed contributions may appear elsewhere in the journal.) Final decisions on publication of articles are made by the editors, Alan Macnaughton, Daniel Sandler, and Kevin Milligan, on the advice of reviewers. Many reviewers are drawn from the editorial board (listed on the inside front cover of this journal), although ad hoc reviewers are also consulted. Submissions may be (1) accepted outright; (2) accepted if recommended revisions are made; (3) revised by the authors, as requested by the editors on the advice of reviewers, and resubmitted for further review; or (4) rejected with reasons. The time from submission to the first editorial decision is usually two months or less.

Prospective contributors should submit a copy of the manuscript to the journal's editorial department. The preferred method of submission is by e-mail with an attached Word document. E-mail inquiries are welcome: write to CTFeditorial@ctf.ca. Contributors are responsible for providing complete and accurate citations to sources, a detailed abstract (200 to 400 words), and up to six keywords for indexing purposes.

The full text of many articles that have appeared in the *Canadian Tax Journal* since 1991 can be found on the Canadian Tax Foundation's website: www.ctf.ca. Additionally, the journal in its entirety appears in the Canadian Tax Foundation's *TaxFind*, which is updated regularly.

The *Canadian Tax Journal* is indexed in EconLit, ABI Inform, LegalTrac, Index to Canadian Legal Literature, CCH Canadian's Canadian Income Tax Research Index, Carswell's Income Tax References, Accounting and Law Index, Current Law Index, Canadian Index, Canadian Periodicals Index, Index to Canadian Legal Periodical Literature, Index to Legal Periodicals and Books, and PAIS International in Print.

■ REVUE FISCALE CANADIENNE

La *Revue fiscale canadienne* publie des recherches et des commentaires éclairés sur la fiscalité et les finances publiques, particulièrement pertinents pour le Canada. À cette fin, la revue invite les personnes intéressées à soumettre des articles en vue d'une éventuelle publication en tant qu'articles revus par des pairs, et elle accueille tout particulièrement les travaux qui contribuent à l'analyse, à la conception et à la mise en oeuvre des politiques fiscales.

Les articles peuvent être rédigés en anglais ou en français et doivent présenter une analyse originale du sujet. Les articles soumis, ou toute partie substantielle ou version des articles, ne doivent pas avoir été publiés antérieurement en format papier ou électronique, et ne doivent pas être soumis ou prévus pour publication ailleurs. Vous pouvez soumettre pour publication, dans la revue fiscale, des articles plus courts (4 000 à 8 000 mots) sur des sujets particuliers ainsi que des articles plus longs (maximum de 20 000 mots) analysant des sujets en profondeur.

Les articles soumis sont sujets à une double revue à l'aveugle par des pairs; l'identité des auteurs n'est pas connue des réviseurs et celle des réviseurs n'est pas connue des auteurs (certains articles non soumis à cette révision par des pairs peuvent paraître ailleurs dans la revue.) La décision finale de publier ou non un article est celle des rédacteurs en chef Alan Macnaughton, Daniel Sandler et Kevin Milligan, à la recommandation des réviseurs. Bien que certains réviseurs *ad hoc* soient aussi consultés, la majorité des réviseurs sont choisis parmi les membres du Comité de rédaction (énumérés à l'endos de la page couverture de la revue). Les articles soumis peuvent être 1) acceptés d'emblée; 2) acceptés après modifications; 3) modifiés par les auteurs tel que demandé par les rédacteurs en chef sur l'avis des réviseurs, et resoumis à une nouvelle révision; ou 4) rejetés avec raisons. Le temps écoulé entre la soumission d'un article et la première décision éditoriale est habituellement de deux mois ou moins.

Les aspirants contributeurs doivent soumettre un exemplaire de l'article proposé au service éditorial. Il est préférable que la soumission se fasse par courriel, avec une pièce jointe en Word. Les demandes de renseignements par courriel sont les bienvenues. Elles doivent être adressées à CTFeditorial@ctf.ca. Les contributeurs doivent soumettre l'ensemble de leurs sources, un précis détaillé de leurs articles (entre 200 et 400 mots), et jusqu'à six mots clés aux fins d'indexation.

On peut trouver le texte intégral de nombreux articles publiés dans la *Revue fiscale canadienne* depuis 1991 sur le site Internet de la Fondation : www.fcf-ctf.ca. De plus, la revue dans son entier se trouve dans *TaxFind*, qui est mis à jour régulièrement.

La *Revue fiscale canadienne* est indexée sous EconLit, ABI Inform, LegalTrac, Index to Canadian Legal Literature, Canadian Income Tax Research Index de CCH Canadian, Income Tax References de Carswell, Accounting and Law Index, Current Law Index, Canadian Index, Canadian Periodicals Index, Index to Canadian Legal Periodical Literature, Index to Legal Periodicals and Books, et PAIS International in Print.

■ CANADIAN TAX FOUNDATION

The Canadian Tax Foundation is Canada's leading source of insight on tax issues. The Foundation promotes understanding of the Canadian tax system through analysis, research, and debate, and provides perspective and impartial recommendations concerning its equity, efficiency, and application.

The Canadian Tax Foundation is an independent tax research organization and a registered charity with over 12,000 individual and corporate members in Canada and abroad. For more than 70 years, it has fostered a better understanding of the Canadian tax system and assisted in the development of that system through its research projects, conferences, publications, and representations to government.

Members find the Foundation to be a valuable resource both for the scope and depth of the tax information it provides and for its services, which support their everyday work in the taxation field.

Government policy makers and administrators have long respected the Foundation for its objectivity, its focus on current tax issues, its concern for improvement of the Canadian tax system, and its significant contribution to tax and fiscal policy.

MEMBERSHIP

Membership in the Foundation is open to all who are interested in its work. Membership fees are \$388.00 a year, except that special member rates apply as follows: (a) \$194.00 for members of the accounting and legal professions in the first three years following date of qualification to practise; (b) \$194.00 for persons on full-time teaching staff of colleges, universities, or other educational institutions; (c) \$31.50 for students in full-time attendance at a recognized educational institution; and (d) \$166.00 for persons who have reached the age of 65 and are no longer actively working in tax. Memberships are for a period of 12 months dating from the receipt of application with the appropriate payment.

Applications for membership are available from the membership administrator for the Canadian Tax Foundation: facsimile: 416-599-9283; Internet: www.ctf.ca; e-mail: ctfmembership@ctf.ca.

■ FONDATION CANADIENNE DE FISCALITÉ

La Fondation canadienne de fiscalité est un organisme indépendant de recherche sur la fiscalité inscrit sous le régime des œuvres de charité. Elle compte environ 12 000 membres au Canada et à l'étranger. Depuis plus de 70 ans, la FCF favorise une meilleure compréhension du système fiscal canadien et aide au développement de ce système par le biais de ses projets de recherche, conférences, publications et représentations auprès des gouvernements.

Les membres considèrent l'étendue et le détail de l'information offerte par la FCF comme une importante ressource. Ils apprécient également les autres services de la FCF qui facilitent leur travail quotidien dans le domaine de la fiscalité.

Les décideurs et administrateurs gouvernementaux respectent depuis longtemps l'objectivité de la FCF, son attention aux questions fiscales de l'heure, sa préoccupation envers l'amélioration du système fiscal canadien et son importante contribution au développement des politiques fiscales.

ADHÉSION

Toute personne intéressée aux travaux de la FCF peut en devenir membre. Les droits d'adhésion sont de 388,00 \$ par année, à l'exception des tarifs spéciaux suivants : a) 194,00 \$ pour les personnes faisant carrière en comptabilité ou en droit pendant les trois premières années suivant leur admission à la profession; b) 194,00 \$ pour le personnel enseignant à temps plein dans un collège, une université ou une autre maison d'enseignement; c) 31,50 \$ pour les étudiants fréquentant à temps plein une maison d'enseignement reconnue; et d) 166,00 \$ pour les personnes qui ont 65 ans et plus et qui ne travaillent plus activement en fiscalité. La période d'adhésion est de 12 mois, à compter de la réception de la demande accompagnée du paiement approprié.

Il est possible de se procurer les demandes d'adhésion auprès de l'administratrice responsable de l'adhésion à la FCF : télécopieur : 514-939-7353; Internet : www.fcf-ctf.ca; courriel : adminmtl@ctf.ca.

■ BOARD OF GOVERNORS/CONSEIL DES GOUVERNEURS

Elected November 25, 2018/Élu le 25 novembre 2018

Cheryl Bailey, ON ¹	Siobhan Goguen, AB ²	Anu Nijhawan, AB ²
Jeffery Blucher, NS ²	Kay Gray, BC ¹	Heather O'Hagan, ON ³
Eoin Brady, ON ¹	Ken Hauser, BC ²	Janette Pantry, BC ¹
Mark Brender, QC ^{2*}	Joan Jung, ON ^{2*}	Shawn Porter, ON ^{1*}
Alycia Calvert, ON ^{1*}	Manu Kakkar, QC ¹	Geneviève Provost, QC ¹
Don Carson, ON ^{1*}	Timothy Kirby, AB ²	Elie Roth, ON ²
Allison Christians, QC ³	Dean Kraus, ON ²	Denis St-Pierre, NB ¹
Grace Chow, ON ¹	Dean Landry, ON ^{1*}	Martin Sorensen, ON ^{2*}
Michael Coburn, BC ²	Rick McLean, ON ¹	Dave Walsh, ON ¹
Marie-Claire Dy, BC ²	Michael Munoz, AB ³	Hugh Woolley, BC ¹
Olivier Fournier, QC ²	Elizabeth Murphy, ON ³	Barbara Worndl, ON ^{2*}
Ted Gallivan, ON ³		

* Executive Committee of the Board of Governors

Comité de direction du conseil des gouverneurs

¹ Nominee of the Chartered Professional Accountants of Canada

² Nominee of the Canadian Bar Association

³ Non-sponsor

■ OFFICERS/MEMBRES DE LA DIRECTION

Chair/ <i>Président du conseil</i>	Mark Brender
Vice-Chair and Chair of the Executive Committee/ <i>Vice-présidente du conseil et présidente du comité de direction</i>	Alycia Calvert
Second Vice-Chair/ <i>Deuxième vice-présidente</i>	Barbara Worndl
Past Chair/ <i>Président sortant du conseil</i>	Shawn Porter
Executive Director and Chief Executive Officer/ <i>Directrice exécutive et chef de la direction</i>	Heather Evans
Regional Director, Quebec/ <i>Directrice régionale du Bureau du Québec</i>	Julie Vézina
Director of Finance and Treasurer/ <i>Directrice financière et trésorière</i>	Shelly Ali

■ STAFF/PERSONNEL

Events and Web Manager/ <i>Directrice des événements et du site Web</i>	Roda Ibrahim
Librarian/ <i>Bibliothécaire</i>	Judy Singh
Managing Editor/ <i>Directeur de la rédaction</i>	Michael Gaughan

■ CANADIAN TAX FOUNDATION PUBLICATIONS

The Foundation's publications comprise a range of forms and delivery formats. A number of the regularly issued publications are distributed without charge to Foundation members: the *Canadian Tax Journal* (4 issues), *Canadian Tax Highlights* (12 issues, delivered electronically), *Tax for the Owner-Manager* (4 issues, delivered electronically), *Canadian Tax Focus* (4 issues, delivered electronically), and the annual conference report. Monographs and books may be purchased on the Foundation's website at www.ctf.ca.

CANADIAN TAX JOURNAL — issued quarterly to members via www.ctf.ca (Non-Members \$75 per copy, \$275 per year).

NEWSLETTERS

Canadian Tax Highlights — issued monthly to members via www.ctf.ca.

Tax for the Owner-Manager — issued quarterly to members via www.ctf.ca.

Canadian Tax Focus — issued quarterly; available to members and non-members via www.ctf.ca.

CONFERENCE REPORTS — Reports of the proceedings of annual tax conferences (Members \$40; Non-Members \$95). Latest issue: 2018 (Members \$40; Non-Members \$350).

— *Tax Dispute Resolution, Compliance, and Administration in Canada: Proceedings of the June 2012 Conference* (Members \$30; Non-Members \$195)

— Collections of papers delivered at regional and special tax conferences (British Columbia, Prairie Provinces, Ontario, and Atlantic Provinces) are available in USB format (Members \$445; Non-Members \$495).

FINANCES OF THE NATION — Review of expenditures and revenues and some budgets of the federal, provincial, and local governments of Canada. PDFs for the years 2002-2012 are available on the CTF website at no cost. In 2014, "Finances of the Nation" began to appear as a feature in issues of the *Canadian Tax Journal*.

MONOGRAPHS

2019. *Funding the Canadian City*, Enid Slack, Lisa Philipps, Lindsay M. Tedds, and Heather L. Evans, eds. (\$40 each)

2018. *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville*, Brian J. Arnold, ed. (Members \$60; Non-Members \$90)

2018. *Reforming the Corporate Tax in a Changing World*, School of Public Policy of the University of Calgary (Members \$30; Non-Members \$50)

2017. *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act*, Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds. (Members \$60; Non-Members \$90)

2016. *Reform of the Personal Income Tax in Canada*, School of Public Policy of the University of Calgary (Members \$35; Non-Members \$50)

2016. *Canadian Taxation of Trusts*, Elie S. Roth, Tim Youdan, Chris Anderson, and Kim Brown (Members \$150; Non-Members \$200; Students \$50)

2016. *User Fees in Canada: A Municipal Design and Implementation Guide*, Catherine Althaus and Lindsay M. Tedds (\$40 each)

2015. *Timing and Income Taxation*, 2d edition, Brian J. Arnold, Colin Campbell, Michael Hiltz, Richard Marcovitz, Shawn D. Porter, and James R. Wilson (Members \$25; Non-Members \$125; Students \$25)

2015. *Effective Writing for Tax Professionals*, Kate Hawkins and Thomas E. McDonnell, QC (Members \$35; Non-Members \$40)

2014. *After Twenty Years: The Future of the Goods and Services Tax*, School of Public Policy of the University of Calgary (Members \$25; Non-Members \$35)

2013. *Essays on Tax Treaties: A Tribute to David A. Ward*, Guglielmo Maisto, Angelo Nikolakakis, and John M. Ulmer, eds. (\$100 each)

2012. *Tax Policy in Canada*, Heather Kerr, Ken McKenzie, and Jack Mintz, eds. (Members \$75; Non-Members \$100; Students \$50)

2011. *Canadian Tax Foundation Style Guide*, 5th edition (Members \$35; Non-Members \$40)
2011. *International Financial Reporting Standards: Their Adoption in Canada*, Jason Doucet, Andrée Lavigne, Caroline Nadeau, Jocelyn Patenaude, and Dave Santerre (Members \$30; Non-Members \$40)
2011. *Tax Expenditures: State of the Art — Selected Proceedings of the Osgoode 2009 Conference*, Lisa Philipps, Neil Brooks, and Jinyan Li, eds. (Members \$45; Non-Members \$55; Students \$30)
2010. *Taxation of Private Corporations and Their Shareholders*, 4th edition (Members \$75; Non-Members \$100; Students \$25)
- TAX PROFESSIONAL SERIES (Please specify title and author when ordering.)
2003. *The Taxation of Business Profits Under Tax Treaties*, Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, eds. (softcover edition, \$75)
2003. *International Taxation in the Age of Electronic Commerce: A Comparative Study*, Jinyan Li. Co-published with International Fiscal Association (Canadian Branch) (Members \$95; Non-Members \$145; Students \$45)
1999. *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue*, Nathalie Goyette (\$75 each)
- CANADIAN TAX PAPER SERIES (Please specify publication number when ordering.)
- No. 112: 2009. *Effective Responses to Aggressive Tax Planning: What Canada Can Learn from Other Jurisdictions*, Gilles N. Larin and Robert Duong, with a contribution from Marie Jacques
- No. 111: 2009. *Reforming Canada's International Tax System: Toward Coherence and Simplicity*, Brian J. Arnold (Members \$100; Non-Members \$125)
- No. 110: 2006. *Financing Education and Training in Canada*, 2d edition, Douglas Auld and Harry Kitchen
- No. 109: 2004. *The Canadian Federal-Provincial Equalization Regime: An Assessment*, Alex S. MacNevin
- No. 108: 2004. *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States*, Daniel Sandler
- No. 107: 2002. *Municipal Revenue and Expenditure Issues in Canada*, Harry M. Kitchen (Members \$20; Non-Members \$40)
- No. 106: 2002. *Taxes and the Canadian Underground Economy*, David E.A. Giles and Lindsay M. Tedds
- No. 105: 2000. *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Tim Edgar
- No. 104: 1999. *Rationality in Public Policy: Retrospect and Prospect, A Tribute to Douglas G. Hartle*, Richard M. Bird, Michael J. Trebilcock, and Thomas A. Wilson, eds.
- No. 103: 1999. *Canadian Tax Policy*, 3d edition, Robin W. Boadway and Harry M. Kitchen
- No. 102: 1997. *Financing the Canadian Federation, 1867 to 1995: Setting the Stage*, David B. Perry
- No. 101: 1997. *General Payroll Taxes: Economics, Politics, and Design*, Jonathan R. Kesselman
- No. 100: 1995. *Growth of Government Spending in Alberta*, Paul Boothe
- No. 99: 1995. *Financing Education and Training in Canada*, Harry Kitchen and Douglas Auld
- SPECIAL STUDIES IN TAXATION AND PUBLIC FINANCE (Please specify publication number when ordering.)
- No. 2: 2000. *Gambling and Governments in Canada, 1969-1998: How Much? Who Plays? What Payoff?* François Vaillancourt and Alexandre Roy
- No. 1: 1998. *Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada*, Ernest H. Smith

■ LES PUBLICATIONS DE LA FONDATION CANADIENNE DE FISCALITÉ

Les publications de la Fondation existent sous différentes formes et elles sont disponibles de diverses façons. Certaines de ces publications régulières sont distribuées gratuitement aux membres de la Fondation : la *Revue fiscale canadienne* (4 numéros), *Faits saillants en fiscalité canadienne* (12 numéros, offerts électroniquement), *Actualités fiscales pour les propriétaires exploitants* (4 numéros, offerts électroniquement), *Canadian Tax Focus* (4 numéros, offerts électroniquement) et le Rapport de la conférence annuelle. Les livres et monographies peuvent être achetés sur le site Web de la Fondation www.fcf-ctf.ca.

REVUE FISCALE CANADIENNE — parution trimestrielle aux membres sur www.fcf-ctf.ca
(Non-membres 75 \$ par numéro, 275 \$ par année).

BULLETINS

Faits Saillants en Fiscalité Canadienne — parution mensuelle disponible aux membres sur www.fcf-ctf.ca.

Actualités fiscales pour les propriétaires exploitants — parution trimestrielle disponible aux membres sur www.fcf-ctf.ca.

Canadian Tax Focus — parution trimestrielle disponible aux membres et non-membres sur www.fcf-ctf.ca.

RAPPORTS DES CONFÉRENCES — comptes rendus des conférences annuelles sur la fiscalité (Membres 40 \$; Non-membres 95 \$). Dernière édition : 2018 (Membres 40 \$; Non-membres 350 \$).

— *Tax Dispute Resolution, Compliance, and Administration in Canada: Proceedings of the June 2012 Conference* (Membres 30 \$; Non-membres 195 \$)

— Collections contenant les travaux présentés aux conférences régionales sur la fiscalité, soit British Columbia, Prairie Provinces, Ontario et Atlantic Provinces, sont disponibles en format USB (Membres 445 \$; Non-membres 495 \$).

FINANCES OF THE NATION — Analyse des recettes et dépenses, et quelques budgets, des gouvernements fédéral, provinciaux et locaux au Canada. Les copies PDF pour les années 2002-2012 sont disponibles sur le site Web de la FCF pour téléchargement gratuit. Dans le numéro 62:3 (2014), « Finances of the Nation » est apparu dans les éditions de la *Revue fiscale canadienne* à titre de nouvelle rubrique.

MONOGRAPHIES

2019. *Funding the Canadian City*, Enid Slack, Lisa Philipps, Lindsay M. Tedds et Heather L. Evans, éd. (\$40 chacun)

2018. *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville*, Brian J. Arnold, éd. (Membres 60 \$; Non-membres 90 \$)

2018. *Reforming the Corporate Tax in a Changing World*, l'École de politique publique de l'Université de Calgary (Membres 30 \$; Non-membres 50 \$)

2017. *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act*, Jinyan Li, J. Scott Wilkie et Larry F. Chapman, éd. (Membres 60 \$; Non-membres 90 \$)

2016. *Reform of the Personal Income Tax in Canada*, l'École de politique publique de l'Université de Calgary (Membres 35 \$; Non-membres 50 \$)

2016. *Canadian Taxation of Trusts*, Elie S. Roth, Tim Youdan, Chris Anderson et Kim Brown (Membres 150 \$; Non-membres 200 \$; Étudiants 50 \$)

2016. *User Fees in Canada: A Municipal Design and Implementation Guide*, Catherine Althaus et Lindsay M. Tedds (40 \$ chacun)

2015. *Timing and Income Taxation*, 2^{ième} édition, Brian J. Arnold, Colin Campbell, Michael Hiltz, Richard Marcovitz, Shawn D. Porter et James R. Wilson (Membres 25 \$; Non-membres 125 \$; Étudiants 25 \$)

2015. *Effective Writing for Tax Professionals*, Kate Hawkins et Thomas E. McDonnell, QC (Membres 35 \$; Non-membres 40 \$)
2014. *After Twenty Years: The Future of the Goods and Services Tax*, l'École de politique publique de l'Université de Calgary (Membres 25 \$; Non-membres 35 \$)
2013. *Essays on Tax Treaties: A Tribute to David A. Ward*, Guglielmo Maisto, Angelo Nikolakakis et John M. Ulmer, édés. (100 \$ chacun)
2012. *Tax Policy in Canada*, Heather Kerr, Ken McKenzie et Jack Mintz, édés. (Membres 75 \$; Non-membres 100 \$; Étudiants 50 \$)
2011. *Canadian Tax Foundation Style Guide*, 5^{ième} édition (Membres 35 \$; Non-membres 40 \$)
2011. *International Financial Reporting Standards: Their Adoption in Canada*, Jason Doucet, Andrée Lavigne, Caroline Nadeau, Jocelyn Patenaude et Dave Santerre (Membres 30 \$; Non-membres 40 \$)
2011. *Tax Expenditures: State of the Art — Selected Proceedings of the Osgoode 2009 Conference*, Lisa Philipps, Neil Brooks et Jinyan Li, édés. (Membres 45 \$; Non-membres 55 \$; Étudiants 30 \$)
2010. *Taxation of Private Corporations and Their Shareholders*, 4^{ième} édition (Membres 75 \$; Non-membres 100 \$; Étudiants 25 \$)
- COLLECTION TAX PROFESSIONAL (Prière d'indiquer le titre et le nom de l'auteur sur votre commande.)
2003. *The Taxation of Business Profits Under Tax Treaties*, Brian J. Arnold, Jacques Sasseville et Eric M. Zolt, édés. (édition brochée, 75 \$)
2003. *International Taxation in the Age of Electronic Commerce: A Comparative Study*, Jinyan Li. Publié en collaboration avec l'Association fiscale internationale (chapitre canadien). (Membres 95 \$; Non-membres 145 \$; Étudiants 45 \$)
1999. *Conter l'abus des conventions fiscales : Point de vue canadien sur une question internationale*, Nathalie Goyette (75 \$ chacun)
- CANADIAN TAX PAPER SERIES (Prière d'indiquer le numéro de la publication.)
- N° 112 : 2009. *Des réponses efficaces aux planifications fiscales agressives : leçons à retenir des autres juridictions*, Gilles N. Larin et Robert Duong, avec la contribution de Marie Jacques
- N° 111 : 2009. *Reforming Canada's International Tax System: Toward Coherence and Simplicity*, Brian J. Arnold (Membres 100 \$; Non-membres 125 \$)
- N° 110 : 2006. *Financing Education and Training in Canada*, 2^{ième} édition, Douglas Auld et Harry Kitchen
- N° 109 : 2004. *The Canadian Federal-Provincial Equalization Regime: An Assessment*, Alex S. MacNevin
- N° 108 : 2004. *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States*, Daniel Sandler
- N° 107 : 2002. *Municipal Revenue and Expenditure Issues in Canada*, Harry M. Kitchen (Membres 20 \$; Non-membres 40 \$)
- N° 106 : 2002. *Taxes and the Canadian Underground Economy*, David E.A. Giles et Lindsay M. Tedds
- N° 105 : 2000. *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Tim Edgar
- N° 104 : 1999. *Rationality in Public Policy: Retrospect and Prospect, A Tribute to Douglas G. Hartle*, Richard M. Bird, Michael J. Trebilcock et Thomas A. Wilson, édés.
- N° 103 : 1999. *Canadian Tax Policy*, 3^e édition, Robin W. Boadway et Harry M. Kitchen
- N° 101 : 1997. *General Payroll Taxes: Economics, Politics, and Design*, Jonathan R. Kesselman)
- N° 102 : 1997. *Financing the Canadian Federation, 1867 to 1995: Setting the Stage*, David B. Perry
- N° 100 : 1995. *Growth of Government Spending in Alberta*, Paul Boothe
- N° 99 : 1995. *Financing Education and Training in Canada*, Harry Kitchen et Douglas Auld
- SPECIAL STUDIES IN TAXATION AND PUBLIC FINANCE SERIES (Prière d'indiquer le numéro de la publication.)
- N° 2 : 2000. *Gambling and Governments in Canada, 1969-1998: How Much? Who Plays? What Payoff?* François Vaillancourt et Alexandre Roy
- N° 1 : 1998. *Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada*, Ernest H. Smith

■ IN THE RESEARCH CENTRE

The Canadian Tax Foundation maintains for its staff and members a comprehensive reference library of current and historical materials on taxation, public finance, and related subjects. The Douglas J. Sherbaniuk Research Centre contains one of the largest publicly accessible collections of tax information in the world. While the collection is built around a large base of Canadian materials, it also contains a significant portion of information covering international taxation, including country tax profiles, low-tax jurisdictions, international tax treaties, and cross-border and international tax planning. The Research Centre currently holds domestic and international periodicals, case reporters, looseleaf services, and books.

Housed at the Foundation's Toronto headquarters, the Douglas J. Sherbaniuk Research Centre is open from 9 am to 5 pm, Monday to Friday. Staff are available for research assistance, particularly to members who cannot visit the Research Centre in person. Access is by e-mail ("Ask the Librarian" on our website or researchcentre@ctf.ca), by telephone (416-599-0283, ext. 505), by facsimile (416-599-9283), or by toll-free (1-877-733-0283, ext. 505).

The following books have been added to the Research Centre in recent months.*

CANADA

Beam, Robert E. *Introduction to Federal Income Taxation in Canada*, 40th ed., 2019-2020, by Robert E. Beam, Stanley N. Laiken, James J. Barnett, Nathalie Johnstone, Devan Mescall, and Julie Robson. Toronto: Wolters Kluwer, 2019.

_____. *Introduction to Federal Income Taxation in Canada: Study Guide*, 2019-2020. Toronto: Wolters Kluwer, 2019.

Bourgard, Gordon. *Portable Tax Court Practice, Act and Rules 2019*, by Gordon Bourgard and Robert McMechan. Toronto: Thomson Reuters Canada, 2019.

Wakaruk, Amanda, ed. *Government Information in Canada: Access and Stewardship*, edited by Amanda Wakaruk and Sam-Chin Li. Edmonton: University of Alberta Press, 2019.

Wolters Kluwer Canada. *Canadian Income Tax Act with Regulations, Annotated*, 107th ed., 2019 Spring. Toronto: Wolters Kluwer Canada, 2019.

INTERNATIONAL

Annacondia, Fabiola, ed. *EU VAT Compass 2019/2020*. Amsterdam: IBFD, 2019.

Avi-Yonah, Reuven S., ed. *Comparative Fiscal Federalism*, 2d ed., edited by Reuven S. Avi-Yonah and Michael Lang. Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2016.

Guibault, Lucie. *Copyright Limitations and Contracts: An Analysis of the Contractual Overridability of Limitations on Copyright*. Amsterdam: 2002.

International Bureau of Fiscal Documentation. *European Tax Handbook 2019*. Amsterdam: IBFD, 2019.

_____. *Global Corporate Tax Handbook 2019*. Amsterdam: IBFD, 2019.

_____. *Global Individual Tax Handbook 2019*. Amsterdam: IBFD, 2019.

Kemmeren, Eric C.C.M., ed. *Tax Treaty Case Law Around the Globe 2018*, edited by Eric C.C.M.

Kemmeren, Peter Essers, Daniël S. Smit, Cihat Öner, Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch, Clau Staringer, and Alfred Storck. Amsterdam: IBFD, 2002.

* Please contact the respective publishers if you wish to purchase any of the items listed.

- Lang, Michael, ed. *Tax Treaty Entitlement*, edited by Michael Lang, Pasquale Pistone, Alexander Rust, Josef Schuch, and Claus Staringer. Amsterdam: IBFD, 2019.
- Pistone, Pasquale. *Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration*, by Pasquale Pistone, Jennifer Roeleveld, Johann Hattingh, João Félix Pinto Nogueira, and Craig West. Amsterdam: IBFD, 2019.
- Organisation for Economic Co-operation and Development. *Global Forum on Transparency and Exchange of Information for Tax Purposes: Canada 2017 (Second Round): Peer Review Report on the Exchange of Information on Request*. Paris: OECD, 2017.
- _____. *Global Forum on Transparency and Exchange of Information for Tax Purposes: The Netherlands 2019 (Second Round): Peer Review Report on the Exchange of Information on Request*. Paris: OECD, 2019.
- _____. *Global Forum on Transparency and Exchange of Information for Tax Purposes: Turks and Caicos Islands 2019 (Second Round): Peer Review Report on the Exchange of Information on Request*. Paris: OECD, 2019.
- _____. *Joint Audit 2019—Enhancing Tax Co-operation and Improving Tax Certainty*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Estonia (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Greece (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Hungary (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Iceland (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Romania (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Slovak Republic (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Slovenia (Stage 1)*. Paris: OECD, 2019.
- _____. *Making Dispute Resolution More Effective—MAP Peer Review Report, Turkey (Stage 1)*. Paris: OECD, 2019.
- _____. *Multi-Dimensional Review of Panama*, vol. 3, *From Analysis to Action*. Paris: OECD, 2019.
- _____. *Prevention of Treaty Abuse—Peer Review Report on Treaty Shopping*. Paris: OECD, 2019.
- _____. *The Sharing and Gig Economy: Effective Taxation of Platform Sellers*. Paris: OECD, 2019.
- _____. *Taxing Wages 2019*. Paris: OECD, 2019.
- Sterling, J.A.L. *Sterling on World Copyright Law*, 5th ed., by J.A.L. Sterling and Trevor Cook. London: Sweet & Maxwell, 2018.
- Yavaşlar, Funda Başaran, ed. *Tax Transparency: 2018 EATLP Congress Zurich, 7-9 June 2018*, edited by Funda Başaran Yavaşlar and Johanna Hey. Amsterdam: IBFD, 2019.

Income Tax Disputes Involving Loss Years: Pitfalls, Foibles, and Possible Reforms

Michael H. Lubetsky*

PRÉCIS

Deux principes de longue date peuvent compliquer la résolution des différends fiscaux impliquant des pertes, soit la « règle relative à une cotisation néant » et le « principe de *New St James* ». La règle relative à une cotisation néant interdit à un contribuable de s'opposer à un avis de cotisation précisant qu'il n'a aucun impôt à payer — y compris tant pour les années déficitaires que les années rentables au cours desquelles le revenu est entièrement compensé par des reports. Le principe de *New St James* prévoit, essentiellement, que les années déficitaires ou les années sans impôt à payer ne deviennent jamais frappées de prescription.

Parce que la règle relative à une cotisation néant et le principe de *New St James* peuvent empêcher le règlement rapide d'un différend sur les soldes de pertes fiscales, le Parlement a modifié la Loi de l'impôt sur le revenu en 1977 afin de permettre au ministre du Revenu national d'envoyer, dans certaines circonstances, un avis de détermination de perte (ADP) pour une année d'imposition donnée. La procédure d'opposition ou d'appel d'un ADP est essentiellement la même que pour un avis de cotisation, et un ADP faisant l'objet d'une opposition ou d'un appel devient obligatoire pour le ministre et le contribuable.

L'existence toutefois d'un système parallèle mais distinct pour résoudre les différends sur les pertes laisse des brèches qui créent divers pièges procéduraux pour les contribuables. Les contribuables pris dans ces pièges peuvent se retrouver à perdre leurs droits d'opposition ou d'appel relativement à des rajustements de revenu contestés, à voir resurgir des questions fiscales qui étaient frappées de prescription, ou être tenus de payer des intérêts accumulés sur des dettes fiscales éteintes. L'auteur de cet article explore certains de ces pièges et montre comment ils se produisent et ce qu'un contribuable peut faire pour les éviter. Il aborde aussi la question de savoir si le

* Of Davies Ward Phillips & Vineberg LLP, Toronto (e-mail: mlubetsky@dwvp.com). I wish to thank Nathan Boidman, Brian T. Bloom, Colin Campbell, Connor Campbell, Brian R. Carr, Joseph Havas, Bobby J. Sood, Anne-Sophie Villeneuve, Christine Purden, and two anonymous reviewers for this journal, for their insight and comments during the preparation of this article. I disclose that I have acted and/or am acting for clients in various disputes with the Canada Revenue Agency, the Agence du revenu du Québec, the Alberta Tax and Revenue Administration, and/or the Ontario Ministry of Finance that have raised some the issues discussed in this article. However, the views expressed herein are mine alone.

temps est venu de réformer la règle relative à une cotisation néant ou le principe de *New St James*, ou les deux, afin de permettre la résolution plus rapide par la Cour canadienne de l'impôt des différends relatifs aux pertes. Il propose également plusieurs réformes possibles.

ABSTRACT

Tax disputes involving losses can be challenging to resolve owing to two longstanding principles, commonly known as “the nil assessment rule” and “the *New St James* principle.” The nil assessment rule bars taxpayers from objecting to assessments that result in no tax being payable—including both loss years and profitable years where income is completely offset by carryovers. The *New St James* principle provides, essentially, that loss years or years with no tax payable never become statute-barred.

Because the nil assessment rule and the *New St James* principle can prevent the resolution of disputes over tax loss balances in a timely manner, Parliament amended the Income Tax Act in 1977 so as to allow, in certain situations, for the issuance by the minister of national revenue of a notice of determination of losses (NODL) for a given taxation year. Once issued, a NODL can be objected to or appealed in basically the same manner as an assessment and, subject to any objection or appeal, becomes binding upon the minister and the taxpayer.

However, the existence of a parallel but distinct system for resolving loss disputes leaves gaps that result in a range of procedural traps for taxpayers. Taxpayers caught in these traps can potentially end up losing their rights to object to or appeal disputed income adjustments, reviving statute-barred issues, or being required to pay arrears interest on extinguished tax debts. This article explores some of these traps, showing how they arise and what a taxpayer might do to avoid being caught by them. It also discusses whether the time has come to reform the nil assessment rule and/or the *New St James* principle so as to allow disputes involving losses to be resolved more readily by the Tax Court of Canada, and proposes several possible reforms.

KEYWORDS: LOSSES ■ CARRYOVER ■ OBJECTIONS ■ ASSESSMENTS ■ DISPUTES ■ TAX COURT OF CANADA

CONTENTS

Introduction	501
Loss Carryovers	503
The Operative Provision	503
The Assessing Provisions	504
The Nil Assessment Rule	506
Okalta Oils: The Classic Formulation of the Nil Assessment Rule	506
Interior Savings: The “Second Branch” of the Nil Assessment Rule	509
The New St James Principle	510
The Loss Dispute Provisions	511
The Enactment of the Provisions	511
CRA Administrative Positions on the Loss Dispute Provisions	514
Case Law on the Loss Dispute Provisions	515
Aallcann Wood: A NODL Is Not Necessary To Dispute Losses	515
722540 Ontario: A NODL Trumps Disputing Losses in Other Years	516

Inco: The NODL Provisions Presuppose a Dispute with the Taxpayer's Filing Position	517
Pitfalls	518
Extinguishment of the Right To Object or Appeal	518
Arrears Interest on Disputed Tax Debts	520
Revival of Issues Relating to Statute-Barred Years	523
Duplication of Remedies and the Large Corporation Rules	525
Conclusion: Reflections and Options for Reform	528
Addendum	530

INTRODUCTION

If a taxpayer incurs business losses, those losses can often be used to shelter taxable income in other years. Consequently, tax losses have “value” that can give rise to difficult disputes with revenue officials over their quantum and timing.¹ However, disputes involving losses are not always easy to resolve expeditiously, owing in part to two longstanding tax principles—the nil assessment rule and the *New St James* principle.

The nil assessment rule bars taxpayers from objecting to assessments that result in no tax being payable. Consequently, if the minister of national revenue² audits a loss year and issues a notice of reassessment reducing the amount of the loss, the taxpayer cannot object or appeal. Rather, the taxpayer must wait—potentially several years—until it attempts to carry over and deduct the disputed loss in another year in which tax is payable. If the carryover is then refused, the taxpayer can object to or appeal the minister's assessment of that year and dispute the denial of the prior year's loss at that time.

Similarly, if a taxpayer uses loss carryovers to completely offset disputed amounts of income in another year, the nil assessment rule can, in some circumstances, prevent the taxpayer from objecting to or appealing the resulting reassessments. Instead, the dispute over the income inclusions would be recast as a dispute over the amount of losses available for carryover, which again would be subject to objection or appeal only in some future year in which tax was payable.

The *New St James* principle provides, essentially, that the minister can audit and reassess loss years even after the expiry of the “normal reassessment period” as

1 According to the Department of Finance, non-capital loss and capital loss carryovers reduced corporate income taxes by a projected \$8.49 billion in 2018. (Comparable data for personal income tax were not available.) See Canada, Department of Finance, *Report on Federal Tax Expenditures—Concepts, Estimates and Evaluations 2019* (Ottawa: Department of Finance, 2019), at 35-36 (www.fin.gc.ca/taxexp-depfisc/2019/taxexp19-eng.asp).

2 This article deals primarily with the assessment of federal income tax under the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”), as administered by the Canada Revenue Agency (CRA) on behalf of the minister. However, the comments largely apply, mutatis mutandis, to separately administered provincial income tax regimes as well.

defined in section 152 of the Income Tax Act.³ Loss balances do not become statute-barred until they are carried over and deducted in another taxation year in which tax is payable, and that year becomes statute-barred.

Because of the nil assessment rule and the *New St James* principle, disputes over loss balances can potentially remain open for extended periods of time, during which records may be lost, memories may fade, or witnesses may become unavailable—all of which works to the detriment of the taxpayer who ultimately bears the burden of proof. The ongoing uncertainty can create many other challenges for taxpayers by making it more difficult, for example, to attract capital or a potential acquiror.

To assist taxpayers in these situations, in 1977 Parliament enacted subsections 152(1.1) through (1.3) (“the loss dispute provisions”). Under these provisions, if the minister disputes a loss reported by a taxpayer, the taxpayer can require the minister to issue a notice of determination of losses (NODL) for that taxation year. Once issued, a NODL can be objected to or appealed in basically the same manner as a reassessment. Subject to any such objection or appeal, a NODL is binding upon the minister and the taxpayer after the expiry of the normal redetermination period (which is the same length of time as the normal reassessment period, but starts from the date of issuance of the NODL).⁴

While the loss dispute provisions address some of the challenges caused by the nil assessment rule and the *New St James* principle, the existence of a parallel but distinct system for resolving loss disputes leaves gaps that can result in procedural obstacles and traps for taxpayers, including

1. the loss of the right to object to or appeal disputed income adjustments,
2. an obligation to pay arrears interest on extinguished tax debts,
3. the revival of issues relating to statute-barred years, and
4. the duplication of proceedings.

This article explores examples of these situations, showing how they arise and what a taxpayer might do to avoid being caught by them. It also invites a discussion about whether the time has come to reform the nil assessment rule and/or the *New St James* principle so as to allow disputes involving losses to be resolved more readily by the Tax Court of Canada.

The discussion that follows briefly describes the regime in the Act for carrying over losses, traces the origins of the nil assessment rule and the *New St James* principle, and provides an overview of the loss dispute provisions. Then several scenarios are described in which the application of these various provisions and concepts can

3 Supra note 2, subsection 152(3.1). Unless otherwise stated, statutory references in this article are to the Act. The *New St James* principle is derived from a 1964 decision of the Tax Appeal Board, discussed in the text below at note 28 and following.

4 See *Perfect Fry Company v. The Queen*, 2007 TCC 133; aff'd 2008 FCA 218, at paragraphs 43–44.

cause undesirable consequences, along with a discussion of how such consequences might be avoided. The article concludes with some suggestions for possible reform.

LOSS CARRYOVERS

The Act recognizes five broad categories of losses that can be carried over and applied in other taxation years: non-capital losses, net capital losses, restricted farm losses, farm losses, and limited partnership losses.⁵ Specific rules and limitations apply to the various categories; net capital losses, for example, can generally be carried over only to offset capital gains (subsection 111(1.1)),⁶ while limited partnership losses, inter alia, are limited to a taxpayer's "at-risk" amount in a limited partnership (paragraph 111(1)(e)).

The Operative Provision

Subsection 111(1) is the operative provision of the Act for loss carryovers. Paragraph 111(1)(a) allows a taxpayer to deduct from taxable income such portion as the taxpayer may claim of its "non-capital losses for the 20 taxation years immediately preceding and the 3 taxation years immediately following the year." In other words, non-capital losses can be carried forward to a maximum of 20 years or back 3 years. Paragraphs 111(1)(b) through (e) deal with the other categories of losses.

Subsection 111(3) imposes two additional constraints:

1. Losses in a particular year can only be deducted once. For example, if a taxpayer has \$100,000 of losses in 2010 and carries forward and deducts \$75,000 of those losses in 2011, only \$25,000 of the 2010 losses will be available for deduction in subsequent years.
2. For each category of loss, a taxpayer must deduct the earliest losses available first. For example, if a taxpayer has \$100,000 of losses in 2010 and another \$100,000 in 2011, and wishes to carry forward \$50,000 of losses in 2012, the taxpayer must use the losses from 2010, not 2011.

Subsection 111(1) requires a taxpayer to "claim" a loss carryover in order to utilize the loss. Unlike current-year losses, which are automatically deducted from income, loss carryovers are elective and apply only if a taxpayer chooses to claim the deduction. Moreover, as explained by the Federal Court of Appeal in *CCLI (1994) Inc. v. Canada*,⁷ losses are "claimed" on a year-by-year basis; for example, if a taxpayer

5 A discussion of these various categories falls beyond the scope of this article. A useful overview appears in the CRA's *Interpretation Bulletin* IT-232R3 (Archived), "Losses—Their Deductibility in the Loss Year or in Other Years," July 4, 1997.

6 An exception to this rule applies in the case of "allowable business investment losses," a form of capital loss that can be used to offset all income (paragraphs 3(d) and 38(c)).

7 2007 FCA 185.

decides to carry back a certain amount of losses from 2013 to 2010, the minister cannot, on his or her own initiative, substitute losses from another taxation year. This can have important consequences with regard to statute-barred years. If a taxpayer carries losses over from a loss year to a profitable year and the profitable year becomes statute-barred, and the minister subsequently determines that the taxpayer did not have sufficient losses in the loss year to carry over, the minister cannot deduct losses from another loss year to make up the disallowed amount. In the absence of a misrepresentation by the taxpayer attributable to negligence, or another ground on which to reopen the statute-barred year, the minister has no recourse, and the taxpayer is entitled to use its losses from other years as it sees fit.⁸

The Assessing Provisions

Section 152 contains various provisions that either require or permit the minister to assess or reassess taxpayers claiming a loss carryover. As noted by the Federal Court of Appeal in *Canada v. Agazarian*, the provisions are not easy to follow—indeed, Létourneau JA remarked that

[t]he legislative provisions under scrutiny are a mess. With all respect to the contrary opinion, I do not think that they lend themselves to a literal interpretation. They are in such a state of disarray that the literal interpretation leads to incongruous results whether one adopts the appellant's or the respondent's position.⁹

Loss carryforwards are generally claimed like other deductions from income or taxable income. A taxpayer claims the carryforward as a deduction in its tax return for the year in which the deduction is claimed. If a taxpayer wishes to carry forward a loss after filing its original return, the taxpayer can either file an amended return, which the minister will generally review and process if the normal reassessment period has not passed (subsection 152(4)),¹⁰ or object to the original assessment based on its tax return and claim the carryforward on objection.¹¹

8 This is what occurred in *CCLI*, *ibid.* For additional commentary on this decision, including a historical discussion of the origin of the “claim” requirement in subsection 111(1), see David Wentzell, “‘Timing is Everything’—How a Taxpayer Got Double Value from Its Losses” (2007) 55:3 *Canadian Tax Journal* 717-20.

9 *Canada v. Agazarian*, 2004 FCA 32, at paragraph 54.

10 See Ian Crosbie, “Amended Returns, Refunds, and Interest,” in *Tax Dispute Resolution, Compliance, and Administration in Canada* (Toronto: Canadian Tax Foundation, 2013), 27:1-33; and Daniel Sandler and Allison Backler, “(Can’t Get No) Satisfaction? Look Beyond the Fairness Provisions,” in *Report of Proceedings of the Seventieth Tax Conference*, 2018 Conference Report (Toronto: Canadian Tax Foundation, 2019), 33:1-30.

11 If a taxpayer chooses this latter option, the objection will have to be filed within the usual time limits and in accordance with the other requirements set out in section 165.

Loss carrybacks, in contrast, are generally claimed for a particular year only after the taxpayer has already filed a tax return and been assessed for that year.¹² To oblige the minister to process such requests, paragraph 152(6)(c) provides as follows:

(6) Where a taxpayer has filed for a particular taxation year the return of income required by section 150 and *an amount is subsequently claimed by the taxpayer or on the taxpayer's behalf for the year as . . .*

(c) *a deduction . . . under section 111 in respect of a loss for a subsequent taxation year, . . .*

by filing with the Minister, on or before the day on or before which the taxpayer is, or would be if a tax under this Part were payable by the taxpayer for that subsequent taxation year, required by section 150 to file a return of income for that subsequent taxation year, a prescribed form amending the return, the Minister shall reassess the taxpayer's tax for any relevant taxation year (other than a taxation year preceding the particular taxation year) in order to take into account the deduction claimed [emphasis added].

The “prescribed form” mentioned at the end of subsection 152(6) is form T1A (for individuals), T2A (for corporations), or T3A (for trusts), which have been issued administratively by the Canada Revenue Agency (CRA).

As can be seen, paragraph 152(6)(c) requires the minister to process a loss carryback claim and to reassess the prior year accordingly if the taxpayer files a form T1A, T2A, or T3A on or before the due date for filing its tax return for the loss year. If a taxpayer is late in filing the form, the minister is no longer obligated to process the carryback request—a point that is important to remember, given that taxpayers with no tax payable may not be motivated to file their tax returns on time. However, if the taxpayer requests the carryback after the deadline set out in paragraph 152(6)(c), the minister may nonetheless process the request pursuant to the reassessing powers under subsection 152(4) and/or (in the case of individuals) subsection 152(4.2).

Subparagraph 152(4)(b)(i) allows the minister to reassess a taxation year for an additional three years after the expiry of the normal reassessment period to give effect to a loss carryback request,¹³ even if the request is filed after the deadline set out in paragraph 152(6)(c). A reassessment made during this “extended reassessment period” must be limited to such matters as “can be reasonably be regarded as relating to” the carryback request (subparagraph 152(4.01)(b)(i)). Thus, the minister cannot use the carryback request to reopen a statute-barred year. Similarly, the taxpayer is permitted to object to or appeal such a reassessment “only to the extent that the reasons for the objection” pertain to the carryback request (subsections 165(1.1) and 169(2)). Essentially, a taxpayer cannot claim a carryback and then

12 If a taxpayer is late-filing a return and claiming carrybacks from subsequent years at the same time, those losses can be included in the original return and processed in the same manner as carryforwards.

13 This extended reassessment provision applies only to loss carrybacks; it does not apply to loss carryforwards.

reopen the entire year by disputing the reassessment implementing the carryback request.¹⁴

Similarly, although there is no express statement to this effect in the Act, the Federal Court of Appeal in *Agazarian* construed paragraph 152(4.01)(b)(i) as authorizing the minister to make further reassessments during the extended reassessment period to the extent that they reasonably relate to the reassessment allowing the carryback.¹⁵ This means, essentially, that the minister can audit the losses carried back and vary or disallow them during this period.

Finally, the minister is not bound by what appears in the taxpayer's return and may thus vary or reject a carryback request (subsection 152(7)). The latter situation can cause a procedural issue for the taxpayer. If the minister rejects the carryback request without issuing a reassessment, the taxpayer may not be able to dispute the minister's decision through the usual objection and appeal process. Such a situation occurred in *Greene v. The Queen*,¹⁶ where a taxpayer sought to carry back a large capital loss from 1988 to the years 1985, 1986, and 1987. The minister, believing the request to be unfounded, declined to process it. The taxpayer sought judicial review in the Federal Court, asking the court to order the minister to issue "a reassessment" in accordance with subsection 152(6). The Federal Court issued such an order, in response to which the minister "reassessed" the taxpayer's 1985, 1986, and 1987 taxation years in a manner identical to its previous assessments. The taxpayer sought further judicial review, arguing that such "no-change" reassessments were not consistent with subsection 152(6), but the Federal Court of Appeal disagreed. The court held that such "no-change" reassessments were appropriate and that if the taxpayer did not agree with the minister's position, he could and should pursue the matter through an objection and appeal.

THE NIL ASSESSMENT RULE

Okalta Oils: The Classic Formulation of the Nil Assessment Rule

The nil assessment rule traces its origins to the decision of the Supreme Court of Canada in *Okalta Oils v. Minister of National Revenue*.¹⁷ *Okalta Oils* concerned an oil-producing company that received a notice of assessment for its 1946 taxation year disallowing a credit available at the time for oil drilling and exploration costs ("the oil drilling and exploration credit") pertaining to one of its wells. The taxpayer was originally assessed a nominal amount of tax and filed an objection. The

14 Subsection 165(1.1) concludes by saying that "this subsection shall not be read or construed as limiting the right of the taxpayer to object to an assessment or a determination issued or made before that time." This provision ensures that, if a taxpayer has a pending objection or appeal relating to other issues in a taxation year at the time a reassessment is issued to implement a carryback, the taxpayer can raise those former issues again on objection.

15 *Agazarian*, supra note 9.

16 95 DTC 5684 (FCA); aff'g 95 DTC 5078 (FCTD).

17 [1955] SCR 824; aff'g 55 DTC 1029 (Ex. Ct.); aff'g 53 DTC 323 (TAB).

minister allowed the objection in part and varied the assessment into a “nil assessment” that nevertheless still denied the oil drilling and exploration credit for the well at issue. Because the oil drilling and exploration credit could be carried over and applied in subsequent taxation years, the taxpayer appealed the nil assessment to the Income Tax Appeal Board, and from there to the Exchequer Court and the Supreme Court.

The Tax Appeal Board and the Exchequer Court both decided the case on its merits, holding that the taxpayer was not entitled to the oil drilling and exploration credit since, essentially, all of the relevant expenses were paid by another entity. Both lower courts expressly declined to deal with the procedural question of whether the nil assessment was subject to appeal in the first place.

The taxpayer appealed to the Supreme Court of Canada, which dismissed the appeal from the bench following the conclusion of oral argument. In very brief reasons issued subsequently, the court held that no appeal lies from an assessment that claims no tax, and thus the courts below had no jurisdiction to hear the case.

In coming to this conclusion, the court held that sections 69a and 69b of the Income War Tax Act¹⁸ (the predecessors to sections 165 and 169 in the Act today) allowed a taxpayer to serve a notice of objection to an “assessment” and to appeal to the Tax Appeal Board only after the minister had confirmed the assessment or reassessed. The court conceded that the word “assessment” has two distinct meanings in the tax context: (1) the process of ascertaining a taxpayer’s profit for the purpose of charging tax, and (2) the actual sum of tax that the taxpayer is liable to pay.¹⁹ However, it held that the word “assessment” in sections 69a and 69b was to be understood in the latter sense.

The court’s analysis in support of this conclusion was very brief and relied primarily on the fact that the predecessor provision to sections 69a and 69b—section 58 of the Income War Tax Act (repealed in 1946)—conferred a right of appeal upon “any person who objects to *the amount* at which he is assessed.”²⁰ The court also noted that the Tax Appeal Board had previously held, in *No. 111 v. MNR*,²¹ that the word “assessment” in section 69b referred only to an assessment that imposed tax.

With respect, arguably, the Supreme Court’s reasoning in *Okalta Oils* was problematic for a variety of reasons, including the following:

18 RSC 1927, c. 97, as amended.

19 In this regard, the Supreme Court cited Viscount Simon’s comment in *Income Tax Commissioners for City of London v. Gibbs*, [1942] AC 402 (HL), at 406: “The word ‘assessment’ is used in our income tax code in more than one sense. Sometimes, by ‘assessment’ is meant the fixing of the sum taken to represent the actual profit for the purpose of charging tax on it, but in another context the ‘assessment’ may mean the actual sum in tax which the taxpayer is liable to pay on his profits.” See *Okalta Oils*, supra note 17 (SCC), at 825.

20 *Okalta Oils*, supra note 17 (SCC), at 826, citing the Income War Tax Act, 1917, 7-8 George V, c. 28, section 58 (emphasis added).

21 (1953), 8 Tax ABC 440.

- The court did not quote former section 58 of the Income War Tax Act in its entirety; in fact, the section conferred a right of appeal upon “[a]ny person who objects to the amount at which he is assessed, *or who considers that he is not liable to taxation under this Act* [emphasis added].”
- The fact that Parliament replaced the phrase “the amount at which he is assessed” in 1946 with the generic term “assessment” could support the inference that Parliament sought to expand the availability of the objection and appeal procedure.
- The court did not offer any discussion about whether it was just, fair, or reasonable, from a perspective of tax administration, to deny the taxpayer in *Okalta Oils* the opportunity to obtain certainty with respect to its entitlement to the oil drilling and exploration credit through the normal objection and appeal process. The Tax Appeal Board and the Exchequer Court were both perfectly able to decide the case on its merits, and there seemed to be no obvious purpose to obliging the taxpayer to repeat the entire litigation process in some future year in which there was tax payable.
- The analysis in *No. 111* about whether the Tax Appeal Board had the jurisdiction to hear an appeal of a nil assessment was largely in obiter, and in any event could hardly bind the Supreme Court.²²

However perfunctory and questionable the reasoning may have been *Okalta Oils*, the nil assessment rule has become settled law in Canada, notwithstanding the fact that it can cause significant headaches for taxpayers, particularly those who may not have ready access to sophisticated professional assistance in planning their affairs.

The Tax Court of Canada’s decision in *Joshi v. The Queen*²³ illustrates the problems that the nil assessment rule can cause for taxpayers. The case involved a dispute with the minister over moving expenses incurred in 2000 that the taxpayer carried forward to 2001. The minister denied the claim for moving expenses but, without being asked to do so, applied the taxpayer’s unused tuition credits to reduce her tax payable to zero. The minister issued a nil assessment accordingly. This “solution” was unsatisfactory for the taxpayer since it reduced the amount of tuition expenses that she could claim in future years (and the moving expenses could be carried forward only one taxation year). The taxpayer thus objected and appealed. The minister made a motion to strike the appeal based on the nil assessment rule.

22 The primary issue in *No. 111*, supra note 21, was whether a bus company had to include in income, receipts for bus tickets where transportation had not yet been delivered. Three taxation years were at issue, 1946, 1947, and 1948; 1946 and 1947 were profitable, 1948 was loss-making, and the profits of 1947 were completely offset by the 1948 losses, resulting in no tax being due. The Tax Appeal Board decided the main issue on its merits, applicable to all three years. There was an additional, minor issue concerning a clerical error in the minister’s determination of the taxpayer’s loss for 1948. The Tax Appeal Board noted that it could deal with that issue only if and when the taxpayer attempted to apply those losses to a future taxation year.

23 2003 TCC 615.

The Tax Court dismissed the motion, reserving the question of jurisdiction for trial. The case was heard and concluded with the court's issuing an unreported order, dated May 10, 2014, allowing the appeal and referring the assessment "back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant is entitled to additional moving expenses in the amount of \$9,037.43."²⁴ Notwithstanding this fortunate result for the taxpayer, the Federal Court of Appeal subsequently held, in *Canada v. Interior Savings Credit Union*²⁵ (discussed below), that the appeal in *Josbi* should never have been allowed to proceed in the first place. *Josbi* therefore remains an isolated decision that is not followed.

Interior Savings: The "Second Branch" of the Nil Assessment Rule

Okahta Oils was limited to the question of whether a taxpayer can object to or appeal an assessment that imposes no tax. However, subsequent case law developed a "second branch" of the nil assessment rule, according to which an objection or appeal of an assessment is valid only if the taxpayer is seeking an actual *reduction* of tax, as opposed to an adjustment of some other tax balance or element of the assessment.

The Federal Court of Appeal articulated this second branch in *Interior Savings Credit Union*, which concerned a certain tax balance known as the "preferred rate amount" (PRA) applicable to credit unions. Essentially, if the PRA exceeds a certain level, the credit union loses its entitlement to a particular tax credit. In this case, the minister reassessed the credit union taxpayer so as to increase its PRA balance from around \$9.6 million to \$64.3 million. The increase had no impact on the amount of tax due for that year. The credit union nevertheless filed a notice of objection and subsequently an appeal to the Tax Court based, not on the amount of tax assessed, but rather on the determination of the PRA balance. The minister made a motion to strike based on the second branch of the nil assessment rule, even though the assessment under appeal was not, in fact, a nil assessment; the credit union was assessed tax during the year in question.

Little J of the Tax Court dismissed the minister's motion to strike, finding that the credit union had compelling reasons for needing a definitive determination of its PRA balance (including the ability to properly comply with its regulatory obligations) and that the nil assessment rule had been attenuated by the Tax Court's decision in *Josbi* (discussed above).²⁶ The Federal Court of Appeal, however, reversed this decision and granted the motion to strike, holding that *Josbi* was wrongly decided and that the second branch of the nil assessment rule invalidates any objection or appeal that does not put at issue the amount of tax assessed.²⁷

24 A copy of the order and minutes of the hearing was obtained from the Tax Court of Canada records.

25 2007 FCA 151; rev'g 2006 TCC 411.

26 Ibid. (TCC), at paragraphs 35-36.

27 Ibid. (FCA), at paragraphs 17-33.

The Federal Court of Appeal did not provide any indication as to what the credit union could have done to obtain certainty with respect to the amount of its PRA balance, which it needed to comply with its regulatory obligations. However, one may consider whether a reference to the Tax Court of Canada under section 173 of the Act, discussed below, might have been available. If so, it arguably would be a better use of judicial resources for the parties to convert the credit union's appeal into a section 173 reference and to obtain a binding judicial determination of its PRA while the matter was timely.

THE NEW ST JAMES PRINCIPLE

The *New St James* principle allows the minister to reassess loss years indefinitely, even after the expiry of the normal reassessment period. This result flows from a plain reading of subsection 152(4), which reads in part as follows:

(4) The Minister may *at any time* make an assessment, reassessment or additional assessment of tax for a taxation year, interest or penalties, if any, payable under this Part by a taxpayer or *notify in writing any person by whom a return of income for a taxation year has been filed that no tax is payable for the year*, except that *an assessment, reassessment or additional assessment may be made after the taxpayer's normal reassessment period in respect of the year only if*. . . [emphasis added].

As can be seen, the first part of subsection 152(4) authorizes the minister, “at any time,” to issue assessments, reassessments, and additional assessments for tax, interest, and penalties, as well as to provide a taxpayer who has filed a return with written notification that no tax is payable for a particular year. The second part, however, limits the first part by barring the minister from issuing “an assessment, reassessment or additional assessment” after the normal reassessment period (defined in subsection 152(3.1)). Importantly, this bar does not apply to notifying taxpayers in writing that no tax is due for a particular year (that is, to nil assessments). Consequently, any so-called reassessment from the minister of a particular taxation year that simply varies the amount of a taxpayer's losses but otherwise imposes no tax can be issued at any time, even after the expiry of the normal reassessment period, and is thus not binding on the minister.

The seminal case on this principle remains *New St James v. MNR*,²⁸ which concerned a taxpayer that operated a hotel. The taxpayer reported losses in 1955 and was assessed accordingly, and then carried forward those losses and deducted them in its 1956, 1957, 1958, and 1959 taxation years. Four years after the original assessment for 1955, the minister disallowed most of the 1955 loss (on the basis that many of the expenses claimed were in fact capital expenditures) and reassessed the 1956 to 1959 years accordingly. The taxpayer argued that the minister was barred from revisiting the quantum of losses in 1955, since that year had become statute-barred. The Tax Appeal Board and the Exchequer Court rejected this argument, holding

28 64 DTC 121 (TAB); varied 66 DTC 5241 (Ex. Ct.).

that the taxation years at issue were 1956 to 1959 and those years were not statute-barred, even if the amount of tax due in those years was dependent on the amount of losses available for carryforward from 1955.

The leading case today on the *New St James* principle is the Federal Court of Appeal's decision in *Canada v. Papiers Cascades Cabano Inc.*,²⁹ in which the court endorsed the following comment by Bowman CJ of the Tax Court in *Coastal Construction and Excavating Limited v. The Queen*:

The Minister is obliged to assess in accordance with the law. If he assesses a prior year incorrectly and that year becomes statute-barred this will prevent his reassessing tax for that year, but it does not prevent his correcting the error in a year that is not statute-barred, even though it involves adjusting carry-forward balances from previous years, whether they be loss carry-forwards or balances of investment tax credits.³⁰

Taxpayers also benefit from the *New St James* principle insofar as it allows them to retrospectively modify their tax positions in past years in which no tax was payable, even after the expiry of the normal reassessment period, where doing so is relevant to their tax liability in a taxable year. In *Clibetre Exploration Ltd. v. Canada (Minister of National Revenue)*,³¹ for example, a taxpayer incurred non-capital losses for 16 consecutive years (1980 to 1995) before having a profitable year in 1996. Because non-capital losses at the time could be carried forward only for seven years, the taxpayer took the position that its losses between 1980 and 1995 were not non-capital losses, but instead were Canadian exploration expenses (CEE) giving rise to a cumulative CEE balance that could be deducted in its entirety in 1996. The minister refused to accept this recharacterization and only allowed a carryforward for seven years of non-capital losses. The Tax Court accepted the minister's argument that the taxpayer could not change the characterization of its expenses because the years were statute-barred. The Federal Court of Appeal reversed this holding from the bench, remarking that "there is no statutory bar to the requested recharacterization."³²

THE LOSS DISPUTE PROVISIONS

The Enactment of the Provisions

In the March 1977 federal budget, the government announced its intention to create a procedure whereby taxpayers with capital, non-capital, or restricted farm losses in a particular year could obtain a "determination" of those losses from the minister (that is, a NODL). This determination, once made, would be subject to

29 2006 FCA 419; rev'g 2005 TCC 396.

30 *Coastal Construction and Excavating Limited v. The Queen*, 97 DTC 26, at 31-32 (TCC), quoted in *Papiers Cascades Cabano*, supra note 29 (FCA), at paragraph 23.

31 2003 FCA 16; rev'g *Clibetre Exploration Ltd. v. Canada*, 99 DTC 3503 (TCC).

32 *Ibid.* (FCA), at paragraph 6.

objection and appeal (thus derogating from the nil assessment rule) and would also be binding on both the taxpayer and the minister (thus derogating from the *New St James* principle).³³

The parliamentary records provide little indication as to what specifically prompted the government to enact the loss dispute provisions in that year. It is possible that the initiative was partly motivated by the introduction of the capital gains taxation regime in 1972, followed by the stock market crash of 1973-74, which no doubt raised the importance of capital losses in the workings of the tax system.

The government's first attempt to follow through with the announced amendments came in June 1977, when Bill C-22 enacted (among other things) the first, short-lived iteration of subsections 152(1.1) and (1.2).³⁴ Bill C-22 generated considerable debate between the government and the Senate Standing Committee on Banking, Trade and Commerce (hereinafter referred to as "the Senate standing committee") that reveals competing visions over the intended scope of the loss dispute provisions and ultimately ended in a compromise.

Essentially, the government's view was that the issuance of any NODL should be entirely at the minister's discretion; the original version of the loss dispute provisions enacted by Bill C-22 was consistent with that intention. The Senate standing committee, however, believed that taxpayers have a "fundamental right" to object to assessments and argued that the issuance of NODLs by the minister should be mandatory and more widely available. The standing committee set out its position in its report dated December 9, 1976, which proposed amending the Act to deem a nil assessment to be an "assessment" subject to objection or appeal, or alternatively to require the minister to issue a NODL either on request or when a taxpayer sought to carry over and apply its losses in another taxation year.³⁵

Following this report, the minister of national revenue (the Honourable Monique Bégin) appeared before the standing committee. After explaining the operational challenges that prevented her officials from auditing and determining all taxpayers' losses, the minister undertook to issue a NODL in cases where her determination of taxpayer's losses differed from the amount reported by the taxpayer, and to publicize this undertaking to taxpayers. The minister of finance (the Honourable Donald S. Macdonald) also appeared before the committee and undertook to propose amendments to the loss dispute provisions to give legal effect to Minister Bégin's undertaking. The Senate passed Bill C-22 (which included a variety of other amendments to the Act) largely in reliance on these undertakings.³⁶

33 Canada, Department of Finance, 1977 Budget, Supplementary Budget Papers, Budget Paper C, Notice of Ways and Means Motion To Amend the Income Tax Act, March 31, 1977, at 107.

34 An Act To Amend the Statute Law Relating to Income Tax, SC 1976-77, c. 4, section 61(1).

35 Canada, Senate, Report of the Standing Committee on Banking, Trade and Commerce Relating to the Subject Matter of Bill C-22, 30th Parl., 2d sess., December 9, 1976; reproduced in Canada, Senate, *Debates*, 1976-1977, vol. 1, at 213-16.

36 Canada, Senate, *Debates*, February 24, 1977, at 451-52 and 456 (Hayden).

The government followed through several months later: the 1977 budget legislation (Bill C-11) replaced subsections 152(1.1) and (1.2) with new subsections 152(1.1) through (1.3),³⁷ which provided essentially as follows:

- Where the minister ascertained the amount of a taxpayer's non-capital loss, net capital loss, or restricted farm loss for a taxation year and that amount was different from the amount reported in the taxpayer's income tax return for that year, "the Minister shall, at the request of the taxpayer," issue a NODL for that year in respect of those losses (subsection 152(1.1)).
- The provisions of the Act pertaining to, inter alia, statute-barred years, objections, and appeals were applicable, mutatis mutandis, to a NODL (subsection 152(1.2)).
- The minister could not issue a NODL unless requested to do so by the taxpayer (subsection 152(1.2)).
- A NODL, subject to being varied on objection or appeal, was binding on the minister and the taxpayer for the purpose of calculating the taxable income of the taxpayer for any other year (subsection 152(1.3)).

While the Senate standing committee ultimately recommended adoption of the 1977 budget, it remained dissatisfied with the amended loss dispute provisions and continued to believe that taxpayers should be able to obtain NODLs even in the absence of a dispute with the minister.³⁸ During its hearings on the 1977 budget, the standing committee raised these concerns with revenue officials, who responded that they did not have adequate resources to systematically audit all loss claims as reported on tax returns.³⁹ Describing the matter as "quite a bone of contention," the standing committee pursued it further with the minister (then the Honourable Joseph-Philippe Guay), who undertook to personally study the question of when a taxpayer should have the right to obtain a NODL.⁴⁰

The 1977 budget was adopted and, although subsections 152(1.1) through (1.3) have been amended and reformulated over the years, largely as a consequence of the inclusion of other categories of losses and determinations, their core features as enacted in 1977 remain in the Act to this day as the loss dispute provisions.

37 An Act To Amend the Statute Law Relating to Income Tax and To Provide Other Authority for the Raising of Funds, SC 1977-78, c. 1, section 76.

38 Canada, Senate, Standing Committee on Banking Trade and Commerce, First Report on the Advance Study of the Budget Resolutions Respecting Income Tax and Any Bill or Other Matter Relating Thereto, December 8, 1977, at 11; reproduced in Canada, Senate, *Debates*, 1977-78, appendix A, following 226.

39 Canada, Senate, *Debates*, 30th Parl., 3d sess., December 12, 1977, at 231 (Hayden).

40 Canada, Senate, *Debates*, 30th Parl., 3d sess., December 14, 1977, at 245-46 (Hayden).

CRA Administrative Positions on the Loss Dispute Provisions

Section 11.5.10 of the *CRA Audit Manual* (as revised in January 2014)⁴¹ sets out a number of administrative positions with respect to the loss dispute provisions that reflect the minister's current view on how the provisions are intended by Parliament to operate.

First, the minister will issue NODLs only in the context of a disagreement with the taxpayer over the quantum of losses following an audit by the CRA. The minister will not, for example, issue a NODL to a taxpayer who requests it in order to sell a loss corporation.⁴² This marks an apparent change from prior understanding and practice, given that *Interpretation Bulletin* IT-512, which was in force between July 15, 1988 and September 30, 2012, identified two other situations where "it is the Department's practice to act upon a request for a determination of losses"⁴³—namely, where

(a) a corporation has been wound up under subsection 88(1) into another corporation and that corporation has made the request in respect of losses which are deemed to be its losses under subsection 88(1.1) and 88(1.2); or

(b) there has been an amalgamation and the new corporation has made the request in respect of losses of the predecessor corporation referred to in subsection 87(2.1).⁴⁴

Second, if the minister adjusts a taxpayer's loss for a particular year at the taxpayer's request, such as through an audit request or an amended return, the minister will consider the adjusted loss to be the "reported amount" for the purposes of subsection 152(1.1) and thus will not issue a NODL in such situations. The minister will issue a NODL only "where there has been a material change to a reported loss resulting from an audit by the CRA."⁴⁵

41 Canada Revenue Agency, *CRA Audit Manual* (Ottawa: CRA).

42 At the Tax Executives Institute round table on November 18, 2014 (CRA document no. 2014-0550351C6), the minister expressed the view that a NODL requires, as a *sine qua non*, a difference of opinion between the minister and the taxpayer over the amount of losses available in a particular year. Consequently, the minister cannot simply issue a NODL at the request of a taxpayer upon the filing of its return. The minister's position is that "[t]his interpretation has been confirmed by the courts," presumably in reference to *Inco*, *infra* note 56, and *Armstrong*, *infra* note 57.

43 *Interpretation Bulletin* IT-512, "Determination and Redetermination of Losses," July 15, 1988, at paragraph 3 (cancelled September 30, 2012).

44 *Ibid.* The wording of IT-512 is somewhat unclear in that it states that "it is the Department's practice to act" on such requests "[w]here the provisions of subsection 152(1.1) are otherwise satisfied." Of course, if the provisions of subsection 152(1.1) are satisfied, the minister is obligated to act on such requests. In context, it seems that the minister's "practice" was to issue NODLs in the two circumstances described even in the absence of a live dispute over the loss balances.

45 *CRA Audit Manual*, *supra* note 41, at section 11.5.10.

Third, if a taxpayer reports a profitable or “nil” year and, as a result of an audit, the minister determines that the taxpayer actually suffered a loss and reassesses accordingly, the minister will grant a NODL for that year if requested.⁴⁶

Fourth, if a taxpayer reports a loss and, as a result of an audit, the minister disallows the loss entirely and reassesses the year as a breakeven year, the minister will issue a “nil NODL” (that is, a NODL issued where the minister determines that the taxpayer sustained no loss at all) at the taxpayer’s request. Unlike a nil assessment, a nil NODL *can* be objected to and appealed. Indeed, the case of *Aallcann Wood Suppliers Inc. v. The Queen*,⁴⁷ discussed below, involved such an appeal.

Case Law on the Loss Dispute Provisions

There have been relatively few reported decisions involving the loss dispute provisions. Most of the existing case law concerns procedural issues involving their mechanics of operation and interaction with the other dispute resolution procedures in the Act. In particular, the courts have considered whether and how losses can be put at issue in a tax appeal without a NODL, what constitutes a NODL, and when the minister is obligated to issue a NODL.

Aallcann Wood: A NODL Is Not Necessary To Dispute Losses

A seminal case on the loss dispute provisions is the decision of Bowman J (as he then was) in *Aallcann Wood*. This case concerned losses incurred in 1988 that the taxpayer sought to carry over and deduct in 1985, 1986, 1987, and 1989. The minister took the position that a \$250,000 capital receipt in 1988 constituted business income, and reassessed the taxpayer so as to reduce its loss in 1988 and to disallow the deduction of the 1988 losses in 1985, 1986, 1987, and 1989. The taxpayer objected and appealed the reassessments for all five years. During the proceedings, the minister took the position that

in the appeals for 1985, 1986 and 1987 the appellant could not challenge the Minister’s computation of the loss for 1988 because the appellant had not requested a NODL for 1988.⁴⁸

The taxpayer obliged by requesting a NODL, which was issued, objected to, confirmed, and appealed, the appeal being joined to the appeal of the taxable years.

Bowman J strongly criticized the minister for obliging the taxpayer to obtain a NODL for 1988, noting that the losses incurred in that year were all validly before the court as deductions claimed in other years and that, as a result,

⁴⁶ See also CRA document no. 2013-0508751I7, December 4, 2013.

⁴⁷ 94 DTC 1475 (TCC).

⁴⁸ Ibid., at 1475.

[t]he matter of the 1988 loss is now before the court on two bases—both as an appeal from the 1988 loss determination and as a component of the taxable income for 1985, 1986, and 1987 and, to the extent that any amount of loss remains available for carry-forward, for 1989.⁴⁹

Bowman J observed that

the Crown's position is so out of line with both the law and with prevailing practice and could potentially have such far-reaching effects on any number of appeals before this court that I considered it desirable that the idea be nipped in the bud.⁵⁰

Ten years later, Bowman ACJ (as he then was) reiterated this holding in *Burleigh v. The Queen*,⁵¹ adding that, contrary to the minister's claims, it was not necessary that a loss be previously reported on a tax return and "processed" by the minister in order to be deductible as a carryover to another taxation year.⁵²

722540 Ontario: A NODL Trumps Disputing Losses in Other Years

If a taxpayer obtains a NODL in a particular taxation year but fails to object and appeal in accordance with the procedural requirements and time frames set out in section 152, subsection 152(1.3) bars the taxpayer from challenging the quantum of losses set out in the NODL in other taxation years. Such a situation occurred in *722540 Ontario Inc. v. The Queen*.⁵³ This case concerned (among other things) a corporate taxpayer that had declared losses in 1988, which it sought to carry over and deduct in 1990 and 1991. The minister reassessed all three years so as to deny the loss and the carryovers. The taxpayer objected to the reassessments for all three years and also sought a NODL pertaining to 1988. However, the taxpayer did not file an objection to the NODL. The reassessments of 1990 and 1991 were confirmed. The taxpayer then appealed all three years to the Tax Court. Bowie J held that in the absence of a valid objection to the NODL, the court could not hear any appeal in respect of the quantum of losses available for carryover from 1988 because subsection 152(1.3) deemed the NODL for 1988 to be valid and binding, and the taxpayer could not collaterally attack it through an appeal of the reassessments for 1990 and 1991.

In coming to this conclusion, Bowie J noted that he did not "entirely agree" with Bowman J's comment in *Aallicann Wood* that a loss could come before the court "on

49 Ibid., at 1475.

50 Ibid., at 1476.

51 2004 TCC 197, at paragraphs 8-9.

52 Ibid., at paragraph 13.

53 2001 CanLII 939 (TCC); aff'd (on other grounds) 2003 FCA 112; leave to appeal to the Supreme Court of Canada dismissed, [2003] SCCA no. 201. The appeals were pursued by another appellant and were unrelated to the NODL issue.

two bases”—namely, as an appeal from a NODL and as a component of income for a taxable year.⁵⁴ Instead, Bowie J’s view was that

once there has been a loss determination requested and made, it is only by filing a Notice of Objection to it, followed by a Notice of Appeal from it, that that determination of the loss can be brought before the Court.⁵⁵

Bowie J’s view is more likely the correct one. Bowman J did not discuss the effect of subsection 152(1.3) in *Aallcann Wood*—presumably because it was not relevant to the issues before him—and, read in context, his comment about the taxpayer’s 1988 losses being before the court “on two bases” was simply a complaint about the unnecessary duplication of procedures. It does not stand for the proposition that a taxpayer can obtain a NODL for a particular year, fail to object to or appeal the NODL, and then challenge the amount of losses available in that year in the context of an appeal in respect of a year to which those losses are carried over.

Inco: The NODL Provisions Presuppose a Dispute with the Taxpayer’s Filing Position

In *Inco Limited. v. The Queen*,⁵⁶ the Tax Court held that a statement of account or other document from the minister stating losses that are consistent with the taxpayer’s filing position does not constitute a NODL. In a decision confirmed by the Federal Court of Appeal, the Tax Court held that the ability of a taxpayer to request a NODL was an intentional policy choice by the legislature that was consistent with the *raison d’être* of the loss dispute provisions—namely, to provide a vehicle for the resolution of disputes when the nil assessment rule would otherwise bar an objection or appeal.

The Federal Court of Appeal reiterated this principle in *Armstrong v. Canada (Attorney General)*,⁵⁷ where a taxpayer sought to amend its returns after filing (and, indeed, while the years were under appeal) to declare and carry back additional losses. When the minister refused to process the amended returns, the taxpayer sought a writ of mandamus ordering the minister to issue a NODL. The Court of Appeal held that in the circumstances mandamus did not lie, reiterating that the loss dispute provisions have a “relatively limited scope” and apply only when the minister disagrees with losses reported on a taxpayer’s tax return.⁵⁸ Since an amended return

⁵⁴ *Aallcann Wood*, supra note 47, at 1475.

⁵⁵ 722540 *Ontario*, supra note 53 (TCC), at paragraph 28.

⁵⁶ 2004 TCC 373; aff’d 2005 FCA 44; leave to appeal to the Supreme Court of Canada dismissed, [2005] SCCA no. 278.

⁵⁷ 2006 FCA 119. *Armstrong* involved a number of other procedural issues that go beyond the scope of this article.

⁵⁸ *Ibid.*, at paragraph 17.

does not constitute a “return,” but rather a request to the CRA to reconsider a previous assessment, a refusal by the minister to allow losses claimed on an amended return cannot support the issuance of a NODL under subsection 152(1.1).

As discussed above, the minister seems to interpret *Inco* and *Armstrong* as barring the issuance of a NODL at the request of a taxpayer in the absence of a dispute over the amount of the taxpayer’s losses. However, neither *Inco* nor *Armstrong* expressly articulates such a proposition, and in 2013, the Department of Finance suggested that the minister may retain discretion to issue a NODL at the request of a taxpayer based on the taxpayer’s reporting position.⁵⁹

PITFALLS

As a result of the combined effects of the nil assessment rule, the *New St James* principle, and the loss dispute provisions, taxpayers with disputes involving loss years face various obstacles and traps that can potentially result in

1. the loss of the right to object to or appeal disputed income adjustments,
2. an obligation to pay arrears interest on extinguished tax debts,
3. the revival of issues relating to statute-barred years, and
4. the duplication of proceedings.

The discussion that follows describes various scenarios that illustrate these pitfalls and suggests how they might be avoided.

Extinguishment of the Right To Object or Appeal

Scenario 1

A corporate taxpayer has \$100,000 of non-capital losses in 2010 and \$50,000 of net income in 2011. In its 2011 return, the taxpayer carries forward and deducts \$50,000 of its 2010 losses such that its income for 2011 is reduced to nil. The minister audits the taxpayer’s 2011 year and disallows \$10,000 of expenses. The taxpayer disputes the disallowance of expenses but also asks the minister to carry forward an additional \$10,000 of losses from 2010 to ensure that no tax for 2011 is or ever will be due. The minister obliges and issues a nil reassessment.

In the circumstances described in scenario 1, the taxpayer often does not appreciate that claiming the carryforward to offset the disputed adjustments results in a nil assessment from which there is no right of objection or appeal, giving rise to the question of whether the taxpayer can dispute the disallowance of \$10,000 of expenses (and if so, then how). The NODL provisions are not available in these circumstances since the quantum of the losses in 2010 is not disputed.

The traditional solution in this situation is for the taxpayer to wait until a subsequent taxation year and then attempt to “reclaim” the \$10,000 of losses that covered

59 See CRA document no. 2014-0550351C6, November 18, 2014.

the disallowed expenses. For example, if the taxpayer had \$50,000 of net income in 2012, it could file a tax return claiming a carryforward of \$50,000 of losses from 2010. The minister would presumably take the position that the taxpayer had only \$40,000 of losses remaining from 2010 and therefore assess tax in 2012 based on \$10,000 of income. The taxpayer could object to and appeal the 2012 assessment, putting at issue the expenses previously disallowed in the 2011 reassessment.

The minister might argue that because the 2011 reassessment is deemed to be “valid and binding” (subsection 152(8)), the disallowance of \$10,000 of expenses in the 2011 reassessment cannot be collaterally attacked through an objection to a 2012 assessment. The case law is clear, however, that the minister would be wrong. The 2011 reassessment was a nil assessment, and it is uncontested that the taxpayer owed no tax in 2011. It is the amount of tax that is “valid and binding,” not the process through which the number was reached. As the Federal Court of Appeal held in *Clibetre*, discussed above, a taxpayer is free to argue that its previous expenses and deductions from years in which no tax was due should be recharacterized, even after the normal reassessment period for those years has passed, if doing so is relevant to the determination of tax due in a taxable year.

That said, this method of disputing the \$10,000 of disallowed expenses potentially keeps the issue alive for many years and can complicate greatly the calculation of the taxpayer’s loss balances. For example, suppose that the taxpayer has net income of \$40,000 in 2012, a subsequent loss of \$30,000 in 2013, and income of \$30,000 in 2014. Table 1 illustrates the availability of loss carryforwards from the taxpayer’s and the minister’s respective perspectives.

As the table illustrates, the taxpayer would, without controversy, offset its 2012 income entirely with remaining 2010 losses. For 2014, however, the taxpayer would attempt to offset its income by claiming \$10,000 of remaining 2010 losses and \$20,000 of 2013 losses. The minister would presumably disagree and disallow the 2010 carryforward, but allow the taxpayer to claim an additional \$10,000 of 2013 losses, thus resulting in another nil assessment. By this point, both the taxpayer and the minister would concur that the taxpayer’s 2010 losses were exhausted, but they would disagree over the amount of 2013 losses available for carryforward: the taxpayer would argue that \$10,000 was available; the minister, nil. This difference would be entirely attributable to the disallowed expenses of \$10,000 in 2011—an issue that would remain open and not be subject to adjudication until the taxpayer had another taxable year in the future.

An alternative way to deal with the disputed 2011 audit adjustment is for the taxpayer to not take full advantage of the carryforward but leave a nominal amount of income. For example, the taxpayer in scenario 1 may ask the minister to carry forward \$9,500 of losses from 2010 to offset the \$10,000 of disallowed expenses, thus leaving \$500 of taxable income and a nominal amount of tax.⁶⁰ The resulting reassessment can therefore be objected to or, if confirmed, appealed.

60 If the amount of tax due is \$2 or less, the amount due will be deemed to be nil, resulting in a nil assessment (subsection 161.4(1)).

TABLE 1 Comparison of Minister's and Taxpayer's Positions on Loss Continuity, Scenario 1

	Taxpayer's position				Minister's position			
	Net income/ loss	2010 losses applied	2013 losses applied	Taxable income	Net income/ loss	2010 losses applied	2013 losses applied	Taxable income
<i>dollars</i>								
2010	−100,000			loss	−100,000			loss
2011	50,000	50,000		nil	60,000	60,000		nil
2012	40,000	40,000		nil	40,000	40,000		nil
2013	−30,000			loss	−30,000			loss
2014	30,000	10,000	20,000	nil	30,000		30,000	nil
Losses available for carryforward		nil	10,000			nil	nil	

While this approach may be effective in preserving a right of objection, the taxpayer's right of appeal may still be lost if the minister allows the taxpayer's objection in part. For example, if the minister on objection allows the taxpayer to deduct only \$500 of the \$10,000 of disputed deductions in 2011, a nil reassessment will result with, as a consequence, no right of appeal. This is very similar to what happened in the *Okalta Oils* case. Again, the orthodox solution is for the taxpayer to wait for a subsequent year to attempt to carry forward the \$9,500 of losses used to offset the \$9,500 of disallowed deductions. This approach results, essentially, in the \$9,500 of disallowed deductions in 2011 being the subject of two separate objections: once in the context of an objection to the 2011 reassessment disallowing the deductions themselves, and a second time in the context of an objection to an assessment in a future year disallowing the losses used to offset those deductions.

A third option available for the taxpayer is to not claim any additional carry-forward at the audit stage but rather let the minister reassess with no additional carryforward, and then *in the notice of objection* claim an additional carryforward sufficient to leave \$500 of taxable income, should taxable income exceed \$500 after the minister has disposed of the other issues under objection. However, a potential problem with this approach is that if the taxpayer is a large corporation, one-half of any amount reassessed is immediately collectible (pursuant to subparagraph 164(1.1)(d)(ii) and subsection 225.1(7)). Even if the taxpayer is not a large corporation, a significant reassessment, even one that is destined to be substantially reduced through the application of loss carryforwards, may have to be disclosed to the taxpayer's creditors or in its financial statements.

Arrears Interest on Disputed Tax Debts

Scenario 2

A corporate taxpayer has \$50,000 of net income in 2010 and \$100,000 of non-capital losses in 2011. In its 2011 tax return, the taxpayer carries back \$50,000 of its losses to

2010 so as to leave no tax due in 2010. In 2015, the minister audits the taxpayer's 2010 year and disallows \$25,000 of expenses. The taxpayer disputes and intends to object to this adjustment, but also asks the minister to carry back an additional \$25,000 of losses from 2011 to ensure that no tax for 2010 is or ever will be due. The minister obliges and issues a reassessment with no tax due, but with interest as calculated in accordance with paragraph 161(7)(b).

Scenario 2 resembles scenario 1 but with the key difference that arrears interest will be assessed. Paragraph 161(7)(b) provides that when the minister assesses an amount of tax that is offset by a carryback, interest runs on the tax until such time as the taxpayer requests, in writing, the carryback of losses. In the case of an audit adjustment, requesting the carryback might be possible only years after the fact. In scenario 2, for example, the taxpayer could claim the carryback only in 2015, when first advised of the minister's position about the disputed expenses. If the \$25,000 of increased income resulted in increased tax payable of \$3,750 (prior to the carryback), the latter amount would bear interest from 2010 to 2015, and the taxpayer would be assessed such interest accordingly, even though no tax would be due. The CRA would issue an "interest-only assessment."

Paragraph 161(7)(b) is a troubling provision in that it essentially results in the assessment of interest over periods when no tax is actually due. One might see the logic in assessing interest on unpaid tax between the year in which the tax arose and the year in which the offsetting loss was incurred (that is, between 2010 and 2011 in scenario 2), since the taxpayer had use of those funds during that interval at the public's expense. However, it is difficult to see the fairness of charging the taxpayer interest over the period when tax losses have reduced the tax liability to nil (between 2012 and 2015 in scenario 2).

That said, there is conflicting case law from the Tax Court over whether a taxpayer can object to or appeal an interest-only assessment such as that seen in scenario 2. On the one hand, Pizzitelli J answered "no" in *Nottawasaga Inn Ltd. v. The Queen*.⁶¹ Relying on the second branch of the nil assessment rule as articulated in *Interior Savings Credit Union*, he held that

the Court has no jurisdiction to hear a challenge to the underlying taxable income calculated by the Minister on which interest is calculated in accordance with the *Act* when there is no appeal against taxes assessed or a nil assessments [sic] of tax.⁶²

Pizzitelli J commented that the taxpayer essentially waived its right to dispute the minister's audit adjustment by requesting the carryback that resulted in a nil assessment.⁶³

61 2013 TCC 377.

62 Ibid., at paragraph 27.

63 Ibid., at paragraph 32.

Boyle J, on the other hand, came to a different conclusion in *Shreedhar v. The Queen*, reasoning as follows:

On its face, the reassessment of the Appellant was not a nil assessment. An amount of interest was assessed by the CRA in its reassessment of him. *Assessed interest, as opposed to post-assessment accrued interest, forms part of the assessment. As it is not a nil assessment, an appeal can proceed.*⁶⁴

Both *Nottawasaga Inn* and *Shreedhar* were informal procedure cases and thus non-precedential,⁶⁵ and the Federal Court of Appeal has yet to adjudicate the debate between Boyle and Pizzitelli JJ. However, there are good reasons to believe that Boyle J's view is the correct one. Interest is a liability created by the Act and is assessed by the minister using the same provisions that are used to assess tax and penalties (section 152). If the minister ascertains facts that give rise to added liability for tax, interest, or penalties, sections 165 and 169 allow a taxpayer to challenge those facts through objection or appeal. There is no provision in section 165 or section 169 that states that a taxpayer can dispute an assessment of interest only if it is connected to a live dispute over the amount of tax due.

Moreover, it has long been recognized that the Tax Court can hear and decide disputes over the imposition of penalties in the absence of any dispute over underlying tax liability.⁶⁶ If *Nottawasaga Inn* was correctly decided, it implies that the Tax Court does not have any jurisdiction to hear a dispute over penalties where the underlying tax giving rise to the penalty is undisputed. That conclusion would be a major change in the long-established understanding of the jurisdiction of the court.

Further, it appears that even the minister has come to accept Boyle J's view. According to the *CRA Appeals Manual* (as revised in March 2015), the minister regards

64 2016 TCC 254, at paragraph 5 (emphasis added). This case did not involve a loss carryback, but rather unclaimed education-related deductions that extinguished the disputed tax liability but resulted in the assessment of a nominal amount of interest. The decision in *Roper v. The Queen*, 2000 CanLII 369 (TCC), also potentially supports Boyle J's view. (In *Roper*, the taxpayer appealed an assessment of interest and penalties on allegedly unremitted source deductions that were offset by GST refunds.) According to Tax Court records, the *Shreedhar* case was heard on its merits, and in the middle of the hearing, the taxpayer decided to withdraw his appeal. An unreported order dismissing the appeal without costs was issued on June 16, 2017.

65 Tax Court of Canada Act, RSC 1985, c. T-2, as amended, section 18.28. Apparently, the taxpayer in *Shreedhar* was represented by a pair of volunteer articling students from Pro-Bono Students Canada.

66 There are countless examples of reported decisions by the Tax Court in such cases, including some confirmed by the Federal Court of Appeal. See, for example, *Grier v. Canada* (April 1, 2016), docket no. 2013-1837(IT)I (TCC); aff'd 2017 FCA 129 (appeal limited to a subsection 163(2) gross negligence penalty); *Morgan v. The Queen*, 2013 TCC 232 (appeal limited to a subsection 163(1) failure to declare a penalty); *Khalil v. The Queen*, 2002 CanLII 1029 (TCC) (appeal limited to a section 162 failure to file a penalty); and *741290 Ontario Inc. v. The Queen*, 2011 TCC 91; aff'd 2011 FCA 361 (appeal limited to a subsection 227(9) failure to withhold a penalty).

objections to interest-only assessments resulting from loss carrybacks as validly filed objections and thus not subject to the nil assessment rule.⁶⁷ If such an objection is validly filed, subsection 169(1) provides for a right of appeal to the Tax Court.

Revival of Issues Relating to Statute-Barred Years

Scenario 3

A taxpayer files a timely tax return for his 2010 taxation year and is assessed on \$10,000 of net income. He is subjected to a lengthy audit concerning \$7,000 of claimed expenses. During the audit, the taxpayer also discovers that he was entitled to deduct an additional \$25,000 of unclaimed expenses and asks the auditor to adjust the assessment accordingly. Prior to the expiration of the normal reassessment period, the auditor requests, and the taxpayer provides, a waiver to the minister limited to the claimed and unclaimed expenses. At the conclusion of the audit, the minister decides not only to disallow all the expenses (both claimed and unclaimed), but also to include in income an additional \$5,000 of supposedly undeclared revenues, thus resulting a total net income of \$22,000. The taxpayer objects to these conclusions not only on their merits, but also on the basis that the year is statute-barred, and thus that subsection 152(4) barred the minister from including the supposed undeclared revenues in income. On objection, the minister agrees to allow the \$25,000 of unclaimed expenses but decides against the taxpayer on the other issues, varying the reassessment into a nil assessment with losses of \$3,000 ($\$10,000 + \$7,000 + \$5,000 - \$25,000 = -\$3,000$).

Buried within scenario 3 is the disturbing result that an audit adjustment that was barred by subsection 152(4), and duly objected to on that basis, was arguably “unbarred” when the year was changed to a nil year through a completely unrelated adjustment in the taxpayer’s favour.

As discussed above under scenario 1, the taxpayer can still potentially dispute the \$5,000 income inclusion on its merits in the context of an appeal of a subsequent year. The taxpayer would take the position that the \$5,000 did not constitute undeclared revenues, such that he had \$8,000 of losses in 2010 (rather than \$3,000) available for carryforward. The taxpayer would then attempt to claim the loss in a future year with taxable income. The minister would presumably take the position that the taxpayer had only \$3,000 of losses in 2010 to carry forward and would assess the taxpayer accordingly. The taxpayer would be able to object to or appeal the refusal of the carryforward, putting in issue the same facts and reasons raised by the \$5,000 income inclusion. This would essentially be the taxpayer’s second objection on exactly the same issue.

However, while the taxpayer would be able to dispute the \$5,000 inclusion on its merits, he might no longer be able to argue that it was statute-barred. Although there seems to be no case law on this precise issue, this result seems to flow from the

67 Canada Revenue Agency, *CRA Appeals Manual* (Ottawa: CRA), at section 3.10.3.1: “In the following situations, the objector is considered to have filed a valid objection even though no federal tax is payable: . . . Assessment of interest only (e.g., interest due to assessing adjustments that are eliminated by loss and tax credit carry-backs from subsequent years).”

wording of subsection 152(4) read in conjunction with the nil assessment rule and the *New St James* principle. Subsection 152(4) bars the minister from reassessing *years*, not *issues*. During the normal reassessment period for a particular year, the minister may reassess more or less as he or she sees fit. After the normal reassessment period, however, the minister is barred from reassessing tax for that year unless any of the various exceptions set out in subsection 152(4) or elsewhere apply. One such exception allows the minister to reassess a statute-barred year if the taxpayer has provided a valid waiver for that year (subparagraph 152(4)(a)(ii)), subject to the limitation that any such reassessment can pertain only to the matters specified in the waiver (subparagraph 152(4.01)(a)(ii)). In other words, the minister may reassess a statute-barred *year* in respect of *issues* for which valid waivers have been provided. The starting point, however, is always the *year being assessed*, not the *issue* or the year in which the issue arose.

Because the taxpayer in scenario 3 is in a dispute with the minister over the quantum of losses in 2010, he could request a NODL for that year and then dispute the \$5,000 inclusion through objection and appeal. However, it is unclear whether he could continue to rely on the fact that the \$5,000 audit adjustment was first made after the normal reassessment period. As discussed above, the issuance of a NODL triggers the start of the normal redetermination period, during which the minister can “redetermine” the taxpayer’s losses more or less as he or she sees fit. It arguably follows that the issuance of an initial NODL restarts the statute-barred period and thus reopens any issue in a year that may have been statute-barred, including issues that may even have been under objection on the very ground that the year was statute-barred.

This result is inconsistent with the underlying policy justification for the nil assessment rule, which allows the minister to forgo auditing a taxpayer’s loss claims (however large) until such time as those losses actually make a difference in the amount of tax that the taxpayer has to pay. The minister benefits by being able to focus the CRA’s limited resources on audits that have the greatest potential to reveal unpaid taxes, and taxpayers with money-losing businesses also generally benefit from not having a tax audit to add to their business woes. However, where a taxpayer has filed a return showing tax payable and has been assessed accordingly, the minister has been effectively put on notice that if he or she wishes to challenge the taxpayer’s returns, he or she must take action in a timely manner. If the minister does so, audits the taxpayer, and ultimately makes adjustments in the taxpayer’s favour that convert the year into a loss year, there seems to be no principled reason why the statute-barred period should completely restart and any issues relating to a statute-barred year should suddenly be revived.

Certainly, the reverse is not true: the conversion of a loss year to a profitable year does not restart the normal reassessment period. Under subsection 152(3.1), the issuance of a notification that no tax is due (which includes a notice of assessment for a loss year) starts the normal reassessment period. After the expiry of that period, the minister remains free to “reassess” so as to vary the amount of the losses, but the minister cannot assess tax unless one of the exceptions set out in subsection 152(4) or elsewhere in the Act applies.

Ultimately, the problem is that there is a gap in section 152 insofar as it does not contemplate situations in which a taxation year is originally reported and assessed as taxable but then reassessed as a nil year or a loss year through taxpayer requests or audit adjustments. Although the minister partly fills this gap by issuing NODLs in situations where the taxpayer disputes the quantum of the loss,⁶⁸ this administrative concession does not address the problem of the revival of issues relating to statute-barred years.

It is possible that the courts may decide—in a manner similar to what was done in *Agazarian*—to construe subsections 152(1.2) and (4) in a purposive manner so as to fill this gap, and to hold that if a taxpayer obtains a NODL for a taxation year that was originally reported and assessed as a profitable year, the taxpayer can challenge any of the minister's adjustments made after the normal reassessment period as being statute-barred. Such an interpretation could conceivably find justification in subsection 152(1.2), which provides that subsection 152(4) applies to any NODL “with any modifications that the circumstances require.”

Otherwise, there seems to be little that the taxpayer in scenario 3 can do to avoid losing his ground of objection that the minister was statute-barred from including the \$5,000 of alleged undeclared income in 2010. One possibility might be to preempt the issuance of the nil assessment by proceeding directly to the Tax Court before the minister concedes the \$25,000 of additional expenses at the conclusion of the objection. In the context of an appeal, the Tax Court would hear and decide all the relevant issues—including the application of subsection 152(4) to the \$5,000 of alleged undeclared revenue—and its findings would bind the minister through the doctrine of *res judicata*. This approach, of course, would come with the added costs, complexity, and publicity of a trial. It would also run the risk that the minister might not concede the \$25,000 of additional expenses but instead litigate them as well. The minister could also conceivably seek to put a premature end to the appeal by simply reassessing the taxpayer to apply the undisputed expenses, and then move to strike the taxpayer's appeal on the ground of the nil assessment rule, thus pushing the issue of the \$5,000 undeclared income to another day in a non-statute-barred year.

Duplication of Remedies and the Large Corporation Rules

The three scenarios described below are similar. They illustrate situations where a large corporation taxpayer with a dispute concerning losses (whether the quantum of losses in a particular year or the use of carryovers to offset disputed amounts in taxable years) files multiple objections in different taxation years covering the same disputed adjustment.

⁶⁸ See the discussion above under the heading “CRA Administrative Positions on the Loss Dispute Provisions.” It is unclear from the *CRA Audit Manual*, *supra* note 41, whether the minister will issue a nil NODL if the minister's position is that a profitable year has been converted to a break-even year and the taxpayer claims that it should be converted to a loss year.

Scenario 4a

A large corporation taxpayer has \$100,000 of non-capital losses in 2010 and \$50,000 of net income in 2011. In its 2011 return, the taxpayer carries forward and deducts \$50,000 of its 2010 losses, such that its income for 2011 is reduced to nil. The minister audits the taxpayer's 2011 year and disallows \$10,000 of expenses. The taxpayer claims an additional \$9,500 of its 2010 losses to offset the inclusion, thus leaving net income of \$500, which results in a reassessment for nominal tax. The taxpayer objects to the reassessment, setting out facts and reasons against the disallowance of the \$10,000 of expenses. The minister allows an additional \$500 of expenses but otherwise disallows the objection, issuing a nil reassessment, which is not subject to appeal. Thus, the dispute over the \$9,500 expenses, and the necessity of the carryforward, is deferred to another year (as discussed in scenario 1).

In 2012, the taxpayer has ample net income, against which it seeks to carry forward and deduct \$50,000 of losses from 2010. The minister's position is that the taxpayer has only \$40,500 of available losses to carry forward and reassesses accordingly. The taxpayer objects, offering the same facts and reasons as in its objection to the 2011 reassessment, as well as several new ones.

Scenario 4b

A large corporation taxpayer declares \$40,000 of non-capital losses in 2010 and \$100,000 of net income in 2011. On its 2011 tax return, the taxpayer carries forward and deducts all of its losses from 2010. The minister audits the taxpayer and adds \$10,000 of undeclared revenues to 2010, thus reducing the non-capital loss and the available carryforward. The minister reassesses both 2010 and 2011 accordingly—2010 as a nil assessment and 2011 with tax due. The taxpayer objects to the 2011 reassessment, presenting facts and reasons against the inclusion of the additional revenue in 2010. The taxpayer then obtains a NODL for 2010 and objects to it, offering the same facts and reasons as in its objection to the 2011 reassessment, as well as several new ones.

Scenario 4c

A large corporation taxpayer declares \$100,000 of non-capital losses in 2010 and \$50,000 of net income in 2011. On its 2011 tax return, the taxpayer carries forward and deducts \$50,000 of its 2010 losses, such that its income for 2011 is nil. The minister audits the taxpayer, disallows \$50,000 of the non-capital losses claimed in 2010, and reassesses accordingly. There is no change to the 2011 taxation year. The taxpayer obtains a NODL for 2010 and objects. While the objection is under review, the taxpayer files its 2012 tax return and seeks to carry forward and deduct the disallowed \$50,000 of losses from 2010. The minister disallows the loss claim and assesses the taxpayer's 2012 year accordingly. The taxpayer objects to the 2012 assessment, offering the same facts and reasons as in its objection to the 2010 NODL, as well as several new ones.

The procedural issue presented by scenarios 4a, 4b, and 4c is whether a large corporation taxpayer can adduce new facts and reasons in its various objections. Pursuant to subsection 165(1.11), a large corporation (as defined in subsection 225.1(8)) is required, in a notice of objection, to describe the issues to be decided, to provide facts and reasons in support of its position, and to specify in respect of

each issue the relief sought, expressed as a change in a “balance” (as defined in subsection 152(4.4)). If and when the minister reassesses a large corporation taxpayer following the filing of a notice of objection and the taxpayer objects, the taxpayer may only raise issues that it properly described, substantiated, and quantified in its previous objection (subsection 165(1.13)). Similarly, a large corporation taxpayer may appeal to the Tax Court only with respect to issues that it has described, substantiated, and quantified in its objection (subsection 169(2.1)).

A full review of the case law interpreting subsection 165(1.11) and its related provisions (collectively, “the large corporation rules”) falls beyond the scope of this article. However, there do not seem to be any reported cases that discuss whether a large corporation taxpayer that essentially files objections in different taxation years pertaining to the same underlying adjustment, as a result of the application of the nil assessment rule and/or the loss dispute provisions, can raise new facts and reasons in subsequent objections.

The answer, however, might be found in the precise wording of subsections 165(1.13) and (1.14) and 169(2.1), which set out the consequences for non-compliance with the large corporation rules. As can be seen in these provisions, the large corporation rules produce effects only when (1) the minister varies an assessment under objection (subsection 165(1.13)) or (2) the taxpayer seeks to appeal an assessment to the Tax Court (subsection 169(2.1)). In the former case, subsection 165(1.13) limits the ability of a taxpayer to object to a “particular assessment” for a given taxation year issued in response to an objection. On its plain reading, the provision has no application to reassessments issued for *other* taxation years. Similarly, in the latter case, subsection 169(2.1) applies to situations where a taxpayer seeks to appeal an assessment “for the year” in respect of which the taxpayer has served a notice of objection. Once again, on its plain reading, subsection 169(2.1) starts with an assessment in a given taxation year. It has no application for other assessments issued in other taxation years.

It seems to follow, therefore, that a large corporation taxpayer placed in a position to dispute exactly the same adjustment in multiple years because of the mechanics of the nil assessment rule—as seen in scenarios 1, 3, or 4a, for example—is not bound by its facts, reasons, and quantum as set out in the taxpayer’s first objection. Rather, the taxpayer is free to add new facts and reasons, or revise its quantum, in new objections filed in other taxation years.

A similar result seems to follow for objections to NODLs, such that the taxpayer in scenario 4b should be able to adduce new facts, reasons, and quantum in its objection to the NODL over and above those presented in its objection to the reassessment of the year to which the losses were carried forward.

That said, the converse is not necessarily true, given Bowie J’s analysis in *722540 Ontario*⁶⁹ to the effect that obtaining a NODL for a particular year essentially pre-empts any objections in other taxation years that concern the quantum of losses in

69 See the discussion above at note 53 and following.

that year. Consequently, in scenario 4c, while the large corporation rules would not necessarily preclude the taxpayer from making new arguments in its 2012 objection to the disallowance of the \$50,000 of losses, such arguments would essentially be moot since the question of the amount of losses in 2010 available for carryforward would be resolved definitively in accordance with the 2010 objection.⁷⁰

CONCLUSION: REFLECTIONS AND OPTIONS FOR REFORM

There are sound policy reasons for treating loss years differently than profitable years for the purposes of applying the Act's statute-barring rules or dispute resolution provisions. The minister's resources are no doubt better spent auditing profitable businesses with tax to pay, rather than money-losing businesses where the primary (if only) source of contention is the quantum of losses that might be carried over to future years. The nil assessment rule and the *New St James* principle ensure that disputes over losses can be pursued only when the losses have an actual impact on the amount of tax due.

The loss dispute provisions provide that if the minister does decide to examine a taxpayer's loss claim in a particular year, and then disputes it, the taxpayer can seek a binding resolution of the dispute. However, the loss dispute provisions have limited application, leaving gaps that can result in the duplication, prolongation, or complication of proceedings when loss years are involved, as well as, in some cases, the loss of the right of objection or appeal, either *de jure* or *de facto*.

Section 173 offers a potentially simple and flexible vehicle to address some of these situations without Parliament's involvement. Subsection 173(1) allows the minister and a taxpayer, if they agree, to state a question of law, fact, or mixed law and fact to the Tax Court for resolution "in respect of any assessment, proposed assessment, determination or proposed determination." While the potential scope of application of section 173 is very broad, the provision is rarely used owing to the minister's longstanding position that it is to be used sparingly.⁷¹ However, with a change in attitude on the part of the minister, section 173 could be used to confer jurisdiction on the Tax Court to hear and decide disputes in relation to assessments or determinations other than the precise quantum of tax liability.

70 However, in *Devon Canada Corporation v. Canada*, 2015 FCA 214, at paragraphs 30 and 33, the Federal Court of Appeal held that if a large corporation taxpayer submits additional facts and reasons to the minister while an objection is under review, and the minister considers them, then those facts and reasons are considered to have been part of the objection and can be raised on further objection and appeal. Consequently, in the case of the taxpayer in scenario 4c, if (1) the taxpayer presented its 2012 objection while its 2010 objection was under review, (2) the two objections were assigned to the same officer and processed together, and (3) the officer considered the additional grounds raised in the 2012 objection, then those grounds might be considered to be incorporated into the 2010 objection.

71 See Colin Campbell, *Administration of Income Tax*, 2017 ed. (Toronto: Thomson Reuters, 2017), at section 14.1.1; and *CRA Appeals Manual*, supra note 67, at section 7.9.4.1.

Indeed, if a taxpayer initiates an appeal that is contrary to the nil assessment rule but is otherwise grounded in a live, bona fide dispute with the minister that would benefit from prompt resolution—such as the taxpayer in *Okalta Oils* (which sought certainty with respect to its entitlement to the oil drilling and exploration credit), the taxpayer in *Joshi* (who faced an issue over her education-related credit balances), the taxpayer in *Interior Savings Credit Union* (which sought certainty regarding its PRA), or the taxpayer in *Nottawasaga Inn* (which offset disputed income with loss carryovers)—perhaps the default reaction from the minister should not be a motion to quash but rather an invitation to the taxpayer to convert the appeal into a section 173 reference on the disputed issues.⁷² The Tax Court would then have jurisdiction to hear and decide the reference on its merits while the matter was fresh, and the taxpayer would not be obliged to conserve all of its records with a view to relitigating the issue years later when its tax liability would be affected.⁷³

Alternative reforms would likely require amendments to sections 152, 165, and 169. One possible reform—first suggested in 1977 by the Senate Standing Committee on Banking, Trade and Commerce—would allow taxpayers to seek a NODL for any loss year once a carryover of those losses was claimed.⁷⁴ This approach would enable taxpayers to obtain greater certainty with respect to the use of their losses, while also ensuring that the minister would be potentially bound by a taxpayer's reported losses only when those losses started to have an actual effect on the taxpayer's tax liability in another year. However, although potentially useful, this reform would not address the pitfalls and legislative gaps discussed in the previous section, such as those caused when losses are carried over to offset disputed income inclusions or when profitable years are changed into loss years.

An arguably more useful reform—one that would directly address the problems set out in scenarios 1 and 2 above—would allow taxpayers to object to and appeal from nil assessments that arise simply as a result of the application of loss carryovers. This could potentially be accomplished through the enactment of provisions that would

- deem such a nil assessment to be an “assessment” for the purposes of sections 165 and 169,
- provide that loss carryovers would be essentially disregarded for the purposes of disposing of the issues under objection or appeal, and
- provide that the outcome of the objection and appeal would be valid and binding notwithstanding the *New St James* principle.

72 As stated in the *CRA Appeals Manual*, supra note 67, at section 3.10.1, “[a]lthough an objection to a notification that no tax is payable is invalid, the CRA follows the practice of reconsidering the issues at the time the objection is filed with a view to resolving them when they are current in the minds of the objector and the CRA auditor.”

73 If the minister unreasonably refused to consent to the conversion of an appeal of a nil assessment to a section 173 reference, the taxpayer could seek judicial review of the refusal in the Federal Court.

74 See the discussion of the Senate report, supra note 35 and the accompanying text.

A similar result might also be achieved by enacting provisions analogous to the loss dispute provisions that would permit taxpayers to seek a “notice of determination of taxable income prior to application of loss carryovers” (a NOTIPALC) in years where the minister disputes the taxpayer’s reported calculation of taxable income in a particular year but nevertheless issues a nil assessment owing to loss carryovers. A NOTIPALC would essentially be the counterpart to a NODL, but applicable to years where losses are carried over instead of years where losses are realized.

Another potentially useful reform, which would largely address the issue set out in scenario 3, would involve clarifying how section 152 applies in situations where a profitable year becomes a loss year owing to audit adjustments, and in particular the apparently incongruous result, discussed above, that the statute-barred period essentially restarts if the taxpayer requests a NODL, thus reviving issues that the minister would otherwise be barred from adjusting.

To the extent that all of these possible reforms would reduce the need to file duplicative objections in multiple taxation years relating to the same disputed amounts, the issues and uncertainties set out in scenario 4 would also be largely ameliorated.

Relatively simple steps such as those suggested above have the potential to greatly simplify the resolution of disputes involving loss years and to help taxpayers to navigate a procedural minefield that many—especially average business people—no doubt find impassable.

ADDENDUM

While this article was in production, the Federal Court of Appeal issued its decision in *Bakorp Management Ltd. v. Canada*,⁷⁵ which illustrates another procedural pitfall in claiming losses. In that case, the taxpayer was apparently denied the ability to make full use of its losses even after it had successfully litigated to establish their existence.

Bakorp concerned a taxpayer in a longstanding dispute over the amount of non-capital losses experienced in its 1987 taxation year. The taxpayer carried over and deducted some of the disputed losses in its 1989 taxation year. The minister disputed the carryover, leading to an appeal in the Tax Court in respect of the 1989 taxation year, which was settled partly in the taxpayer’s favour in 2010.

Following the settlement, the taxpayer devised a plan to make the best use of its belatedly established losses. As a result of an amalgamation, the taxpayer had two year-ends in 1992: one in January and one in March. The taxpayer asked the minister, pursuant to subsection 152(4.3), to reassess its taxation year ending in January 1992 so as to reduce the amount of losses carried forward by \$439,581, and to offset any additional tax due in that taxation year with additional investment tax credits.⁷⁶ It then sought, in its return for the taxation year ending in March 1992

75 2019 FCA 195; aff’g the unreported decision of the Tax Court of Canada.

76 Neither the Federal Court of Appeal’s decision nor the decision of the Tax Court in *Bakorp*, discussed below, explains where these investment tax credits came from, or why losses had

(which was not filed until 2011), to carry forward and deduct this additional \$439,581. The minister refused the subsection 152(4.3) request and reassessed the taxation year ending in March 1992 so as to refuse the additional \$439,581 carry-forward. The taxpayer appealed this reassessment to the Tax Court.

Subsection 152(4.3) requires the minister, following a reassessment or a decision on an appeal of a particular year, to reassess subsequent taxation years to effect changes to tax balances (including loss balances) relating to the reassessment, if the taxpayer so requests within the applicable time limit. In its appeal to the Tax Court, the taxpayer argued that it was entitled to carry forward and deduct the losses of \$439,581 since the minister was required, under subsection 152(4.3), to essentially free up that amount of losses previously deducted from the taxation year ending in January 1992. At the Tax Court, in a decision rendered orally, Hogan J dismissed the appeal on the ground that the kind of change requested by the taxpayer was not within the ambit of those required by subsection 152(4.3). He also noted that the Tax Court did not have jurisdiction to decide whether the minister had wrongfully failed to process a request made under subsection 152(4.3) and that the appropriate recourse for a taxpayer seeking to dispute such a refusal by the minister was to request a judicial review by the Federal Court.

On appeal, the Federal Court of Appeal declined to deal with the merits and dismissed the appeal entirely on the question of jurisdiction, holding that the taxpayer could challenge the minister's denial of its subsection 152(4.3) request only through judicial review in the Federal Court. In coming to this conclusion, the court distinguished cases such as *Aallcann Wood*⁷⁷ and *Papiers Cascades Cabano*,⁷⁸ noting that those cases concerned alleged errors in tax treatment in statute-barred years, the correction of which could affect tax liability in subsequent years. In *Bakorp*, however, there was no error in the taxpayer's return for its taxation year ending in January 1992; the taxpayer was legally entitled to carry forward the amount of the losses claimed, to offset taxable income, and it could not change its mind about using those losses in the context of an appeal relating to a subsequent taxation year.

Essentially, *Bakorp* has clarified that the ability of taxpayers to recharacterize and restate past tax returns in statute-barred years under the *New St James* principle does not allow a taxpayer to modify previously taken positions that were factually and legally well founded.

Perhaps more important, *Bakorp* provides another example of how unclear the line often is between the jurisdiction of the Tax Court and the jurisdiction of the Federal Court over tax matters, and the unfortunate consequences to taxpayers who choose to litigate a complex dispute in the wrong forum.

previously been carried forward to the taxation year ending in January 1992 instead of these credits being used.

77 *Aallcann Wood*, supra note 47.

78 *Papiers Cascades Cabano*, supra note 29.

Subsidies and Value-Added Tax: A Comparative Study of Law and Practice in Canada and the European Union

Robert F. van Brederode and Simon B. Thang*

PRÉCIS

La taxe à la valeur ajoutée (TVA) est une taxe levée sur les dépenses de consommation privée. Lorsqu'on lève la TVA sur chacune des opérations de la chaîne d'approvisionnement, on atteint l'objectif de taxer uniquement la consommation privée en accordant aux entreprises un crédit pour déduire le montant de TVA payé sur les achats du montant de TVA perçu sur les ventes. Cet article présente une étude comparative des lois et de la pratique de l'Union européenne et du Canada concernant les subventions et la TVA (au Canada, la taxe sur les produits et services). Les subventions sont l'un des instruments financiers qu'utilisent les gouvernements, et parfois des organismes privés, pour contribuer à la réalisation de certaines politiques. Cet article établit les circonstances dans lesquelles des subventions peuvent être incluses dans la contrepartie payée pour une opération, et peuvent donc être assujetties à la TVA, et dans quelle mesure le droit à demander des crédits de taxe sur les intrants peut être exercé. Les auteurs se penchent sur ces questions en examinant la nature des subventions du point de vue des principes de la TVA, en passant en revue les dispositions réglementaires et les pratiques administratives de l'Union européenne et du Canada, et en analysant la jurisprudence pertinente dans les deux compétences.

ABSTRACT

Value-added tax (VAT) is a tax levied on private consumption expenditures. Where VAT is levied on each transaction within the supply chain, the aim of taxing only private consumption is achieved by allowing businesses a credit to offset the VAT paid on purchases against the VAT collected on sales. This article provides a comparative study of the law and practice in the European Union and Canada regarding subsidies and VAT (in Canada, the goods and services tax). Subsidies are among the financial instruments used by governments, and sometimes private organizations, to support the realization

* Robert F. van Brederode is an independent tax lawyer and academic researcher, Lancaster, PA (e-mail: robvanbrederode@aol.com). Simon B. Thang is of Thang Tax Law, Toronto (e-mail: simon@thangtaxlaw.com). The authors want to express their gratitude to the anonymous reviewers for their insights and recommendations, and to Nicholas Shatalow, JD candidate 2019, Osgoode Hall Law School, York University, Toronto, for his assistance.

of certain policies. This article is concerned with determining the circumstances in which subsidies may be included in the consideration paid in a transaction and may therefore be subject to VAT, and the extent to which the right to claim input tax credits can be exercised. The authors investigate these questions by discussing the nature of subsidies from the perspective of VAT principles, reviewing the statutory provisions and administrative practices in the European Union and Canada, and analyzing the relevant case law in both jurisdictions.

KEYWORDS: VALUE-ADDED TAX ■ GOODS AND SERVICES TAX ■ SUBSIDIES ■ INPUT TAX CREDIT ■ EUROPEAN UNION ■ GRANTS

CONTENTS

Introduction	534
The Concept of Subsidy in Light of VAT Consumption and Neutrality Principles	539
The Concept of Subsidy	539
Applying Consumption and Neutrality Principles of VAT to Subsidies	540
The Legal Definitions of “Consideration” and “Payment”	541
Definitions in Canada’s Excise Tax Act and Administrative Explanation	541
Legislative Definitions	541
Administrative Explanation	544
Definitions in the EU VAT Directive and the European Commission’s Explanation	546
Input Tax Credits Related to Taxable Subsidies	548
Case Law on the Application of VAT to Subsidies	551
Canada	551
The European Union	562
Pseudo-Subsidies	563
Existence of a Direct Link	564
Existence of a Supply—Individualized Consumption	569
Influence of Subsidies on the Input VAT Credit	571
Summary and Conclusions	577

INTRODUCTION

Value-added tax (VAT), including Canada’s federal goods and services tax (GST), is designed to tax expenditures on private consumption. VAT is a so-called all-stage tax; that is, subject to certain exceptions, the tax is levied at every stage of the supply chain regardless of whether the supply is made from business to business or from business to consumer. The aim of taxing only private consumption is realized by allowing businesses a credit to offset the VAT paid on purchases against the VAT collected on sales. As a result, business-to-business transactions are relieved from the tax and only the final supply to a consumer effectively bears VAT.

While VAT is sometimes described as a consumption tax, it is not levied on consumption itself but on the expenditure made for consumption; that is, the expenditure, or consideration, is a proxy for the actual consumption. It follows that the determination of the amount of consideration is crucial for the proper functioning of the VAT system.

It is generally irrelevant for the application of VAT who pays for the consumption purchase. In many instances, a third party may pay for the use or consumption of goods and services by someone else—as, for example, is the case when parents buy food, clothing, or educational services for their children. Thus, the payer and the consumer may be different persons. (As we will discuss below, there are, however, notable exceptions where the person who pays is relevant for VAT purposes.) Whether consumption actually takes place is also irrelevant—for example, VAT is not refunded if a child accidentally drops the ice cream cone that her grandmother bought for her. Consumption is assumed once payment has been made.

Subsidies are among the financial instruments used by governments to support the realization of certain policies, such as Canadian or EU agricultural policies, or by private organizations to stimulate certain activities, such as research or charitable activities. The question arises whether, or under what circumstances, subsidies are part of the payment received and thus subject to VAT.

This article presents a comparative study of the law and practice in the European Union and Canada regarding subsidies and VAT/GST. The European Union is the birthplace of VAT and offers a mature, traditional version of the tax, whereas Canada's GST is an example of a modern VAT. In the discussion that follows, we compare the legislation, administrative practices, and the interpretation of the law by the courts in the two jurisdictions with respect to the application of VAT to subsidies. As we explain below, the comparison is justified in part on the basis that the Canadian tax authorities and some courts have been influenced by the "direct link" concept for subsidies from the EU VAT directive. In this context, it is important to keep in mind the constitutional and jurisdictional similarities and differences between Canada and the European Union.

Canada is a sovereign, federal state consisting of the federal government and 10 provincial governments, which receive their authority from the constitution,¹ and three territorial governments, which exercise authority delegated by the Parliament of Canada. The provinces are sovereign within certain areas based on the constitutional division of powers between the provinces and the federal government; any change in the division of powers would require a constitutional amendment. The constitution is the "supreme law of Canada, and any law that is inconsistent with the provisions of the Constitution is, to the extent of the inconsistency, of no force or effect."² The territories do not have inherent sovereignty, and changing their authority would require no more than an act of Parliament. Canada has a dual tax system: both the federal government³ and the subnational governments⁴ have a constitutional right to levy taxes within their respective jurisdictions. Taxes that exceed their permitted jurisdictional scope have been held to be unconstitutional

1 Constitution Act, 1867, 30 & 31 Vict., c. 3, as amended.

2 Section 52(1) of the Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK), 1982, c. 11.

3 Constitution Act, 1867, *supra* note 1, section 91.

4 *Ibid.*, section 92.

and hence invalid.⁵ Notably, one level of government is immune from taxation by the other level.⁶ As a result, a number of provinces do not pay federal VAT on their purchases while others do at first instance but receive a full refund.

As to general consumption tax, the federal government levies a 5 percent GST, which is a VAT, and six provinces levy a VAT as well.⁷ In five of those provinces, the provincial VAT is collected by the federal government in conjunction with the federal GST through the harmonized sales tax (HST); in Quebec, the provincial government is responsible for collecting both the provincial VAT and the federal GST.⁸ Three provinces⁹ levy a retail sales tax instead of VAT; one province and the three territories¹⁰ do not levy any general sales taxes of their own.

The European Union is a supranational entity, instituted by a succession of treaties¹¹ and currently consisting of 28 independent member states.¹² It is a political and economic organization whose members share common goals, values, and

5 See, for example, *Kingstreet Investments Ltd. v. New Brunswick (Finance)*, 2007 SCC 1.

6 Constitution Act, 1867, supra note 1, section 125.

7 The six provinces are Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador. The federal GST, and the provincial VAT, except in Quebec, are levied under part IX of the federal Excise Tax Act, RSC 1985, c. E-15, as amended (herein referred to as “the ETA”). The Quebec VAT (Quebec Sales Tax [QST]) is levied under separate provincial law (Act Respecting the Quebec Sales Tax, CQLR c. T-0.1).

8 In most instances. There are exceptions for certain financial institutions.

9 British Columbia, Saskatchewan, and Manitoba.

10 Alberta and the Northwest Territories, Nunavut, and Yukon.

11 Treaty Establishing the European Economic Community, Rome, March 25, 1957 (“the EEC treaty”), as amended by subsequent treaties, entered into force January 1, 1958; Treaty Establishing the European Coal and Steel Community, April 18, 1951, 261 UNTS 167 (“the ECSC treaty”), entered into force July 23, 1952; and Treaty Establishing the European Atomic Energy Agency, 298 UNTS 167 (“the EURATOM treaty”), entered into force January 1, 1958. Together these are the original founding treaties of European integration. The ECSC treaty expired on July 23, 2002, and since then the coal and steel sectors have been incorporated within the legal scope of the EEC treaty. The Treaty of European Union, 1992, OJ C191, July 29, 1992 (“the Maastricht treaty”), changed the name “European Economic Community” to “European Community” to reflect the evolution of the community beyond a concern with economic policy alone to include social, cultural, and environmental policies. The Maastricht treaty also established the European Union. The terminology may be confusing, especially to the non-European reader. It is important to recognize that the EC (formerly the EEC) and EURATOM treaties, with their common structures and institutions, remain in place. Following the rejection of the proposed European constitution in French and Dutch referendums in 2005, the member states signed the treaty of Lisbon, which retains much of the content of the rejected constitution (Treaty of Lisbon, amending the Treaty of European Union and the Treaty Establishing the European Community, signed at Lisbon on December 13, 2007). The treaty of Lisbon amended both the Maastricht treaty and the Treaty Establishing the European Community, [2002] OJ C 325 (“the TEC”), which was subsequently renamed the Treaty on the Functioning of the European Union, [2012] OJ C 326/01 (“the TFEU”).

12 Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the

economic, social, and security policies. The European Union embodies the formal relations between the member states in specific areas of common interest but is not a separate legal entity; in essence, it is a combination of supranational and inter-governmental power. EU law is the common internal law in the member states. It creates mutual rights and duties between the states and regulates the relation between the European Union and its subjects, and between these subjects among themselves.¹³ EU law regulates the powers, rights, and obligations of the European Union and its subjects, and provides for the procedures required for determining, adjudicating, and sanctioning infringements of the law.¹⁴

EU law has priority over the national laws of the member states.¹⁵ In the area of taxation, insofar as it affects intra-EU cross-border trade, the European Union and its member states have shared competence with pre-emption;¹⁶ that is, when and to the extent that the European Union exercises its competence, the member states lose their individual competences. The extent to which EU law affects the member states depends on the legal instrument used. The most important legal instruments are regulations and directives. A regulation is directly applicable in every member state; it does not require any action by the national legislature, and it can convey rights to and impose obligations on the member states and their institutions, and on individuals in those states.¹⁷ A directive, however, is binding on each member state only with respect to the result to be achieved and leaves to the national authorities the choice of form and method of implementation.¹⁸

Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. At the time of writing, the United Kingdom is scheduled to withdraw from the European Union on October 31, 2019.

- 13 See C.W.A. Timmermans, "General Aspects of European Union and the European Communities," in P.J.G. Kapteyn, A.M. McDonnell, K.J.M. Mortelmans, and C.W.A. Timmermans, eds., *The Law of the European Union and the European Communities*, 4th rev. ed. (Alphen aan den Rijn, the Netherlands: Wolters Kluwer, 2008), 53-114; and Robert F. van Brederode and Gerard Meussen, "The European Union," in Robert F. van Brederode and Richard Krever, eds., *Legal Interpretation of Tax Law*, 2d ed. (Alphen aan den Rijn, the Netherlands: Wolters Kluwer, 2017), 133-89, at 133-36.
- 14 *Commission v. Luxembourg and Belgium*, [1964] ECR 1217 (November 13, 1964), cases 90/63 and 91/63 (CJEU), ECLI:EU:C:1964:80.
- 15 *Flaminio Costa v. ENEL*, [1964] ECR 1194 (July 5, 1964), case 6/64 (CJEU), ECLI:EU:C:1964:66.
- 16 The competence in the field of taxation is based on article 4(2)(a) of the TFEU.
- 17 TFEU article 288, paragraph 2.
- 18 *Ibid.*, paragraph 3. However, the form and method of implementation should be chosen in such a way that the stated result or objective of a certain provision in the directive is in fact achieved. See *Jean Noël Royer*, [1976] ECR 497 (April 8, 1976), case 48/75, ECLI:EU:C:1976:57, at paragraph 75 (CJEU); and *Enka BV v. Inspecteur der Invoerrechten en Accijnzen (Inspector of Customs and Excise)*, [1977] ECR 2203 (November 23, 1977), case 38/77, ECLI:EU:C:1977:190, at paragraph 11 (CJEU).

Private parties have no direct access to the Court of Justice of the European Union in respect of EU law based on regulations and directives. A litigant who wishes to invoke EU law must approach a national court. The national court may—or, if it is the highest court in the case, must—refer a preliminary question to the EU Court of Justice where the application of EU law to a case is unclear.¹⁹ The functions of the EU Court of Justice and the national courts are distinct: the role of the EU Court of Justice is limited to the interpretation of EU law and to deciding whether actions by the European Union or its institutions are valid, while the national courts apply EU law (as interpreted and explained by the EU Court of Justice) to the facts of the particular case.²⁰

Most taxes within the European Union are national taxes: they are levied by each member state, and the revenues therefrom accrue to the treasury of that state. For the purpose of establishing an internal market, taxes are harmonized to varying degrees via EU directives and regulations. The European Union funds its budget primarily through its own resources.²¹ It has three main sources of income:

1. Customs duties are levied on the importation of goods into the European Union.²²
2. A standard percentage is levied on the harmonized VAT base of each member state. This is not an EU VAT charged separately on supplies of goods and services in addition to the national VATs; rather, it is a tax levied on the members.
3. A uniform percentage is levied on the gross national income of each member state. This also qualifies as an EU tax on the member states.

We have limited the scope of our research for this article to legislation and court rulings at the Canadian federal and EU levels. Our study of the VAT treatment of subsidies begins with a preliminary analysis of what actually constitutes a subsidy in the context of a VAT. We then set out a theoretical framework explaining the practical problems associated with applying or not applying VAT to subsidies, in light of the consumption and neutrality principles of a VAT. Next, we take a closer look at the definitions of “payment” and “consideration” in the Canadian and EU VAT statutes, respectively, and the interpretation of these terms by the administrative bodies in the two jurisdictions. We go on to explain theoretical and de facto approaches to

19 TFEU article 267.

20 This functional separation between interpretation and application is not as strict in practice as it may be in theory, because the EU Court of Justice renders its ruling on the interpretation of EU law within the context of the facts of the referred case. The facts and circumstances may be so specific that the preliminary ruling given by the court cannot be generally applied; see, for example, *CJEU RLRE Tellmer Property*, [2009] ECR I-4983 (June 11, 2009), case C-572/07 (CJEU), ECLI:EU:C:2008:697.

21 European Union, Council Decision 2014/335/EU of 26 May 2014 on the System of Own Resources of the European Union, OJ L 168/105, June 7, 2014.

22 Duties are collected by the customs agencies of the member states but accrue fully to the European Union, minus a 20 percent collection fee for the member states.

input VAT credits related to taxable subsidies, and then present an overview and analysis of jurisprudence from the federal courts in Canada and from the EU Court of Justice. We end the article with a summary of our conclusions and a comparative overview of the Canadian and EU approaches.

THE CONCEPT OF SUBSIDY IN LIGHT OF VAT CONSUMPTION AND NEUTRALITY PRINCIPLES

The Concept of Subsidy

A subsidy is a form of privileged financial aid paid out directly or indirectly by a government or a private institution to a beneficiary for the purpose of removing or lessening some type of burden borne by the recipient. Subsidies are provided in the interest of the (perceived) common good—for example, to promote a social good or a particular action, or a social or economic policy.

Subsidies may be granted by private institutions, such as foundations promoting the arts and sciences, but most come from governments and are intended to support particular sectors of the economy or specified categories of individuals.

Subsidies can be used to promote growth, increase income, overcome market failures, support disadvantaged regions or groups of people, or encourage the development of innovative technologies. However, subsidies can also have adverse effects; for example, they may lead to efficiency losses owing to the distortion of market prices, or they may have a negative impact on the environment through the overuse of subsidized resources. Notwithstanding that subsidies are incompatible with the principles of a free market, they remain a popular instrument for realizing government policies.²³

There are many forms of subsidies given out by government, but not all are relevant from a VAT perspective. For example, some subsidies (such as welfare payments and unemployment benefits) merely effect a transfer of funds from the government to individuals, unrelated to any market transactions.

Subsidies must also be distinguished from gifts and donations that are purely charitable in nature and are provided unconditionally, in that the donors do not expect any particular return. Gifts and donations are, again, just transfers of funds, from individuals, governments, or institutions to the recipient entities. Subsidies, in contrast, require that certain conditions be met by the recipient; if the conditions are not fulfilled, the subsidy may not be paid out or may have to be refunded.

Gerson and Feng²⁴ have classified subsidies as falling into three categories: subsidies that increase revenue (output subsidies), subsidies that lower the cost of

23 See, for example, Abukar Warsame, Rune Wigren, Mats Wilhelmsson, and Zan Yang, “The Impact of Competition, Subsidies, and Taxes on Production and Construction Cost: The Case of the Swedish Housing Construction Market” (2013) *ISRN Economics* (<http://dx.doi.org/10.1155/2013/868914>).

24 Kampungu K. Gerson and Han Feng, “A Review of Different Types of Subsidies and How They Work in Theory” (2013) 5:11 *Asian Agricultural Research* 1-4.

production (input subsidies), and subsidies that are not linked to either output or input. Subsidies that increase revenue are granted to sustain or stimulate production output, such as market price support to maintain income levels. This category includes many subsidies employed to further agricultural policies. Subsidies that target inputs lead to lower production costs and potentially²⁵ lower prices for downstream consumers.²⁶ Subsidies that are not conditional on production or input levels are direct income support payments and lump-sum support for an industry.

Another approach is to distinguish between types of subsidies on the basis of their respective purposes.²⁷ Thus, we can identify exploitation subsidies intended to cover the budget deficits of an organization; stimulation subsidies for certain economic activities (generally those that contribute to the common good); and market regulation subsidies (such as those that have been used in the European Union in respect of the agricultural sector).

Finally, we note that various objectives can be advanced through special treatment under the VAT system itself, rather than through the payment of subsidies. For example, “merit goods” such as education are often VAT-exempt to encourage consumption, and basic groceries may be zero-rated (exempt with the right to a deduction) owing to concerns regarding regressivity. While these instruments lower the costs of supply, zero-ratings and exemptions do not take the form of a payment and are therefore not addressed below. Here we are concerned only with forms of support that may constitute consideration or payment for a supply and hence may be subject to VAT.

Applying Consumption and Neutrality Principles of VAT to Subsidies

The classification of subsidies described above is relevant in determining the application of VAT. Because VAT is charged on consumption expenditure, lump-sum and direct income support fall outside the scope of the tax. VAT kicks in where there exists a quid pro quo: there must be a transaction in which, for example, goods and/or services are exchanged for payment or consideration. Although these types of subsidies may well lower the sales price of products and services provided by the beneficiary, it is in most cases impossible to allocate exactly the subsidized amount to each individual transaction, especially where the supplier makes different types of supplies subject to different and, over time, varying demand curves. Even when a business only produces a single product, a lump-sum or income subsidy may be used partly for sales price reduction and partly for capital investment, which may not be known until after the fact and the allocation of which may vary from year to year.

25 Part of the subsidy may leak to the input supplier, depending on the elasticity of the supply and demand of the subsidized item.

26 Depending on the relative bargaining powers of the producers and the consumers.

27 See, for example, R.N.G. Paardt, *Subsidies en BTW in de Europese Unie* [Subsidies and VAT in the European Union] (Deventer, the Netherlands: Wolters Kluwer, 2000).

Since output subsidies are related to production (for example, of goods or services to be sold in the marketplace), they could potentially be part of the consideration received. In contrast, although input subsidies may lead to lower prices for downstream consumers, they are not linked to the output of goods and services of the beneficiary and therefore cannot be taxed. In this article, we are interested in establishing under what circumstances subsidies may or may not be taxable, on the basis of the jurisprudence from the courts in Canada and the European Union, and in evaluating the case law in light of the VAT principles of consumption expenditure taxation and neutrality.

THE LEGAL DEFINITIONS OF “CONSIDERATION” AND “PAYMENT”

Definitions in Canada’s Excise Tax Act and Administrative Explanation

Legislative Definitions

Canada’s GST (the federal VAT) is calculated on the value of the “consideration” for taxable supplies made in Canada pursuant to section 165 of the Excise Tax Act (ETA). Thus, consideration is the tax base for most applications of the GST/HST, and so it is important to identify all amounts that constitute consideration.²⁸ As defined in ETA subsection 123(1), “consideration includes any amount that is payable for a supply by operation of law.” The use of the word “includes” suggests that this definition merely augments the ordinary meaning of “consideration,” by explicitly incorporating amounts payable owing to the application of legal principles.²⁹ The full meaning of “consideration” for GST/HST purposes therefore should reflect the meaning under general legal principles, such as contract law.³⁰ In fact, there was initially no statutory definition of “consideration” when the GST legislation was introduced; it was added several years later and made retroactive to the inception of the tax. As explained by the drafters of the legislation, the definition was intended to remove doubt that payments that did not fit the traditional contract-law concept were nonetheless intended to be treated as consideration for GST/HST purposes. On the other hand, amounts paid as gifts are not consideration.

28 GST/HST applies to imports as well as domestically sourced supplies, and is required to be self-assessed on services and intangibles in certain situations. The tax base is not necessarily the “consideration” in such instances.

29 On the interpretation of “includes” in tax definitions, see, for example, *Storvick v. The Queen*, [1978] CTC 792 (FCTD).

30 See *Canada v. Costco Wholesale Canada Ltd.*, 2012 FCA 160, at paragraph 4: “[C]onsideration” should be understood to include anything that would be consideration under the law of contract.” Because the ETA is federal legislation, it has application across Canada, including in the civil-law province of Quebec. Accordingly, it may be necessary to refer to the relevant civil law in cases where the ETA provisions incorporate other legal concepts.

“Consideration” is a term most commonly used in the context of contracts. However, in some circumstances, amounts can become payable for a supply by operation of law in the absence of a contract. The definition “consideration” is being added so as to remove any doubt that such amounts that clearly would be consideration for a supply if there were a contract, are treated as consideration. . . . This would address, for example, situations where services are rendered to a person without having been contracted for and the person is required, by law, to pay fair value for the services received. The amount so required to be paid would be treated as consideration. In all cases, in order to be consideration, the amount must be payable “for a supply.” Therefore, amounts that are paid, for example, as taxes, fines or gifts from governments or other persons, whether payable by operation of law or under an agreement, will continue not to be treated as consideration since these amounts are not payable for a supply.³¹

Unlike the EU VAT directive (discussed in a separate section below), the Canadian legislation does not explicitly address the status of subsidies in the definition of “consideration” (in ETA subsection 123(1)). There is also no explicit statutory requirement for a direct link between the payment of a subsidy and a particular supply. Instead, the status of subsidies is based on the general legal principles described above. The definition of “consideration” does, however, refer to an amount payable “for a supply [emphasis added].” Similarly, the main taxing provision, ETA section 165, imposes tax on the consideration “for the supply [emphasis added].” This connotes some degree of connection between the payment and a supply. Thus, as discussed below, the Canadian tax authority (the Canada Revenue Agency [CRA]) has explicitly adopted the concept of a direct link in the context of subsidies, as have the courts in a number of cases.³² The issue in the European Union of whether there should be differential treatment of different forms of subsidies (also discussed in the separate section below) does not appear to arise. This could be in part due to the lack of any reference in the Canadian rules to subsidies “directly linked to the price.” Thus, all subsidies—whether input, output, or neither—appear to be subject to the same analysis.

One difficulty with the concept of consideration is that it is often intertwined with the concept of supply. “Supply” is defined broadly in ETA subsection 123(1) to mean “the provision of property or a service in any manner, including . . . gift.” “Service” is defined in the same subsection to mean anything other than property, money, and employee labour. Thus, it is often not difficult to conclude that a supply has been made. The question then becomes whether there is consideration. For example, a public service body (such as a charity) may give publicity or recognition to a sponsor of an activity carried on by that body. Owing to the broad definitions of “supply” and “service,” it is possible that the public service body could be viewed

31 Canada, Department of Finance, *Explanatory Notes to Legislation Relating to the Goods and Services Tax* (Bill C-112) (Ottawa: Department of Finance, February 1993), at 16-17.

32 See, for example, *Regina (City) v. R.*, [2001] GSTC 68 (TCC) (discussed in the text below at notes 56 and 74).

as making a supply to the sponsor in exchange for consideration in the form of the sponsorship. However, ETA section 135 would deem the public service body not to have made a supply in some circumstances. As discussed in the case-law review below, the broad definitions of “supply” and “service” can also lead to the question of what is the supply for which the consideration is paid. Is the consideration a third-party payment for the subsidized supply, or is it consideration for a separate supply to the subsidy payer?

The meaning of “consideration” is also affected by various deeming provisions in the legislation. For example, ETA subsection 153(1) deems the value of non-monetary consideration to be equal to its fair market value. As a result, transactions involving goods or services provided “in kind” can be taxable. Where a donation is made to a charity or other public institution and the donor receives taxable goods and services in return, the amount of the consideration is limited to the fair market value of the goods or services if certain conditions in ETA section 164 are met. In effect, the amount of the donation above the fair market value is treated as a gift and is ignored in calculating GST/HST.

ETA section 155, an anti-avoidance provision, deems non-arm’s-length supplies made for nil consideration or consideration that is less than fair market value to have been made for consideration equal to the fair market value of the property or service where full input tax credits would not be available. There are special rules for barter and trade-in transactions in ETA subsections 153(3) and (4), respectively. Finally, ETA section 154 includes in the consideration for GST/HST purposes certain federal or provincial levies (among other things).³³ This may be relevant to subsidies collected as levies imposed on certain supplies. The CRA’s written policy statement on this matter cites as an example a province’s “waste diversion legislation [that] creates a regulatory framework under which a tire manufacturer is required to pay stewardship fees to a waste diversion organization . . . for every tire it supplies.”³⁴ The amount paid by the manufacturer to the organization would become subject to GST/HST as part of the consideration for the supply of the tire when it is passed on through the supply chain.

It should be noted that entities receiving subsidies may be making exempt supplies. This is often the case for supplies by charities and for certain supplies by public service bodies such as non-profit organizations (NPOs), public universities and colleges, schools, and hospitals.³⁵ In these situations, it may not matter whether an amount is a subsidy or consideration because there is no relevant tax base.

33 Unless they are specifically excluded. See Taxes, Duties and Fees (GST/HST) Regulations, SOR/91-34. The main exclusions are provincial sales taxes, land transfer taxes, and, of course, the federal GST.

34 *GST/HST Memorandum* 3.5, “Application of GST/HST to Other Taxes, Duties, and Fees,” April 2016, at paragraph 21.

35 See the exemptions in ETA schedule V, respectively, parts V.1 (charities), VI (public sector bodies), II (education), and III (health).

Whether an amount is “consideration” is, however, relevant in other contexts. An important instance is section 141.01, which requires that taxable supplies be made for consideration in order for related inputs to be eligible for input tax credits (discussed below). Supplies made for no consideration or for nominal consideration are ineligible. Thus, there is a connection between consideration and the ability to claim input tax credits. However, subsection 141.01(1.2) deems certain grants or subsidies to be consideration for input tax credit purposes. The ETA also provides for rebates to public service bodies (such as NPOs) provided that they receive a minimum amount of government funding. Government funding is defined to include financial assistance but excludes consideration other than payments for exempt supplies.³⁶

Administrative Explanation

Technical Information Bulletin B-067, “Goods and Services Tax Treatment of Grant and Subsidies” (“TIB B-067”) sets out the CRA’s administrative policy with respect to the taxation of “transfer payments”—the term used in the bulletin to describe subsidies, grants, contributions, gifts, or other similar payments.³⁷ TIB B-067 states that, in general, transfer payments made in the public interest or for charitable purposes will not be regarded as consideration for a supply. However, if there is a direct link between a transfer payment received by a person and a supply provided by that person, either to the grantor of the transfer payment or to third parties, the transfer payment will be regarded as consideration for the supply. If a transfer payment is consideration for a supply, it must then be determined whether or not the supply is taxable. TIB B-067 explicitly endorses the concept of third-party consideration where a recipient may use a transfer payment to provide a supply of goods or services to one or more third parties rather than to the grantor of the payment.

TIB B-067 sets out two steps for determining whether a transfer payment is consideration for a supply. First, the supply must be made “as a result” of the transfer payment.³⁸ This appears to be a low threshold, and the bulletin devotes little space to this question. Second, there must be a “direct link” between the transfer payment and the supply.³⁹

36 See ETA subsection 259(2) and the Public Service Body Rebate (GST/HST) Regulations, SOR/91-37.

37 *GST/HST Technical Information Bulletin* B-067, “Goods and Services Tax Treatment of Grant and Subsidies,” August 24, 1992, “Introduction.” This bulletin has been considered in a number of cases, including *Commission Scolaire des Chênes v. The Queen*, [2000] GSTC 36 (TCC); rev’d [2002] GSTC 11 (FCA); *Thompson Trailbreakers Snowmobile Club Inc. v. R*, 2005 TCC 269; *Westcan Malting Ltd. v. The Queen*, [1998] GSTC 34 (TCC); *Meadow Lake Swimming Pool Committee Inc. v. Canada*, 2000 GSTC 617 (TCC); and *Corporation des loisirs de Neufchâtel v. The Queen*, 2006 TCC 339. These decisions are discussed in our case-law review below.

38 TIB B-067, *supra* note 37, “Part II Policy Guidelines.”

39 *Ibid.*

In order to determine whether a supply made as a result of a transfer payment has a direct link to that payment, TIB B-067 examines a number of factors,⁴⁰ including

- the purpose of the payment,
- whether the payment is part of an ongoing program of financial support,
- the nature of the individual or organization making the payment, and
- the rights bestowed upon the grantor in exchange for the payment.

According to TIB B-067, transfer payments have either a public purpose or a purchase purpose. A transfer payment made for a public purpose serves the public good and is not likely to be deemed to be consideration. The CRA cites, as an example, a transfer payment from a municipality to a charitable group to help that group provide a fragrant garden for blind people. In contrast, a transfer payment made for a purchase purpose serves the interests of either the grantor or a specific third party. Transfer payments made for purchase purposes are likely to be deemed to be consideration.

Transfer payments that are part of an ongoing program of financial support through government grants and contributions are less likely to be viewed as consideration.

TIB B-067 also considers the nature of the individual or organization making the transfer payment in determining whether there is a direct link. A transfer payment made by a funding or granting organization, for example, may not be consideration for a supply because such organizations often indicate the presence of a public purpose. In contrast, a transfer payment made by a commercial organization is presumed to be made for a purchase purpose and therefore to be consideration for a supply. Commercial organizations can make transfer payments for a public purpose, but they must demonstrate that they receive no direct benefit from the payments in question.

As noted above, the CRA will also consider the rights bestowed upon the grantor in determining whether there is a direct link between the payment and the supply. If the grantor receives rights with respect to the supply, such as distribution rights or rights to income, a direct link between the transfer payment and the supply will likely be established, such that the transfer payment is consideration for the supply. The bulletin provides the following example:

Under a contribution agreement and through an on-going funding program to support non-profit research, a government department gives a transfer payment to a non-profit organization (NPO) to assist in the NPO's research project. The NPO agrees to provide a final report on its findings and on the use of the funds, but maintains copyright on the research results. Because the payment is made for a public purpose and the grantor receives no direct benefit, the transfer payment is not consideration.

40 Ibid.

If, however, the NPO gives the copyright on the research report to the grantor and also provides royalties on sales to the grantor, a direct link will exist between the payment and a supply. Since there is a purchase purpose, the transfer payment will be regarded as consideration for a taxable supply.⁴¹

Finally, TIB B-067 attempts to distinguish supplies made merely to allow the grantor to maintain accountability. The fact that some accountability mechanism exists does not necessarily indicate that no other supply takes place, or that the payment is not consideration. An analysis of the objectives of the agreement should be made to determine the purpose for which the payment is made. Thus, the bulletin attempts to distinguish “the” supply for which consideration is paid from other obligations that are ancillary.

Definitions in the EU VAT Directive and the European Commission’s Explanation

In the European Union, the taxable amount for the purposes of VAT is defined in article 73 of the EU VAT directive to include “everything which constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer or a third party, including subsidies directly linked to the price of the supply.”⁴² This definition is essentially the same as the one provided under the predecessor directive.⁴³ It is noted that the English version of the EU VAT directive uses the term “consideration” as the basis on which the tax is to be applied. If we compare other language versions,⁴⁴ this term is best understood as meaning “against payment.”⁴⁵

41 Ibid.

42 European Union, Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax, OJ L 347, December 11, 2006, article 73.

43 See European Union, Sixth Directive 77/388/EEC of 17 May 1977, OJ L 145, June 13, 1977, article 11A(1)(a).

44 All 24 EU languages are equally authoritative in the interpretation of EU statutes; therefore, when interpreting the VAT directive, it is important to compare different language versions to arrive at the most likely meaning of a certain provision. On this subject, see, for example, Lawrence M. Solan, “The Interpretation of Multilingual Statutes by the European Court of Justice” (2009) 34:2 *Brooklyn Journal of International Law* 277-301; Mattias Derlén, *Multilingual Interpretation of European Union Law* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2009); and Gerd Toscani, “Translation and Law—The Multilingual Context of the European Union Institutions” (2002) 30:2 *International Journal of Legal Information* 288-307.

45 See, in particular, article 2 of the directive. The French version uses “à titre onéreux,” the German version “gegen Entgelt,” the Dutch version “onder bezwarende titel,” and the Spanish version “a título oneroso.” In common-law countries, “consideration” has a particular technical meaning where it forms a constituent element in the legal formation of a contract, but the same significance is absent in civil-law countries. However, EU law is a legal system sui generis, and the meaning and scope of terms are not determined on the basis of the national law of the

From the legal provision, it follows that a subsidy would be taxed if it was payment for a supply of goods and/or services made to the grantor of the subsidy (and thus a pseudo-subsidy), or if the subsidy would constitute a third-party payment of all or part of the consideration owing to the supplier. It is not immediately clear what constitutes a subsidy “directly linked to the price of the supply.”

The European Commission (the executive branch of the European Union), in its first report to the European Council on the application of the VAT system, discussed the requirement of a direct link between a subsidy and the price of a supply, stating that

it is relatively easy to decide straight away that subsidies are “directly linked to the price” when their amount is determined either by reference to the selling price of the goods or services supplied, or in relation to the quantities sold, or again in relation to the cost of goods or services supplied to the public free of charge.⁴⁶

The criterion by which a subsidy is judged to have a direct link is the proportionality between the amount of the subsidy payment and the output (quantitatively or monetarily) of the subsidized person or entity. It follows that the Council refers only to output subsidies, as described in the text above. Direct income and lump-sum support subsidies are not considered to be part of the consideration. Although they may lead to lower consumer prices, the link would be indirect only.

The commission further stated that

it is extremely difficult to decide [the question of linkage] in the case of other types of subsidy such as deficit subsidies or operating subsidies, which are paid with the aim of improving a firm's economic position and which are granted without specific reference to any price. The absence of any substantial difference between these two types of subsidy (those “directly linked to the price” are usually also aimed at improving a firm's position), together with the fact that a Member State can convert a subsidy of the first type into a subsidy of the second type, illustrate the fragility of a distinction based on purely formal criteria (the manner in which the subsidy is granted) and thus the inadequacy of the Directive in this respect.⁴⁷

In its second report to the Council, the commission noted that the expression “subsidies directly linked to the price” should be interpreted in a strict and literal

member states; rather, in applying EU law, the terms used are understood to have a common meaning throughout the European Union. See *Staatssecretaris van Financiën v. Association coopérative 'Coöperatieve Aardappelenbewaarplaats GA'*, [1981] ECR-445 (February 5, 1981), case 154/80 (CJEU), ECLI:EU:C:1981:38. On the interpretation of EU law, see van Brederode and Meussen, *supra* note 13.

46 Commission of the European Communities, First Report from the Commission to the Council on the Application of the Common System of Value Added Tax, Document 83/426, COM(83) 426 final (Brussels: September 14, 1983), at 37 (<http://aei.pitt.edu/6340/1/6340.pdf>).

47 *Ibid.*, at 37-38.

sense for the purposes of the legal provision and that a subsidy is to be included in the taxable amount only if three conditions are met:⁴⁸

1. The subsidy constitutes the consideration (or part of the consideration).
2. The subsidy is paid to the supplier.
3. The subsidy is paid to a third party.

Although the commission in its first report concluded that no material difference exists between the types of subsidies, it did not explicitly conclude that, therefore, all subsidies should be taxed. The commission recognizes the inadequacy of the directive, but it has not taken any legislative steps since issuing the second report to clarify or fine-tune the concept of a taxable subsidy. Whether a subsidy is subject to VAT is not determined on material grounds but only on the basis of formal criteria.

INPUT TAX CREDITS RELATED TO TAXABLE SUBSIDIES

As discussed above, VAT is a tax on private consumption expenditure. Although the tax is levied at each stage of the supply chain, business-to-business transactions are relieved by allowing the purchaser to claim a credit (a so-called input tax credit) for VAT paid on procurement (input VAT) against VAT charged on sales (output VAT). To exercise the right to deduct input VAT, it is generally irrelevant who actually pays the price charged for the supply. If, for example, a young entrepreneur orders a delivery van for his startup flower shop and his father pays part of the purchase price directly to the dealer, the business, as the recipient of the supply, can still fully deduct the VAT charged to it in relation to the supply.⁴⁹ There is a taxable supply of a van, which is used in the course of the business of the flower shop, so the business can deduct the VAT. The gift by the father is not subject to VAT since it is not consideration for a supply made to the father. The same should be true for subsidies. If a subsidy has the character of a third-party payment, the service supplier should remit VAT on the total sales price, including the subsidy. The payment of VAT on the subsidy would be irrelevant owing to the credit system.

A problem arises when a price subsidy is determined after the supply has been made—for example, because the amount of the subsidy depends on volume. In such a case, the recipient will be unable to include the amount subsidized in the invoice for the sale, but because the subsidy is taxable, the recipient must account for the VAT included in the subsidy as output VAT. In effect, this would lower the subsidized amount by the amount of the VAT.

48 Second Report from the Commission to the Council on the Application of the Common System of Value Added Tax, COM(88) 799, December 20, 1988.

49 For Canada, see ETA subsection 123(1), the definition of “recipient,” and section 169. See also *Canada v. General Motors of Canada Ltd.*, 2009 FCA 114.

To illustrate this, assume that a taxable person makes a supply for consideration of 150 and receives a subsidy of 50. If the subsidy is granted prior to the supply, the recipient can invoice the customer as follows at a VAT rate of 10 percent.

Sales price	150.00
VAT	15.00
Subsidy received	<u>(50.00)</u>
Amount due	<u>115.00</u>

Assuming that a credit can be claimed for the VAT included in the invoice, the customer effectively pays 100.

If the subsidy is determined after the supply, the recipient will invoice the customer as follows:

Sales price	100.00
VAT	<u>10.00</u>
Amount due	<u>110.00</u>

Again, the customer pays 100 after taking a credit for the VAT invoiced. However, the supplier must account for VAT in relation to the subsidy on an inclusive basis (calculated as $10/110 \times 50 = 4.55$). The supplier loses the VAT amount included in the subsidy since the tax cannot be passed on to the customer. Compare this result with the example of the delivery van partly paid for by the business owner's father. The dealer invoices the business for the full price and receives payment from two sources: the son and the father. The son deducts all input VAT. With a government subsidy, which is paid directly to the manufacturer and of which the buyer may have no knowledge, the input VAT included in the subsidy is lost.

In modern VAT jurisdictions, this problem is resolved by allowing government bodies to register and recuperate any VAT. The recipient simply invoices the government agency for the subsidy amount and charges VAT on top of it, which the government agency subsequently deducts as an input VAT credit. This solution is theoretically correct where the subsidized output is supplied to a taxable business, since business procurement should be relieved from VAT, but obviously it is not correct where the output is supplied to a consumer, since the expenditure is then only partially taxed. This difficulty could perhaps be resolved by disallowing input VAT credits related to subsidies for goods and services supplied to consumers. In practice, however, the solution may not always be so straightforward—for example, where subsidized output is supplied by the recipient to both businesses and consumers. The modern VAT approach is based on the premise that the government agency receives something of value in return for the payment of the subsidy. That approach appears to be blocked in the European Union because “consideration” in the legal definition includes “subsidies directly linked to the price of the supply.” In other words, through the legal definition, these subsidies cannot be considered to be payments for services rendered to the government body that granted the subsidy;

rather, they are considered to constitute payments for the underlying supplies made to a business's customers. To apply the modern VAT approach to subsidies, the EU VAT directive would need to be amended on this point.

A related issue is how government activities are treated in general under VAT. In modern VAT jurisdictions, notably New Zealand and Australia, most supplies made by government bodies are taxable, and input VAT can therefore be recovered. In traditional VAT jurisdictions, such as the European Union, either government output is exempt or government bodies are not considered to be taxable persons⁵⁰ and thus are prevented from deducting VAT on costs incurred in their capacity as government bodies. Even if a government body were registered for business activities, it would not be eligible to a credit for input VAT incurred on the cost of a subsidy, because subsidies are granted by the government itself and not by the commercial enterprise conducted by the government.

Canada occupies a middle position between exemption and full taxation of government activities. While many supplies are exempt, some or all of the VAT incurred in the course of rendering exempt supplies is subsequently rebated.⁵¹

In short, in order to prevent a VAT cost on subsidies, traditional VAT jurisdictions, such as the European Union, would need to fundamentally change the treatment of government bodies from exempt to fully taxable, or follow the Canadian model and develop a rebate model to relieve government agencies from VAT costs.⁵²

If a government agency grants a subsidy in return for which it receives a supply of goods and/or services, the supplier should, depending on the agreement, either charge VAT on the amount of the subsidy or invoice for the amount of VAT included in the subsidy. Insofar as the government uses the purchased supplies for the furtherance of a taxable business, it should be able to recover the VAT. However, if the subsidy is in fact a consumption expenditure of the government agency, the VAT will "stick" (unless it is included in the rebate model).

A particular issue is how to treat subsidies granted by the government to contribute to the common good. The recipient may be required, under the terms of the subsidy, to make supplies of certain goods or services, or refrain from certain actions, or discontinue certain commercial activities; but where a consumption expenditure appears to be absent, VAT cannot adhere to any such "supplies" made.

50 Compare article 13 of Council Directive 2006/112/EC, *supra* note 42.

51 See Pierre-Pascal Gendron, "VAT Treatment of Nonprofits and Public-Sector Entities," in *The VAT Reader: What a Federal Consumption Tax Would Mean for America* (Falls Church, VA: Tax Analyst, 2011), 239-47.

52 According to Gendron, *ibid.*, at 240, "[T]here are no convincing conceptual or practical arguments to remove the activities of the nonprofit and public sectors from the VAT base. Arguments concerning income distribution, social objectives, or the difficulty of taxing the sectors don't survive scrutiny when it comes to VAT. From the perspectives of efficiency, equity, and simplicity, the argument for full taxation is strong." See also Pierre-Pascal Gendron, "How Should the United States Treat Government Entities, Nonprofit Organizations, and Other Tax-Exempt Bodies Under a VAT?" (2010) 63:2 *Tax Law Review* 477-508.

That, at least, is the approach taken by the EU Court of Justice, as we will discuss later. Under this doctrine, taxation is dependent on consumption. Where the government pays a subsidy to entice the recipient to perform certain duties or activities that are in the interest of the common good, there is no consumption expenditure, and the subsidy therefore should not be subject to VAT. The opposite approach is followed in modern VAT jurisdictions where, in essence, the recipient is assumed to make a supply to the government unit that granted the subsidy.

The recipient of such a subsidy should retain the right to a full input VAT deduction because the subsidized activity falls within the scope of the recipient's enterprise, even if the activity does not constitute a taxable supply. As discussed below, this result appears to be achieved in Canada through a specific legislative provision deeming grants and subsidies to be consideration for input tax credit purposes.

As discussed below, the concept of third-party consideration is explicitly recognized under the EU rules. In Canada, a similar result is achieved because the rules for input VAT deduction are based on the person liable to pay the consideration under the agreement with the supplier, rather than who actually makes the payment.⁵³

The other connection between subsidies and input VAT credits is illustrated by many of the Canadian cases below. In cases where a subsidy payment is viewed as consideration for a taxable supply, the payer of the subsidy will not be able claim an input tax credit unless it uses, consumes, or resupplies the supply in commercial activities.⁵⁴ Commercial activities exclude the making of exempt supplies. Where inputs are used, consumed, or resupplied for both commercial activities and exempt supplies, those inputs must be apportioned in claiming input tax credits.⁵⁵ Generally, there is considerable leeway in making the apportionment, other than for financial institutions. Various methodologies can be used so long as they are fair and reasonable, and are used consistently throughout the year; the apportionment is not limited to relative turnover. (That is, apportionment can be based on other methodologies, such as personnel hours or floor space.) Public service bodies often make exempt supplies and may therefore be unable to claim input tax credits if the subsidies they receive are in fact consideration for taxable supplies; however, they may be able to claim partial rebates.

CASE LAW ON THE APPLICATION OF VAT TO SUBSIDIES

Canada

Fundamentally, the GST/HST treatment of subsidies hinges on the issue of whether a subsidy is consideration, because consideration is the statutory tax base. If a subsidy

53 See ETA subsection 123(1), the definition of "recipient." See also *Club 63 North v. The Queen*, [1995] GSTC 75 (TCC).

54 See ETA sections 141.01 and 169.

55 See ETA sections 141.01(5) and 141.02.

is consideration for a taxable supply, it will generally be subject to GST/HST. If a subsidy is not consideration but is, for example, a gratuitous payment such as a donation, it should not be subject to GST/HST. Labels such as grants, subsidies, and sponsorship are not determinative. The characterization is based on whether the payment has sufficient nexus to an induced supply. In evaluating this nexus, courts often apply the direct link concept espoused in the CRA's bulletin discussed above. As explained by the Tax Court of Canada,

[t]he concept of linkage is simply a means to determine if a transfer payment was made to fund a particular supply or, in other words, if a supply was made for consideration.

The concept of direct link permits one to recognize if consideration was paid for a supply.⁵⁶

There are numerous Canadian cases on subsidies, and several of them are reviewed below. Some notable patterns can be identified.

- First, it appears that the courts have adopted an approach centred on contract law, such that where a granting entity has imposed conditions under an agreement for the payment of a grant, this often leads to the conclusion that the grant is consideration for a specific supply, as opposed to a payment for a generic public purpose. As stated by the Federal Court of Appeal, “[a] payment made under a contract will inevitably meet that requirement since the very existence of the obligation to pay is conditional on the co-contracting party fulfilling the corresponding obligation that rests on him or her.”⁵⁷
- Second, because of the provinces’ constitutional immunity from federal taxation, the recipient of a grant from a province that does not pay GST/HST may be motivated to argue that the grant is consideration for a taxable supply to the province and thus eligible for input tax credits, but with no tax collectible on the output supply.
- Third, given the broad definitions of “supply” and “service,” there sometimes arises an issue of what exactly an amount is paid *for*. For example, is an amount third-party consideration for subsidized supplies, or is it consideration for a different supply made to the payer?
- Fourth, as noted above, there does not appear to be any special regard for whether the subsidy at issue is input- or output-based, or based on neither input nor output.
- Fifth, in contrast to the EU Court of Justice decisions discussed below, Canadian courts to date do not appear to take the analysis beyond ascertaining whether there is a direct link. Once a link is found to be direct, the payment

⁵⁶ *Regina (City)*, supra note 32, at paragraphs 31-32.

⁵⁷ See *Commission Scolaire des Chênes*, supra note 37 (FCA), at paragraph 20.

is characterized as consideration, and the analysis stops. Generally, the courts have not, for example, further evaluated this conclusion from the perspective of the GST/HST as a tax on private consumption.⁵⁸

To illustrate the direct link concept, consider *Westcan Malting*.⁵⁹ In that case, a malting company had entered into an arrangement with the village of Alix to build a waste and effluent treatment facility in the village. The village would obtain federal and provincial grant monies and pay them over to Westcan for the construction of the facility. The village would own the facility but would transfer it to Westcan for \$1 if the village stopped operating it. Westcan would be entitled to receive the village's water and effluent disposal services at cost. The CRA assessed Westcan for failing to collect GST on the supply of the facility to the village. The Tax Court held that Westcan made a supply of the facility to the village. Ownership of the facility passed to the village upon final payment of the grant money to Westcan, and thus the payments and the supply were directly linked. Applying the CRA's TIB B-067, the court held that the grants constituted consideration for the supply. Had the village simply retained the grant monies and constructed the facility itself, it is quite possible that the court would have reached a different conclusion. However, because the monies were paid over to Westcan in exchange for ownership of the facility, they were viewed as consideration. (Note that the village likely would not have been able to claim an input tax credit for the GST that Westcan was required to charge on the supply, although it could claim a partial rebate.)⁶⁰

In *Commission Scolaire des Découvreurs*,⁶¹ there was similarly a clear connection between a payment and a reciprocal property right based on the form of the agreement. In that case, Quebec City had paid a school board a subsidy to enable the board to renovate a school and expand its gymnasium. The board agreed to make the new facility available to the city at no charge for 30 years, for use by local residents as a community centre. If the facility were sold or destroyed, the subsidy would have to be repaid. The Tax Court ruled that the subsidy was consideration for a taxable supply; it was not financial assistance in the nature of a donation. The contracts indicated that there was a direct link between the subsidy and the (free) rental of the facility to the city. The court went on to find that the value of the consideration was equal to the full amount of the subsidy, since that was the amount to be repaid under the contract if the premises were destroyed or sold. The supply was

58 However, TIB B-067, *supra* note 37, perhaps reflects this perspective in the example of a municipal grant for a garden for the blind.

59 *Westcan Malting*, *supra* note 37.

60 The financial impact for municipalities is now somewhat lessened because in 2004 they began receiving 100 percent rebates of the 5 percent GST. However, they continue to receive only partial rebates of the tax where the HST is applicable.

61 *Commission Scolaire des Découvreurs v. The Queen*, [2004] GSTC 49 (TCC).

taxable because it did not meet the conditions for the exemption of leases of real property by public service bodies.⁶²

*Meadow Lake Swimming Pool Committee*⁶³ is a more difficult case, in which the Tax Court had to consider what the payment was for. An NPO had received annual grants from a municipality for the operation of a local swimming pool, which would otherwise be operated at a deficit. The NPO was assessed by the CRA for failing to collect GST on the grants, on the basis that they were consideration for the taxable supply of operating the pool.⁶⁴ The NPO argued that the grants were not consideration because they were paid for a public purpose, benefiting the general public. The court rejected the NPO's arguments and upheld the assessment and related penalties. The relevant bylaws indicated that the municipality was engaging the NPO to operate a facility owned by the municipality. In the court's view,

[the] Town did not pay \$100,000 per year to the appellant to promote aquatics as a lifestyle or to advance general knowledge of the sport of swimming or water polo in Meadow Lake. Pool Committee Inc. received money each year in accordance with a well-tuned mechanism and was required to utilize the funds solely in connection with the stated purpose of operating, maintaining and regulating the swimming pool.⁶⁵

Thus, the level of specificity in the written bylaws influenced the court's conclusion that the payments were linked to the operation of the pool for the municipality, as opposed to a more general benefit to the public. What was arguably an input subsidy for the pool was characterized by the court as consideration for a supply of services to the municipality.

Characterizing what a payment was for was also pivotal in *Loisirs de Neufchâtel*.⁶⁶ In that case, a community service agency in Quebec City had received funding from the city to operate summer playground programs for children. Because the funding was not sufficient to cover all costs, the agency was allowed to charge program fees to make up the shortfall. The written agreement between the agency and the city was drafted in the form of a contract for services and imposed various conditions on the agency for receiving the funds. The CRA assessed the agency for failing to collect GST on the basis that, in organizing and implementing the programs, it had made taxable supplies to the city for consideration. Thus, the CRA characterized what was arguably an output subsidy for the programs provided to children as consideration for a different supply, namely, organizing and implementing the programs.

62 The provision requires, among other conditions, a minimum period of continuous possession or use. See ETA schedule V, part VI, paragraph 25(f).

63 *Meadow Lake Swimming Pool Committee*, supra note 37.

64 Certain supplies by NPOs are exempt, although tax did appear to be applicable in this case. For example, ETA schedule V, part VI, section 28 exempts certain supplies between a municipality and any of its para-municipal organizations.

65 *Meadow Lake Swimming Pool Committee*, supra note 37, at paragraph 20.

66 *Corporation des loisirs de Neufchâtel et al. v. The Queen*, [2008] GSTC 153 (TCC).

The agency's position was that it supplied services to children or their parents, and not to the city. The city supported the agency's mission of promoting healthy leisure activities for children through the provision of a subsidy, which kept the cost of programs affordable. The Tax Court was willing to accept that the agreement was not in fact a contract for services to the city, but rather a subsidy agreement for the consideration paid by children or their parents. Ultimately, the agency was not liable for tax because the court accepted the CRA's determination that those supplies were exempt.⁶⁷

In *Boardwalk Equities*,⁶⁸ the Alberta government had paid amounts (called "grants") under a program to assist consumers with higher energy costs. For administrative convenience, the payments were made directly to the utilities supplying the services (electricity and gas companies), which in turn were to apply the grants to offset the usage charges on customers' electricity and gas bills. The utilities charged tax on the pre-grant amount. Customers sought a refund of the tax on the grant amounts. The grant was held not to affect the amount of consideration payable by customers. Taking a technical approach, the Federal Court of Appeal noted that the consumer's liability for the full amount of consideration was already determined upon invoicing, which was prior to the payment of the assistance by the province (even though the amount of the payment was shown on the invoice). There was also no evidence that the province assumed consumers' contractual liability to pay. Thus, technically, the grant could not affect the consideration payable by the customer. Instead, the grant was characterized as partial payment of consumers' bills by the province—for example, as third-party consideration. The court also held that the grant was not consideration for a separate supply by the utilities to the province, which would have been non-taxable (as discussed further below). (The appellant had advanced an alternative argument that the utility company had made a separate non-taxable supply to the province for consideration equal to the assistance amount.)

In all of the aforementioned cases except *Boardwalk Equities*, the suppliers did not charge tax on the subsidy and had been assessed by the CRA for failing to do so. Thus, their position on appeal was that the payments were not consideration for supplies. In *Boardwalk Equities*, the supplier did charge tax on the subsidy and the customer sought a refund, arguing that the subsidy was not consideration for supplies. In contrast, there are instances where a supplier wishes to establish that its activities are taxable supplies and that grants received are consideration in order to claim input tax credits. This scenario usually arises because of section 125 of the Constitution Act, which, as noted earlier in this article, provides immunity for one level of government from taxation by the other. While a number of provinces have agreed to pay GST/HST (and receive a rebate), others have not. Supplies to the latter provinces are not subject to GST/HST, but they are not exempt, and so suppliers can claim input tax credits. Effectively, such supplies are zero-rated. Hence, there is an incentive for suppliers (and in particular municipalities, which often make exempt

67 Certain children's programs are exempt under ETA schedule V, part VI, section 12.

68 *Boardwalk Equities Inc. v. Canada*, 2013 FCA 140; aff'g 2012 TCC 7.

supplies and do not enjoy immunity from taxation, but are entitled only to a partial rebate of GST/HST paid) to attempt to characterize grants and similar payments from such provinces as consideration for taxable supplies and thereby claim input tax credits. As discussed above, ETA section 141.01 generally requires that taxable supplies be made for consideration in order to constitute commercial activities and therefore qualify for input tax credits. ETA subsection 141.01(1.2) deems certain grants, etc., to be the consideration for those supplies in certain situations for input tax credit purposes.⁶⁹

The *Calgary (City)* case,⁷⁰ for example, illustrates the circumstances under which it is advantageous for a supplier to characterize its supply as being made for consideration. In that case, the city of Calgary had constructed a public transit system, which it also operated. It had incurred costs to do so and had received funding from the province (Alberta). The city attempted to bifurcate its activities into the provision of public transit (which would be exempt, with no entitlement to input tax credits) and a separate putative supply of making transit facilities available to the province. Since the Alberta government has not agreed to pay GST/HST, the putative supply, if allowed, would not be non-taxable and the city would be entitled to claim full input tax credits. The Supreme Court of Canada resolved the case on the basis that there was only a single supply made by the city, that being exempt public transit services. The construction of the facilities was merely an input into the supply of public transit to the public, not a separate supply to the province. The court concluded that, among other factors, there was no distinct benefit being provided to the province because the province had no statutory obligation to provide public transit, and thus the city could not be said to be discharging such obligation. Further, there was nothing to suggest that the city was transferring the ownership of any property to the province.

In *County of Lethbridge*,⁷¹ the Alberta government had introduced programs offering grants to municipalities that agreed to carry out certain projects and activities on roads owned by the province. One such program was the rural transportation grant program. The county of Lethbridge incurred costs to repair roadways under the program. As a public service body, it received partial rebates for the input tax (GST) on those costs and claimed input tax credits for the remaining tax. In order to be eligible for the input tax credits, the county had to make a taxable supply to the province for consideration. In a preliminary decision on a question of law, the Tax Court concluded that the county did make a supply to the province because the work was performed by the county on roads owned by the province. Further, the grants were consideration for that supply because they were enforceable payments under agreements for the supply. The court's conclusion was firmly rooted in contract law,

69 For an application of this rule to allow input tax credits, see *British Columbia Transit v. The Queen*, 2006 GTC 437 (TCC).

70 *Calgary (City) v. Canada*, 2012 SCC 20.

71 *County of Lethbridge v. The Queen*, 2005 TCC 809.

and the court was frankly dismissive of the direct link notion endorsed by the CRA in TIB B-067. Specifically, the court stated that

[t]he test to be applied is not whether there is a “direct link.” [The bulletin’s] rhapsodic venture into a mire of possibilities is foreign to the common law concept of contractual consideration. The test in this case is whether there was “consideration” as that term, both under the definition in the *Act*, and under common law, exists.⁷²

The court rejected the Crown’s arguments that the county did not make any supply but simply discharged a statutory obligation to maintain the roads. The court also did not accept the Crown’s contention that the grants were financial assistance used for the appellant’s own benefit, and not consideration for a supply. The grants covered only part of the costs, and in other instances were based on factors such as population, rather than relating to the work actually performed. To the court, the adequacy of the consideration was irrelevant under contract law.⁷³ In obiter, the court also expressed doubt as to whether the relevant provisions truly contemplated that a municipality could provide supplies to a province for GST/HST purposes. Yet on simple application of the consideration concept, this was indeed the conclusion. The court did not, for example, consider whether there should also be a requirement for individualized consumption by an entity other than a government (discussed below in respect of the EU cases).

In a similar case, however, the Tax Court concluded that provincial grants for road construction were not consideration. In *Regina (City)*,⁷⁴ the city of Regina had constructed roads connecting to provincial highways and had received grants in respect of that work from the Saskatchewan government. The city claimed input tax credits on the construction costs, which the CRA denied on the basis that the city was not carrying out commercial activities and that the grants, being unconditional, were not consideration. The court upheld the CRA’s denial of input tax credits because the grants were unconditional and were not sufficiently linked to the road work to constitute consideration:

Normally, when a supplier contracts to provide a supply, the cost or consideration for that supply appears in the contract. An unconditional grant or subsidy does not identify a specific purpose or cause for funding. If a person can reasonably determine that there is a specific object for the grant, as it is usually described in a contract, then linkage between the grant and the supply exists and the amount of the grant is consideration for the supply for purposes of the *Act*.⁷⁵

72 Ibid., at paragraph 100.

73 Ultimately, this finding was a pyrrhic victory for the county since a subsequent court found that the road work was exempt (ETA schedule V, part VI, section 21.1) and did not entitle the county to input tax credits. *Municipal District of Spirit River No. 133 v. The Queen*, 2009 TCC 42.

74 *Regina (City)*, supra note 32.

75 Ibid.

The court appeared to set a low threshold based on identifying a specific purpose or cause for funding.

*Société de transport de Laval*⁷⁶ involved a municipal transit authority that operated a local public transit system. The local authority received grants from the Quebec government covering part of the cost of providing transit to persons with mobility impairment. The local authority argued that the grants were consideration paid by the provincial government for taxable supplies. The Tax Court concluded that there was a sufficient connection between the services and the grant for the payments to be consideration:

In my opinion, there is no doubt that there was an obligation to pay a subsidy to the Appellant, and the Minister of Transport could not pay such a subsidy for any purpose other than to enable the Appellant to transport handicapped persons. There is no ambiguity about either the purpose of the subsidy or its connection with the contemplated supply. If the Appellant did not provide that service to handicapped persons as provided for in the orders in council (that is, at the regular fare), the Minister of Transport would not pay the Appellant any subsidy (the subsidy being between 65% and 75% of the paratransit costs). In the absence of a contractual relationship between the Appellant and the Ministère des Transports, it is difficult to imagine a more direct connection between the payment (the subsidy) and the supply of a paratransit service for mobility-impaired persons. It can therefore be concluded that the subsidies so paid were “consideration.”⁷⁷

*Commission Scolaire des Chênes*⁷⁸ illustrates the interaction between the consideration concept and rules based on the person by whom consideration is payable. These rules can affect whether the supply in question is taxable or exempt—an example of a situation where the identity of the payer matters. *Des Chênes* involved a group of school boards across Quebec that provided school bus transportation to children. The boards outsourced the transportation services to independent carriers and paid GST on the carriers’ fees. The Quebec government provided a subsidy to the boards to pay for the transportation services. Initially, the boards claimed partial rebates for the GST paid to the carriers. They later claimed full input tax credits on the basis that they had made taxable supplies for consideration in the form of the subsidies. To understand this argument, consider that prior to amendments to the ETA (discussed below), school bus services were exempt if the supply was “made to” elementary or secondary school students.⁷⁹ Under the ETA, where consideration is payable for a supply, the recipient of the supply is generally “the person who is liable

76 *Société de transport de Laval v. The Queen*, 2008 TCC 14.

77 *Ibid.*, at paragraph 43.

78 *Commission Scolaire des Chênes*, *supra* note 37.

79 ETA schedule V, part III, section 5, as it read prior to the amendments described in note 85, *infra*.

to pay that consideration.”⁸⁰ Alternatively, if there is no consideration, the recipient of the supply is the person to whom the services are rendered.⁸¹ Thus, if the subsidy was consideration payable by the province for school bus services, the supply of those services would not be exempt. Instead, it would be taxable, and the boards would be entitled to full input tax credits. Further, the boards would not be liable for charging GST because Quebec is one of the provinces that does not pay GST. If the subsidy was not consideration, then the supply would be an exempt supply made to the students, and the board’s appeal would fail. The Tax Court concluded that

[t]he subsidy is in the nature of financial assistance made available to the school board to enable it to perform one of its tasks, that is, to provide a student transportation service. It is not in the nature of a payment of the price of a service. Therefore no consideration is paid for this service.⁸²

Notably, the Tax Court reached its decision in part on the basis of secondary materials discussing the requirement for a direct link with price under EU law:

The evidence did not show that the subsidy provided by the Department of Education was linked to the price of the transportation service. On the contrary, the evidence revealed that the Department had no obligation with respect to the actual cost of the student transportation service, that the school boards had broad latitude with respect to the use of the funds allocated for such transportation and that there was no link between the payment of the subsidy and the actual cost of the service.⁸³

However, the Federal Court of Appeal reversed the Tax Court’s decision. It ruled that the link between the subsidy and the transportation services was sufficiently direct to constitute the provision of the services “made to” the Quebec government.⁸⁴ As discussed above, “consideration” is defined to include “any amount that is payable for a supply by operation of law.” The operation of the provincial legislation made the amount payable by the Quebec government to the school boards. Moreover, the subsidy could be cancelled if the boards did not provide the services. Thus, the amount payable was “consideration.” The Court of Appeal downplayed the significance of a connection between the subsidy and the cost of the supply.⁸⁵

80 See ETA subsection 123(1), the definition of “recipient,” paragraphs (a) and (b).

81 Ibid., paragraph (c).

82 *Commission Scolaire des Chênes*, supra note 37 (TCC), at paragraph 32.

83 Ibid.

84 Ibid. (FCA), at paragraph 28.

85 The potential financial impact of the decision in *Commission Scolaire des Chênes* was significant since a number of boards had similar claims. In response, Parliament enacted retroactive amendments to the rules in the ETA, making the transportation services exempt (and thus precluding input tax credits) provided that they are rendered to students, regardless of the identity of the person liable to pay the consideration. See ETA schedule V, part III, section 5.

*Thompson Trailbreakers Snowmobile Club*⁸⁶ is a fitting case to conclude this review of the Canadian jurisprudence. The case involved a non-profit snowmobile club that maintained snowmobile trails on provincially owned land in Manitoba. The club charged snowmobilers a fee (plus GST) for passes (“SnoPasses”) allowing them to use the trails. Under a contract between the club and the province, monies collected were deposited into a trust fund settled by the province for the use of the club and other similar clubs in providing safe trails. The club claimed input tax credits on its costs on the basis that it received revenues directly from snowmobilers from the sale of passes. The CRA disallowed the claim, asserting that the club received grants and not consideration, and thus made exempt supplies.⁸⁷ (It allowed the club to claim a partial public service body rebate as a qualifying NPO receiving requisite government funding.) At trial, the Tax Court did not accept the club’s argument that it received revenues directly from snowmobilers from the sale of passes.⁸⁸ The monies that the club received from selling passes were provincial government revenues, paid back to the club by the province in exchange for the club’s agreement to keep the trails open. Thus, those monies were consideration for a supply by the club to the province.

The court was cognizant of the difficulty in

determining when a government payment constitutes “consideration” for a supply and when it is a payment to support a project or program for the good of the community with conditions designed to ensure the integrity of that project or program in terms of the community’s interest in it.⁸⁹

The court went on to provide a perceptive summary of the issues posed by grants in light of the differing GST consequences for municipalities, provinces, and end users of supplies:

a) Some grant recipients want grant monies not to be regarded as “consideration” for a supply. Typically they would be cases where the grants are from entities such as municipalities who pay GST. If the payment by the municipality is consideration for a supply or sufficiently linked to a supply to properly be viewed as consideration for the supply, GST is chargeable on the supply and the grant recipient is required to collect

86 *Thompson Trailbreakers Snowmobile Club*, supra note 37.

87 ETA schedule V, part VI, section 10 exempts most supplies by public service bodies if all or substantially all of the supplies of the property or service by the body are made for no consideration.

88 The fact that the club may have collected GST from snowmobilers was not determinative of the question whether the club was entitled to input tax credits. Generally, if a supplier has collected tax in error from a purchaser, the purchaser has recourse in the form of a claim to a rebate under section 261. The supplier can claim input tax credits only if it meets the statutory preconditions, such as having made a taxable supply for consideration.

89 *Thompson Trailbreakers Snowmobile Club*, supra note 37, at paragraph 19.

and remit the tax. To avoid this liability, the grant recipient would argue that the grant was made for a public purpose and not given as consideration. In these cases, to protect or expand the fisc, the Minister may be inclined to seek support for a test that views consideration broadly, which is to argue the sufficiency of any link between a supply and a payment in terms of constituting consideration and treating a public benefit as incidental to the making of the grant as opposed to being the real object of it;

b) Then there are cases, such as the one at bar, where the Minister may be inclined to seek support for a test that views consideration narrowly, which is to argue treating any public benefit or purpose for the making of the grant as being the real object or legal effect of it. The Minister would then argue that the grant is not consideration given the public purpose involved and that any apparent purchase element, purchase link or purchase purpose in respect of a supply should be seen as incidental to the grant (even if necessarily incidental to the grant) but not a supply that the grantor was “paying for” in a contractual or legal sense. This approach by the Minister might be expected where the services are provided to a province. Provinces are immune from taxation so supplies to a province create an unbalanced result where the supplier receives ITCs [input tax credits]. That is, no GST is collected where the province is the end-user of the supply. But this is a result of the system as legislated. In the ordinary case of a commercial service provider, the Minister has little to say—the fisc loses; but where the service provider is a non-profit organization the Minister has a chance to restore “balance” if the payment to the supplier is a grant that is not consideration. The Appellant argues it is unfair to be put in a worse position than commercial suppliers, especially since in the case at bar, GST is paid by the snowmobilers who are the real end-users of their supplies. However, this argument puts too much focus on “balance” in a system where balance is clearly not always of paramount importance to the legislators who in an attempt to restore *some* balance have, for example, offered non-profit suppliers a rebate; and

c) Some user funded community activities operated by non-profit organizations get ITCs which the system sees as appropriate where the users pay GST. Why distinguish the user funded activity in the present case where users pay GST, just because a government has placed itself as a conduit between the user fees paid and the supplier? From a policy point of view, treating these two cases differently is arguably not consistent with the objectives of a value added tax system. If the SnoPass system is a user-pay system—if SnoPass fees are consideration paid to the clubs for providing groomed trails—and the province is merely giving up the lands as a concession to snowmobile enthusiasts in the province—an ITC would seem appropriate in terms of fiscal neutrality in a value added tax system. The snowmobilers are the end-users of groomed trails. They pay GST for the use of the trails and the supplier of them should get ITCs on its tax paid purchased supplies. A non-profit golf club that charges user fees and grooms its course for those users would be entitled to ITCs on grooming equipment acquired. From the Appellant’s perspective it is hard to justify why it should be treated differently. One problem with this perspective however is that it does not pay adequate attention to the role played by the government in the case under appeal, such as the use of government lands, and ignores the contractual relationship that the Appellant has with the government.⁹⁰

90 Ibid. (emphasis in original).

The court quite aptly noted that whenever the grant arrangement is given the form of a contract, the presumption often arises that the grant is consideration for a supply. It is then often necessary to determine whether there is actually a supply or whether the grant simply has conditions attached for accountability. Citing the decision of the Federal Court of Appeal in *Commission Scolaire des Chênes*, the court noted that

where there is an obligation to pay for a service in a written contract, the inevitable consequence of that is that there is consideration payable for the service. This confirms that the purchase purpose can be drawn from the reality or substance of the contract regardless of even a readily apparent public purpose, but the difficulty will be to determine “where there is an obligation to pay for a service” as opposed to awarding a grant in respect of which there are performance requirements imposed as conditions to ensure accountability for the use of public funds.⁹¹

The court questioned earlier decisions (including *Westcan Malting*, *Meadow Lake Swimming Pool Committee*, and *Commission Scolaire des Chênes*) suggesting that a “loose connection”⁹² between a service and government funding was sufficient to constitute consideration. This was inappropriate, in the court’s view, because the notion of consideration is an essential element of a contract. In the case under consideration, although a public purpose was served, the actual provision of the service was undertaken by a public service body and was funded by the government. The trail maintenance activities were services that the province had undertaken to provide, and it effectively retained the club to perform them. The court concluded that the funding under the contract was consideration for the service provided by the club.

The European Union

Our review of the decisions of the EU Court of Justice is organized thematically, as follows:

- First, we discuss cases involving pseudo-subsidies. These are payments that are presented as subsidies but that do not fulfill all the constituent elements to be accepted as such. Often, they represent third-party payments for the recipient’s output.
- Second, given that subsidies with a direct link to goods or services provided by the recipient are included in the legal definition of consideration, we review the conditions set out by the court to determine the circumstances in which such a direct link exists.

91 Ibid., at paragraph 21.

92 Ibid.

- Third, we discuss the requirement for the existence of individualized consumption, which the court has held to be a necessary condition for a subsidy to be subject to VAT.
- Fourth, we investigate the court's views on whether the receipt of a subsidy may affect the right of the recipient to deduct input VAT, and if so, under what conditions this limitation may apply.

Not all VAT case law discussed in this section is related to subsidies per se, but those cases that are not are nevertheless relevant by analogy.

Pseudo-Subsidies

As discussed earlier in this article, under EU law, subsidies should be taxed if they actually constitute payment for supplies of goods and services made to the grantor or to a third party. This rule may seem straightforward, but it is not always clear when it should apply. In *Keeping Newcastle Warm*,⁹³ a government had paid a subsidy to a supplier of energy advice ("KNW") on the basis of a fixed amount per piece of advice rendered to individual homeowners. KNW took the position that the subsidy did not have a direct link to the price of the service and should remain outside the scope of VAT.⁹⁴ The EU Court of Justice followed the position taken in the procedure by both the European Commission and the United Kingdom,⁹⁵ and concluded that the subsidy, regardless of whether there existed a direct link with the price of the supply, was in fact a third-party payment for the advice. Where the taxable amount comprises "everything which makes up the consideration for the service,"⁹⁶ the subsidy is, logically, included in the taxable amount.

Similarly, in *Le Rayon d'Or*, the court concluded that a lump-sum payment paid out by a national health insurance fund to a residential care home for the elderly constituted consideration for the health care provided to the latter's patients.⁹⁷ Although lump-sum payments generally will be outside the scope of VAT, in this case the court concluded that the payment was related to the caregiver's output, since providing care to its patients was a condition for receiving the payment.

93 *Keeping Newcastle Warm Limited v. Commissioners of Customs and Excise*, [2002] ECR I-5419 (June 13, 2002), case C-353/00 (CJEU), ECLI:EU:C:2002:369.

94 *Ibid.*, at paragraph 20. KNW offered the additional argument that the subsidy was a non-taxable exploitation subsidy, but this was not supported by the facts of the case: the individual householder had the obligation to pay for the service when, for whatever reason, the financial assistance was not forthcoming.

95 *Keeping Newcastle Warm*, *supra* note 93, at paragraphs 22 and 21, respectively.

96 *Tolsma v. Inspecteur der Omzetbelasting Leeuwarden*, [1994] ECR I-743 (March 3, 1994), case C-16/93 (CJEU), ECLI:EU:C:1994:80, at paragraph 13.

97 *Le Rayon d'Or v. Ministre de l'Économie et des Finances* (March 27, 2014), case C-151/13 (CJEU), ECLI:EU:C:2014:185.

Existence of a Direct Link

For any form of payment or consideration to be included in the taxable amount, there must exist a direct link between the supply and the consideration received.⁹⁸ Obviously, a link will be direct where the supply is conditional on receiving payment of the price.⁹⁹ A clear example of circumstances in which that condition is missing can be found in *Tolsma*,¹⁰⁰ where the EU Court of Justice held that a street musician was not liable for VAT because the payments he received from the public were not a condition for his provision of music. Some people pay and listen to street musicians; others pay and walk on; others again listen and do not pay; in essence, the musician is a beggar and thus not involved in any economic activity under the EU VAT directive.¹⁰¹ In a later case, *Český rozhlas*,¹⁰² the court indicated that the existence of a legal or contractual relationship between the supplier and the purchaser is a prerequisite for the existence of a direct link. The contractual relationship, and thus the direct link between payment and supply, was found to be absent where a public radio station was financed through a mandatory fee (tax) to be paid by everyone in the possession of a radio receiver. The obligation to pay a radio fee does not create any legal relationship between the person liable to pay it and the public broadcaster because, first, the event triggering that obligation lies not in the use of the services supplied by the broadcaster in question but in the possession of a radio receiver, and, second, access to those services is not subject to payment of the fee.

The referring court also asked whether the solution found in *Le Rayon d'Or* could possibly be applied to the radio fees, but there is a significant difference between the cases. In *Le Rayon d'Or*, a contractual relationship existed between the patients and the provider of the care; in *Český rozhlas*, such a relationship was found to be absent.¹⁰³

It is also clear from the *Keeping Newcastle Warm* case, discussed in the previous section, that if a subsidy does not have a direct link with the price that a provider charges to its customers, the subsidy can still be included in the taxable amount if the subsidy itself has a direct link to the supply made as a third-party payment for that supply.

98 *Naturally Yours Cosmetics Limited v. Commissioners of Customs and Excise*, [1988] ECR 6365 (November 23, 1988), case C-230/87 (CJEU).

99 See, for example, Christian Amand, "When Is a Link Direct?" (1996) 7:1 *International VAT Monitor* 3-11; and Richard Pinscher, "Is There A Link?" [1996] no. 3 *British Tax Review* 306-16.

100 *Supra* note 96.

101 Robert F. van Brederode, "De orgelman als bedelaar" (1994) 99 *Fiscaal Periodiek BTW*.

102 *Odvolačí finanční ředitelství v. Český rozhlas*, (June 22, 2016), case C-11/15 (CJEU), ECLI:EU:C:2016:470, at paragraph 25. Compare *Commission of the European Communities v. Republic of Finland*, (October 29, 2009), case C-246/08 (CJEU), ECLI:EU:C:2009:671, at paragraph 44; and *Finanzamt Essen-NordOst v. GFKL Financial Services AG*, (October 27, 2011), case C-93/10 (CJEU), ECLI:EU:C:2011:700, at paragraph 18.

103 *Český rozhlas*, *supra* note 102, at paragraphs 34-35.

The earliest case discussing the concept of a direct link is not related to subsidies and was ultimately resolved by defining what is not a direct link. In *Aardappelenbewaarplaats*,¹⁰⁴ a cooperative association ran a cold-storage depot in which it laid in and stored potatoes at a constant temperature for its members. Each grower owning shares was entitled to deposit 1,000 kilograms of potatoes a year for each share against the payment of a storage charge fixed by the cooperative and payable at the end of the season. Pursuant to a decision by the association, in the year in question no storage charge had been imposed and, consequently, no VAT remitted. The tax authorities assessed the cooperative for VAT on the basis of the ordinary storage charge, reasoning that (1) the cooperative had charged its members for the storage in the form of a reduction in the value of their shares owing to the non-collection of their storage fees, or (2) alternatively, the members had provided the cooperative with a benefit (in return for the storage) by accepting a reduction in the value of their shares in proportion to the usual storage charge not collected. In the decision, the EU Court of Justice explained:

There must therefore be a direct link between the service provided and the consideration received which does not occur in a case where the consideration consists of an unascertained reduction in the value of the shares possessed by the members of the cooperative and such a loss of value may not be regarded as a payment received by the cooperative providing the services.¹⁰⁵

Moreover,

the consideration for the provision of a service must be capable of being expressed in money . . . secondly . . . such consideration is a subjective value since the basis of assessment for the provision of services is the consideration actually received and not a value assessed according to objective criteria.¹⁰⁶

We may therefore conclude that the direct link condition requires that the consideration must be determinable (that is, not be fictitious)¹⁰⁷ and also that it must be possible to express the consideration in monetary terms. By extension, that means that for a subsidy to have a direct link with a supply, the monetary value of the supply must be determinable.

¹⁰⁴ *Aardappelenbewaarplaats*, supra note 45.

¹⁰⁵ Ibid., at paragraph 12.

¹⁰⁶ Ibid., at paragraph 13.

¹⁰⁷ The condition that the price of goods and services must be determinable is repeated in *Office des produits wallons ASBL v. Belgian State*, [2001] ECR I-9115 (November 22, 2001), case C-184/00 (CJEU), ECLI:EU:C:2001:629, at paragraph 13, stating that “it is not necessary for the price of the goods or services—or a part of the price—to be ascertained. It is sufficient for it to be ascertainable.”

The judgment in *First National Bank of Chicago*¹⁰⁸ provides clarification as to the required strength of the link between the activity and the consideration. That case concerned a commission charged by a bank for foreign-currency transactions, whereby the commission consisted of the spread between the purchase and the sale price of currency. The EU Court of Justice considered that the bank carried out a large number of transactions relating to different amounts and involving different currencies, the rates of which were in constant fluctuation. Traders cannot normally foresee, when concluding one particular transaction, at what moment and at what price they may subsequently effect one or more transactions enabling them to eliminate or fix, at a specific amount, the risk of a change in rate to which they are exposed following the first transaction. It follows that it is unnecessary to establish an identifiable link between the activity (the currency transactions) and the consideration charged therefor. The court concluded that the consideration—that is, the amount that the bank could actually take for itself—must be regarded as consisting of the overall result of its transactions over a given period of time.¹⁰⁹

Nor is it necessary for either the taxable person supplying the goods or performing the service or the other party to the transaction to know the exact amount of the consideration serving as the taxable amount in order for it to be possible to tax a particular type of transaction. . . . Consequently, it does not matter that when the transaction is concluded the parties do not know the basis on which VAT will be charged and that it remains unknown, even afterwards, to the recipient of the service.¹¹⁰

In another case, Midland Bank had acted as a merchant bank (a taxable activity) for a client involved in an acquisition attempt that had led to litigation.¹¹¹ The client was sued for damages for breach of contract and claimed indemnification from Midland Bank for damages awarded. The bank was also sued by the other party in the transaction for negligent misrepresentation. Midland Bank incurred attorneys' fees relating not only to its liability under the indemnity clause but also to its defence against the alleged misrepresentation. The tax authorities were of the opinion that the VAT on the attorneys' fees would be only partly deductible because the legal

108 *Commissioners of Customs & Excise v. First National Bank of Chicago*, [1998] ECR I-4387 (July 14, 1998), case C-172/96 (CJEU), ECLI:EU:C:1998:354.

109 *Ibid.*, at paragraph 47. The same approach underlies *Muys' en De Winter's Bouwen Aannemingsbedrijf BV v. Staatssecretaris van Financiën*, [1996] ECR I-5311 (October 27, 1993), case C-281/91 (CJEU), ECLI:EU:C:1993:855, where it was decided that the taxable amount must be defined on the basis of the interest accrued over a deferred payment period, which was not yet known at the time the transaction was concluded.

110 *First National Bank of Chicago*, *supra* note 108, at paragraph 49. See also *Argos Distributors Ltd v. Commissioners of Customs & Excise*, [1996] ECR I-5311 (October 24, 1996), case C-288/94 (CJEU), ECLI:EU:C:1996:398, at paragraphs 21-22.

111 *Commissioners of Customs and Excise v. Midland Bank plc*, [2000] ECR I-4177 (June 8, 2000), case C-98/98 (CJEU), ECLI:EU:C:2000:300.

services were obtained to defend the bank against claims that it was liable in damages as a result of acts attributable to it that were performed while it was making the supply to its client. The legal services were thus also attributable to Midland Bank's business generally. Since the bank was a mixed supplier, the input VAT needed to be apportioned.

Under the EU VAT system, only the amount of VAT borne directly by the various cost components of a taxable transaction may be deducted.¹¹² Thus, the court held that "to give the right to deduct . . . the goods or services acquired must have a direct and immediate link with the output transactions giving rise to the right to deduct."¹¹³ If a taxable person uses an input for an exempt supply, the related VAT is not deductible, even if the ultimate purpose of the transaction is the carrying out of a taxable transaction.¹¹⁴ In other words, intent is irrelevant.

The main question in the *Midland Bank* case is whether a taxable person, making both transactions in respect of which VAT is deductible and transactions in respect of which it is not, may deduct in its entirety the input VAT charged on goods or services, even where such goods or services have been used, not for the purpose of carrying out a deductible transaction, but in the context of activities that are no more than the consequence of such a transaction.

As the court stated in *Midland Bank*, the requirement of a direct and immediate link between deductible input VAT and a taxable transaction presupposes

that the expenditure incurred in obtaining [the goods and services] was part of the cost components of the taxable transactions. Such expenditure must therefore be part of the costs of the output transactions which utilise the goods and services acquired. That is why those cost components must generally have arisen before the taxable person carried out the taxable transactions to which they relate. . . . Although the expenditure incurred in order to obtain the . . . [legal] services is the consequence of the output transaction, the fact remains that it is not generally part of the cost components of the output transaction. . . . [T]he costs of those services are part of the taxable person's general costs and are, as such, components of the price of an undertaking's products. Such services therefore do have a direct and immediate link with the taxable person's business as a whole . . . and the VAT is . . . deductible only in part.¹¹⁵

In *Office des produits wallons*,¹¹⁶ a private non-profit association ("OPW") engaged in the promotion of Walloon horticultural and agricultural products for which it

112 See European Union, First Council Directive 67/227/EEC of 11 April 1967 on the Harmonization of Legislation of Member States Concerning Turnover Taxes, OJ 1967/71, article 2.

113 *Midland Bank*, supra note 111, at paragraph 20.

114 *BLP Group plc v. Commissioners of Customs & Excise*, [1995] ECR I-983 (April 6, 1995), case C-4/94 (CJEU), ECLI:EU:C:1995:107.

115 *Midland Bank*, supra note 111, at paragraphs 30-31.

116 *Office des produits wallons*, supra note 107.

was subject to VAT. Under a framework agreement with the Walloon Region, OPW was charged with the performance of four types of activities for which it received an annual operating subsidy based on a budget of permitted expenditure. The EU Court of Justice was asked to decide whether these operating subsidies were subject to VAT. As to the point of the existence of a direct link, the court stated:

[T]he mere fact that a subsidy may affect the price of the goods or services supplied by the subsidised body is not enough to make that subsidy taxable. For the subsidy to be directly linked to the price of such supplies, . . . it is also necessary . . . that it be paid specifically to the subsidised body to enable it to provide particular goods or services. Only in that case can the subsidy be regarded as consideration for the supply of goods or services, and therefore be taxable.¹¹⁷

The court continued:

That makes it necessary to verify at an early stage that the purchasers of the goods or services benefit from the subsidy granted to the beneficiary. The price payable by the purchaser must be fixed in such a way that it diminishes in proportion to the subsidy granted to the seller or supplier of the goods or services, which therefore constitutes an element in determining the price demanded by the latter. The [national] court must examine, objectively, whether the fact that a subsidy is paid to the seller or supplier allows the latter to sell the goods or supply the services at a price lower than he would have to demand in the absence of subsidy.¹¹⁸

Because, under the framework agreement, OPW was charged with carrying out specific activities, the EU Court of Justice further directed that it was necessary to verify

whether each activity gives rise to a specific and identifiable payment or whether the subsidy is paid globally in order to cover the whole of OPW's running costs. In any event, it is only the part of the subsidy identifiable as being the consideration for a taxable supply that may, in appropriate cases, be subject to VAT.¹¹⁹

This case formulates three conditions that must be met for a subsidy to be taxable.

1. The subsidy must be paid for the particular purpose of allowing the recipient to make the supplies.
2. The purchasers of the supplies must benefit in that the purchase price is reduced in proportion to the subsidy received by the supplier.
3. The subsidy must be identifiable. For this purpose, the accounts of the grantor and the recipient may be examined, or a comparison may be made between the selling price and the normal cost price, or between the amount

117 Ibid., at paragraph 12.

118 Ibid., at paragraph 14.

119 Ibid., at paragraph 15.

of the subsidy before and after the production of the goods. These comparisons do not have to produce an exact match. It is sufficient if the relationship between the diminution in price and the subsidy, which may be set at a flat rate, is significant.¹²⁰

It also follows from the reasoning of the court that purely operational subsidies, which cannot be related to specific output, are outside the scope of VAT.¹²¹

These three constituent elements for subsidies to be considered directly linked to price have been confirmed by the EU Court of Justice in a number of subsequent cases, all of which were related to subsidies for the production of green fodder (live-stock feed).¹²² Subsidies must have a direct effect on the amount of consideration received by the supplier. There must be a direct, causal relationship, which is precisely quantified or quantifiable, between those subsidies and the supply of the goods or services—that is, in circumstances where the subsidy is granted only if and to the extent that those goods or services are in fact sold on the market.

Existence of a Supply—Individualized Consumption

For a supply to fall within the scope of VAT, its benefits must be able to be individualized; collectively enjoyed benefits do not accrue to a service being rendered. In *Apple and Pear Development Council*,¹²³ the EU Court of Justice ruled that activities aimed at the promotion of apples and pears are outside the scope of VAT where the service provider acts in the common interest of the collective beneficiaries (growers). Even where individual apple and pear growers derive a benefit from the promotional activities, they derive it indirectly from the benefit accruing to the industry as a whole.

The court went a step further in *Mohr*.¹²⁴ Mr. Mohr was a dairy farmer who received compensation in exchange for his agreement to discontinue his production of milk and to waive any claim for a milk reference quantity under the terms of

120 Ibid., at paragraphs 16-17.

121 Compare Bruno Peeters and Danny Stas, “The VAT Treatment of Subsidies: An Evergreen Debate,” in H.P.A.M. van Arendonk, J.J.M. Jansen, and R.N.G. van der Paardt, eds., *VAT in an EU and International Perspective: Essays in Honour of Han Kogels* (Amsterdam: International Bureau of Fiscal Documentation, 2011), 137-47.

122 *Commission of the European Communities v. Italian Republic*, [2004] ECR I-6845 (July 15, 2004), case C-381/01 (CJEU), ECLI:EU:C:2003:642; *Commission of the European Communities v. Republic of Finland*, [2004] ECR I-6889 (July 15, 2004), case C-495/01 (CJEU), ECLI:EU:C:2004:442; *Commission of the European Communities v. Federal Republic of Germany*, [2004] ECR I-6985 (July 15, 2004), case 144/02 (CJEU), ECLI:EU:C:2004:444; and *Commission of the European Communities v. Kingdom of Sweden*, [2004] ECR I-7335 (July 15, 2004), case C-463/02 (CJEU), ECLI:EU:C:2004:455.

123 *Apple and Pear Development Council v. Commissioners of Customs and Excise*, [1988] ECR 1443 (March 8, 1988), case 102/86 (CJEU), ECLI:EU:C:1988:120.

124 *Jürgen Mohr*, [1996] ECR I-0959 (February 29, 1996), case C-215/94 (CJEU), ECLI:EU:C:1996:72.

the common market organization.¹²⁵ Mr. Mohr did not report the compensation in his VAT return. However, the tax authorities considered the compensation to have been paid as consideration for a taxable supply, namely, the discontinuation of milk production. According to the tax authorities, the payment of compensation was conditional on Mr. Mohr's termination of milk production, and thus there existed a direct link between the service provided and the payment received, as required under the earlier rulings of the EU Court of Justice in *Tolsma* and *Aardappelenbewaarplaats*. The court, however, did not accept this reasoning, pointing out that the VAT is a tax on the consumption of goods and services, and that such consumption was absent in this case:

[B]y compensating farmers who undertake to cease their milk production, the [European Economic] Community does not acquire goods or services for its own use but acts in the common interest of promoting the proper functioning of the Community milk market.

In those circumstances, the undertaking given by a farmer that he will discontinue his milk production does not entail either for the Community or for the competent national authorities any benefit which would enable them to be considered consumers of a service. The undertaking in question does not therefore constitute a supply of services.¹²⁶

The government is not a consumer where it does not acquire goods or services for its own use but acts in the common interest. This reasoning seems to be in line with the decision in *Apple and Pear Development Council*, where the court held that a taxable supply required individualized benefits. When the government acts in the common interest, individualization is also not possible; instead, the benefits are shared collectively by society as a whole.¹²⁷

In *Landboden*,¹²⁸ the EU Court of Justice confirmed its ruling in *Mohr* in the case of a German farmer who undertook not to harvest at least 20 percent of his potato crop in return for the payment of compensation. The German government took the position that given the broad catchall definition of the concept of service in the underlying directive—that is, any transaction that does not constitute a supply of goods¹²⁹—the agreement by the farmer to reduce his production must constitute a

125 Under European Union, Council Regulation (EEC) No 1336/86 of 6 May 1986, Fixing Compensation for the Definitive Discontinuation of Milk Production, OJ L 119/21, May 8, 1986.

126 *Mohr*, supra note 124, at paragraphs 21-22.

127 This seems to align with the economic definition of the concept of “public goods” as those that cannot be exchanged in the marketplace or consumed individually; see Philippe Derouin, *La Taxe sur la Valeur Ajoutée dans la Communauté Economique Européenne* (Paris: Éditions Jupiter and Éditions de Navarre, 1977), at 495.

128 *Landboden-Agrardienste GmbH & Co. KG v. Finanzamt Calau*, [1997] ECR I-7387 (December 18, 1997), case C-384/95 (CJEU), ECLI:EU:C:1997:627.

129 See article 24 of Council Directive 2006/112/EC, supra note 42 (which was article 6 of the Sixth Directive 77/388/EEC, supra note 43, in force at the time of the procedure).

taxable service, since it was clear that the payment of compensation was conditional on the farmer's fulfilling his part of the agreement; in other words, there was a direct link. The court made it clear that the existence of a direct link is not the only factor to be considered in determining whether a service is supplied under the directive. As the court explained, actually the requirement of a direct link follows the prerequisite that consumption has occurred:

Only the nature of the undertaking given is to be taken into consideration: for such an undertaking to be covered by the common system of VAT it must imply consumption.¹³⁰

The court elaborated:

A transaction such as that at issue in the main proceedings, namely the undertaking given by a farmer to reduce production, does not fall within the scope of that principle because it does not give rise to any consumption. . . . [T]he farmer does not provide services to an identifiable consumer or any benefit capable of being regarded as a cost component of the activity of another person in the commercial chain.¹³¹

The court therefore concluded that

[s]ince the undertaking given by a farmer to reduce production does not entail either for the competent national authorities or for other identifiable persons any benefit which would enable them to be considered to be consumers of a service, it cannot be classified as a supply of services.¹³²

So, first it must be established that consumption takes place, then whether there exists a direct link between the underlying transaction and the payment received.

Influence of Subsidies on the Input VAT Credit

Because VAT is a tax on private consumption, businesses must receive relief from the tax they pay on their procurement, which is realized by allowing businesses to deduct input VAT from the tax charged on supplies made. The EU model of VAT allocates inputs to outputs to determine whether VAT incurred on those inputs can be deducted. VAT can be deducted only to the extent that it relates to a taxable output. As a main rule, the European Union applies the direct-use method: VAT incurred on inputs used for the purposes of taxed transactions can be deducted; VAT on inputs related to exempt or non-taxable supplies, or activities outside the scope of the VAT, is not deductible.¹³³ Therefore, input VAT related to supplies (partly) funded with taxable subsidies is fully recoverable.

130 *Landboden*, supra note 128, at paragraph 20.

131 *Ibid.*, at paragraph 23.

132 *Ibid.*, at paragraph 24.

133 See article 168 of Council Directive 2006/112/EC, supra note 42.

Correction mechanisms exist to allow for situations where goods and services are not used in connection with taxable output—most notably, where they are used for making exempt supplies, or for private purposes or for the benefit of the business's employees.

In reality, it is not always easy to determine whether certain inputs relate to taxable output, because many business transactions involve a mixture of deductible and non-deductible inputs. In general terms, according to the EU Court of Justice, the right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring those goods or services was a component of the cost of the output transactions that gave rise to the right to deduct.¹³⁴ Even if the costs are related to exempt output, the input VAT deduction could still remain intact if the costs were absorbed by the general economic costs of the taxpayer, so that the cost would be included in the cost price of goods and services sold.¹³⁵ Moreover, if a good is to be used simultaneously for making taxable supplies and free-of-charge supplies to the public, the supplier retains its right to the input VAT deduction.¹³⁶ That is also the case when the input has a link with the taxable outputs but is supplied directly and free of charge to a third party, if the free-of-charge supply is essential for completing the taxable outputs.¹³⁷

A preliminary question is whether the right to deduct input VAT can be restricted by member states in cases where the subsidy is financed by public funds. In Hungary, VAT law limited the right to deduct input VAT when public subsidies were received:

A taxable person receiving any subsidies charged to public funds . . . not subject to taxation shall, unless otherwise prescribed by the act on the annual budget, be entitled to exercise his right of tax deduction only up to the amount not subsidised in the purchases of individual goods for which any subsidy is received.¹³⁸

If, for example, a business received a subsidy of 40 on an expenditure of 100, only 60 percent of the input VAT could be recovered.

In *PARAT Automotive*,¹³⁹ a business (“Parat”) made an investment for the purpose of enlarging its production capacity under a subsidy contract with the Hungarian

134 *Skatteverket v. AB SKF*, [2009] ECR I-10413 (October 29, 2009), case C-29/08 (CJEU), ECLI:EU:C:2009:665, at paragraph 57.

135 *Ibid.*, at paragraph 60.

136 *UAB ‘Sveda’ v. Valstybinė mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos*, (October 22, 2015), case C-126/14 (CJEU), ECLI:EU:C:2015:712.

137 *Direktor na Direktsia ‘Obzhalvane i danachno-osiguritelna praktika’—Sofia v. ‘Iberdrola Inmobiliaria Real Estate Investments’ EOOD*, (September 14, 2017), case C-132/16 (CJEU), ECLI:EU:C:2017:683, at paragraphs 32–35.

138 Chapter VIII, article 38(1)(a) of Hungarian Law no. LXXIV of 1992.

139 *PARAT Automotive Cabrio Textiltetőket Gyártó Kft. v. Adó-és Pénzügyi Ellenőrzési Hivatal, Hatósági Főosztály, Észak-magyarországi Kibélyezett Hatósági Osztály*, [2009] ECR I-3459 (April 23, 2009), case C-74/08 (CJEU), ECLI:EU:C:2009:261.

Development Bank, acting on behalf of the Ministry of Economic Affairs and Transportation. Parat deducted all input VAT and, when audited and assessed, claimed that the restriction under Hungarian law violated the EU VAT directive. The EU Court of Justice agreed with the taxpayer, citing the crucial importance of the right to deduct input VAT for the proper operation of the VAT system. Only derogations explicitly allowed in the directive can be accepted. The court concluded that the directive “precludes national legislation which, in the case of acquisition of goods subsidised by public funds, allows the deduction of related VAT only up to the limit of the non-subsidised part of the costs of that acquisition.”¹⁴⁰

In many instances, it is not possible to allocate inputs exactly between taxable output, on the one hand, and exempt and non-taxable output, on the other hand. Logically, if goods and services are used in both transactions in respect of which VAT is deductible and transactions in respect of which VAT is not deductible, input VAT can only be proportionally deductible.¹⁴¹ The directive prescribes that the calculation must be made on the basis of a fraction of which the numerator is the total annual turnover (excluding VAT) attributable to transactions in respect of which input VAT is deductible,¹⁴² and the denominator is the total annual amount (excluding VAT) comprising both turnover in respect of which input VAT is deductible and turnover in respect of which input VAT is non-deductible.¹⁴³ Thus, in equation form, the so-called pro rata formula can be expressed as follows:

$$\text{Recovery \%} = \frac{\text{Taxable output}}{\text{Total output}}.$$

This is in essence a proxy method of establishing the use of an input, and consequently the deductible VAT amount, on the basis of realized turnover. In other words, the pro rata formula assumes that inputs are used in proportion to the value of the outputs. This is an inherently inaccurate assumption, justified on grounds of simplicity.¹⁴⁴

The directive excludes turnover from certain supplies¹⁴⁵ from the pro rata formula—namely, turnover attributable to supplies of capital goods used within the business, turnover attributable to incidental real estate and financial transactions, and turnover attributable to incidental financial services.¹⁴⁶ Obviously, if a subsidy

140 Ibid., at paragraph 30.

141 See article 173 of Council Directive 2006/112/EC, *supra* note 42.

142 Ibid., article 174(1)(a).

143 Ibid., article 174(1)(b).

144 Paul Lasok, “The Right To Deduct for Partially Exempt Bodies” (2011) 22:5 *International VAT Monitor* 337-39, gives several examples of circumstances in which turnover does not accurately represent the use of inputs.

145 Article 174(2) of Council Directive 2006/112/EC, *supra* note 42.

146 As specified in article 135(1), items (b) to (g), of Council Directive 2006/112/EC, *supra* note 42.

is granted in relation to such supplies, that subsidy should also be disregarded for the purpose of calculating the deductible input VAT proportion.

The directive explicitly provides member states with the option to “include in the denominator the amount of subsidies, other than those directly linked to the price of supplies.”¹⁴⁷ Logically, such an inclusion would restrict or reduce the input VAT recovery rate. To the contrary, subsidies that are directly linked to the price should be included in the denominator.¹⁴⁸

The scope of the permitted restriction—that is, whether the restriction can only be applied to mixed taxable persons—was raised in two cases involving, respectively, the laws of the French Republic¹⁴⁹ and the laws of Spain.¹⁵⁰ Both were infringement procedures¹⁵¹ initiated by the European Commission. Spain and France both included non-taxable subsidies in the denominator regardless of whether the supplier was a mixed or a fully taxable person. The Spanish government argued that the additional restriction of the input VAT deduction restored the balance in terms of competition; however, the EU Court of Justice rejected that position, referring to an earlier case¹⁵² and stating that member states have the obligation “to apply the . . . Directive even if they consider it less than perfect.”¹⁵³ The court concluded that

by providing for a deductible proportion of value added tax for taxable persons who carry out only taxable transactions, and by laying down a special rule which limits the right to deduct VAT on the purchase of goods and services which are subsidised, the Kingdom of Spain has failed to fulfil its obligations under Community law.¹⁵⁴

As a result, on the basis of a literal interpretation of the directive, it is now clear that in the European Union the input VAT deduction available to fully taxable persons

147 Ibid., article 174(1).

148 The same conclusion is drawn by Peeters and Stas, *supra* note 121.

149 *Commission of the European Communities v. French Republic*, [2005] ECR I-8411 (October 6, 2005), case C-243/03 (CJEU), ECLI:EU:C:2005:589.

150 *Commission of the European Communities v. Kingdom of Spain*, [2005] ECR I-8389 (October 6, 2005), case C-204/03 (CJEU), ECLI:EU:C:2005:588. For an analysis of the case and the opinion of the advocate-general prior to the court’s ruling, see Ignacio Arias and Antonio Barba, “The Impact of Subsidies on the Right To Deduct Input VAT: The Spanish Experience” (2004) 15:1 *International VAT Monitor* 13-18; and Ignacio Arias and Antonio Barba, “VAT and Non-Taxable Subsidies” (2005) 16:4 *International VAT Monitor* 264-66.

151 A procedure before the EU Court of Justice under then article 226 of the TEC, now article 258 of the TFEU, against member states that fail to implement EU law.

152 *Commission of the European Communities v. Kingdom of the Netherlands*, [2001] ECR I-8265 (November 8, 2001), case C-388/98 (CJEU), ECLI:EU:C:2001:596, at paragraphs 55-56.

153 *Kingdom of Spain*, *supra* note 150, at paragraph 28. See also *French Republic*, *supra* note 149, at paragraph 35.

154 *Kingdom of Spain*, *supra* note 150, at paragraph 32. See also *French Republic*, *supra* note 149, at paragraph 37.

cannot be restricted by including non-taxable subsidies in the denominator of the allocation formula.

The pro rata method can be applied only in cases where a taxable person uses the same inputs for making both taxable and exempt supplies. The reference to “transactions in respect of which VAT is not deductible” in articles 173 and 174 of the directive¹⁵⁵ does not cover transactions performed in the course of an activity that falls outside the scope of the VAT system. This is perhaps not obvious from the literal text of the provisions but can be inferred from EU Court of Justice case law.¹⁵⁶ In other words, the directive contains no specific rules for allocating input VAT in cases where acquired goods and/or services are inseparably used for both taxable transactions and transactions falling outside the scope of VAT. In *Securenta*, the court provided rather vague guidelines for the input VAT allocation in this situation:

[T]he determination of the methods and criteria for apportioning input VAT between . . . [taxable and non-taxable] activities . . . is in the discretion of the Member States who, when exercising that discretion, must have regard to the aims and broad logic of the directive and, on that basis, provide for a method of calculation which objectively reflects the part of the input expenditure actually to be attributed, respectively, to those two types of activity.¹⁵⁷

However, the court also said that

[w]hen exercising that discretion, the Member States have the right to apply, as necessary, an investment formula or a transaction formula or any other appropriate formula, without being required to restrict themselves to only one of those methods.¹⁵⁸

The vagueness of the *Securenta* ruling is unavoidable, since almost all situations will be factually different, preventing detailed guidance. Most cases, therefore, will be resolved at the national level, and only a few will be suitable for further fine-tuning by the EU Court of Justice.

155 Council Directive 2006/112/EC, *supra* note 42.

156 In particular, *Sofitam SA (formerly Satam SA) v. Ministre chargé du Budget*, [1993] ECR I-3513 (June 22, 1993), case C-333/91 (CJEU), ECLI:EU:C:1993:261, at paragraphs 13-14; *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v. Fazenda Pública*, [2004] ECR I-4295 (April 29, 2004), case C-77/01 (CJEU), ECLI:EU:C:2004:243, at paragraph 54; and *Floridienne SA and Berginvest SA v. Belgian State*, [2000] ECR I-9567 (November 14, 2000), case C-142/99 (CJEU), ECLI:EU:C:2000:623, under the heading “Operative Part.”

157 *Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG v. Finanzamt Göttingen*, [2008] ECR I-1597 (March 13, 2008), case C-437/06 (CJEU), ECLI:EU:C:2008:166, at paragraph 39. See also Joep J.P. Swinkels, “Some Aspects of Input Deduction Under the Pro Rata of the EU VAT System” (2008) 19:5 *International VAT Monitor* 343-50, at 347, under section 4.1; and Mandy Gabriël and Herman van Kesteren, “Calculation of the (Pre-)Pro Rata Under EU VAT Law” (2011) 22:5 *International VAT Monitor* 332-37.

158 *Securenta*, *supra* note 157, at paragraph 38.

Non-economic activities also play a role in determining the pro rata allocation. Where the non-economic activities benefit the economic activities and the inputs related to the former can be linked to the totality of economic activities, the pro rata formula still applies.¹⁵⁹

The question arises whether and, if so, how subsidies should be included in the pro rata formula. Obviously, where the subsidy is taxed, the subsidy amount should be included in both the numerator (taxable output) and denominator (total output). Where the subsidy has a direct link to exempt supplies, it should be included in the denominator only. Member states may, at their discretion, include in the denominator subsidies that lack such a direct link. If a non-direct-linked subsidy is given to finance costs of inputs used for both taxable and exempt outputs, there exists no requirement to include part of the subsidy in the numerator, though that approach would be fairer and would make the pro rata percentage more accurate. Of course, that would trigger a new apportionment problem of how to calculate the portion of the subsidy linked to the taxable supplies. In cases where a subsidy fully relates to non-economic activities, the subsidy can be ignored for the purpose of determining the pro rata deduction; that is, the subsidy should not be included in either the numerator or the denominator because, according to the EU Court of Justice, the pro rata rule does not apply to non-economic activities. If the inputs related to the non-economic activities are linked to the general costs of the beneficiary and are passed on through inclusion in the price of taxable supplies, the input VAT can still be deducted, but in that case the pro rata formula does not need to be applied at all. It appears that if a subsidy is used for both taxable transactions and non-economic activities, the subsidy should be apportioned to the two activities, to allow inclusion of the part that related to the taxable output to be included in the denominator of the formula. Thus, the pro rata deduction percentage would slightly decrease.

Because the turnover-based pro rata formula can be inaccurate and even distortive, the directive allows the use of alternative methods to determine the deductible proportion.¹⁶⁰ Indeed, divergence from the turnover-based pro rata formula is widespread. Whether to apply alternative methods rests fully within the discretion of the individual member states, and this is not an enforceable right allotted to individual taxpayers. Although the use of alternatives is not harmonized, the freedom of the member states in exercising that discretion will be guided by the general principles governing input tax deduction. Therefore, member states, when exercising their discretion, should choose alternative pro rata methods that best reflect the actual use made of the inputs in question.¹⁶¹

159 *Cibo Participations SA v. Directeur régional des impôts du Nord-Pas-de-Calais*, [2001] ECR I-6663 (September 27, 2001), case C-16/00 (CJEU), ECLI:EU:C:2001:495; and *Kretztechnik AG v. Finanzamt Linz*, [2005] ECR I-4357 (May 26, 2005), case C-465/03 (CJEU), ECLI:EU:C:2005:320.

160 See article 173(2) of Council Directive 2006/112/EC, *supra* note 42.

161 *Lasok*, *supra* note 144. This also follows from *Hausgemeinschaft Jörg und Stefanie Wollny v. Finanzamt Landshut*, [2006] ECR I-8297 (September 14, 2006), case C-72/05 (CJEU),

The use of an alternative method for determining the deductible portion pre-empts the use of the standard pro rata formula in article 174 of the directive. This follows from the *Varzim Sol* case.¹⁶² *Varzim Sol* simultaneously carried out activities in the gaming sector, which were exempt from VAT; activities in the sectors of catering and entertainment, which were subject to VAT; and activities in the administrative and finance sector, which were entitled to a partial deduction of VAT. The tax authorities claimed that *Varzim Sol* had received a non-taxable operating subsidy and took the position that the subsidy should be included in the denominator of the pro rata formula, thereby reducing the amount of input VAT eligible for deduction. *Varzim Sol* was authorized to apply an alternative method of determining the deductible portion, namely, on the basis of actual use of inputs.¹⁶³ Since the activities of *Varzim Sol* in the catering and entertainment sectors were subject to VAT, the right to deduct on the basis of the method of actual use related to all the taxes charged on the input transactions. Because the taxable person was authorized to make the deduction on the basis of the method of actual use, the provisions on proportional deduction were not applicable and therefore could not limit the right to deduct in those sectors as provided for in the directive. Thus, the EU Court of Justice held that the applicable provisions of the directive

[preclude] a Member State, where it authorises mixed taxable persons to make the deduction provided for in those provisions on the basis of the use of all or part of the goods and services, from calculating the deductible amount, for sectors in which such taxable persons carry out taxable transactions only, by including untaxed “subsidies” in the denominator of the fraction used to determine the deductible proportion.¹⁶⁴

SUMMARY AND CONCLUSIONS

Input subsidies are generally exempt from VAT since they cannot be directly linked to individual transactions—that is, supplies made by the recipient. Output subsidies are related to production—that is, subsidies for goods or services to be sold in the marketplace—and, potentially, these subsidies could be part of the consideration received. Under EU law, subsidies are taxed if they are directly linked to the price of the supply. The criterion by which a subsidy is judged to have a direct link is the proportionality between the amount of the subsidy payments and the output (quantitatively or monetarily) of the subsidized person or entity. Although input subsidies may reduce the sales price of goods and services, and in this sense materially do not

ECLI:EU:C:2006:573, at paragraph 28, stating that where the directive does not provide guidance, member states are required to exercise their discretion having regard to the aims and broad logic of the directive.

162 *Varzim Sol—Turismo, Jogo e Animação SA v. Fazenda Pública*, (February 16, 2012), case C-25/11 (CJEU), ECLI:EU:C:2012:94.

163 Article 173(2)(c) of Council Directive 2006/112/EC, *supra* note 42.

164 *Varzim Sol*, *supra* note 162, at paragraph 43

differ from output subsidies, they cannot be taxed owing to the direct link requirement. This inadequacy of the VAT directive has never been remedied, and as a result, the taxability of a subsidy is determined on the basis of purely formal criteria. For a direct link to be present, the EU Court of Justice requires a contractual relationship between the supplier and the purchaser of a good or service. On the basis of non-subsidy cases, a direct link requires that the consideration be determinable (that is, not be fictitious), but it also must be possible to express the consideration in monetary terms. By extension, that means that for a subsidy to have a direct link with a supply, its monetary value must be determinable. For a subsidy to be taxable, the EU Court of Justice has formulated a number of conditions. First, the subsidy must be paid for the particular purpose of allowing the recipient to make the supplies. Second, the purchasers of the supplies must benefit in that the purchase price is reduced in proportion to the subsidy received by the supplier. Third, the subsidy must be identifiable. For this purpose, the accounts of the grantor and the recipient may be examined, or a comparison may be made between the selling price and the normal cost price, or between the amount of the subsidy before and after the production of the goods. These comparisons do not have to produce an exact match. It is sufficient if the relationship between the diminution in price and the subsidy, which may be set at a flat rate, is significant.

Even if there is no direct link, subsidies may be taxable if they constitute a third-party payment for output produced by the recipient. In that case, they are not truly subsidies but pseudo-subsidies.

For a subsidy to be taxable, the benefits of the underlying supply must be able to be individualized. Collectively enjoyed benefits (which occur, for example, when the government acts in the common interest) do not accrue to a service being rendered by the recipient of the subsidy, and thus that subsidy would escape VAT.

The EU model of VAT allocates inputs to outputs to determine whether VAT incurred on the former can be deducted. VAT can be deducted only to the extent that it relates to a taxable output. If goods and services are used in both transactions in respect of which VAT is deductible and transactions in respect of which VAT is not deductible, input VAT can only be proportionally deductible. In the European Union, the deductible portion is determined on the basis of a formula. Subsidies directly linked to the price of output are included in the formula. Member states have the option to also include subsidies that are not directly linked to the price, which would reduce the recovery rate of input VAT. This restriction can be applied only to partially exempt businesses. The input VAT deduction of fully taxable persons cannot be restricted by including non-taxable subsidies in the denominator of the allocation formula.

The guidance provided by the EU Court of Justice in the area of the taxation of subsidies, the right to deduct input VAT, and the application of the pro rata formula is focused on articulating general principles within the context of a particular legal procedure, naturally requiring further explanations and fine-tuning in subsequent cases.

As discussed above, whether a subsidy is taxable under Canada's GST/HST rules ultimately hinges on the question of whether the subsidy is consideration for a taxable supply. This determination is based on specific legislative rules and general legal concepts, especially contract law. There is also generally a requirement for a direct link, based on administrative and judicial criteria influenced by the EU cases. Although this general picture is straightforward on its face, several factors complicate Canada's treatment of subsidies from a GST/HST perspective—specifically, the broad statutory definitions of “supply” and “consideration,” and the broad concept of transfer payments under the CRA's administrative guidance. Further, courts have adopted a contract-centred approach to the issue. They tend to conclude that a transfer is consideration if conditions for that transfer are stipulated in a written contract, even while they acknowledge that this may not be the intended result. Together, these factors often lead to the conclusion that a subsidy is consideration for a supply. Unfortunately, in contrast to EU cases such as *Mohr*,¹⁶⁵ there does not appear to have been much recognition that GST/HST should apply only to individualized consumption within the policy intent of a VAT, and that this rule should prevail even if application of the rules suggests a direct link.¹⁶⁶ A more nuanced analysis along these lines would be welcome and, arguably, consistent with the willingness of Canadian courts in the GST/HST context to draw from EU VAT principles.¹⁶⁷ Further, because of the broad definitions of supply and service, there is sometimes an issue as to what precisely a subsidy is consideration for. It may be third-party consideration for the subsidized supply, but it could also be consideration for a separate supply to the subsidy payer. While various forms of subsidies can be identified, such as input- and output-based subsidies, they are not distinguished in the GST/HST rules and thus are not treated differently. This simplifies the Canadian analysis. It also leads to more neutral results if one accepts that there should be no rationale for differential treatment of subsidies on the basis of form. Finally, the provinces' constitutional immunity from federal taxation has uniquely generated numerous cases in which suppliers seek to establish that subsidies are consideration for supplies made to the province. Where this argument succeeds, the supplier is entitled to claim input tax credits while having no obligation to collect tax.

165 *Mohr*, supra note 124.

166 Although this could be inferred from certain examples in TIB B-067, supra note 37.

167 For example, the single versus multiple analysis based on EU VAT principles is widely accepted by Canadian courts. See, for example, *O.A. Brown Ltd. v. The Queen*, [1995] GSTC 40 (TCC).

Suing the Canada Revenue Agency in Tort

Amir A. Fazel*

PRÉCIS

Les contribuables qui ont fait l'objet d'une vérification fiscale abusive peuvent, comme recours, intenter une action en dommages et intérêts contre l'Agence du revenu du Canada (ARC). Dans cet article, l'auteur soutient qu'en réalité, ce recours n'en est pas tellement un. Il présente tout d'abord le problème des vérifications fiscales abusives et donne l'exemple d'une affaire où les contribuables ont intenté une action en dommages et intérêts contre l'ARC pour une poursuite criminelle infructueuse après une vérification. L'auteur présente ensuite les aspects dont les contribuables doivent tenir compte avant d'intenter une action en dommages et intérêts contre l'ARC, il examine les causes des actions en dommages et intérêts qui ont été intentées jusqu'à présent contre l'ARC, et il traite de deux jugements récents au Québec (la seule province de droit civil au Canada). Il propose en conclusion des solutions dont le Parlement devrait tenir compte pour corriger les lacunes du régime existant.

ABSTRACT

Suing the Canada Revenue Agency (CRA) in tort is a remedy available to taxpayers who have been subjected to an abusive tax audit. In this article, the author argues that in practice this is not much of a remedy. He first introduces the problem of abusive tax audits and gives an example of a case in which the taxpayers sued the CRA in tort for a failed criminal prosecution following an audit. The author then sets out the preliminary matters that taxpayers must consider before starting an action in tort against the CRA, examines the causes of action in tort that taxpayers have brought so far against the CRA, and discusses two recent judgments from Quebec (Canada's sole civil-law jurisdiction). He concludes with suggested solutions for Parliament to consider in addressing the shortcomings of the current system.

KEYWORDS: AUDITS ■ ABUSES ■ JURISDICTION ■ TORTS ■ NEGLIGENCE ■ CIVIL LAW

* Lawyer, licensed in British Columbia and California (e-mail: amir.a.fazel@gmail.com). A shorter draft of this article was submitted for the course "Law 567: Tax Administration and Dispute Resolution" offered in the fall of 2018 at the Peter A. Allard School of Law, University of British Columbia. I thank Edwin Kroft for his invaluable guidance. I am solely responsible for the opinions expressed in this article.

CONTENTS

Introduction	582
The Audit of the Samaroos	584
What Pretrial Matters Should the Taxpayer Consider?	586
What Laws Govern?	586
In Which Courts Should Taxpayers Sue the CRA?	586
What Immunities Does the CRA Have?	587
What Causes of Action in Tort May Exist Against the CRA for an Abusive Audit?	589
Intentional Torts	589
Misfeasance in a Public Office	590
Malicious Prosecution	593
Abuse of Process	596
Intentional Interference with Economic Relations	598
Unintentional Torts—Negligence	598
Federal Courts	600
British Columbia	600
The Other Common-Law Provinces	604
Civil Remedies for an Abusive Audit in Quebec	607
Conclusion	609

INTRODUCTION

How can the law remedy the harm that an abusive audit inflicts on a taxpayer? According to the Federal Court of Appeal, an action in tort is the proper remedy for a taxpayer subjected to an abusive audit.¹ This article defines an abusive audit as a tax audit in which one or more employees of the Canada Revenue Agency (CRA) intentionally or unintentionally commit a wrongful act against a taxpayer under audit.

A wrongful act may occur during the audit and may range from malicious conduct, such as asking the taxpayer for a bribe, to an innocent mistake, such as applying the wrong law or standard in an audit. A wrongful act may also occur after the conclusion of the audit and may have little to do with the audit itself; again, the wrongful act may range from malicious conduct, such as knowingly taking collection action on a wrong assessment, to an innocent mistake, such as erroneously referring a case for criminal investigation for tax evasion. Abusive audits may cause taxpayers public humiliation, social stigma, financial ruin, and psychological and emotional distress.

Abusive audits happen. Regardless of how conscientious tax officials may be, they may commit errors through negligence, and those errors may cause taxpayers under

1 *Ereiser v. Canada*, 2013 FCA 20, at paragraph 36; leave to appeal to the Supreme Court of Canada dismissed July 11, 2013, case no. 35296. This article examines the tort remedies available to taxpayers who have been subjected to an abusive audit; Charter remedies, injunctive remedies, and administrative remedies are beyond the article's scope. (References herein to "the Charter" are to the Canadian Charter of Rights and Freedoms, part I of the Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK), 1982, c. 11.)

audit enormous damages. An unintentional error in an audit impugns the competence of a tax official, but a malicious act impugns his or her integrity. In the context of an abusive audit, absence of competence in a tax official leads to a negligence cause of action, but lack of integrity leads to several intentional torts. In an article on the exercise of audit powers, Guy Du Pont and Michael Lubetsky point to some of the following experiences among tax practitioners who have represented taxpayers under audit:²

- Some auditors, conscious of their powers, professional independence, and personal immunity from civil lawsuits, largely “act with near impunity.”
- Some auditors may “propose and issue assessments and reassessments for substantial amounts of tax not justified by the law or the facts.”
- Some auditors may “drag out an audit for years, making expansive, repetitive, and costly requests for information, extorting waivers of the statutory limitation periods while [threatening] . . . immediate assessment action.”
- Some auditors may issue orders or demands to banks, employers, and other third parties, not only embarrassing taxpayers but also potentially putting their sources of financing at risk.

Furthermore, there can be financial incentives for auditors and collectors to recover tax liabilities, which motivate them to extract as much money as possible from taxpayers.³ Unfortunately, “[t]he CRA does not publicly disclose the details of the performance metrics it uses” to evaluate employees.⁴

This article analyzes the causes of action in tort that taxpayers subjected to an abusive audit can bring against the CRA. It seeks to add to the previous work in this area of the law—in particular, articles by Du Pont and Lubetsky (referred to above) and David Jacyk.⁵ In many tort actions against the CRA, the taxpayers have represented themselves in the federal and provincial courts, including provincial appellate courts.⁶ Often, taxpayers who have been subjected to an abusive audit have

2 Guy Du Pont and Michael H. Lubetsky, “The Power To Audit Is the Power To Destroy: Judicial Supervision of the Exercise of Audit Powers” (2013) 61, special supplement *Canadian Tax Journal* 103-21, at 105.

3 Ibid., at 104. See *Québec (Agence du revenu) c. Groupe Enico inc.*, 2016 QCCA 76, for a discussion of the CRA’s “Tax Earned by Audit” scheme. See *Ludmer c. Attorney General of Canada*, 2018 QCCS 3381, for a discussion of the CRA’s structure, mandate, and processes pertinent to a tax audit.

4 Kenneth J. Klassen, *Auditing the Auditors: Tax Auditors’ Assessments and Incentives*, C.D. Howe Institute E-Brief (Toronto: C.D. Howe Institute, April 2016), at 2 (www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/e-brief_234.pdf).

5 David Jacyk, “The Dividing Line Between the Jurisdictions of the Tax Court of Canada and Other Superior Courts” (2008) 56:3 *Canadian Tax Journal* 661-707.

6 Several such cases are discussed below. See *Chhabra*, *infra* note 54; *Longley*, *infra* note 67; and *Footte*, *infra* note 33.

been financially ruined because of that audit and are unable to afford a lawyer. Thus, abusive audits raise serious problems of access to justice. Successful cases against the CRA are rare, take a long time, and produce relatively small awards. When the CRA settles such civil actions privately, that settlement is not public information, so it is not possible to analyze whether the taxpayer was compensated fairly. Therefore, it appears that despite what the Federal Court of Appeal said in *Ereiser*,⁷ suing in tort is not much of a remedy for a taxpayer subjected to an abusive audit.

In the next section of the article, I describe a recent case of an abusive audit and its consequences for the taxpayers. In subsequent sections, I discuss the preliminary matters that taxpayers must consider before starting a civil action in tort against the CRA; examine the causes of action in tort that taxpayers have brought to date against the CRA; and review two recent judgments from Quebec, Canada's sole civil-law jurisdiction. I conclude with some suggested solutions for Parliament to consider in addressing the shortcomings of the current system.

THE AUDIT OF THE SAMAROOS

On March 2, 2018, the Supreme Court of British Columbia awarded Tony and Helen Samaroo approximately \$1.7 million in damages against the CRA.⁸ The Samaroos were a married couple who owned a restaurant, a nightclub, and a motel in Nanaimo, British Columbia. The restaurant operated in three shifts—day, night, and graveyard. In 2006, the CRA received a tip from a former employee that the Samaroos did not report the sales of their graveyard shift. The CRA conducted an audit, which revealed that Mr. Samaroo had made substantial cash deposits into his business accounts using old \$50 and \$100 bills. After that finding, the CRA started a full investigation of the Samaroos with searches of their residence, three business locations, and their accountant's office, but did not find any incriminating evidence. As of 2007, the CRA official in charge of the investigation knew that he could not show that the Samaroos had underreported the sales of their restaurant. Nonetheless, he referred the case to the Crown to initiate prosecution of the couple for tax evasion. The Crown prosecutor charged the Samaroos and their closely held corporations with 21 counts of tax evasion. The news of the charges was a front-page story in Nanaimo's local newspaper.

In April 2011, the Samaroos and their corporations were acquitted of all charges after a 19-day trial.⁹ They subsequently sued the CRA for malicious prosecution, claiming \$7 million in damages plus out-of-pocket expenses.

The BC Supreme Court found that the Crown prosecutor had relied on the CRA not just to gather the evidence but also to draft and essentially approve the charges. It was not the Crown prosecutor but the CRA official who had overseen the criminal investigation who determined whom to charge, with what offence, and in what

7 *Ereiser*, supra note 1.

8 *Samaroo v. Canada Revenue Agency*, 2018 BCSC 324.

9 *R v. Samaroo*, 2011 BCPC 503.

amount. The court found that that official had suppressed exculpatory evidence and had intentionally misled the Crown prosecutor in his report of information provided by the Samaroos' bookkeeper; that report formed the basis of the theory of the Crown's case.¹⁰

More important than one employee's misconduct, the evidence presented in court revealed what the judge described as "an unfortunate culture within the CRA."¹¹ The judge noted that some of the CRA employees looked forward with "unprofessional glee" to the Samaroos' anticipated conviction and ruin,¹² and he found it "appalling that the incarceration of the plaintiffs would be joked about."¹³ He also considered that the CRA's advertising of its successes on its website indicated "a deeply troubling approach to its duties," and likened the practice to a police force advertising on a government website how many people it incarcerated each year.¹⁴

The trial judge observed that "[t]he impact of the tax evasion charges and the resulting publicity on [the Samaroos] and their children was . . . [traumatic] and long lasting."¹⁵ Their daughter changed her name in order not to be associated with the stigma of the criminal charges against her parents.¹⁶ Their business lost many customers, including officers of the Royal Canadian Mounted Police (RCMP) who were frequent customers and had their own special section in the restaurant.¹⁷ As a result of the criminal tax evasion prosecution, Tony and Helen Samaroo were traumatized emotionally and their mental health deteriorated. Helen Samaroo "would not go to work and would stay in bed all day as she was too embarrassed to go to work or out in public."¹⁸ Tony Samaroo "[would] spend his days watching TV and no longer socialize"; he started to drink and smoke heavily.¹⁹ The case cost him close to \$350,000 in legal defence fees.²⁰ At the time of the judgment, Mr. and Mrs. Samaroo no longer lived together.

On April 9, 2019, the BC Court of Appeal overturned the lower court's judgment and dismissed the case in its entirety.²¹ The Court of Appeal found that the circumstances of the case justified the CRA's view that the Samaroos had probably evaded

10 *Samaroo*, supra note 8, at paragraphs 195 and 197.

11 *Ibid.*, at paragraph 259.

12 *Ibid.*, at paragraph 327.

13 *Ibid.*

14 *Ibid.*, at paragraph 328.

15 *Ibid.*, at paragraph 291.

16 *Ibid.*, at paragraph 292.

17 *Ibid.*

18 *Ibid.*, at paragraph 293.

19 *Ibid.*, at paragraph 296.

20 *Ibid.*, at paragraph 295.

21 *Samaroo v. Canada Revenue Agency*, 2019 BCCA 113.

paying taxes and it was reasonable to believe that evasion could have been proved in a court of law beyond a reasonable doubt.²² The court found it unnecessary to review whether the CRA officials had acted maliciously toward the Samaroos.²³

I will return to these judgments later in the article, to explain the legal analysis on which the courts based their decisions. First, I will outline the underlying legal issues to be considered by a taxpayer who is subjected to an abusive audit.

WHAT PRETRIAL MATTERS SHOULD THE TAXPAYER CONSIDER?

If, during or after an audit, the conduct of CRA employees toward the taxpayer becomes tortious, the taxpayer may be entitled to damages. The taxpayer must know what laws apply to a tort action against the CRA, what remedies exist, and where to seek them. The taxpayer must also know when the CRA is immune from being sued in a civil action.

What Laws Govern?

The CRA is a federal agent of the Crown. Under the common-law doctrine of sovereign immunity, the Crown is not subject to private tort actions without its consent. In Canada, that immunity has been considerably limited by statute, and the Crown may be held liable in tort to the same extent as a private individual.²⁴ The Crown Liability and Proceedings Act²⁵ imposes liability in tort on the Crown for the tortious actions of its servants. The act does not affect the Crown's other liabilities, such as those under contract or property laws.²⁶ Moreover, the Crown is vicariously liable for the tort actions against its agents; that is, it is vicariously liable for damages caused by its servants for which, as their principal, it would be liable if it were a natural private person.²⁷

In Which Courts Should Taxpayers Sue the CRA?²⁸

A taxpayer's choice of court in which to sue the CRA depends on the type of remedies sought and the stage of the audit process. If the taxpayer seeks to challenge the correctness or validity of an assessment, the Tax Court of Canada is the only available

22 Ibid., at paragraph 6.

23 Ibid., at paragraph 7.

24 *Miazga v. Kvello Estate*, 2009 SCC 51, at paragraphs 4 and 43.

25 RSC 1985, c. C-50.

26 See, for example, *Soleiko v. Canada* (1988), 22 FTR 20 (TD) (finding the Department of Fisheries, a federal Crown agency, liable for the torts of nuisance and negligence); and *Arsenovski v. Bodin*, 2016 BCSC 359 (finding the Insurance Corporation of British Columbia, a provincial Crown corporation, liable for the tort of malicious prosecution).

27 Crown Liability and Proceedings Act, *supra* note 25, section 3(b)(i).

28 For a more detailed discussion, see Jacyk, *supra* note 5.

court to which the taxpayer can appeal to redress the issue.²⁹ If the taxpayer seeks judicial review of the conduct of the CRA's employees while the audit is still ongoing or afterward, and wishes to apply for injunctive relief through a writ of certiorari, mandamus, prohibition, or quo warranto, or any injunction, the Federal Court is the only available court with jurisdiction to hear the application and issue such an injunction against the CRA.³⁰ If the taxpayer seeks monetary damages against the CRA for tortious conduct of its officials, the provincial superior courts and the Federal Court have concurrent jurisdiction for relief.³¹

However, a taxpayer may not launch a collateral attack on a tax assessment by bringing a civil claim against the CRA.³² A collateral attack is an attack "made in proceedings other than those whose specific object is the reversal, variation, or nullification of the order or judgment,"³³ and is forbidden. As Du Pont and Lubetsky note, while the Federal Court of Appeal has affirmed the Tax Court of Canada's exclusive jurisdiction to determine the correctness and validity of a tax assessment, it has also held that this exclusive jurisdiction does not include the power to consider procedural matters regarding a tax assessment.³⁴ The direct consequence of this assignment of jurisdiction is that taxpayers must be prepared for prolonged proceedings in multiple courts, litigating the same facts but seeking different remedies. Thus, a taxpayer seeking to sue the CRA for damages for an abusive audit may have to either concede the correctness of any assessment at issue or first appeal to the Tax Court of Canada to vacate the assessment, and then sue the CRA in tort.³⁵

What Immunities Does the CRA Have?

The CRA, as an agent of the Crown, is immune from tort actions when exercising any power exercisable by the prerogative of the Crown or by any power conferred on it by an act of Parliament, such as the Income Tax Act.³⁶ For example, the CRA is immune from liability when deciding to assess or reassess the tax liability of a

29 Tax Court of Canada Act, RSC 1985, c. T-2, as amended, section 12(1).

30 Federal Courts Act, RSC 1985, c. F-7, as amended, section 18(1). See *861808 Ontario Inc. v. Canada (Revenue Agency)*, 2013 ONCA 604; leave to appeal dismissed by the Supreme Court of Canada [2014] GSTC 24, 472 NR 398 (note). (The Ontario Court of Appeal upheld a trial court's dismissal of a taxpayer's action under contract law when the CRA allegedly breached a settlement agreement; the court held that the action should have been brought in the Federal Court of Canada.)

31 *Ereiser*, supra note 1, at paragraphs 35-36.

32 *Ibid.*, at paragraph 35.

33 *Foote v. Canada (Attorney General)*, 2011 BCSC 1062, at paragraph 22, citing *Wilson v. The Queen*, [1983] 2 SCR 594, at 599. See also *Canada v. Roitman*, 2006 FCA 266, at paragraph 20.

34 Du Pont and Lubetsky, supra note 2, at 105.

35 *Ibid.*, at 116.

36 Crown Liability and Proceedings Act, supra note 25, section 8; Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

taxpayer.³⁷ However, the Supreme Court of Canada has held that this immunity is “limited to true core policy acts,”³⁸ and even then, it is not absolute. As defined by the court, “‘core policy’ government decisions protected from suit are decisions as to a course or principle of action that are based on public policy considerations, such as economic, social and political factors, provided they are neither irrational nor taken in bad faith.”³⁹ Moreover, making policy decisions is “the proper role of government, not the courts. For this reason, decisions and conduct based on these [public policy] considerations cannot ground an action in tort.”⁴⁰ The court has also stated that no immunity exists when the plaintiff proves that the Crown acted in bad faith.⁴¹

Bad faith can be established by proving that the [Crown] acted deliberately with the specific intent to harm another person . . . [or] by proof of serious recklessness that reveals a breakdown of the orderly exercise of authority so fundamental that absence of good faith can be deduced, and bad faith presumed.⁴²

While the decision to exercise a power conferred by Parliament is immune from a tort action, such immunity does not extend to the way the power is exercised. In this regard, the Supreme Court of Canada has distinguished “policy” from “discretion”:

Discretion is concerned with whether a particular actor had a choice to act in one way or the other. . . . Policy decisions are always discretionary, in the sense that a different policy could have been chosen. But not all discretionary decisions by government are policy decisions.⁴³

In particular, the Canada Revenue Agency Act explicitly excludes the power to make regulations from the powers of the CRA.⁴⁴ The minister of finance, not the minister

37 *Sinba v. MNR*, 81 DTC 465, at paragraph 5. In *Neumann v. Canada (Attorney General)*, 2011 BCCA 313, the court overturned a \$1.3 million jury verdict and dismissed Mr. Neumann’s action for violation of his rights under the Charter. The CRA had obtained a warrant to search Mr. Neumann’s residence in the course of its investigation of another taxpayer for tax evasion charges. The search warrant was legally obtained and properly executed. The court held that “the search warrant is an important and accepted enforcement tool utilized by those charged with investigating crime. If a search warrant is lawfully obtained and executed, those subjected to it cannot seek compensation for its unintended repercussions.” (Ibid., at paragraph 7.) So even though Mr. Neumann maintained that he had been traumatized by the search of his residence, the CRA was not liable in respect of such trauma.

38 *Ludmer*, supra note 3, at paragraph 144, citing *R v. Imperial Tobacco Canada Ltd.*, 2011 SCC 42, at paragraphs 87-90; and *Hinse v. Canada (Attorney General)*, 2015 SCC 35, at paragraphs 23-24.

39 *Imperial Tobacco*, supra note 38, at paragraph 90.

40 Ibid., at paragraph 87.

41 *Hinse*, supra note 38, at paragraph 53.

42 Ibid.

43 *Imperial Tobacco*, supra note 38, at paragraph 88.

44 Canada Revenue Agency Act, SC 1999, c. 17, section 8(3)(a).

of national revenue or the commissioner of the CRA, is charged with exercising a legislative or regulatory power in setting tax policy.⁴⁵ The conduct of an audit is never a “true core policy act”; therefore, the CRA cannot claim any immunity from a tort action for the conduct of its employees during or after an audit.⁴⁶

WHAT CAUSES OF ACTION IN TORT MAY EXIST AGAINST THE CRA FOR AN ABUSIVE AUDIT?

Tort actions against the CRA for an abusive audit can be classified under two heads:

1. intentional torts, in which one or more CRA employees acted with deliberate intent to harm the taxpayer; and
2. unintentional torts, in which one or more CRA employees negligently harmed the taxpayer.

Intentional Torts

So far, the CRA has been sued successfully under four categories of intentional tort; however, “success” in this context means that a court recognized a cause of action as a valid tort and allowed the case to continue beyond the pleading stage.⁴⁷ Going beyond the pleading stage allows the court to review the merits of the case, but it does not mean that the court ruled, or would have ruled, in favour of the plaintiff-taxpayer. The four categories of intentional tort are

1. *misfeasance in a public office*,⁴⁸ in which the CRA acted maliciously or outside its powers, against a taxpayer;
2. *malicious prosecution*, in which the CRA maliciously initiated criminal proceedings against a taxpayer for tax evasion;
3. *abuse of process*, in which the CRA wrongfully initiated criminal or civil proceedings against a taxpayer; and
4. *intentional interference with economic relations*, in which the CRA intentionally interfered with the economic relations between a taxpayer and a third party.

45 *Ludmer*, supra note 3, at paragraph 146.

46 *Ibid.*

47 When the taxpayer becomes aware of the conduct of a CRA official that gives rise to a tort, the applicable statute of limitations will start to run. See *Gardner v. Canada (Attorney General)*, 2012 ONSC 1837, in which the taxpayer’s tort action was dismissed as being outside the limitation period; and *Leroux*, infra note 63, at paragraphs 233–34, for another example of a possible limitations defence. A discussion of defences available to the CRA is beyond the scope of this article.

48 Some authorities call this tort “misfeasance of public office.” The two phrases refer to the same tort.

Misfeasance in a Public Office

The tort of misfeasance in a public office can arise in one of two ways: (1) a public officer's conduct is specifically intended to injure a person or class of persons; or (2) a public officer "acts with knowledge . . . that he or she has no power to do the act complained of and the act is likely to injure the plaintiff."⁴⁹ For the first category, evidence that the public officer acted for the express purpose of harming the plaintiff (that is, with malice) is sufficient to prove the tort, because "a public officer does not have the authority to exercise his powers for an improper purpose, such as deliberately harming a member of the public."⁵⁰ For the second category, however, the plaintiff must prove that the defendant acted with "deliberate disregard of official duty" and "knowledge that the misconduct [was] likely to injure the plaintiff";⁵¹ and the plaintiff must also prove that "the tortious conduct was the legal cause of his or her injuries" and that "the injuries suffered are compensable in tort law."⁵²

The first category of this tort has a single element, so if the taxpayer can prove that the CRA acted maliciously toward him or her, the taxpayer does not have to prove any damages caused by that malicious conduct. If the taxpayer suffered any damages, the compensatory damages will be in addition to the punitive damages that the court will award against the CRA. Moreover, to allege this tort against the CRA, the taxpayer does not need to specifically identify the official who allegedly committed it.⁵³

An example of an action in the first category is *Chhabra*.⁵⁴ In that case, the court found that the conduct of the CRA employees was malicious, and a finding of malice was sufficient to prove the cause of action. Specifically, the court found that the CRA committed the tort of misfeasance in a public office when its employees' abusive audit and subsequent collection actions forced a physician to end his medical practice and caused him financial ruin, emotional trauma, and public humiliation. Dr. Chhabra had entered into a partnership with his American nephew to buy real estate in California, but the nephew embezzled his uncle's funds and stole from him with the aid of an accountant.⁵⁵ In 1981, in what the court described as "not one of [the CRA's] finest hours," the CRA reassessed Dr. Chhabra on the basis of falsified financial documents that he had provided as examples of his nephew's wrongdoing.⁵⁶ The Federal Court Trial Division set aside the reassessments in 1987.⁵⁷ Up

49 *Odhavji Estate v. Woodhouse*, 2003 SCC 69, at paragraph 22.

50 *Ibid.*, at paragraph 23.

51 *Ibid.*

52 *Ibid.*, at paragraph 32.

53 *Merchant Law Group v. Canada Revenue Agency*, 2010 FCA 184, at paragraph 37.

54 *Chhabra v. The Queen*, 89 DTC 5310 (FCTD).

55 *Chhabra v. The Queen*, 88 DTC 6015, at 6020 (FCTD).

56 *Ibid.*, at 6020-21.

57 *Ibid.*, at 6025; and *Chhabra*, *supra* note 54, at 5312.

to that time, however, the CRA imposed a 75 percent garnishment order on Dr. Chhabra's wages, and it refused to make any arrangement with him to settle his debt, despite knowing of his proven inability to pay.⁵⁸ Dr. Chhabra endured public exposure of his tax problems in a TV program and newspaper articles, which, the court found, had a serious impact on his reputation.⁵⁹ He lost his hospital privileges, and he had to close his medical practice and move out of province.⁶⁰ The court found that the tax officials were guilty of the tort of misfeasance because they had acted both with malice and with the knowledge that they did not have the power that they purported to exercise (because the collection division had knowingly continued to collect even after the audit division within the same office had become aware that the underlying assessment was wrong).⁶¹ The court awarded Dr. Chhabra \$1,000 for general damages and \$10,000 for exemplary damages.⁶²

Malice is difficult to prove; therefore, the decision to accuse the CRA of malicious conduct must not be taken lightly. In cases such as *Chhabra* and the trial decision in *Samaroo*, where the courts held that CRA officials had acted maliciously, the proof came from documentary evidence found in the CRA's internal communications. Oral evidence, however, may not be enough to prove that a CRA employee's conduct was malicious. For example, in *Leroux*,⁶³ the Supreme Court of British Columbia was not persuaded that an alleged bribery attempt (that is, malicious conduct) took place even though the taxpayer had credible witnesses corroborating his testimony. Mr. Leroux alleged that in December 1998, the CRA auditor responsible for his case told him that "the CRA was coming after him for a lot of money" and if Mr. Leroux "gave him \$25,000 . . . he would make his CRA problems disappear."⁶⁴ Mr. Leroux testified that he had informed his son-in-law (who was a member of the RCMP), one of his friends, and his member of Parliament (MP) about this alleged extortion or bribery attempt at the time, and at trial all three confirmed that testimony.⁶⁵ However, the court was not persuaded on a balance of probabilities that the alleged extortion had occurred. The court noted that the CRA auditor had died within the same month as the alleged extortion, and the notices of reassessment had already been issued; therefore, the auditor had no power to change or dismiss the reassessment.⁶⁶ While not being able to defend one's name because of an untimely

58 *Chhabra*, supra note 54, at 5312.

59 *Ibid.*, at 5320.

60 *Ibid.*, at 5312.

61 *Ibid.*, at 5318-19.

62 *Ibid.*, at 5322-23.

63 *Leroux v. Canada Revenue Agency*, 2014 BCSC 720.

64 *Ibid.*, at paragraph 33.

65 *Ibid.*, at paragraphs 34 and 227.

66 *Ibid.*, at paragraph 230. The court found that Mr. Leroux genuinely believed that he had been asked to pay a bribe, and he had told others that it had happened, but that belief by itself did not mean that an attempted bribery had in fact occurred. The decision does not indicate

death may be a relevant factor to consider, the fact that the court in *Leroux* considered whether an official had the power to act on a promise allegedly given in exchange for a bribe is curious, because it suggests that taxpayers who may be victims of attempted bribery may have to prove that the allegedly corrupt officials had the power to deliver on their promises.

An example of the second category of the tort of misfeasance in a public office is the conduct at issue in the *Longley* case,⁶⁷ though this did not involve an abusive audit. Deliberately misleading a taxpayer or dealing with a taxpayer dishonestly are grounds for a finding of misfeasance in a public office. In *Longley*, the CRA was found to have committed this tort. The plaintiff, Mr. Longley, had discovered a possibly unintended consequence (which he referred to as “a loophole”) of a provision in the Income Tax Act under which “taxpayers could receive federal political contribution tax credits for contributions made to a political party which the taxpayer could direct to be paid so as to benefit either the taxpayer or some other individual whom the taxpayer designated.”⁶⁸ From 1985 to 1990, Mr. Longley sought written confirmation from the CRA that his tax scheme based on his interpretation of the statute was legal. Although the CRA had obtained legal advice confirming that Mr. Longley’s tax scheme did not violate the Act, it nevertheless advised him that it had no such advice. The CRA’s employees evidently hoped that if they did not confirm the legality of the scheme, Mr. Longley would not be able to attract many contributors, and Parliament would correct what the CRA considered to be a flaw in the legislation.⁶⁹ In 1990, the CRA told Mr. Longley that his scheme violated section 245 of the Income Tax Act (the general anti-avoidance rule, or GAAR), which had been enacted in 1988. Mr. Longley sued the CRA for misfeasance in a public office. The court found that the CRA had intentionally misled Mr. Longley from 1985 until the adoption of GAAR in 1988, and thus had dealt with Mr. Longley dishonestly. On the basis of these two findings, the court was satisfied that the CRA was liable for misfeasance in a public office.⁷⁰ It awarded Mr. Longley \$5,000 in general damages and \$50,000 in punitive damages against the CRA.⁷¹

Merely being wrong is not sufficient for the CRA to be liable for misfeasance in a public office. For example, in *Canus*,⁷² the auditor used the wrong methodology

whether Mr. Leroux’s son-in-law (as a member of the RCMP) or his MP took any action after being told about an alleged bribery attempt by a federal official.

67 *Longley v. Canada (MNR)*, 1999 CanLII 5750 (BCSC); aff’d 2000 BCCA 241; leave to appeal to the Supreme Court of Canada dismissed June 7, 2000, docket no. 27927.

68 *Ibid.* (BCSC), at paragraph 1.

69 *Ibid.*, at paragraphs 93 and 94.

70 *Ibid.*, at paragraphs 92 and 94-95.

71 *Ibid.*, at paragraphs 136 and 141. Both sides appealed the decision, but the minister discontinued his appeal (without explanation). The BC Court of Appeal dismissed Mr. Longley’s cross-appeal (he wanted \$99 billion in damages) and affirmed the lower court’s judgment. See *Longley*, supra note 67 (BCCA), at paragraphs 1 and 26.

72 *Canus v. Canada*, 2005 NSSC 283.

in reassessing the taxpayer's transfer-pricing audit; however, he did not breach any relevant statutory provisions, acted within his statutory powers, and did not act for any improper purpose. He did not intend to harm the taxpayer by his actions, though his mistake clearly did have that result. Therefore, the court dismissed the taxpayer's action for misfeasance in a public office.⁷³

Malicious Prosecution

In an action for malicious prosecution, the plaintiff seeks compensation for losses caused by an unjustified prosecution.⁷⁴ The claim targets the defendant's decision to initiate or continue with a criminal prosecution against the plaintiff.⁷⁵ In *Miazga*, the Supreme Court of Canada held that for such an action to succeed,

a plaintiff must prove that the prosecution was: (1) initiated by the defendant; (2) terminated in favour of the plaintiff; (3) undertaken without reasonable and probable cause; and (4) motivated by malice or a primary purpose other than that of carrying the law into effect.⁷⁶

For the first element, the plaintiff must satisfy the court that the defendant named in the action initiated the prosecution. While as a matter of procedure the Crown prosecutor always initiates a criminal prosecution, the initiation requirement of the tort may be met when an individual—for example, a CRA employee—swears an information (which sets out the charges against the accused). Therefore, someone other than the Crown prosecutor who appears on behalf of the CRA in court can be liable for this tort. This is illustrated by *Samaroo*, where the court found that the CRA investigator was clearly instrumental in the prosecution of the Samaroos for tax evasion. It was he, and not the Crown prosecutor, who was really in charge of the criminal investigation into the Samaroos; he also drafted and swore the final draft of the information without the Crown prosecutor's review. He, and therefore his employer, the CRA, caused everything to be done to “set the law in motion” wrongfully against the Samaroos.⁷⁷

The second element, termination of the prosecution in the plaintiff's favour, may be satisfied regardless of *how* the proceedings ended—whether in an acquittal, a

73 Ibid., at paragraph 43. Misfeasance in a public office is personal in nature, so a bankrupt individual, but not the trustee of a bankrupt estate, can bring an action against the CRA for an abusive audit that led to the plaintiff's bankruptcy. (In *Canus*, the CRA was the taxpayer's sole creditor.) See *Edell v. Canada*, 2010 FCA 26. However, a minority shareholder of a corporation does not have standing to bring an action against the CRA for an alleged abusive audit of the corporation. See *Leighton v. Canada (Attorney General)*, 2012 BCSC 961, at paragraphs 22–28.

74 *Miazga*, supra note 24, at paragraph 42.

75 Ibid., at paragraph 6.

76 Ibid., at paragraph 3.

77 *Samaroo*, supra note 8, at paragraph 198; see also paragraphs 112 and 196–97.

discharge at a preliminary hearing, a withdrawal, or a stay.⁷⁸ In *Samaroo*, because the plaintiffs had been acquitted, satisfaction of this requirement was not in dispute. However, as the Supreme Court of Canada noted in *Miazga*, in situations where the criminal proceedings did not end with a decision on the merits of the charges (for example, where there was a settlement or a plea bargain), it may not be considered that those proceedings had ended in the plaintiff's favour, even if the outcome might have appeared to be a victory for the plaintiff at the criminal proceeding stage.⁷⁹ To illustrate, if a taxpayer charged with tax evasion settles the charge by paying a nominal fine and subsequently sues the CRA for malicious prosecution in a civil court, the court may not treat that settlement as an outcome favouring the taxpayer.

Regarding the third element, reasonable and probable cause, the Supreme Court of Canada noted in *Miazga* that a court is not concerned with the personal views of the prosecutor regarding the guilt of the accused, but rather with the prosecutor's professional assessment of the legal merits of the case.⁸⁰ In a criminal trial, belief in probable guilt means that the prosecutor believes that, in the existing circumstances, he or she can prove the guilt of the accused beyond a reasonable doubt in a court of law.⁸¹ Reasonable and probable cause is "a question of law to be decided by the judge";⁸² and, as noted in *Samaroo*, the same test applies to both an investigator and a Crown prosecutor.⁸³ Only if the court determines that no objective grounds existed for the prosecution at the relevant time can the court consider whether the intent to prosecute the accused was malicious.⁸⁴ In *Samaroo*, the court found that on the basis of the circumstances actually known to the CRA's investigators, the lead investigator did not have reasonable and probable cause to believe that the Samaroos' guilt could be proved beyond a reasonable doubt.⁸⁵

The BC Court of Appeal, however, disagreed. The court found that the CRA offered "a considerable body of circumstantial and other evidence from which an inference could be drawn that the Samaroos were suppressing the existence of taxable income by skimming cash out of the businesses."⁸⁶ For example, before the audit began in 2006, Mr. Samaroo routinely destroyed documents, such as the till tapes, even though he had an obligation under the Income Tax Act to preserve documents underlying the tax returns.⁸⁷ Furthermore, Mr. Samaroo commingled

78 *Miazga*, supra note 24, at paragraph 54.

79 Ibid.

80 Ibid., at paragraph 63, citing *Proulx v. Quebec (Attorney General)*, 2001 SCC 66.

81 *Miazga*, supra note 24, at paragraph 63.

82 Ibid., at paragraph 74.

83 *Samaroo*, supra note 8, at paragraph 130.

84 *Miazga*, supra note 24, at paragraph 77.

85 *Samaroo*, supra note 8, at paragraph 211.

86 *Samaroo*, supra note 21, at paragraph 59.

87 Ibid., at paragraph 85.

cash income from his various businesses and did not keep proper records for the source of various deposits into personal or business bank accounts.⁸⁸ Finally, after the audit began, the gross revenue of Mr. Samaroo's restaurant increased by almost \$50,000 a month while the makeup and volume of customers remained about the same.⁸⁹ Clearly, this evidence was not compelling at the criminal trial; however, whether the evidence was compelling enough to convict is not the test in an action for malicious prosecution. The test is "whether objectively, as a matter of law, the evidence known at the time . . . met the requisite standard of reasonable and probable cause to initiate a prosecution."⁹⁰ The plaintiff bears the onus "to prove *an absence* of reasonable and probable cause to initiate the prosecution."⁹¹ In other words, in the view of the BC Court of Appeal, the plaintiff must prove a negative: that the CRA could not have had reasonable and probable cause to initiate the prosecution.

As to the fourth element, the motivation for the prosecution, the Supreme Court said in *Miazga* that this element is proved

when a court is satisfied, on a balance of probabilities, that the defendant Crown prosecutor commenced or continued the impugned prosecution with a purpose inconsistent with his or her role as a "minister of justice." The plaintiff must demonstrate on the totality of the evidence that the prosecutor deliberately intended to subvert or abuse the Office of the Attorney General or the process of criminal justice.⁹²

Satisfying the third element does not dispense with the necessity of proving an improper purpose. Moreover, incompetence, recklessness,⁹³ or gross negligence is not sufficient to prove malice.⁹⁴

In *Samaroo*, the trial court found on a balance of probabilities that the lead CRA investigator had acted deliberately to subvert and abuse his office by (1) suppressing exculpatory evidence and attributing inaccurate evidence to witnesses; (2) knowingly misstating material evidence essential to the proof of tax evasion; (3) filing a misleading report on which he knew the Crown would rely to authorize the prosecution; and (4) swearing the information—"all in the hope of convicting the Samarooos."⁹⁵ Because his purpose was improper, the court found that the malice

88 Ibid., at paragraph 84.

89 Ibid., at paragraph 87.

90 Ibid., at paragraph 40.

91 Ibid., at paragraph 45 (emphasis in original).

92 *Miazga*, supra note 24, at paragraph 89.

93 Compare *Hinse*, supra note 38, at paragraph 53. Recklessness shows bad faith but not malice. Thus, even if a prosecutor was reckless, that is not enough for the prosecutor to be held liable for malicious prosecution. In *Samaroo*, the cause of action for malicious prosecution against the person of the Crown prosecutor was dismissed over this distinction.

94 *Miazga*, supra note 24, at paragraph 81.

95 *Samaroo*, supra note 8, at paragraph 257.

requirement of the tort was satisfied, and therefore that the Samaroos had proved malice vicariously against the CRA.⁹⁶ However, the BC Court of Appeal found it unnecessary to review the element of malice after finding that the CRA had sufficient evidence to initiate the prosecution. The court found that it was

not necessary to examine whether [the CRA investigator] intentionally suppressed or withheld material evidence from the prosecutors, [or] failed to make clear disclosure of witness statements, grapple with the many criticisms leveled at him about his conduct in the investigation and criminal prosecution, nor to otherwise consider whether he acted for an improper purpose.⁹⁷

In my view, the decision of the BC Court of Appeal could be criticized under the law of torts for at least two reasons. First, as discussed under the first category of the tort of misfeasance in a public office, if a Crown official acts maliciously toward an individual, that individual is entitled to receive punitive damages even if he or she did not suffer any other damages. Here, the Samaroos had proved at trial that the CRA investigator had acted with malice toward them. Regardless of whether the Samaroos had proved the other three elements of the tort of malicious prosecution, the BC Court of Appeal had to review the element of malice because, once proved, existence of malice entitled the plaintiffs to some damages. Instead, the court proceeded to dismiss the case in its entirety without considering the actions of the CRA investigator.

Second, the court made a glaring error of law in misstating the test of malicious prosecution from *Miazga*. In *Miazga*, the Supreme Court said, “It is readily apparent from its constituent elements that the tort of malicious prosecution targets the decision to initiate *or continue* with a criminal prosecution.”⁹⁸ The BC Court of Appeal did not state and never considered whether the CRA had reasonable and probable cause *to continue* with the prosecution of the Samaroos. The charges against the Samaroos were laid in 2007; the criminal trial started in 2010 and ended in 2011. The prosecution of the Samaroos continued even after the CRA lead investigator had admitted to his mistakes during the criminal phase of the audit.⁹⁹ The BC Court of Appeal applied the test of reasonable and probable cause only to the initiation of the prosecution in 2007, and not to its continuation through 2011.

It remains to be seen whether the Supreme Court of Canada will grant leave to appeal the decision.

Abuse of Process

The tort of abuse of process exists if the defendant used a legal process for a purpose other than the administration of justice, such as oppression or extortion. There are

⁹⁶ Ibid.

⁹⁷ *Samaroo*, supra note 21, at paragraph 7.

⁹⁸ *Miazga*, supra note 24, at paragraph 6 (emphasis added).

⁹⁹ *Samaroo*, supra note 9, at paragraph 33.

two elements to be satisfied in an action for abuse of process: (1) the defendant had a collateral and improper purpose in using the legal process, and (2) the defendant committed a definite act to serve that improper purpose.¹⁰⁰ No liability exists when the defendant, even with bad intentions, merely employs a regular legal process reaching a proper conclusion.¹⁰¹

Taxpayers usually plead the tort of abuse of process along with malicious prosecution when suing the CRA for initiating criminal proceedings against them. In *Miazga*, the Supreme Court described the torts of malicious prosecution and abuse of process as “two sides of the same coin”¹⁰² when the underlying legal proceeding involves criminal charges. Therefore, to avoid double recovery for the same wrongful act, a court will award damages for one, but not both, of these torts when the plaintiff has alleged both. The tort of abuse of process becomes a distinct tort when the CRA initiates a civil proceeding against a taxpayer; however, circumstances in which the CRA will undertake a civil proceeding against a taxpayer (meaning that the CRA is the plaintiff or petitioner in a civil court rather than the defendant or respondent) are rare. In contrast to malicious prosecution, in an action for abuse of process the plaintiff is not required to prove malice on the part of the CRA; therefore, it may be advantageous for taxpayers to plead and argue this tort even when the tort of malicious prosecution also is pleaded.

The only case that discusses the tort of abuse of process against the CRA is *McCreight*.¹⁰³ Mr. McCreight was a chartered accountant. The case began in 1998 when the CRA investigated several corporate taxpayers and their accounting firm, in which Mr. McCreight was a partner. The CRA believed that the corporate taxpayers were fraudulently applying for tax credits with the help of the accounting firm. It executed three search warrants on the homes and businesses of the corporate taxpayers, as well as those of their lawyers and accountants, including Mr. McCreight. Pursuant to these searches, the CRA seized some 60 boxes of materials and three hard drives. Later, the court ordered the CRA to return the seized materials. On the day the CRA had to return the seized materials, the Crown charged the corporate taxpayers and their accountants, including Mr. McCreight, with fraud and conspiracy. As a result of the criminal charges, the CRA could keep the seized materials. In the subsequent criminal proceedings, the court found that the CRA had brought the charges primarily to enable it to keep the seized documents.¹⁰⁴ Mr. McCreight was acquitted of all charges in 2006, and afterward sued the CRA for abuse of process. The trial court struck his pleading for not stating a valid cause of action;¹⁰⁵ the

100 *Smith v. Rusk*, 2009 BCCA 96, at paragraph 34.

101 *Ibid.*

102 *Miazga*, *supra* note 24, at paragraph 51.

103 *McCreight v. Canada (Attorney General)*, 2013 ONCA 483.

104 See *ibid.*, at paragraph 8. See also *Miller, Canfield, Paddock and Stone v. BDO Dunwoody*, 2015 ONSC 4806, at paragraph 2.

105 *McCreight v. Canada (Attorney General)*, 2012 ONCA 1983.

Ontario Court of Appeal overturned the order to strike and allowed the action to continue.¹⁰⁶ *McCreight*, however, was an appeal from an order dismissing the pleadings. The case did not reach a judgment on its merits.

Intentional Interference with Economic Relations

A cause of action for intentional interference with economic relations between parties arises when the defendant intentionally commits an unlawful act against a third party and that act harms the plaintiff economically. However, the Supreme Court of Canada has defined this tort as being narrow in scope, and if the plaintiff can recover losses by pursuing another cause of action in relation to the alleged misconduct, this tort is less likely to succeed.¹⁰⁷ Six elements must be satisfied to prove this tort: (1) a valid business relationship (or business expectancy) existed between a plaintiff and a third party; (2) the defendant knew of the business relationship; (3) the defendant intentionally interfered, and that interference induced or caused the termination of the business relationship; (4) the interference was by unlawful means; (5) the interference legally caused the termination of the business relationship; and (6) the plaintiff suffered a loss as a result.¹⁰⁸ Considering the number of elements that the taxpayer must prove and the Supreme Court's strong qualification regarding the use of this tort, it is unlikely that an action against the CRA based on this tort will ever succeed.

A cause of action for this tort was challenged by the CRA in *Gordon*.¹⁰⁹ In an appeal of the trial court's ruling not to strike Mr. Gordon's cause of action, the CRA argued that the claim was a collateral attack on the tax assessments, and a collateral attack on an assessment could not be made through a civil action for damages.¹¹⁰ The Federal Court disagreed, because the CRA employees were alleged to have frightened off customers and potential customers of the taxpayer's business, and those customers would otherwise have used the taxpayer's services and would have paid him.¹¹¹ Although the taxpayer in *Gordon* succeeded in persuading the court that his cause of action should survive the pleading stage, the case did not reach trial on its merits.

Unintentional Torts—Negligence

Unintentional torts include negligence, product liability, or nuisance (among other causes). In the context of an abusive audit, the most common scenario occurs when

106 *McCreight*, supra note 103, at paragraphs 72 and 74.

107 *AI Enterprises Ltd. v. Bram Enterprises Ltd.*, 2014 SCC 12, at paragraph 81.

108 *Gordon v. Canada*, 2013 FC 597, at paragraph 16.

109 *Ibid.*

110 *Ibid.*, at paragraph 18.

111 *Ibid.*, at paragraph 21.

an auditor unintentionally makes an error that harms the taxpayer, thus raising the possibility of an action for negligence. The absence of intent to harm is key: even a conscientious auditor whose personal integrity is beyond reproach may be negligent in his or her conduct toward a taxpayer. Negligence is the most commonly litigated cause of action in tort; consequently, whether the CRA can be found liable for negligence in an abusive audit has been the subject of many commentaries, from articles in peer-reviewed journals¹¹² to online posts on law firms' websites.¹¹³ Since several new judgments have been issued in recent years, this section will update the jurisprudence in this area of law.

The Crown Liability and Proceedings Act allows victims to sue the Crown when one of its agents is liable in tort to that victim;¹¹⁴ neither that act nor any other federal legislation limits the Crown's liability only to intentional torts. Therefore, the CRA will be vicariously liable for negligence by its agents in respect of a taxpayer if a court finds those agents liable. The taxpayer must establish on a balance of probabilities that the CRA was negligent, meaning that it did not follow an objective standard of care regardless of its good intentions. However, negligent conduct by itself does not establish liability; the taxpayer must still prove that that conduct legally caused the damages that he or she suffered, and that the law provides remedies for those types of damages. Proof of causation and damages are questions of fact to be determined in all negligence actions, and a trial court must decide them on a case-by-case basis. However, whether the CRA owes a duty of care to a taxpayer,¹¹⁵ and, if so, what the standard of care is for the conduct of the CRA's agents, are questions of law. Parliament and the Supreme Court of Canada have not answered those questions yet, and the federal courts and superior courts of three provinces have reached different answers.¹¹⁶

112 See, for example, John Bevacqua, "Suing Canadian Tax Officials for Negligence: An Assessment of Recent Developments" (2013) 61:4 *Canadian Tax Journal* 893-914; and Shaira Nanji, "Can Taxpayers Successfully Sue the CRA for Negligence?" *Tax Topics* no. 2171, October 17, 2013, 1-4.

113 See, for example, Graham Purse, "How To Sue the CRA," *Mondaq*, June 3, 2015 (www.mondaq.com/canada/x/402130/tax+authorities/How+To+Sue+The+CRA).

114 Crown Liabilities and Proceedings Act, *supra* note 25, section 3(b)(i).

115 This article discusses whether the CRA owes a taxpayer a duty of care during or after an audit. In *Canada v. Scheuer*, 2016 FCA 7, the taxpayer argued that the CRA owed a duty to warn third-party taxpayers regarding a scam tax-shelter scheme. The court dismissed the action at the pleading stage. See also *Deluca v. Canada*, 2016 ONSC 3865, for a similar argument and result. The question of whether the CRA owes a duty to warn third-party taxpayers is beyond the scope of this article.

116 In Canada's common-law provinces, a decision of the highest court in the province is a binding authority for all the lower courts in that province for future lawsuits, but merely persuasive in other provinces. For example, absent a decision to the contrary by the Supreme Court of Canada or the federal or provincial legislature, a decision of the Alberta Court of Appeal is binding and must be followed by all lower courts in Alberta, but a court in any other province has no obligation to follow it.

A duty of care is “an obligation, recognised by law, to take reasonable care to avoid conduct that entails an unreasonable risk of harm to others.”¹¹⁷ To decide whether a defendant owes a duty of care to a plaintiff as a matter of law, a Canadian court must apply the Anns-Cooper test,¹¹⁸ in which a trial judge must first inquire whether a sufficiently close relationship between the plaintiff and defendant existed such that the defendant owed the plaintiff a prima facie duty of care.¹¹⁹ The trial judge must then consider whether there are any residual policy considerations that ought to cancel the duty altogether, narrow its scope, or reduce the class of persons to whom it is owed.¹²⁰

Federal Courts

The federal courts have held that the CRA may be held liable in negligence depending on the facts of a case. In *Edell*, the Federal Court of Appeal reversed the trial judge’s decision to strike the plaintiff’s claim for negligence against the CRA because the “CRA . . . failed to demonstrate a valid basis to exclude its duty of care or to shelter it completely from an action in the tort of negligence.”¹²¹ In *Gordon*, the Federal Court dismissed the CRA’s appeal of the trial judge’s order to allow the taxpayer’s claim of negligence against the CRA to continue.¹²² Applying the Anns-Cooper test, the court held that the taxpayer’s action may have “a reasonable prospect of success,”¹²³ noted that the case law was “evolving,” and found that the continuation of the claim was not “unduly burdensome.”¹²⁴ Therefore, a finding of negligence against the CRA for an abusive audit is possible at a federal court.

British Columbia

In British Columbia, the CRA owes a duty of care to taxpayers, although the circumstances in which this duty arises may be narrow and fact-specific.¹²⁵ The Supreme Court of British Columbia found that this duty existed in *Leroux*. Mr. Leroux was a small-business owner in northern British Columbia.¹²⁶ The CRA started goods and services tax (GST) and income tax audits of Mr. Leroux in October 1996. A long chain of events followed, which the court described as “Kafkaesque,”¹²⁷ and which

117 *Odhavji Estate*, supra note 49, at paragraph 45.

118 Named after *Anns v. Merton London Borough Council*, [1977] UKHL 4; and *Cooper v. Hobart*, 2001 SCC 79.

119 *Odhavji Estate*, supra note 49, at paragraph 47.

120 *Ibid.*, at paragraph 51.

121 *Edell*, supra note 73, at paragraph 9.

122 *Gordon*, supra note 108.

123 *Ibid.*, at paragraph 35.

124 *Ibid.*, at paragraph 39.

125 *Leroux*, supra note 63, at paragraph 309.

126 See *ibid.*, at paragraphs 1-205, for the findings of fact in this 18-year-long story.

127 *Leroux v. Canada Revenue Agency*, 2010 BCSC 865, at paragraph 2; rev’d 2012 BCCA 63.

has been featured in news magazines and on CBC radio, and even on dedicated websites.¹²⁸ At the outset of the process, the CRA's auditors went to Mr. Leroux's residence without a warrant and seized two boxes of documents. In the years that followed, Mr. Leroux and the auditors maintained continuous communications, which included many phone calls and face-to-face meetings. While the court did not expressly so find, Mr. Leroux perhaps never realized the adversarial nature of his relationship with the auditors, but rather treated them as tax advisers, or at least as neutral intermediaries between himself and the CRA. In October 1998, Mr. Leroux received GST notices of reassessment for 1994, 1995, and 1996 totalling more than \$82,000.¹²⁹ In September 1999, he received income tax notices of reassessment for 1993, 1994, and 1995 totalling more than \$600,000.¹³⁰ By 2006, all the assessments were settled, and the related penalties and interest were set aside.¹³¹ Perhaps the most important fact was the finding of the Tax Court of Canada that Mr. Leroux had been correct in characterizing the proceeds from the sale of some logs from his property as capital assets instead of income.¹³² The CRA's patently unreasonable characterization was the basis on which the CRA had accused Mr. Leroux of gross negligence to justify its reassessment of his income in statute-barred years.

Mr. Leroux sued the CRA for negligence and alleged that its abusive audits and the subsequent objections, appeals, Tax Court proceedings, and fairness application to the minister, all of which had lasted over 10 years at the time of filing of the action, had caused his financial ruin, loss of his business, loss of his home, and his deteriorating health in his senior years.¹³³ It was suggested that *Leroux* realistically raised the possibility that a court would at last find the CRA liable in negligence because the case offered "clear and seemingly uncontroverted evidence of purely operational failures" that had caused Mr. Leroux's ordeal.¹³⁴ The subsequent legal proceedings at the Supreme Court of British Columbia started in 2006 and concluded in 2014 when the court dismissed Mr. Leroux's action in its entirety.¹³⁵

The court's analysis included an examination of the following elements:

- *Proximity*. Applying the Anns-Cooper test, the court found that the CRA owes a private duty of care to taxpayers under audit.¹³⁶ An audit does not necessarily place a taxpayer in a close and direct relationship with an auditor;

128 Nanji, *supra* note 112.

129 *Leroux*, *supra* note 63, at paragraph 32.

130 *Ibid.*, at paragraph 107.

131 *Ibid.*, at paragraph 59.

132 *Ibid.*, at paragraph 164.

133 *Ibid.*, at paragraphs 63-66.

134 Bevacqua, *supra* note 112, at 914.

135 *Leroux*, *supra* note 63, at paragraph 410.

136 *Ibid.*, at paragraph 305.

generally, the required degree of proximity does not exist. But in this case, an extended and personal relationship had been formed between the auditors and Mr. Leroux, a close and direct nexus existed between the discretionary decisions taken by the auditors and the harm that Mr. Leroux allegedly suffered, and the devastating effects of those discretionary decisions on Mr. Leroux were obvious to the auditors at the time they made them.¹³⁷ When such proximity existed, the CRA auditors had to be held liable for the consequences of their decisions.¹³⁸

■ *Foreseeability*. The court described the audit of Mr. Leroux as

a focussed and intensive one taking place over many years, covering three years of statute barred taxes, involving three auditors, many face to face meetings and phone calls, significant changes in tax characterization between the [tax returns] and the assessments as a result of discretionary decisions, and huge penalties. The results were foreseeably and obviously devastating to Mr. Leroux.¹³⁹

The court held that the foreseeability of devastating consequences to Mr. Leroux “was evident to everyone involved at the time the assessment was levied, . . . even if the specifics of Mr. Leroux’s business difficulties were not known to them.”¹⁴⁰ Because of the proximity of the auditors’ relationship with Mr. Leroux and the foreseeability of the harm of their decisions to him, the court found that the CRA’s employees had a duty “to conduct themselves as reasonably careful professionals in these circumstances.”¹⁴¹

■ *Public policy*. The court then addressed the question of whether policy considerations should prevent a duty of care from being imposed on the CRA. The CRA advanced two policy arguments that this duty should not be imposed: first, it would conflict with the CRA’s duty to collect taxes; and second, it would open the floodgates to litigation by taxpayers under audit. The first argument is a variation of the “chill-factor” argument, which holds that imposing legal liability on revenue authorities may result in a range of undesired administrative responses, such as not providing taxpayers with information or guidelines, avoiding high-risk tax collection activities, or not auditing sophisticated taxpayers out of fear of prolonged litigation.¹⁴² The court rejected both of the CRA’s policy arguments.

137 Ibid., at paragraph 301.

138 Ibid., at paragraph 304.

139 Ibid., at paragraph 302.

140 Ibid., at paragraph 303.

141 Ibid.

142 John Bevacqua, “A Chilling Account: North American and Australian Approaches to Fears of Over-Defensive Responses to Taxpayer Claims Against Tax Officials” (2015) 13:1 *eJournal of Tax Research* 262-79, at 263. (Bevacqua argues that fears of overdefensive administrative responses to liability of tax authorities are unfounded.)

While the court acknowledged that the CRA owes “a duty to the public and to the Minister of National Revenue to collect taxes that are properly payable,” it did not find that that duty conflicted with “a duty to take reasonable care in assessing taxes, auditing taxpayers, and . . . imposing penalties.”¹⁴³ Within the Canadian tax system, the CRA’s auditors are not accountable to any independent body for their actions, except through an appeal to the Tax Court of Canada, and then only in respect of the correctness and validity of their assessments of taxpayers’ tax liabilities. Accordingly, the court suggested, holding CRA auditors to a standard of care that might make them more careful “is not necessarily a bad thing.”¹⁴⁴ Moreover, the onus on any taxpayer in a negligence action against the CRA is high, so fear of widespread litigation is unfounded.¹⁴⁵ A taxpayer undertaking such an action must first establish the required degree of foreseeability and proximity in his or her situation, “followed by proven breaches, causation, and damages.”¹⁴⁶ Furthermore, the CRA will defend itself vigorously against any suit, employing all resources at its disposal, so it is unlikely that it would face a flood of lawsuits if legal liability were imposed.¹⁴⁷

- *Breach.* After finding that the CRA auditors owed Mr. Leroux a duty of care, the court found that the applicable standard of care for the auditors was that of a “reasonably competent tax auditor in the circumstances.”¹⁴⁸ The auditors breached that standard of care when they unjustifiably reopened Mr. Leroux’s income tax for statute-barred years and assessed penalties with daily compound interest against him, while acting as if the burden was on Mr. Leroux to prove that he was not grossly negligent (whereas it is the CRA that bears the burden to prove gross negligence on the part of the taxpayer).¹⁴⁹
- *Causation.* The court nevertheless went on to dismiss Mr. Leroux’s action for negligence, because he had failed to prove on a balance of probabilities that the CRA auditors’ breach of the applicable standard of care legally caused “the impairment of his credit, his difficulties with the mortgage payments, and the consequent loss of his RV park and home.”¹⁵⁰ Moreover, Mr. Leroux did not provide any medical evidence to support his claim that the CRA’s negligence legally caused his declining health.¹⁵¹ Basically, Mr. Leroux’s action

143 *Leroux*, supra note 63, at paragraph 306.

144 *Ibid.*

145 *Ibid.*, at paragraph 307.

146 *Ibid.*

147 *Ibid.*

148 *Ibid.*, at paragraph 311.

149 *Ibid.*, at paragraph 355.

150 *Ibid.*, at paragraph 385.

151 *Ibid.*, at paragraph 397.

failed because too many other intervening factors were present that had nothing to do with the CRA.¹⁵²

Leroux is the only decision in Canada finding that the CRA's auditors owe a private duty of care toward taxpayers under audit. However, the duty found in *Leroux* is too narrow in scope to form a strong foundation for future cases against the CRA, because the facts surrounding the conduct of the auditors toward Mr. Leroux influenced the reasoning of the court when it analyzed the proximity requirement for the existence of a duty of care. Such a finding will be highly unlikely when a sophisticated taxpayer deals at arm's length with a CRA auditor, with a full appreciation of the inherent adversity of interests that exists between a taxpayer and an auditor. An earlier BC decision denied that the CRA owes any duty to a taxpayer. In *Footte*, the Supreme Court of British Columbia held that "[t]he duty of care owed by the [CRA] is to the Crown—not to the taxpayer. As long as the auditor is reasonably competent, any flaws in the investigation are not subject to liability."¹⁵³ The court in *Leroux* distinguished *Footte* (after pointing out that Mr. Footte was a self-represented litigant) on the basis that the ruling on liability in that case was qualified by the phrase "as long as the auditor is reasonably competent."¹⁵⁴ So even applying *Footte*, liability for negligence may arise if the auditor is found to be incompetent. However, *Footte* is no longer reliable law because of a subsequent decision of the BC Court of Appeal in *Leroux*. Ruling on whether the CRA may owe a private duty of care to Mr. Leroux, the Court of Appeal allowed his action for negligence to advance from the pleading stage, and declared that Mr. Leroux "must ultimately plead and prove that the CRA or one of its employees was in a close and direct relationship to him such that it is just to impose a duty of care in the circumstances."¹⁵⁵ That ruling led to the BC Supreme Court's subsequent decision in 2014, discussed at length above.

The Other Common-Law Provinces

Wrongful conduct of an audit is not a ground for a claim of liability against the CRA in Nova Scotia. In *Canus*, the Supreme Court of Nova Scotia dismissed the taxpayer's actions for negligence and misfeasance in a public office, even though the court found that the CRA auditor "wrongly conducted the audit."¹⁵⁶ The taxpayer was a fish-processing company in Nova Scotia and its parent was a US company. In 1995, the CRA conducted a transfer-pricing audit of the taxpayer for its income in 1991 and 1992, and reassessed its tax liability for more than \$1 million.¹⁵⁷ As a

152 Ibid., at paragraph 399.

153 *Footte*, supra note 33, at paragraph 41.

154 *Leroux*, supra note 63, at paragraph 293.

155 Ibid., at paragraph 298.

156 *Canus*, supra note 72, at paragraph 29.

157 Ibid., at paragraphs 14–15.

result of the unexpected tax liability, in 1997 the taxpayer lost part of its bank financing; it had to reduce the size of its business and consequently lost profits. The CRA's appeal division vacated the reassessment in 1998, and in 2000, the taxpayer sued the CRA for negligence.

In 2005, the Supreme Court of Nova Scotia dismissed the case, even though it found that the harm that the taxpayer had suffered was foreseeable to the auditor.¹⁵⁸ The court held that because the interests of a taxpayer and the CRA are inherently opposed, no legal proximity for the rise of a duty of care can possibly exist between the CRA and taxpayers: "The interest of a taxpayer is to pay as little in taxes as is legally possible and the interest of CRA is to ensure all taxes legally owing are remitted."¹⁵⁹ Further, "any duty owed by [an auditor] is to the Minister of National Revenue whose duty is owed in turn to Parliament and to all taxpayers generally."¹⁶⁰ Moreover, public policy considerations would prevent the imposition of a duty of care on the CRA, because the "purpose of the *Income Tax Act* is to raise revenue for the government" and "[t]he Minister of National Revenue under the *Act* has a duty to administer and enforce the *Act* for the benefit of Parliament and the general public."¹⁶¹ The court believed that imposing a duty of care "would [negatively] affect the ability of the Minister of National Revenue to raise revenue."¹⁶² It also held that the imposition of a duty of care would require CRA employees (that is, its auditors) to "always correctly interpret the *Income Tax Act*."¹⁶³ In other words, they would have to be right all the time; otherwise, "there could be a successful lawsuit every time an assessment or reassessment was overturned on appeal."¹⁶⁴

In Alberta, as the law currently stands, the CRA is never liable for negligence against a taxpayer. Adopting similar proximity and public policy reasonings to those set out in *Canus*, the Alberta Court of Appeal has denied that a duty of care can ever exist between the CRA and taxpayers. First, a finding of sufficient proximity to ground a private-law duty of care cannot exist because the relationship between the CRA auditors who exercise a statutory function and taxpayers is inherently adverse.¹⁶⁵ Second, public policy considerations militate against finding the existence of a

158 Ibid., at paragraph 69.

159 Ibid., at paragraph 73.

160 Ibid., at paragraph 87.

161 Ibid., at paragraph 103.

162 Ibid.

163 Ibid., at paragraph 50.

164 Ibid.

165 *Grenon v. Canada Revenue Agency*, 2017 ABCA 96, at paragraph 25; aff'g 2016 ABQB 260; leave to appeal to the Supreme Court of Canada dismissed September 21, 2017, case no. 37584. The CRA does not have a duty to protect a taxpayer from losses caused by any "competitive disadvantage" that may result from the taxpayer's going through a tax audit. See *783783 Alberta Ltd. v. Canada (Attorney General)*, 2010 ABCA 226, at paragraph 45.

prima facie duty of care on the part of the CRA when it is auditing a taxpayer.¹⁶⁶ In *Grenon*, the trial court¹⁶⁷ had struck the pleadings of the taxpayer, who was in a protracted taxation dispute still pending before the Tax Court of Canada; the taxpayer then appealed the ruling on its pleading. The decision of the Alberta Court of Appeal criticized *Leroux* for “insufficient footing” and “bad policy” in creating a new private duty of care, which would raise “the spectre of indeterminate liability.”¹⁶⁸ The court reasoned that in the “regulatory context,” a “regulator does not owe a private law duty of care to plaintiffs who might be damaged by activities of the regulated parties.”¹⁶⁹ As between CRA employees and taxpayers, not enough foreseeability and proximity exist to establish a private-law duty of care, and strong policy reasons prevent the imposition of a duty of care.¹⁷⁰

In my view, *Canus* and *Grenon* were incorrectly decided. The taxpayers, courts, and Parliament should expect the CRA *always* to correctly and faithfully execute the Income Tax Act and the other legislation that it enforces; if the CRA makes a mistake in an audit and a taxpayer suffers damages legally caused by that mistake, the CRA should be held liable in tort as any private person in place of the CRA would have been liable—as the Crown Liability and Proceedings Act asserts. The CRA will not be liable to all taxpayers under audit or in all audits in which the auditor made a mistake, but only in those cases where the taxpayer suffers damages legally caused by the CRA’s negligence. The burden will still be on the taxpayer to prove causation and damages. The court in *Canus* was correct to hold that there “are no directions in the [*Income Tax*] Act about how the Minister [of National Revenue] and his employees should carry out the duties under the Act”;¹⁷¹ however, the Income Tax Act is not the only legislation that governs the conduct of the CRA as an agent of the Crown. That is the error of law in *Canus*.

The error of law in *Grenon* is even more palpable than in *Canus*. The Alberta Court of Appeal assumed that an audit is a “regulatory” function of the CRA. However, the “Commissioner [of the CRA] or any other person employed or engaged by the [CRA] or who occupies a position of responsibility in the [CRA]” may not have “a power to make regulations” under section 8(3)(a) of the Canada Revenue Agency Act.¹⁷² So the conduct of an audit of an individual taxpayer cannot be a regulatory function; it is an administrative or quasi-adjudicative function open to objection and review at the same administrative agency (that is, the CRA’s appeal division), appeal to the Tax Court of Canada, or judicial review before the Federal Court. After relying

166 See *Grenon*, supra note 165 (ABCA).

167 Ibid. (ABQB).

168 Ibid. (ABCA), at paragraph 13.

169 Ibid., at paragraph 17.

170 Ibid.

171 *Canus*, supra note 72, at paragraph 74.

172 Canada Revenue Agency Act, supra note 44, sections 8(3)(a) and (1).

on a series of authorities showing that the courts must grant deference to the power of an administrative body to make regulations, the court dismissed Mr. Grenon's appeal.¹⁷³ The court could have reached the same disposition if it had characterized the negligence action as a collateral attack on an assessment that was pending before the Tax Court of Canada.¹⁷⁴ In addition, the court could have relied on the fact that Mr. Grenon had been a resident of New Zealand since 2012, and even though the income tax audit of Mr. Grenon and his several corporations started in 2007, the claim that the audit itself had put the CRA "in a close and direct relationship" with a sophisticated taxpayer like Mr. Grenon was perfunctory at best.¹⁷⁵ Instead, the court chose to permanently close a negligence cause of action against the CRA, contrary to the text, context, and purpose of the Crown Liability and Proceedings Act.

CIVIL REMEDIES FOR AN ABUSIVE AUDIT IN QUEBEC

Tort is an area of law in all of Canada's common-law provinces. Quebec, however, has a fundamentally different system of "obligations" under its Civil Code.¹⁷⁶ For example, "common law notions of duty of care, proximity, foreseeability, and public policy" do not exist under the Civil Code of Québec.¹⁷⁷ Moreover, Quebec has its own provincial revenue agency, l'Agence du revenu du Québec (Revenu Québec), to enforce the Quebec income tax act.¹⁷⁸ Quebec also has its own Charter of Human Rights and Freedoms, which grants Quebec residents the constitutional right to protection of their private property: "Every person has a right to the peaceful enjoyment and free disposition of his property, except to the extent provided by law."¹⁷⁹ The residents of Canada's common-law provinces do not have an equivalent right under the Canadian Charter; therefore, if a resident of Quebec brings an action against Revenu Québec for abuse of its powers and unjust deprivation of property, the taxpayer's case may have an additional constitutional dimension that a civil claim in a common-law province never has. Finally, there are stark differences between legal analysis under the civil-law system and legal analysis under a common-law regime, which affect the precedential value of Quebec jurisprudence in other provinces, and vice versa. However, two recent decisions show how the courts in Quebec

173 *Grenon*, supra note 165 (ABCA), at paragraphs 17-26.

174 See *Grenon*, supra note 165 (ABQB), at paragraph 15.

175 *Ibid.*, at paragraph 16.

176 Code civil du Québec, RLRQ c. CCQ-1991.

177 *Ludmer*, supra note 3, at paragraph 141.

178 An examination of the extent to which Revenu Québec follows the methods, processes, and procedures of the CRA is beyond the scope of this article.

179 Charter of Human Rights and Freedoms, CQLR c. C-12, section 6.

have ruled in cases of abusive audits by the CRA and Revenu Québec. More importantly, these cases cast additional light on the CRA's structure, practices, and auditing processes, which may prove invaluable in future cases against the CRA.

In *Ludmer*,¹⁸⁰ the CRA conducted a nine-year-long audit of a group of taxpayers regarding an international investment scheme in Bermuda, but the audit was eventually abandoned. When the taxpayers' investment scheme failed, they alleged that this was the result of the protracted and inconclusive audit and sued the CRA for \$117 million. Evidence presented at trial showed that, during the audit, the CRA had requested information from the authorities in Bermuda and had falsely claimed that the civil audit was a criminal investigation.¹⁸¹ Significantly breaking away from its prior practice, the CRA had applied an assessing position to the taxpayers that it had not previously applied to any other taxpayer¹⁸²—even though the consistent application of taxation law is a fundamental principle set out in the Taxpayer Bill of Rights. Later, the CRA had made settlement offers to the taxpayers in bad faith, knowing that its position was wrong and could not be maintained.¹⁸³ Finally, the CRA had broken specific undertakings that it had given to the taxpayers, wrongfully delayed providing necessary information that the taxpayers had requested, and destroyed material documents.¹⁸⁴ The court applied the pertinent article of the Civil Code of Québec, which states that “[e]very person has a duty to abide by the rules of conduct incumbent on him, according to the circumstances, usage or law, so as not to cause injury to another,”¹⁸⁵ and found the CRA to be “at fault.”¹⁸⁶ The court then applied the Crown Liabilities and Proceedings Act and ordered the CRA to pay close to \$4.8 million to the taxpayers.¹⁸⁷ *Ludmer* is under appeal.

The second illustration of how civil claims for abusive tax audits can succeed in Quebec is *Groupe Enico*.¹⁸⁸ In that case, Revenu Québec had audited two taxpayers and their business. The auditors engaged in many clearly wrongful acts over several years, with knowledge of the consequences of their actions for the taxpayers and their business. For example, during the audit, Revenu Québec's agents had intentionally created 153 false entries in the taxpayers' business records; destroyed a box of taxpayers' documents; intentionally delayed correcting proven errors in the assessment, with knowledge of the consequences of their delay for the taxpayers and their business; and seized the taxpayers' line of credit, causing the bank to cancel

180 *Ludmer*, supra note 3.

181 *Ibid.*, at paragraphs 554-71 and 702.

182 *Ibid.*, at paragraphs 426-40.

183 *Ibid.*, at paragraphs 639-70.

184 *Ibid.*, at paragraphs 677-702.

185 Code civil du Québec, supra note 176, article 1457.

186 *Ludmer*, supra note 3, at paragraph 702.

187 *Ibid.*, at paragraph 832.

188 *Groupe Enico*, supra note 3. For another example of a successful civil claim against Revenu Québec, see *Foncas c. Agence du revenu du Québec*, 2012 QCCQ 5096.

it.¹⁸⁹ Furthermore, Revenu Québec knew that the main auditor was an “at-risk individual,” who was at the time the target of an internal investigation for misappropriating another taxpayer’s confidential information.¹⁹⁰ The court described the auditors’ actions as “malicious and abusive conduct, gross carelessness tantamount to abuse of power, and reckless conduct tantamount to bad faith,”¹⁹¹ and it awarded the taxpayers almost \$4 million, including \$2 million in punitive damages.¹⁹² In 2016, the Quebec Court of Appeal largely affirmed the judgment, but admonished the trial judge for criticizing the internal procedures of Revenu Québec, especially the “tax earnings by audit” system, which effectively motivates auditors to inflate taxpayers’ tax liability in order to receive larger performance bonuses.¹⁹³

CONCLUSION

Tort actions against the CRA take a long time. *Leroux* lasted 18 years; the audit started in 1996 and the resulting legal dispute ended in 2014. The CRA audited the Samaroos in 2006, but the subsequent legal disputes continue to this day. The Income Tax Act presumes that an assessment is valid and binding¹⁹⁴ unless eventually the courts say otherwise. Consequently, taxpayers who are subjected to an abusive audit must go through the process of challenging an assessment and, once the assessment is set aside, must file a civil action for damages at the Federal Court or the relevant provincial superior court. Because the CRA defends itself against civil cases zealously, going through each level of these processes may take many years.

While the Quebec courts in *Ludmer* and *Groupe Enico* awarded multi-million-dollar judgments against the CRA and Revenu Québec respectively, in common-law provinces only *Samaroo* has resulted in a large judgment. However, whether these judgments truly compensated the enormous losses suffered by those taxpayers is certainly debatable.

Moreover, the courts often dismiss tort cases against the CRA at the pleading stage; not many have reached trial on their merits. The courts have been, in my view, unnecessarily cautious in applying to the CRA the same principles of law that they apply to other Crown agencies, mainly because of the inherent adversarial interests of the CRA and taxpayers. This unnecessary caution has led the courts to a narrow application of the Crown Liability and Proceedings Act, such that it is applied only to intentional torts, and mostly to those requiring a finding of malice. Some decisions do not rely on or even cite that act. For example, the court in *Canus* held that “there is no duty of care owed to an individual taxpayer under the *Income*

189 Ibid., at paragraph 76.

190 Ibid.

191 Ibid.

192 Ibid., at paragraph 137.

193 Ibid., at paragraphs 92-95.

194 Income Tax Act, supra note 36, subsection 152(8).

Tax Act.”¹⁹⁵ But the CRA is an agent of the Crown, and the Income Tax Act is not the only legislation that governs its conduct. The general duty of care not to harm another person arising out of the Crown Liability and Proceedings Act, though qualified by the Anns-Cooper test, still applies to the CRA. Because the courts have treated the CRA differently from other Crown agencies, the body of case law necessary to guide taxpayers in tort litigation against the CRA is thin. The tort awards that exist are relatively small and, from a practitioner’s perspective, rarely justify advising a client to fight the CRA with a tort case, even though the trend created by *Groupe Enico*, *Ludmer*, and *Samaroo* appears to favour taxpayers.

It has been suggested that one solution is for Parliament to amend the Income Tax Act, the Federal Courts Act, and the Tax Court of Canada Act to expand the jurisdiction of the Tax Court (1) to hear matters of procedure as well as substance, (2) to be able to vary or dismiss penalties and interest, and (3) to be able to vacate an assessment or award damages against the CRA for the wrongful conduct of its employees.¹⁹⁶ There are several arguments that support this solution:

1. It would avoid multiple proceedings; the taxpayer and the CRA could present their cases before one court in one trial. As currently constituted, the Tax Court of Canada cannot review whether the CRA exercised its powers properly; it can only review whether a taxpayer properly owes an assessment under the Income Tax Act.¹⁹⁷
2. The judges on the Tax Court are experts in tax administration and dispute resolution; the taxpayer and the CRA do not need to spend time and money on detailed explanations of the internal procedures of the CRA or the administration of the Income Tax Act.
3. Parliament has already given the CRA the privilege of recourse to a tax court in which it has the benefit of always being the respondent and therefore not having the burden of proof most of the time. Having the same lawyers and judges deal with procedural as well as substantive matters is clearly efficient and cost-effective.
4. Parliament has already given the Federal Court concurrent jurisdiction with provincial superior courts to hear offences under the Crown Liability and Proceedings Act (that is, tort cases) against a Crown agency, and exclusive jurisdiction to issue injunctive relief against Crown agencies. Expanding the jurisdiction of the Tax Court to include powers that Parliament has

195 *Canus*, supra note 72, at paragraph 87.

196 See Du Pont and Lubetsky, supra note 2, at 120-21.

197 *Main Rehabilitation Co. v. Canada*, 2004 FCA 403, at paragraph 8; leave to appeal to the Supreme Court of Canada dismissed January 27, 2005, docket no. 30739. See *Gallant v. The Queen*, 2012 TCC 119. (The Tax Court dismissed a taxpayer’s appeal for lack of jurisdiction “with considerable regret,” though it found the conduct of the CRA to be unfair: *ibid.*, at paragraph 19.)

already granted to the Federal Court means that the CRA and taxpayers would litigate all aspects of a tax dispute before one court with expertise in those matters.

5. This solution would allow the Tax Court to have other legal and equitable remedies available even if the assessment itself were upheld.

Parliament should also amend the Crown Liability and Proceedings Act for greater clarity. The decisions of the Supreme Court of British Columbia in *Leroux* and the Alberta Court of Appeal in *Grenon* clearly contradict each other. The taxpayer in *Grenon* appealed to the Supreme Court of Canada, but that court did not grant leave to hear the case. Therefore, the question of whether a taxpayer can bring a cause of action in negligence has contradictory answers in different provinces. Parliament can solve this problem by overruling *Grenon* and clarifying that the Crown Liability and Proceedings Act includes unintentional torts such as negligence and is not limited to intentional torts.

Until Parliament adopts these solutions, an action in tort against the CRA is a possible remedy for an abused taxpayer, but it will rarely be a satisfactory one.

Re-Imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar

This issue of the *Canadian Tax Journal* features the first of four groups of papers presented at a symposium on February 8-9, 2019 titled Re-Imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar. The symposium was co-organized by Osgoode Hall Law School and the School of Law, University of Sydney (Australia), and it was supported by the Canadian Tax Foundation, the Social Sciences and Humanities Research Council (SSHRC), and the International Fiscal Association (IFA) (Canadian Branch). The event was inspired by the scholarship of the late Tim Edgar, who taught in Canada and Australia and was a pillar of the Canadian tax academy. In his scholarship, Tim tackled some of the most challenging issues in tax law and policy. He did so with a relentless commitment to the underlying economic and moral principles of an efficient and just tax system. He never allowed political considerations or easy solutions to affect the integrity of his research and writing. In his career-long commitment to improving the quality of our tax law, his voice was a unique and unmistakable one in the community of Canadian tax scholarship.

The symposium brought together a large number of leading Canadian and Australian tax experts from multiple disciplines—tax practitioners, scholars, and students. The choice of theme for the conference (“re-imagining tax for the 21st century”) was motivated by the current turbulence of circumstances that are affecting taxation and that have given rise to fundamental questions about the utility and adequacy of income taxation as (1) a primary (or even a reliable) source of government revenue, (2) an instrument for social justice, and (3) a catalyst for economic direction. Income tax was introduced in 1917 in Canada, and in 1915 in Australia. Over the past 100 years, profound social and economic changes have affected how the income tax system functions. It is true that the need to rely on income tax to raise revenue, redistribute income, and regulate private activities remains the same; the “DNA” and structure of the tax system are more or less unchanged. Some would say, however, that the income tax system has become exceedingly complex and possibly outdated in important ways and is thus inadequate for addressing 21st-century issues in both domestic and international contexts. As a fitting tribute to Tim Edgar, presenters and discussants at the symposium tackled some of the most difficult tax policy questions, and they shared insights on future reforms.

The papers selected for publication in this journal fall under the following themes: the future of income tax; globalization and digitization; automation and tax

transplants; and the GAAR and tax as accessory. These papers are book-ended by an introduction (and tribute) by J. Scott Wilkie in this issue of the journal, and a review of Tim Edgar's scholarship by Rick Krever, which will appear in the second issue of volume 69, 2020.

Jinyan Li
J. Scott Wilkie
Graeme Cooper
June 2019

An Introduction and a Tribute

J. Scott Wilkie*

THE CONFERENCE TO HONOUR TIM EDGAR

On February 8 and 9, 2019, friends and colleagues gathered at a conference in Tim Edgar's name to honour his memory and reflect on his scholarship, and to be inspired and encouraged to imagine—and “re-imagine”—a forward-looking tax system that would align with Tim's interests and ideals. In what follows, I offer both an introduction to the collection of papers produced by this conference and my own tribute to Tim.

At the conference, a variety of presentations were made by well-known and distinguished thinkers in the tax area from Canada, Australia, and the United States. The range of subjects discussed at the conference by the presenters whose papers are being published in this issue of the *Canadian Tax Journal* and the next three issues, and the ensuing debate among all conference participants, reflect topics of deep interest to Tim. In a sense, the conference and these papers are Tim's continuing voice.

The presenters all shared Tim's friendship and were inspired by his scholarship, which has no doubt influenced them as students and practitioners of taxation. Their contributions to the conference, and now to this journal, reflect a common interest—an interest that they shared with Tim and that lies, indeed, at the heart of his academic life—in understanding and improving taxation and attendant tax systems. These systems, as all of the contributors recognize, are the engines for implementing and funding fiscal choices with respect to economic and social welfare, which reflect a country's social and institutional civility.

TIM EDGAR'S SCHOLARSHIP: FAIRNESS, COHERENCE, AND “CALLING IT AS IT IS”

Tim's scholarship was marked by a passionate concern that a tax system be fair and coherent and that it support, accordingly, predictable, rational outcomes that are consistent with the system's private-law underpinnings but not overpowered by them in the face of supervening fiscal and policy objectives, or by unreasonable

* J. Scott Wilkie is of Blake Cassels & Graydon LLP. He is distinguished professor of practice at Osgoode Hall Law School.

deference to opaque or excessively formal legal distinctions among economically and financially equivalent outcomes, to the detriment of what Tim would perceive as the unvarnished fiscal threads of the tax system. This passionate concern is nowhere more evident than in Tim's formidable monograph, published by the Canadian Tax Foundation, on the treatment of financial instruments: *The Income Tax Treatment of Financial Instruments: Theory and Practice*.¹

The disarming and somewhat agnostic title of this monograph does not do justice to the work's real force and scope. It drew attention to the importance of perceiving the tax system as an essential part of the legal system, one that orchestrates significant social and economic objectives according to recurring and enduring fiscal themes. The importance of this work by Tim cannot be overstated. Although readers who lack Tim's facility with financial economics may find some of the analysis in this monograph difficult, Tim's work attempts to grapple with major financial undercurrents in the tax system, which, typically, are examined only within the context of typical, predictable, and predominant private-law notions. Tim's interests extended far beyond doctrinaire tax and related private-law notions; they led him to investigate cases where the general legal system did not help its tax system "cousin" by neatly classifying transactions to which the tax system could then easily apply.

In his preface to this monograph, Tim explains his goal for the work—namely, to examine all manner of financial transactions and their combinations in "hybrids" and "synthetics." It is worth noting that he announced this goal well before the Organisation for Economic Co-operation and Development (OECD) and the Group of Twenty (G20) initiated the base erosion and profit shifting (BEPS) project, a project aimed at, among other things, addressing the "re-sourcing" of income through the use of (1) new financial instruments and (2) disunity in the treatment of these instruments among legal and tax systems globally. In the preface, Tim said the following:

I have tried to emphasize the historical context within which the income tax treatment of these instruments should be seen. I am convinced that this perspective reveals clearly that in matters of taxation "everything that is old is new again." In short, many of the issues associated with the income tax treatment of the new financial instruments are longstanding issues that tax-policy makers have struggled with for decades in designing legislative responses to more conventional instruments. . . . More important, the common themes from the past mean that many of the features of past responses are still relevant. There is, I believe, no need to reinvent the wheel with radical legislative solutions. All that is required is a little massaging and extension of past responses.²

Embryonic in this introductory observation are many of the themes that were explored in the conference honouring Tim. Tax history is important, not merely as an interesting subject of research but as a source of understanding and inspiration.

1 Tim Edgar, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Canadian Tax Paper no. 105 (Toronto: Canadian Tax Foundation, 2000).

2 Ibid., at viii.

Tax policy is about the adaptation and dynamic development of a few seminal fiscal themes, with history providing guidance in this process, in order to meet challenges to coherent taxation arising from private-law constructions that, in Tim's view, are less different in kind and financial outcome than as an expression of normative legal formulations.

Tim venerated intellectual honesty, and he abjured jargon. Such an approach, when applied to the area of financial transactions and instruments, requires careful attention and discipline. The analyst must both want and be able to understand the fundamentals of business and commerce while maintaining a steady focus on the law, undistracted by the glitter of transactional engineering and financial alchemy. An inquiry into the tax system's seemingly glaring inadequacies may reveal, to a discerning and well-informed critical mind like Tim's, that the tax system and the general legal system to which it is accessory are in fact more resistant to the strain of transactional complexity than they might initially seem. Further, attention to the essence (rather than the appearance) of how the law applies lends itself to the development of law, including tax law, whose objectives and underlying influences are well formulated and expressed. Such was the outcome of Tim's scholarship.

As his monograph reflects, Tim was reluctant to embrace—and was not satisfied in any respect with—the “cubbyhole” approach to tax policy and legislation. He recognized (and, in penetrating analysis, identified the limits of) the extent to which different forms that achieve fundamentally the same financial or economic outcomes should go unchecked by tax policy, which should concentrate, instead, on manifestations of enrichment and the transmission of value. Tim's focus was on questions concerning (1) the intrinsic features of income, (2) when income should be realized, and (3) the material distinctions between expected and unexpected returns. Of course, these questions are the core questions for financial innovation. In this context, Tim was particularly concerned with single and composite transactions that seem to defy typical legal designations and therefore, possibly, to escape the reach of prescriptive tax provisions—subject, possibly, to the overarching influence of general anti-avoidance rules (GAARs) and underlying doctrine. Tim had much to say about GAAR and related doctrine, informed as he was by his constant focus on the fundamentals of the tax system, not merely its occasional decorations. Perhaps this is why Tim was so engaged by the analysis of financial instruments and transactions: such analysis encompassed the cosmic questions of income taxation. For these questions, Tim's scholarship in the financial context provides significant inspiration for continuing inquiry and perspective.

TIM EDGAR'S PEDIGREE AS A SCHOLAR: INSPIRING FRIENDS AND INFLUENCES

Two leaders in Canadian tax policy, Brian Arnold and Neil Brooks (to whom Tim was close both personally and professionally), influenced Tim's way of thinking, the tax issues that were of fundamental interest to him, and even his manner of expression. He did not imitate them, but his words and his candour sometimes brought to

mind both their courageous challenging of the orthodoxies of Canadian taxation and their willingness to expose the system's shortcomings—a no-holds-barred willingness to point out when the tax emperor is wearing no clothes. Informed candour in tax policy matters is a distinguishing feature of Tim's intellectual legacy, and it is possible, if one listens closely, to hear the voices of Brian and Neil in Tim's confident tones.

Recently, for example, in the Arnold Report, Brian commented on two recent reports by the OECD and the International Monetary Fund. He touched on two enduring themes—themes that we also find in Tim's work and, indeed, in the preface to Tim's monograph on financial instruments. Brian said:

[T]he reports do not confront the primary difficulty which . . . is the balance between certainty and fairness in any tax system. In addition, in my view there is danger in treating the issue of tax certainty as the subject of a project, suggesting that the problems can be identified and studied, and solutions developed and implemented—and then the international tax community can move on to the next project. But tax certainty isn't a set of "problems" to be "solved"—it's an objective that should be infused into every aspect of the tax system of every country, in the same way that fairness should be.³

Apparent here (both as a practical observation and an attitude to the study of taxation) is Brian's impatience with distracting "cubbyholes" and with an approach to tax issues that lacks both a suitable context and an awareness of why taxation exists in the first place. This attitude is a consistent feature of Tim's work, and it is not surprising that Brian's clarity and deliberateness in cutting to the essence of tax issues not only are a feature of Tim's writing but also were evident in his (always engaging) spoken words on tax issues.

Less recently, but with no less force, Neil Brooks argued that tax legislation is meaningful only in the context in which the legislative words are used. Neil's approach, sometimes mistaken for an excessively political orientation to tax policy, is in fact driven by the law. It is a conception of the law, however, that seeks to discover, through informed statutory construction, why the targeted tax provisions exist in the first place—that is, to approach them not as mechanical devices but as part of a policy and legislative weave that is fundamentally coherent and has, as its objective, the enabling of fiscal policy choices born of the political system that defines who we are as a community. Two decades ago, Neil commented on the approach that, in his view, judges should take to deciding tax cases, and he expressed principled incredulity that any other approach could be sensible:

[Judging tax cases] should involve the operation of the creative process inherent in tax policy analysis. It should involve three steps: (1) the postulation of a range of plausible, alternative policy options for each interpretive issue; (2) a consideration of the consequences of each in terms of tax fairness, the neutrality of the tax system, administrative

3 Brian Arnold, "Tax Certainty," *The Arnold Report*, posting 154, May 3, 2019.

practicality, and other relevant evaluative criteria; and then (3) a choice among the alternatives based upon what makes the most sense in terms of tax principles (given the general structure of the tax legislation being interpreted). This process necessarily entails an explication of the basic principles, theories and tools of analysis that are needed for a sensible, serious discussion of income tax policy. Basically, there should be no sharp distinction between tax policy and tax interpretation: between what treasury department tax analysts do in formulating tax statutes and what judges do in interpreting and applying them. . . . [I]f a judge decides that the application of tax principles would lead to a particular conclusion in a case, the judge should reach that conclusion even though the words used in the disputed provision have not borne the usage that must be imputed to them in another context. And, this is the case not only when the words used are ambiguous or are used in a way that is over- or under-inclusive of a sensible interpretation of the section, but also when the words are specific. Indeed, the only circumstance in which judges should reach a result that they feel is not consistent with the tax policy principles underlying the structure of the legislation is in a case in which it is clear that the statute was designed to resolve the specific case in a way other than the judge thinks sensible in terms of tax policies and principles.⁴

In other words, tax analysis involves intense, fundamental legal analysis, despite the all too common (and unfortunately casual) reduction of difficult issues of legal interpretation into questions of “substance”—questions to which the law all too frequently seems an unwelcome bystander (if, indeed, it is present at all). Neil seeks, and has long sought, the essence of tax law; it is a search in which the presumption of knowing what the tax law is should not substitute for the hard thinking required to discover what it is, given that we must reconcile tax law and private law in the service of coherent and fair outcomes. In both Neil’s work and Tim’s work (as, again, the preface to Tim’s monograph reveals), we are constantly reminded of Judge Learned Hand’s admonition in the Second Circuit decision in *Gregory v. Helvering*, later affirmed by the US Supreme Court. To paraphrase (with the impatient and enduring sense of Neil’s thinking as our bedrock): Words have no meaning except in the context in which they are used, and the process of discovering the meaning of those words and their context involves a legal and not some other kind of analysis.⁵ In the context of financial instruments and financial transactions, Tim’s quest,

4 Neil Brooks, “The Role of Judges,” in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD, 1997), 93-129, at 99-100.

5 No doubt others have offered the same (or a similar) sentiment, particularly poignant in this tribute. See *Helvering v. Gregory*, 69 F. 2d 809, at 810-11 (2d Cir. 1934); aff’d sub nom. *Gregory v. Helvering*, 293 US 465 (1935). In the Second Circuit decision, Judge Learned Hand decided what “reorganization” meant in the context of the objectives served by the tax statute—not as the exposition of some sort of loose experiential or anti-avoidance notion but rather as a suitably penetrating examination of what the law was: “Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a

notably, was to discover meaning within the law without being distracted by words or, more generally, by private-law constructions that are meaningless outside the legal context of which they are a meaningful, deliberate part.

The sense and spirit of the foregoing quotations from Brian Arnold and Neil Brooks resonate in Tim Edgar's scholarship. In some respects, Tim's work serves to make the interests, concerns, and approaches that he shared with these two scholars accessible to the professional audience in whose context Tim mostly worked—that is, an audience that might not otherwise have engaged with these ideas as they were expressed by Brian and Neil. Tim recognized and strove to reinforce that a tax system is fair only if it offers coherent and consistent outcomes that capture the economic and financial significance—and equivalence—of similar circumstances, regardless of how the private law might classify, or be contorted to classify (or, worse, ignore), transactional events necessitating a tax response. Any tribute to Tim would be incomplete without noticing the spirit of his scholarship, which was infused with his mentors' passion, curiosity, intellectual honesty, good humour, and frank, penetrating articulation.

THE CONFERENCE: A CELEBRATION, MANIFESTATION, AND EXTENSION OF TIM'S SCHOLARSHIP

Let me turn now to the papers presented at the conference held in Tim's honour. All of them are in keeping with the themes that distinguished Tim's life as a teacher and scholar. I will begin by reviewing, more particularly, how these papers tie in with Tim's own scholarship—with its central concerns, its range, and its preoccupation with coherence, consistency, and, above all, fairness (fairness in general, and distributive fairness in particular).

The conference opened with two sessions under the general heading "The Future of Income Tax." This broad topic encompassed papers on the objectives of taxation and these objectives' roots in tax policy; a few of the papers were devoted to promoting, on an evolving basis, social welfare goals and systemic, proportionate fairness in the tax system. Such goals formed an undercurrent in Tim's work, and his approach to their pursuit, notably, was to look beyond appearances in order to discover the essence of tax principles and their purposeful manifestation in meaningful tax legislation.

Another group of presenters—under the general rubric "Tax Transplants in a Border-Less World?"—addressed aspects of tax reform, pivoting off interesting ideas from other jurisdictions. As Tim's work reminds us, and as numerous tax commentators have observed, taxation is practical: it "works" only when the legislative

melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." In noting this case, I offer thanks to Robert Raizenne, who recently reminded me of the poetic but penetrating exposition of legal analysis in Hand's words, which also, and aptly, describe Tim Edgar's approach to legal analysis and the approaches of his friends and mentors Brian Arnold and Neil Brooks.

outgrowths of tax theory can be administered and the tax collected, and when good ideas are able to migrate and grow together. Another theme addressed in this part of the conference was the fundamental responsibility of tax practitioners to contribute to the health of the tax system by responsible, enlightened practice.

A recurrent theme in Tim's work is the inevitable connection between private law and tax law; tax law is, of course, accessory to private law. This means that possibly the most important aspect of practising tax law—whether as a private practitioner, a scholar, or a tax administrator—is being knowledgeable about and attentive to the features of private-law constructions. In the part of the conference devoted to this question (“Must Tax Law Be a Hostage to Private Law Constructions?”), various points of reference were used to explore the intersection of taxation and private law, again with a view to achieving coherence in tax legislation and, accordingly, outcomes that withstand the test of institutional fairness.

Tax not paid is tax avoided; the manipulation of legal constructions to avoid tax may entail tax avoidance—in the sense that the outcomes of such manipulation are not justified by the tax law as it is understood in the context of relevant private law and the underlying objectives of the tax system manifested legislatively. Tim was intensely interested in “legal ambiguity” and in GAAR, not for their own sake but as necessary counterparts to the more doctrinaire legal and tax analysis that is undertaken to illuminate the point and purpose of tax legislation. In the segment of the conference titled “General Anti-Avoidance Rule and Legal Ambiguity in the Age of Artificial Intelligence,” these themes and, particularly, Tim's contributions to learning in this area were explored. The resulting papers, in addition to exploring GAAR and, more generally, tax avoidance, consider how clarity in the law lies at the essence of how it is interpreted—a process now challenged by the displacement of human beings by algorithms manifesting “artificial intelligence.” This consideration uniquely extends traditional questions about clarity and ambiguity in tax law (which were themes of Tim's work) and what to do in this regard.

Tim was an active contributor to the international tax conversation. The part of the conference titled “BEPS and International Tax” provided a convenient opportunity to reflect on how Canada's tax system relates to the tax systems of other countries. Attention was paid to the tax treatment of interest, which is a recurring subject of Tim's writing and speaking. Tim's analysis of financial instruments was particularly important in discerning the various, sometimes subtle ways in which the time value of money can be manifested in complex or composite transactions without being expressed as “interest” in the form to which the tax system is accustomed.

The conference concluded with what might be described as “next stage issues,” addressed in sessions under the rubric “Tax, Technology, and Digital Economy.” As the preface to Tim's monograph on financial instruments reflects, Tim focused on the enduring themes that underlie tax policy and tax law; he noted that

in matters of taxation “everything that is old is new again.” In short, many of the issues associated with the income tax treatment of the new financial instruments are long-standing issues that tax-policy makers have struggled with for decades in designing

legislative responses to more conventional instruments. . . . More important, the common themes from the past mean that many of the features of past responses are still relevant.⁶

The papers based on this portion of the conference explore what is and is not “new” and how we can learn from what has come before, focusing directly, in one case, on the environment in which financial transactions take place.

A FITTING TRIBUTE

The papers presented at this conference, various as they are, reflect the deep undercurrents of Tim’s life in the law: his devotion to the fundamentals of law, and his interest in adapting the law to new circumstances without concluding that the law as it is currently understood is no longer fit for its original purpose. As these papers show, coherence and fairness—the two concerns that animate Tim’s work—offer the path by which his friends and admirers may remember him and, in fact, extend his work in those areas of tax policy and legislation that mattered to him. These papers constitute a fitting tribute.

6 Supra note 2.

The Income Tax in an Uncertain World: Pillar, Symbol, and Instrument

Richard M. Bird*

PRÉCIS

L'une des rares certitudes que l'on peut avoir à propos de l'avenir du Canada est que la politique fiscale va évoluer au fil du temps, surtout peut-être sur le plan des impôts sur le revenu. L'évolution dépendra non seulement des changements dans la conjoncture économique et les préoccupations du parti au pouvoir, mais aussi de comment nous (« la population ») voyons les impôts comme symboles de ce que nous sommes et de ce que nous souhaitons — la nature de notre démocratie, dans quelle mesure nous souhaitons redistribuer le revenu, et à qui, ainsi que comment et dans quelle mesure nous voulons modifier les effets du marché. L'auteur esquisse le contexte plus vaste dans lequel on doit considérer la politique fiscale et suggère quelques conséquences possibles d'une réforme de l'impôt sur le revenu dans l'avenir.

ABSTRACT

One of the few certainties about Canada's future is that tax policy will change over time, especially, perhaps, with respect to income taxes. Exactly what changes are made will depend not only on changes in economic conditions and the concerns of the party in power but also on how we (“the people”) think of taxes as symbols of what we are and want to be—the nature of our democracy, the extent to which we want to redistribute, and to whom, and how and to what extent we want to alter market outcomes. The author sketches this broader setting in which tax policy needs to be considered and suggests a few possible implications for future income tax reform.

KEYWORDS: CANADA ■ TAX POLICY ■ INCOME TAXES ■ INCOME REDISTRIBUTION

CONTENTS

Introduction	624
Dealing with Uncertainty	624
Taxation as a Pillar of the State	629
The Income Tax as a Symbol	633
Taxation as an Instrument of Policy	635
What Does All of This Mean for the Future of the Income Tax?	640

* Professor Emeritus, University of Toronto (e-mail: rbird@rotman.utoronto.ca).

INTRODUCTION

Now, more than ever, political, business and civic leaders must embrace the fact that ours is an age of rapid transformation, significant risk and sometimes bad outcomes.

Stephen Harper¹

Those concerned with tax policy are no more certain than anyone else about what the future holds. One thing they can be sure of, however, is that dealing with change, expected and unexpected, good and bad, will continue to be a problem in the years to come. In addressing change, it is important to remember that taxation—and the income tax in particular—is not simply an instrument that governments employ to achieve specific economic (or social) policy objectives; it is also an important political symbol and one of the fundamental pillars of the relationship between society and the state. Tax changes matter not only for the immediate political and economic reasons of which politicians and officials are usually well aware, but also because changes may have important symbolic as well as practical effects and because how we tax is fundamental to the very nature of the country. After a brief review, in the next section, of the nature of the uncertainty facing Canada over the next few decades, this paper offers a few reflections on why—given the key role of the income tax as a pillar and a symbol, as well as a policy instrument—would-be tax reformers should proceed with caution.

DEALING WITH UNCERTAINTY

There are things we know that we know. There are known unknowns. That is to say there are things that we know we don't know. But there are also unknown unknowns. These are things that we do not know we don't know.

Donald Rumsfeld, US Secretary of Defence²

Some people ridiculed Mr. Rumsfeld for these words, but he, like Mr. Harper, was quite right. The “known unknowns” include, for example, the “predictable surprises” arising from demographic shifts³ and the inevitable (though seldom precisely predictable) problems arising from volatile resource prices or from other economic factors, such as the following:

- People get older, often become ill, and cease working, which leads to rising pension and health costs, increased pressure on the tax system, and, usually, more tension between federal and provincial governments.

1 Stephen Harper, “Populism’s Rise Points to Real Problems in Our World. We Ignore It at Our Peril” *The Globe and Mail*, October 6, 2018 (www.theglobeandmail.com/opinion/article-worried-about-the-current-populist-upheaval-what-comes-next-will-be).

2 North Atlantic Treaty Organization, “Press Conference by US Secretary of Defence, Donald Rumsfeld,” *NATO Speeches*, June 6, 2002 (www.nato.int/docu/speech/2002/s020606g.htm).

3 David K. Foot and Daniel Stoffman, *Boom Bust and Echo 2000: Profiting from the Demographic Shift in the New Millennium* (Toronto: Macfarlane, Walter and Ross, 1998).

- People move, and they have tended increasingly to cluster in larger metropolitan areas, with the result that the gap increases between the fiscal needs of local governments and their tax revenues. This gap, again, raises both inter-governmental tensions and the pressure on taxes.
- Oil (and other resource) prices rise, fall, and perhaps rise again, leading to large and diverse fiscal impacts on different regions and (once again) the exacerbation of tensions related to both tax and governance.
- The housing boom slows or resumes, and the result in either case is popular unrest, tax tension, and pressure on intergovernmental relations.

Such “known unknowns” should not come as a surprise, although they often seem to do so, even to those who should know better. Still, on the whole, Canada’s fiscal institutions have managed over the last half century or so to accommodate both cyclical and demographic surprises moderately well. Consider the following, for example:

- The relatively strong automatic stabilizers built into the federal fiscal system—most of them introduced during the first flush of post-war Keynesianism—have on the whole served us well,⁴ although it remains to be seen whether our persistent failure to have sufficient “shovel-ready” public works on the shelf in times of need will be remedied to any extent by the recently launched Canada Infrastructure Bank.⁵
- Canada managed in the 1990s not only to dig itself out of a substantial fiscal hole, but also, almost simultaneously, to restructure the Canada Pension Plan (CPP) more sensibly than most similar plans in other countries⁶—although the 2017 decision to cancel a planned increase in the age of eligibility was clearly a step in the wrong direction.
- Although Canada has not done so well in managing the differential effects on different regions of changes in circumstances and policies, we have, on the whole, so far managed to juggle the tax, transfer, and spending components of our fiscal constitution with sufficient success to hold the country together.⁷

4 For a recent review, see Peter Dungan, Steve Murphy, and Thomas Wilson, *Fiscal Policies in Canada: A Twenty-Five Year Retrospective* (Toronto: University of Toronto, Rotman School of Management, Policy and Economic Analysis Program, August 2018) (available on request from Murphy@chass.utoronto.ca). Although payroll taxes are not further discussed here, it should perhaps be noted that this study finds that employment insurance (EI) is an especially important automatic stabilizer and that increases in payroll taxes (for example, for EI or CPP) should be avoided when the economy is weak.

5 Infrastructure Canada, “Canada Infrastructure Bank” (www.infrastructure.gc.ca/CIB-BIC/index-eng.html).

6 As noted recently in “The Canada Pension Plan Investment Board: Moose in the Market,” *The Economist*, January 19, 2019, at 74.

7 Richard M. Bird, “Equalization and Canada’s Fiscal Constitution: The Tie that Binds?” (2018) 66:4 *Canadian Tax Journal* 847–69. For an interesting perspective on this issue, see Jack M.

As yet, however, little has been done to accommodate at the local level either metropolitan expansion or the very different reality found in many less urbanized regions.

One reason we have not handled the national policy issues (identified in the last item on the list) as well as we have the essentially federal issues (identified in the first two items) is perhaps that, although we have moved a long way toward a more integrated federal-provincial tax system in recent years, our 19th-century constitution continues to make it hard to deal with 21st-century problems, especially with respect to resource policy and local governments. Nonetheless, on the whole, Canada seems to have done as well or better than most countries in coping with such “known unknowns.”

Unfortunately, no one has done well when it comes to dealing with less probable but possibly disastrous “unknown unknowns”—the “black swans,” as Taleb calls them.⁸ Are our political and fiscal institutions sufficiently robust to cope with large problems that call for an immediate and major policy response—for example, the unexpected erection of a wall on our southern border, or some other international crisis that disrupts the economy in a significant way and calls for a major policy response if life as most of us know it is to continue? Another big problem area is climate change: those who believe in evidence-based decision making should presumably, by now, be battenning down the environmental hatches, moving to higher ground, and laying in supplies: What are we doing? Not much. That no one else seems to be doing much either is not very reassuring.

Gradual incrementalism—or “muddling through,” as Canada’s usual approach to policy problems might (not inappropriately) be characterized—has served us well for over a century. As I argue below, this approach may continue to serve us well, absent complete disaster, provided that it becomes less purely reactive and more purposeful.⁹ The normal response of human beings who are faced with crisis is to delay making changes until they really have to do so. When disaster finally arrives, most of us tend to rely on the “fast-thinking” instincts that we perhaps inherited from the days when we stayed alive by dodging the current predator. Instinct alone, however, is seldom enough when the problems that we face are large and complex. In that case, what is usually needed is what Kahneman calls “slow thinking”—the process of deliberation needed to reach a reasoned response that is sufficient to allow us

Mintz, “Two Different Conflicts in Federal Systems: An Application to Canada” (2019) 12:14 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-25 (<http://dx.doi.org/10.11575/sppp.v12i0.56878>).

8 Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2007).

9 Geoffrey Hale makes a similar point in a somewhat different context, in “Navigating Disruption: The Politics of Business Tax Reform as Two-Level Game,” paper presented at the conference on Re-Imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar, Osgoode Hall Law School, Toronto, February 8, 2019.

collectively to escape a deep hole from which no one can get out on his or her own.¹⁰ All too often, instead of thinking through problems in a reasoned, systematic way, many people choose an alternative approach, such as deferring to some authority that they find credible (a so-called strong leader, perhaps, or some ideology or creed), reverting to tribal loyalty and blaming everything on some easily identifiable group from outside the tribe, or simply relying on magical thinking.¹¹

We usually react only after catastrophe is upon us. The First World War led us to introduce the first national income and sales taxes.¹² The Second World War turned the income tax into the most important mass tax, and over the next 50 years of (mostly) increasing prosperity, Canada's federal and provincial taxes became much more integrated, and an extensive system of both interpersonal and federal-provincial transfers was developed. Few foresaw any of these changes much in advance. To reimagine how the future tax system may change in the years to come as we face a series of uncertain but almost certainly erratic—and possibly catastrophic—events is not easy.

Every tax expert likely has some concept of an ideal tax system (or at least of a system better than the existing one) ready to hand, and thus an obvious first response, when a tax expert is asked to think about the future tax system, is simply to suggest that we implement that ideal system. Alas, experience shows not only that many are reluctant to accept even the best ideas but also that, even if they do accept such ideas, things seldom work out as well as forecast. The desired product may be a better tax system, but what we actually get depends very much on the process through which policy decisions are made and implemented. How do we decide how to tax, how much to tax, and which level of government should tax? Should taxes be more centralized, or less? How should taxes in Canada relate to taxes elsewhere? What role should taxation play in redistribution? To what extent and in what ways should taxes be used to regulate and shape economic and political decisions? None of these questions are simple or easy. That said, perhaps the following examples may provide some hints about possible ways to improve the process—and perhaps even the product—of tax policy:

- First, with respect to the many difficult and important issues in international taxation to which so much attention has been paid in recent years, we should continue to follow closely what other countries are doing, to analyze why they are doing it, and to work out what, if anything, their way of doing things means for us, as well as what lessons, good and bad, we may learn from their

10 Daniel Kahneman, *Thinking, Fast and Slow* (New York: Farrar, Straus and Giroux, 2011).

11 For an articulate assault on all of these “non-enlightened” approaches, see Steven Pinker, *Enlightenment Now: The Case for Reason, Science, Humanism, and Progress* (New York: Viking, 2018).

12 Colin Campbell and Robert Raizenne, “The 1917 Income War Tax Act: Origins and Enactment,” in Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds., *Income Tax at 100 Years* (Toronto: Canadian Tax Foundation, 2017), 2:2-96.

experiences. Canada is a relatively small frog in the international pond, and small frogs, if they are to act with sufficient speed and efficacy to survive, need to watch closely both the actions of the bigger players in the pond and the changes in the environment.¹³ Playing an active role in every relevant international forum is not a frivolous extravagance but an essential component of good tax policy in an interdependent world.

- Second, close attention must be paid to ensuring that both federal and provincial governments have sufficient freedom to differ from each other while continuing to maintain a largely integrated system in the context of the world at large. As mentioned above, Canada has not done too bad a job of this up to now.¹⁴ Both levels of government, however, could usefully spend more time talking to each other and thinking about these issues. For example, most provinces need to build up their tax policy capacity, and the federal government needs to pay more attention to the provincial perspective on tax issues. As with international issues, talking to the provinces is not a distraction from the real work of federal tax policy makers but an essential component of good policy formulation in Canada.
- Finally, from both a short- and a long-term perspective, it is important to consider tax policy and tax administration together. Digitization, for example, has potentially deep implications, for good or ill, with respect to the organization and effectiveness of tax administration, the effective taxation of different tax bases, the extent to which taxes are “personalized” and redistributive, and the relationships between citizens and the state.¹⁵

13 For further discussion, see Richard Bird, “Reforming International Taxation: Is the Process the Real Product?” (2016) 216:2 *Hacienda Pública Española/Review of Public Economics* 159-80; the analogy of the small frog comes from Peter J. Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca, NY: Cornell University Press, 1985).

14 For a comparative perspective, see Richard M. Bird, “Fiscal Decentralisation and Decentralising Tax Administration: Different Questions, Different Answers,” in Alice Valdesalici and Francesco Palermo, eds., *Comparing Fiscal Federalism*, Study in Territorial and Cultural Diversity Governance, vol. 10 (Leiden, The Netherlands: Brill, 2018), 190-219. For Canada, the income tax is discussed in Richard M. Bird and François Vaillancourt, “Changing with the Times: Success, Failure and Inertia in Canadian Federal Arrangements, 1945-2002,” in Jessica S. Wallack and T.N. Srinivasan, eds., *Federalism and Economic Reform: International Perspectives* (Cambridge, UK: Cambridge University Press, 2006), 189-248; and the sales tax is discussed in Richard M. Bird, “The GST/HST: Creating an Integrated Sales Tax in a Federal Country,” in Jack M. Mintz and Stephen R. Richardson, eds., *After Twenty Years: The Future of the Goods and Services Tax* (Toronto and Calgary: Canadian Tax Foundation and University of Calgary, School of Public Policy, 2014), 1-50.

15 For further discussion of the critical importance of administration, see Richard M. Bird and Eric M. Zolt, “Technology and Taxation in Developing Countries: From Hand to Mouse” (2008) 61:4 *National Tax Journal* 791-821 (<http://dx.doi.org/10.17310/ntj.2008.4S.02>); and Richard M. Bird, “Improving Tax Administration in Developing Countries” (2015) 1:1 *Journal of Tax Administration* 23-45.

TAXATION AS A PILLAR OF THE STATE

Taxes build states, but they can also be used to build society and, in particular, to help cement “embeddedness”: strong, supportive relations binding states and businesses, allowing them to negotiate and bargain over policies and strategies.

Deborah Brautigam¹⁶

Economics has made significant contributions to tax design.¹⁷ Good economics is an essential ingredient of good tax policy, but economics alone is not enough.¹⁸ Tax economists properly focus on the impact of tax changes on economic decisions; they do so both because that is their field of expertise and because it is what policy makers usually want and expect them to do. But taxes are more important than their economic effects. It is partly because taxation plays a critical role in enabling and sustaining the very political institutions through which it is implemented that efficiency is not the only criterion that must be used in appraising tax policy. To reimagine how to structure taxes in an uncertain future, one must cast the net more widely.

16 Deborah Brautigam, Odd-Helge Fjeldstad, and Mick Moore, eds., *Taxation and State-Building in Developing Countries: Capacity and Consent* (Cambridge, UK: Cambridge University Press, 2008), at 30.

17 As is shown by Robin Boadway, in *From Optimal Tax Theory to Tax Policy: Retrospective and Prospective Views* (Cambridge, MA: MIT Press, 2012), and as is illustrated at length by James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, in *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011).

18 The key role of economists with respect to taxation is, as Harberger once said, to bear the proud banner of efficiency, which is an objective that no one else in the tax game is usually pursuing. See Arnold C. Harberger, “Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay” (1971) 9:3 *Journal of Economic Literature* 785-97. As this section and the next section of this paper suggest, however, other aspects of taxation are also important. The emphasis, in this section’s epigraph, on the extent to which a successful tax system requires business and governments to work together is not pursued further here; however, Durst’s recent study of multinational taxation in developing countries similarly stresses that the key issues can be resolved only if corporations and governments are willing to work together. See Michael C. Durst, *Taxing Multinational Business in Lower-Income Countries: Economics, Politics and Social Responsibility* (Brighton: UK: International Centre for Taxation and Development, Institute of Development Studies, 2019). As argued elsewhere, however, it is hard to imagine an effectively global tax policy in the near future in the absence of some kind of global state (and society) (Richard M. Bird, “Are Global Taxes Feasible?” (2018) 25:5 *International Tax and Public Finance* 1372-1400). Still, as Bird (supra note 13), and Richard Bird and Jack Mintz (“Sharing the Wealth: Article 82 of UNCLOS—The First Global Tax?” paper presented at the Conference on International Tax Cooperation: The Challenges and Opportunities of Multilateralism, Oxford University Centre for Business Taxation, Oxford, United Kingdom, December 10-11, 2018) suggest in different contexts, perhaps we may be beginning to move, to a limited extent, in this direction.

Aristotle once remarked that one can know a thing completely only when one knows its causes and first principles.¹⁹ Few seem likely to reach this high standard with respect to knowledge of anything; however, to think usefully about the future of tax, we must indeed know at least something of its past (that is, know something of why we have the system that we do) as well as what we want taxes to do and why. In recent years, many studies have considered the critical role that taxes have played in developing effective governance around the world.²⁰ Some authors have emphasized the power of taxation to destroy: Rabushka goes so far as to assert that “the origins of recorded history were inextricably linked to oppressive taxation” and that “civilization tends to self-destruct from excessive taxation.”²¹ Others have been more positive, stressing the extent to which taxes (taxes of the right kind, at the right time) have been essential to building rather than destroying countries. Steinmo has recently argued, for example, that modern democracies exist and thrive in large part because their citizens have (so far) proven to be largely willing to pay taxes.²² As he puts it, “Jean Baptiste Colbert once famously argued: ‘the art of taxation consists in so plucking the goose as to obtain the maximum amount of feathers with the smallest possible amount of hissing.’ In the most successful societies, the geese pluck themselves.”²³

Why have so many people been apparently willing to make the huge “leap of faith” required to give governments control over so much of the people’s income and wealth? Steinmo’s answer is that they have been willing to do so for essentially two reasons: first, people believe that they will get something in return, and, second, they think that the burden is shared fairly with their fellow citizens. These two tenets

19 As cited by Hanneke du Preez and Madeleine Stiglingh, “Confirming the Fundamental Principles of Taxation Using Qualitative Analysis” (2018) 16:1 *eJournal of Tax Research* 139-74.

20 On Canada, for example, we have recent, thorough historical studies by E.A. Heaman, *Tax, Order, and Good Government: A New Political History of Canada, 1867-1917* (Montreal and Kingston, ON: McGill-Queen’s University Press, 2017); and Shirley Tillotson, *Give and Take: The Citizen-Taxpayer and the Rise of Canadian Democracy* (Vancouver: UBC Press, 2017).

21 See Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization*, 2d ed. (Landham, MD: Madison Books, 2001), at xiii and xiv. The Adams book is replete with examples—from ancient Egypt to the United States in the 1990s—of poor tax policies and their undesirable outcomes. In a later and impressively exhaustive study of taxation in colonial America, Rabushka concludes that the very existence of the United States is largely the result of bad taxes: “The American Revolution . . . was a tax revolt, first and foremost.” See Alvin Rabushka, *Taxation in Colonial America* (Princeton, NJ: Princeton University Press, 2008), at 868. These books overstate the case, but there is much to be learned from them.

22 Sven H. Steinmo, ed., *The Leap of Faith: The Fiscal Foundations of Successful Government in Europe and America* (Oxford, UK: Oxford University Press, 2018) (<http://dx.doi.org/10.1093/oso/9780198796817.001.0001>).

23 *Ibid.*, at 4.

are also central to what is sometimes called the “fiscal contract” between citizens and the state—the agreement that underlies democracy.²⁴

Building a strong and sustainable tax system is not a simple or short process. It requires the establishment of sufficient capacity to administer taxes in a way that most people consider fair, and it requires the delivery of public services that most people value and consider worth the price.²⁵ Many studies have explored whether and how developing countries might be able to emulate—and, ideally, to shorten and make less painful—this key component of state building.²⁶ Little success has been achieved to date: the building of state capacity and the development of the kinds of social norms that underlie Steinmo’s “leap of faith” are not the work of a few years or tasks that can be imposed or imported from outside. Creating and sustaining an effective and sustainable governance structure for the heterogeneous societies that are found within most national boundaries is far more difficult than designing an optimal tax system or simply emulating someone’s idea of “best practice”—an idea that, all too often, is based on experiences in very different places.²⁷

Taxes may be “the price we pay for civilization,”²⁸ but developing and maintaining the underlying fiscal contract between state and citizens is always and everywhere a work in progress. What do people understand by “fair” taxes? How do governments enforce such taxes effectively? What services do people value, and

-
- 24 See, on the matter of fiscal contracting, Jeffrey F. Timmons, “The Fiscal Contract: States, Taxes, and Public Services” (2005) 57:4 *World Politics* 530-67; and Richard M. Bird and Eric M. Zolt, “Taxation and Inequality in Canada and the United States” (2015) 52: 2 *Osgoode Hall Law Journal* 401-27. Many studies have found that both propositions are also important in explaining tax compliance: for a recent review, see James Alm, “What Motivates Tax Compliance?” (2019) 33:2 *Journal of Economic Surveys* 353-88 (<https://doi.org/10.1111/joes.12272>).
- 25 For example, see Niall Ferguson, *The Cash Nexus: Money and Power in the Modern World 1700-2000* (New York: Basic Books, 2001). On the United Kingdom, see John Brewer, *The Sinews of Power: War, Money and the English State, 1688-1783* (Cambridge, MA: Harvard University Press, 1990); and for a brief overview of the role of taxation in political and economic development, see Philip T. Hoffman, “What Do States Do? Politics and Economic History” (2015) 75:2 *Journal of Economic History* 303-32 (<https://doi.org/10.1017/S0022050715000637>).
- 26 For a good introduction to the subject, see Brautigam, Fjeldstad, and Moore, *supra* note 16. For two good country studies, see Marcelo Bergman, *Tax Evasion and Rule of Law in Latin America: The Political Culture of Cheating and Compliance in Argentina and Chile* (Philadelphia: University of Pennsylvania Press, 2009); and Wilson Prichard, *Taxation, Responsiveness and Accountability in Sub-Saharan Africa: The Dynamics of Tax Bargaining* (Cambridge, UK: Cambridge University Press, 2015).
- 27 Richard M. Bird, “Foreign Advice and Tax Policy in Developing Countries,” in Richard M. Bird and Jorge Martinez-Vazquez, eds., *Taxation and Development: The Weakest Link? Essays in Honor of Roy Bahl* (Cheltenham, UK: Edward Elgar, 2014), 103-44.
- 28 Inscription on Internal Revenue Service building in Washington, and US Supreme Court Justice Oliver Wendell Holmes’s famous remark. See *Campania General de Tabacos v. Collector*, 275 US 87, at 100 (1927).

how much are they willing to pay for them, especially when they do not themselves directly benefit from these services? Our only way of dealing with such complex and difficult questions is through cumbersome political processes, which are often encrusted with the remnants of past ages, respond (almost always) only slowly to changing conditions, and seldom work to the satisfaction of all citizens.

Viewed from a historical and worldwide perspective, Canada seems to be a “lucky country” (as Australia, too, has sometimes been characterized) that has had a relatively short and easy passage through these turbulent waters. Viewed from inside, however—although Canada has thus far been spared the recent political upheavals of some other high-income democracies, where citizens unhappy with their governments (and, often, with their tax systems) have taken to the streets and polls to express their discontent—many of our citizens seem (as they have always been)²⁹ to be rather unhappy. The ship of state, powered by a fairly robust tax system, continues to sail on into the uncharted waters of the future. But what if it hits one of the hidden reefs described above, or if citizen support falters?

Bergman and Steinmo have recently suggested three guidelines for maintaining a sustainable tax system in turbulent times:

1. Taxes must be seen to produce services—infrastructure, education, health, and security—that people at all levels perceive to be beneficial to the health of the society in which they live, if not to them personally.
2. Everyone, including the poorest (but, of course, especially the rich), must be seen to pay something, and the system must be perceived to be acceptably progressive. For most people, however, acceptability in this sense seems to require not the achievement of a particular standard in terms of the Gini coefficient, but the satisfaction of a more nebulous standard that Sheffrin calls “folk justice.”³⁰
3. What matters, finally, is not only who pays how much in tax but also how the system operates. As Adam Smith told us centuries ago, taxes should be as simple and certain as possible, and, as recent experience has underlined, they should also be visibly, fairly, and strictly enforced across borders as well as domestically, which implies that only taxes that can be properly enforced should be imposed.³¹

29 See the many taxpayer complaints over the years reported in Heaman, *supra* note 20, and in Tillotson, *supra* note 20.

30 Steven M. Sheffrin, *Tax Fairness and Folk Justice* (Cambridge, UK: Cambridge University Press, 2013), at x (<https://doi.org/10.1017/CBO9781139026918>), defines “folk justice” as how most people understand “tax fairness”—that is, “receiving benefits commensurate with the taxes one pays, being treated with basic respect by the law and the tax authorities, and respecting legitimate efforts to earn income.” He goes on to note, *ibid.*, that “the average person is not totally indifferent to inequality, but concerns for redistribution are moderated by the extent to which income and wealth are perceived to be earned through honest effort.”

31 Marcelo Bergman and Sven Steinmo, “Taxation and Consent: Implications for Developing Nations,” in *The Leap of Faith*, *supra* note 22, 273-92.

There is nothing new or startling in any of these propositions, although few commentators appear to have sufficiently stressed (1) the critical importance, in democracies, of good spending as the foundation of a good tax system;³² (2) the importance of perceived fairness in ensuring the acceptability of taxes; or (3) the central role of good tax administration not only in determining how taxes work but also in shaping how people perceive the tax system. Of course, even those who have chosen, perhaps wisely, not to venture into the murky waters of political economy recognize that taxes do not simply raise revenue. Taxes also redistribute income and wealth, and, by altering the incentives facing economic actors, they shape the rate and pattern of growth. Moreover, an acceptable and sustainable tax system is an essential foundation of democracy.

THE INCOME TAX AS A SYMBOL

A tax system is not simply a device for redistributing goods and services with the least social pain. It is also a system in which individuals express their values. Tax reforms that reflect these values are more likely to endure.

Steven Sheffrin³³

Not all taxes are equally important in creating and sustaining a viable state. In Canada, the most important tax has for many years been the income tax, in particular the personal income tax, the postwar rise of which has largely financed the marked expansion of social expenditure.³⁴ Because the income tax is an important and many-faceted instrument of public policy, it is not surprising that income tax reforms often give rise to heated and prolonged public discussions. This occurs for two quite different reasons, however. The first and most obvious reason is simply that income tax changes usually affect different groups in different ways, benefiting some and penalizing others. Those who lose—or think that they may lose—almost always protest loudly, and they are often heard. The second reason is that income tax reform, perhaps more than any other kind of reform, is seen by many to symbolize the political stance of the government in power.³⁵ Tax reforms are not simply instrumental.

32 A conspicuous and important exception is Richard A. Musgrave, “Combining and Separating Fiscal Choices: Wicksell’s Model at Its Centennial,” in *Public Finance in a Democratic Society*, vol. 3, *The Foundations of Taxation and Expenditure* (Cheltenham, UK: Edward Elgar, 2010), 81–103.

33 Sheffrin, *supra* note 30, at 255.

34 In Canada’s first 50 years, the important taxes, as Heaman, *supra* note 20, discusses, were customs duties and a few excise taxes, as well as local property taxes. For the next 50 years, the big story, as Tillotson, *supra* note 20, shows, was the introduction and expansion of the income tax. Despite the fuss occasioned by the introduction of the GST in the early 1990s (Bird, *supra* note 27), personal income taxation has remained the mainstay of Canadian public finances since the Second World War (Kevin Milligan, “Data on Government Revenue in Canada: Sources and Trends,” *Finances of the Nation* feature (2017) 65:3 *Canadian Tax Journal* 693–709).

35 For a good early overview of policies as symbols (though without reference to taxes), see Murray Edelman, *The Symbolic Uses of Politics* (Urbana, IL: University of Illinois Press, 1974).

They are also expressive and may carry meanings, intended or not, for particular segments of the public. For instance, some people may see the reduction of the top rate of the income tax as a sensible, even necessary measure to encourage investment, innovation, and growth, but others may see it as a signal that the government in power is catering to the rich and neglecting the rest of the population.

The relative importance of income taxation has often been seen as a good indicator of the political environment. The share of total taxes coming from income tax is a common proxy for the progressivity of taxes or of the fiscal system (or even of public policy as a whole). One classic history of public finance, for example, labelled the income tax “a mirror for democracy,”³⁶ noting that for the United States, this mirror (a moderately progressive tax, with major exceptions) appeared to be a relatively accurate reflection of the balance of popular sentiment, which, in the authors’ view, favoured the fair sharing of the tax burden in the form of moderately progressive rates, provided that many people, often those in the middle range of the income distribution, were relieved from some of the burden (for example, through concessions to homeowners). Such a tax, with all of its inherent complexities and contradictions, was, the authors argued, a necessary compromise for a responsible and responsive democracy, delicately balancing the state’s need for revenue with the fact that most people wanted to pay less.

People complain about the income tax all the time, but they accept it. Why? One important reason—reminiscent of Churchill’s famous remark about democracy being “the worst form of Government except for all those other forms”³⁷—is that the income tax law, in which each provision is almost always considered separately and debated, for the most part, by those most affected by it, may in the end be seen “as the refined product of public preferences tested and retested at the margin.”³⁸ Tax reformers whose major concern is to increase the effective progressivity of the income tax face a major obstacle: many of the provisions to which these reformers most object are valued not just by a few rich individuals but also by important segments of society. People may be happy to see tax increases on the few at the top of the income heap, but few of these people welcome increases in their own tax burden. Similarly, although the corporate income tax may no longer be a very effective backstop for the personal income tax in technical terms,³⁹ it will likely remain—so long as most people see it as taxing rich owners rather than workers or consumers—

36 Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986), at 552.

37 See Richard M. Langworth, ed., *Churchill by Himself: Definitive Collections of Quotations* (New York: Public Affairs, 2008), at 574.

38 Webber and Wildavsky, *supra* note 36, at 552; on the context and meaning of Churchill’s remark, see Peter H. Lindert, “Voice and Growth: Was Churchill Right?” (2003) 63:2 *Journal of Economic History* 315–50 (<https://doi.org/10.1017/S0022050703001815>).

39 Robin Boadway, “Rationalizing the Canadian Income Tax System,” paper presented at Re-Imagining Tax for the 21st Century, *supra* note 9.

a necessary political backstop not just for the income tax but also for the tax system in general.

TAXATION AS AN INSTRUMENT OF POLICY

As Avi-Yonah has noted, the “three Rs” of the conventional approach to taxation—revenue, redistribution, and regulation—mesh surprisingly neatly with the three major taxes in most countries: the value-added tax (VAT) for revenue, the personal income tax (PIT) for redistribution, and the corporate income tax (CIT) for regulation.⁴⁰ This categorization could easily be expanded by, for instance, adding excises as regulatory taxes, payroll taxes as revenue taxes, and, more arguably, property taxes as redistributive taxes. Each tax could also be characterized in terms of how it relates to such presumably desirable social norms as certainty, simplicity, and linkage to benefits, with the weight assigned to different goals doubtless varying for different groups and at different times, as ideas, interests, and circumstances change.⁴¹

Regardless of decision makers’ intentions, however, policies often affect objectives other than the ones being targeted. For example, a reduction in corporate tax rates, even if well designed and likely to have a positive impact on investment and growth, may not be acceptable in the face of the importance that taxpayers may attach to this tax rate as a symbol that even the rich and powerful are being taxed.⁴² As Hirschman long ago emphasized, there are no such things as “side effects” (or collateral damage) when it comes to policy outcomes: there are only consequences, all of which need, ideally, to be taken into account before a decision is made.⁴³

Of course, one can no more think through every possible consequence when deciding tax policy than one can when deciding to cross the street: trying to do so would mean never reaching a decision or getting to the other side. The point, however, is that because taxation is always political, it is always important to recognize the potential for not only political but also economic consequences of particular decisions.⁴⁴ Given the importance that people attach to tax fairness, and given the

40 Reuven S. Avi-Yonah, “The Three Goals of Taxation” (2006) 60:1 *Tax Law Review* 1-28.

41 Of course, policy objectives may be achieved not only by taxes but also by other instruments such as direct expenditures, transfers, and regulation, as well as by such macroeconomic factors as exchange and interest rates. Although this topic is not discussed further here, for discussion of the relative merits of and connections between different governing instruments, see, for example, Michael J. Trebilcock, Douglas G. Hartle, J. Robert S. Prichard, and Donald N. Dewees, *The Choice of Governing Instrument*, a study prepared for the Economic Council of Canada (Ottawa: Supply and Services, 1982); and Stephen H. Linder and B. Guy Peters, “Instruments of Government: Perceptions and Contexts” (1989) 9:1 *Journal of Public Policy* 35-58 (<https://doi.org/10.1017/S0143814X00007960>).

42 Geoffrey Hale, *The Politics of Taxation in Canada* (Peterborough, ON: Broadview Press, 2002).

43 Albert O. Hirschman, *Development Projects Observed* (Washington DC: Brookings Institution, 1967).

44 Walter Hettich and Stanley L. Winer, *Democratic Choice and Taxation: A Theoretical and Empirical Analysis* (Cambridge, UK: Cambridge University Press, 1999) remains perhaps the best analytical introduction to this subject.

current interest of many in making taxation more equitable, an appropriate way to conclude this brief overview of the possible future role of the income tax is to consider how past developments suggest what Canadians think about redistribution through the fiscal system and, in particular, through the income tax.

Revenue needs are often the immediate drivers of government tax decisions.⁴⁵ For most people, however, the main tax question is simply: Who pays? Although it is usually technically difficult to be definitive about the distributive effect of any proposed tax change, people are invariably sensitive to what they perceive to be its distributional effects on themselves, and they seldom hesitate to make strong (and often unwarranted) assumptions about who pays. Some think that consumption taxes and user charges invariably and unfairly target the poor. Others think that increases in income taxes inevitably make everybody poorer by discouraging savings, investment, and growth. The evidence provides little support for either of these extreme views, but many who are prominent in the public discussion of fiscal matters often ignore the evidence, rely heavily on prior beliefs and (often atypical) examples to support their cases, and focus on the presumed impact of particular changes on this or that margin of interest to them. To overcome the clamour of the frequently self-interested and unfounded claims that often dominate public forums, those who propose tax changes need to provide consistent and comprehensible answers to the questions raised in such discussions. Advocates of tax reform should also, of course, try to shift the focus to the more relevant question of what impact the policies as a whole will have on social policy objectives. Both of these tasks are difficult, time-consuming, and often frustrating, and they require considerable and persistent efforts from those advocating tax reform.

The importance of distributional concerns has recently been underlined by the growing evidence of international tax avoidance and evasion and by the noticeable growth of inequality in many countries, including Canada. Many believe, with some reason, not only that many large multinational firms are not paying their “fair share” but also that the rich in general are getting off much too lightly. These concerns pose two problems for tax policy: How should cross-border transactions be taxed? How progressive should domestic taxes be? Tax experts everywhere have been working to find better answers to the first of these questions, although, as yet, they have had only limited success. Milligan and others have addressed the issue of progressivity, but the basic question is: What do people want their government to do with respect to redistributing income?⁴⁶

45 Matthew Lesch, for example, in “Playing with Fiscal Fire: The Politics of Consumption Tax Reform” (PhD dissertation, University of Toronto, Department of Political Science, 2018), interprets British Columbia’s brief and disastrous recent venture with the HST as essentially an ill-considered attempt to deal with a budget shortfall, with little advance planning and no real attempt to sell the public on the desirability of the change, in contrast to Ontario’s much better planned, better marketed, and, of course, successful move to the HST.

46 Kevin Milligan, “The Future of the Progressive Personal Income Tax: How High Can It Go?” paper presented at Re-Imagining Tax for the 21st Century, *supra* note 9. Redistributing wealth is

Canada, like most countries, redistributes mainly through expenditures, not taxes. It is thus not surprising that some people seem to think that the best way to deal with distributional issues is simply to increase taxes and spend them on good things such as education and health. In the postwar era, for example, the substantial increase in such spending clearly made the lives of many—notably the old—much better, so perhaps it is natural that many see more of the same as the best course. Unfortunately, considerable evidence suggests that simply pouring more money into existing programs seldom results in more and better public services.⁴⁷ Some money inevitably flows into the elaboration of ever more complex administrative structures or simply increases the incomes of service providers.

Even in the 1980s, it was difficult to see how the tax increases then facing the mythical average taxpayer were matched by any visible gain in the benefits received from public sector activities.⁴⁸ Nonetheless, in real (constant dollar) terms, for every dollar paid in 1985 individual income tax, taxpayers arguably received about \$1.15 in benefits through government expenditures on health and education. By the mid-1990s, however, this figure had fallen to \$1.06,⁴⁹ and by 2017, the (roughly) equivalent figure was only about \$0.98.⁵⁰ The first pillar underlying the “leap of faith” that is required (as discussed earlier) to maintain a sustainable tax system in a democracy—namely, the sense of linkage between what people pay (or believe they pay) and what they get (or believe they get)—has, it seems, become noticeably weaker in recent decades.

not discussed here, although, of course, it is closely related to the key issues with respect to taxing capital income that Boadway, *supra* note 39, and others have discussed in detail.

- 47 For a clear discussion of this point with respect to health care in Canada, see A.J. Culyer, *Health Care Expenditures in Canada: Myth and Reality; Past and Future*, Canadian Tax Paper no. 82 (Toronto: Canadian Tax Foundation, 1988). An international overview of the evidence may be found in Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: A Global Perspective* (Cambridge, UK: Cambridge University Press, 2000).
- 48 Richard M. Bird, “Closing the Scissors, or The Real Public Sector Has Two Sides” (1982) 35:4 *National Tax Journal* 477–81.
- 49 Richard M. Bird, “Taxation and Social Policy,” in D.A. Albregtse, A.L. Bovenberg, and L.G.M. Stevens, eds., *Er Zal Gebeven Worden! Liber amicorum S. Cnossen* (Deventer: Kluwer BV, 2001), 43–54.
- 50 Owing to substantial changes in government accounting over time, the equivalence of the figures shown for different years is at best approximate. The (crude) basic methodology and the argument underlying this comparison, which is based in part on Kuznets (see Simon Kuznets, “Quantitative Aspects of the Economic Growth of Nations: VII. The Share and Structures of Consumption” (1962) 10:2, part 2 *Economic Development and Cultural Change* 1–92 (<https://doi.org/10.1086/449958>), is set out in Bird, *supra* note 48. The basic assumption is that “visible” tax burden may be approximated by per capita personal income taxes (measured in terms of the amount of real personal consumption that could be purchased by this amount), and that the offsetting “visible” benefits can be estimated by the real (per capita) value of government expenditure on health and education. When, as has usually been the case, the implicit price deflator of government final consumption increases more rapidly than the

The second pillar underlying that leap of faith is the belief that the taxes are imposed fairly, even if not every dollar collected is spent in ways that citizens can clearly perceive as benefiting them (either personally or as members of a desirable society). Unfortunately, this pillar, too, seems to have become weaker, in part because it is the rich—the group that has visibly gained the most from growth in recent decades—who have benefited most from the government's increasingly public failure to capture cross-border transactions adequately within the tax net.

Many have suggested that an obvious way to overcome this problem and to shore up the foundations of fiscal civilization is simply to increase tax rates on higher-income people. Some progressivity—most visibly through personal income tax rates—does indeed seem to be an essential component of any tax system that is considered “fair” in a democratic country.⁵¹ Those who have more should clearly contribute more to financing government activities. Many people may also agree that a high-income country like Canada should provide at least a minimum level of support to those with incomes below a certain level, as well as a decent opportunity to access such public services as health and education. But neither of these objectives requires either a highly progressive income tax or a more vigorous targeting of public services to favour the less fortunate. The major redistributive spending programs that we have—pensions, health care, and employment insurance—are essentially intended more to insure the not-so-poor against foreseeable risks than to alleviate poverty as such. As incomes have risen, we as a society have in effect chosen to purchase more social insurance, in part to offset the marked loosening of family and community ties that have accompanied growth.⁵² Health care, education, employment, and retirement are all matters of direct and personal interest to almost

deflator for all final consumption, the perceived tradeoff worsens even if nominal taxes and expenditures are constant. The 2017 estimate is based on population data from Statistics Canada, table 17-10-0009-01 (formerly CANSIM table 051-0005), “Population Estimates, Quarterly”; on individual income tax data from Statistics Canada, table 10-10-0147-01 (formerly CANSIM table 385-0042), “Canadian Government Finance Statistics (CGFS), Statement of Operations and Balance Sheet for Consolidated Governments (x 1,000,000)”; on government expenditure data from Statistics Canada, table 36-10-10127-01 (formerly CANSIM table 380-0088, “General Governments Final Consumption Expenditure, Canada, Quarterly (x 1,000,000)”; and on implicit price indexes for final consumption (to deflate income taxes) and final government consumption (to deflate health and education expenditures) from Statistics Canada, table 36-10-0223-01 (formerly CANSIM table 384-0039), “Implicit Price Indexes, Gross Domestic Product, Provincial and Territorial.”

51 Richard M. Bird and Eric M. Zolt “Fiscal Contracting in Latin America” (2015) 67 *World Development* 323-35 (<https://doi.org/10.1016/j.worlddev.2014.10.011>).

52 This is an argument made clearly by, for example, John Burbidge, *Social Security in Canada: An Economic Appraisal*, Canadian Tax Paper no. 79 (Toronto: Canadian Tax Foundation, 1987). The weak link between tax progressivity and fiscal redistribution in most countries is explored in depth in works such as Junko Kato, *Regressive Taxation and the Welfare State: Path Dependence and Policy Diffusion* (Cambridge, UK: Cambridge University Press, 2003); and Peter H. Lindert, *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century*, vol. I, *The Story* (Cambridge UK: Cambridge University Press, 2004).

everyone, and some public underpinning of these programs is probably desired by all except (perhaps) the richest. Everyone fears becoming ill, losing a job, lacking adequate qualifications for employment, and having to look after the elderly (including themselves). It is not surprising that redistribution—from the well to the sick, from the employed to the unemployed, and from workers to retirees—dominates social spending and hence accounts for most of the tax burden. These major social outlays are easily understood by and justified to taxpayers as insurance from which they and their immediate families may potentially benefit.

For much the same reason, targeting subsidies more explicitly to the poorest, as many have urged, may sometimes weaken rather than strengthen public support for redistribution. For a public policy to come into being and survive, it must be supported by a sufficiently broad coalition, and it is far from clear that substantially increased redistribution from the middle strata of taxpayers to the poor has sufficient support to be sustainable over time. Canada, for example, has been much more reluctant than most European countries to introduce any kind of a two-tier health-care system. One rationale for this reluctance may be the belief, by some, that allowing better-off consumers (and more providers) to opt out of a single-tier system may lead not only to a decline in service quality but also to a weakening of the support for the public health system that now exists among the majority of Canadians. Indeed, in the worst case, permitting (let alone requiring) the better-off to opt out of the public system may weaken the social contract holding the country together.⁵³

Tax changes are often driven largely by spending decisions, and spending decisions in recent decades have been driven largely by social policy. But social policy includes both social insurance and social assistance (welfare), and many people view these two very differently. The dominant goal of social spending (and hence tax increases) in Canada has been to provide public services that most people consider worthwhile—health, education, and support for the elderly. To maintain broad popular support, most such policies are not narrowly targeted to the poor, and, indeed, additional subsidization for some private outlays for related purposes is often provided through the tax system. In contrast, social assistance intended to directly benefit the poorest and most needy appears to be viewed by many not as something directly related to them but, in effect, as conscience-salving “public charity.”

53 An even more worrying development, though not one further discussed here, is the striking movement in recent years of many better-off families out of the public education system, especially in major metropolitan areas. This trend may not only reduce support for public education—and for the taxes that support it—but also lower the quality of this education by removing some of the more articulate parents from the mix. It may also lead to an undesirable growth in class division: those who have not mixed as children with people much different from themselves may as adults know—or even care—little about how the “other half” lives. (For recent empirical support of this proposition—though in a very different context (India)—see Gautam Rao, “Familiarity Does Not Breed Contempt: Generosity, Discrimination, and Diversity in Delhi Schools” (2019) 109:3 *American Economic Review* 774–809 (<https://doi.org/10.1257/aer.20180044>). This is not the way to build a sustainable democracy.

Whether one finds this perception morally acceptable or not, such policies seem generally to be most strongly supported when, like the Elizabethan Poor Law of 1601, they are considered to be both narrowly targeted to the “deserving poor” and strictly enforced to exclude others.⁵⁴

Most people seem to support increased progressivity when it means additional taxation of the rich, provided that these people are not persuaded—correctly or not—that one result of such taxation may be reduced employment opportunities or reduced income growth. But few are eager to increase progressivity in the middle-income range, especially if they think that the additional revenues will flow to people with whom they do not easily identify. Tax policy is difficult, but social policy is more difficult, and the interaction between the two needs to be taken more explicitly into account in formulating policy, because the most critical problem is usually how to sell tax changes to a seldom sympathetic audience. Redistribution may be what taxes are, in a sense, all about. But redistribution, like taxation itself, is a many-faceted and complex subject with important economic, political, and social dimensions, all of which need to be factored—somehow—into good tax policy.

WHAT DOES ALL OF THIS MEAN FOR THE FUTURE OF THE INCOME TAX?

Much of the current discussion of tax policy is focused on the international dimension. The “big boys” have long set the rules in international taxation, and they are likely to continue to do so.⁵⁵ Perhaps the best strategy, from a Canadian perspective, is simply to watch closely what is going on and to build up the agility and skill needed to respond quickly and flexibly enough to survive in the changing and uncertain international environment.

Ultimately, Canada is the master of its own tax fate. Unless some “unknown unknown” forces a drastic change in the level of government activity, changes in taxation seem more likely to affect the mix of taxes than the level of taxation. From a purely economic perspective, a good case can be made for securing more revenue from property and consumption taxes than from income tax. However, no one seems keen on increasing property taxes, and, given the history of the goods and services tax/harmonized sales tax (GST/HST), it seems unlikely that much more revenue will be obtained from this source in the absence of a major fiscal crisis. One

54 As Reuben Hasson, “Tax Evasion and Social Security Abuse—Some Tentative Observations” (1980) 2:2 *Canadian Taxation: A Journal of Tax Policy* 96-108, noted long ago, Canada has often taken quicker and stronger action to deal with abuses of social spending programs than it has to deal even with “abusive” tax evasion. One reason, perhaps, is that it is easier to generate public support for actions against people known to have “stolen” public funds than it is to generate support for penalties against the more indirect theft by people (with whom voters can often identify) who hide income from the taxman. Another reason may be simply that few recipients of social assistance can hire lawyers and accountants to argue their case.

55 Richard M. Bird, “A View from the North” (1995) 49:4 *Tax Law Review* 745-57.

possible move would be to reduce the visible blow by emulating the rest of the world and moving away from separate quotation of the GST. Although this step would make governments even less accountable than they now are,⁵⁶ it might be a price worth paying in political terms if it made it possible to sustain our binding social policies. Other desirable reforms could of course be made in other taxes—excises, payroll taxes, and property taxes, for example—but the main tax story in Canada is likely to continue to be the personal income tax.⁵⁷

This tax is not only the most important tax but also the most salient when people think of taxation. This “mirror of democracy” provides, albeit “through a glass, darkly,” an interesting way to view the relationship between the state and the society that it is supposed to represent.⁵⁸ Recent concern about increases in inequality and about other, related developments has already led to some mild increases in personal income tax rates, and tax changes in the near future seem likely to continue to focus on this tax. Is making the personal income tax more explicitly progressive the best or most acceptable way to share the burden of financing government fairly? What about taxing capital income more heavily (and more evenly) or, perhaps, even (re-)imposing some form of wealth tax? Tightening tax enforcement? All the preceding, and more?

Is raising the top rate the best way to go? From a symbolical perspective, some may think so, even though the highest effective marginal rates often have an impact on those near the bottom of the rate scale, owing to the imperfect and differentiated way in which personal taxes and transfers are integrated. Giving more attention to cleaning up this mess at the bottom may provide a higher payoff, in terms of both efficiency and distribution, than simply increasing rates at the top, although this approach has little political appeal. Moreover, improving the linkages between the tax and transfer systems would require a degree of coordination and cooperation between federal and provincial governments that would be difficult to achieve. Still, this is the sort of issue on which we need to spend more time and effort, even if doing

56 Richard M. Bird, “Policy Forum: Visibility and Accountability—Is Tax-Inclusive Pricing a Good Thing?” (2010) 58:1 *Canadian Tax Journal* 63–76.

57 Possible reforms to the corporate income tax are discussed in Richard M. Bird and Thomas A. Wilson, “The Corporate Income Tax in Canada: Does Its Past Foretell Its Future?” in Bev Dahlby, ed., *Reforming the Corporate Tax in a Changing World* (Toronto: Canadian Tax Foundation, 2018), 1–43; for possible reforms to the GST, see Mintz and Richardson, *supra* note 14; and for possible reforms to the property tax, see Enid Slack and Richard M. Bird, *How To Reform the Property Tax: Lessons from Around the World*, University of Toronto, Munk School of Global Affairs, IMFG Papers on Municipal Finance and Governance no. 21 (Toronto: Institute on Municipal Finance and Governance, 2015).

58 The cited phrase comes from Webber and Wildavsky (*supra* note 36, at 526), who interpret the extent to which a country relied on visible income taxes as a symbol of the strength of the country’s egalitarianism and commitment to social justice. The previous section of this paper argues, in effect, that the second of these characteristics is more important in Canada than the first characteristic. But, as the second quotation above (from the King James Bible) suggests, this “mirror” can at best provide only a faint and perhaps distorted glimpse of reality.

so requires us to revisit the basic problem of how best to accommodate differing political realities within a relatively coherent national policy so that we can cope more adequately with the changing world. For this and many other reasons, those charged with income tax reform will no doubt continue for many decades to live in interesting times.

Rationalizing the Canadian Income Tax System

Robin Boadway*

PRÉCIS

Le régime fiscal canadien repose sur des principes tirés du rapport Carter, et ces principes ont été contestés car les circonstances ont changé et les idées sur ce que doit être la politique fiscale ont évolué. Le régime d'imposition des particuliers adhère seulement en principe à l'idéal global de l'impôt sur le revenu, et l'impôt des sociétés est conçu comme un complément à un régime fiscal global qui n'existe pas. Les responsables des politiques canadiennes font face aux défis sans précédent que sont 1) la mondialisation, 2) une économie qui repose de plus en plus sur les services et la technologie, et 3) l'augmentation des inégalités en matière de revenu, de richesse et de possibilités. Les propositions récentes de réforme fiscale énoncées dans l'examen de Mirrlees au Royaume-Uni présentent les principes modernes de la conception fiscale. D'autres pays membres de l'Organisation de coopération et de développement économiques ont entrepris d'importantes réformes fiscales. Au Canada, des innovations dans le domaine de la politique fiscale ont été mises en œuvre par étape, tels les régimes enregistrés d'épargne-retraite, les comptes d'épargne libre d'impôt, la taxe sur les produits et services/la taxe de vente harmonisée, et les crédits d'impôt remboursables, mais il n'y a pas eu de coordination dans leur mise en œuvre. La structure fiscale des sociétés a très peu changé. Cet article explore les options de réforme du régime fiscal canadien qui pourraient améliorer l'équité et l'efficacité.

ABSTRACT

The Canadian tax system is based on principles informed by the Carter report, and these principles have been challenged as circumstances have changed and ideas about tax policy have evolved. The personal tax system pays only lip service to the comprehensive income tax ideal, and the corporate tax is designed as a complement to a comprehensive tax system that does not exist. Canadian policy makers face the unprecedented challenges of (1) globalization, (2) an economy increasingly based on services and technology, and (3) growing inequality of income, wealth, and opportunity. Modern principles of tax design are reflected in recent tax reform proposals recommended by the Mirrlees review in the United Kingdom. Major tax reforms have been undertaken in other member countries of the Organisation for

* Of the Department of Economics, Queen's University, Kingston (boadwayr@econ.queensu.ca). This paper draws on the Hanson Lecture delivered at the University of Alberta in October 2018.

Economic Co-operation and Development. Some piecemeal innovations in tax policy have been implemented in Canada, such as registered retirement savings plans, tax-free savings accounts, the goods and services tax/harmonized sales tax, and refundable tax credits, but these measures have not been coordinated. The corporate tax structure has changed only modestly. This paper explores options for feasible reform of the Canadian tax system that might enhance equity and efficiency.

KEYWORDS: CANADIAN TAX SYSTEM ■ TAX REFORM ■ PERSONAL INCOME TAX ■ CORPORATE INCOME TAX

CONTENTS

Introduction	644
Anomalies and Inconsistencies in the Canadian Tax System	645
Incoherent Sheltering of Asset Income	645
Imperfect and Unnecessary Integration of Corporate and Personal Taxes	648
The Structure of the CIT Is Outdated	649
The PIT Rate Structure Is Inconsistent and Inequitable	651
The Exclusion of Inheritances from Taxation	653
Some Principles for a Modern Tax System	654
Individual Income Taxation	655
Corporation Income Taxation	657
Sales Taxation	660
Inheritance Taxation?	660
Implications for Reform of the Canadian Tax System	661
Summary	665

INTRODUCTION

The Canadian tax system has undergone many piecemeal reforms since the landmark Carter report.¹ Notable changes include the introduction of various devices for sheltering capital income; the replacement of the federal manufacturing sales tax and some provincial retail sales taxes with a harmonized value-added tax system (that is, the harmonized sales tax [HST]); the changing of most tax deductions to tax credits, and the introduction of some refundable tax credits; the devolving of revenue-raising authority to provincial governments and the instituting of income tax collection agreements; and the streamlining of tax administration through the creation of the Canada Revenue Agency (CRA).

Each of these reforms has improved some aspect of the tax system. But, given the piecemeal introduction of the changes, the consequences for the system as a whole have been less than coherent. Although the income tax system pays lip service to the Carter-inspired ideal of the comprehensive income tax base, it deviates from it in

1 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966-67) (herein referred to as "the Carter report").

significant ways. As the system as a whole moves from income- to consumption-based taxation, the corporate tax loses relevance as a backstop to the personal tax.

Moreover, circumstances have changed. The Canadian economy increasingly produces services rather than goods, and information- and knowledge-based industries have grown. Canada faces a more globalized setting, with capital and production becoming more mobile and domestic manufacturing industries increasingly facing challenges from emerging economies. Income and wealth inequality have increased as capital's share of national income has risen, and productivity has slowed. There has been growing recognition of the contribution of windfall gains (or rents) to inequality. At the same time, tax-transfer policies have become less effective at addressing market-driven inequality.

The principles and practices of tax policy have evolved, including views on the tax treatment of capital versus labour income and on the role of the tax-transfer system in mitigating inequality. This evolution has included a reassessment of the role of business taxation and its distortions. Complementary objectives of taxation have been emphasized in the process, including equality of opportunity and the addressing of behavioural anomalies. Much of the current thinking can be found in the Mirrlees review and its background studies.²

My purpose is to revisit the Canadian tax system with this background in mind, and to suggest some reforms that would improve the equity, efficiency, and coherence of the system. I begin by reviewing the inconsistencies in the existing system. I then summarize some tax reform suggestions that draw on current principles of public finance and best practices. Finally, I propose directions for reform that would address existing anomalies and shortcomings and that would be economically and administratively feasible.

ANOMALIES AND INCONSISTENCIES IN THE CANADIAN TAX SYSTEM

The current Canadian income and sales tax system has evolved through a series of discrete reforms. The consequence is a tax system that is sometimes incoherent and contradictory. In this section, I describe the ways in which irrational elements are embedded in the tax system. Of particular importance are the inconsistencies in the treatment of different forms of asset income, and this is where I begin the discussion.

Incoherent Sheltering of Asset Income

The income tax system—and the tax law that underlies it—is nominally based on the concept of “comprehensive income,” as espoused by the Carter report, and this

2 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) (herein referred to as “the Mirrlees review”).

concept is reflected in the benchmark system used to define tax expenditures.³ Gradually, as increasing amounts of capital income have been sheltered, the actual tax system has evolved toward a progressive consumption or expenditure tax system. The sheltering of capital income takes many forms, no two of which are identical. Four forms of sheltering can be identified.

First, the combination of income taxation, which includes capital income, with sales taxation, which is based on consumption, implicitly results in a lower tax on capital income relative to earnings. Consumption alone is subject to one of the goods and services tax (GST), the harmonized sales tax (HST), or the Quebec sales tax (QST), depending on the province of consumption, whereas income taxation applies to consumption plus saving (the sum of which equals income). Moreover, if we define “income” as including inheritances and gifts received, not even all income can be said to be included in the current income tax base (although bequests made are not deducted, either, and so, to the extent that such bequests are not regarded as consumption, consumption is overtaxed). Even if there were no explicit sheltering of capital income, the system would effectively tax capital income preferentially.

Through the second form of capital income sheltering, some assets are afforded registered or *tax-deferred* treatment. Such assets primarily include savings held in registered pension plan (RPP) or registered retirement savings plan (RRSP) accounts, both of which are intended to support savings for retirement. RPPs and RRSPs both have maximum contribution limits, but they differ in that RRSPs, unlike RPPs, allow full carryforward of unused deductions. The two differ in their limits, although the contribution limits of RRSPs depend on the size of the RPP contributions. RRSPs can be withdrawn at will and with no financial penalty; in that sense, they allow lifetime income averaging. RRSPs are based on defined contributions, whereas RPPs can be of the defined-benefit form. Compulsory contributory pension schemes such as the Canada or Quebec pension plans (CPP/QPP) also resemble tax-deferred savings vehicles. They are imperfect defined-benefit schemes, and contributions to them are not income-deductible. Thus, even within the tax-deferred category of assets, tax treatment of the two differs significantly. Note also that human capital investment is treated roughly as a tax-deferred asset. Much of the cost of education consists of forgone earnings, which are effectively tax-deductible. The increases in earnings that result from human capital investment are taxed when they accrue.

A third form of asset income sheltering involves *tax-prepaid* treatment, such that asset income is not taxed and contributions are not deductible. There are two main forms of tax-prepaid assets. One is owner-occupied housing, whose return is imputed rent (including capital gains) and for which there is no maximum allowable size. The other is the tax-free savings account (TFSA), which carries an annual limit and allows unused limits to be carried forward. TFSAs can be withdrawn without penalty; thus, like RRSPs, they deviate from pure retirement-savings schemes. The absence

3 Canada, Department of Finance, *Report on Federal Tax Expenditures: Concepts, Estimates and Evaluations* (Ottawa: Department of Finance, 2018) (<https://www.fin.gc.ca/taxexp-depfisc/2018/taxexp-depfisc18-eng.pdf>).

of limits on housing investments implies that housing and TFSAs embed differential tax treatment. In addition, the limits on TFSAs and RPPs/RRSPs, respectively, are not comparable and are independent of contributions to one another, although limits on contributions to TFSAs are lower than limits on contributions to RPPs/RRSPs. Tax-deferred and tax-prepaid assets differ in one further respect. The tax savings obtained from RRSPs and TFSAs depend on the difference between the marginal income tax rates at the time of contribution and the rates at the time of withdrawal, and on the timing of contributions and withdrawals. These can differ considerably. In particular, the higher the tax rate at the time of contribution relative to the time of withdrawal, the greater the tax savings on RRSPs; whereas the opposite applies for TFSAs.

Finally, under the capital gains exemption, one-half of capital gains are tax-exempt. Two reasons are usually given for this. First, the exemption roughly offsets the fact that some capital gains are owing to the inflation of asset values, so they are not real gains. Second, the capital gains exemption, along with the dividend tax credit, is a component of the integration of the personal income tax (PIT) and the corporate income tax (CIT). Neither of these rationales is convincing. Although comprehensive income should ideally be measured on a real basis, consistency would require that all forms of taxable capital income be indexed, not just capital gains. Moreover, since capital gains are taxed on realization rather than accrual, taxpayers can shelter them by postponing realization and thereby offsetting the disadvantage that arises from the taxation of nominal gains. The integration argument is also unconvincing, for the reasons discussed below.

One further important observation poses a challenge to two of the forms of income sheltering—namely, the capital gains exemption and tax-prepaid assets. Capital income can include three components: (1) a risk-free return, (2) a return to risk, and (3) a windfall return representing unanticipated windfalls or rents. From a tax policy perspective, rents should be taxed even if the sheltering of normal capital income is desirable, because such taxation would be an efficient (and possibly equitable) source of tax revenue. Since one cannot distinguish rents from returns to risk, the exemption of one implies the exemption of the other. Rents and returns to risk are captured both in unsheltered capital income and in tax-deferred savings plans (including the GST/HST/QST), but they escape taxation with tax-prepaid assets. Given the evidence that rents constitute a significant share of capital income,⁴ a compelling case can be made for limiting the use of tax-prepaid devices (capital gains exemption, TFSAs, and housing) in the sheltering of capital income from taxation. Of course, taxing all capital income in order to tax rents implies taxing returns

4 Andreas Fagereng, Luigi Guiso, Davide Malacrino, and Luigi Pistaferri, *Heterogeneity and Persistence in Returns to Wealth*, NBER Working Paper no. 22822 (Cambridge, MA: National Bureau of Economic Research, 2016); Marcin Kacperczyk, Stijn Van Nieuwerburgh, and Laura Veldkamp, "A Rational Theory of Mutual Funds' Attention Allocation" (2016) 84:2 *Econometrica* 571–626 (<https://doi.org/10.3982/ECTA11412>); Laura Power and Austin Frerick, "Have Excess Returns to Corporations Been Increasing Over Time?" (2016) 69:4 *National Tax Journal* 831–45.

to risk and could discourage risk taking. However, with generous loss-offsetting arrangements, taxing risk need not result in less risk taking, since the government effectively shares risk with taxpayers.

Not all assets can be sheltered. An important exception is assets in an unincorporated business. The returns to these assets are fully taxed as individual income, by the use of a tax base defined in the same way as for corporations.

The consequences of these varied and uncoordinated forms of asset-income tax treatment are many. Different forms of capital income are treated very differently. Housing equity is fully sheltered, while personal business income is unsheltered; and capital gains, interest, and dividends are treated differently. Assets that are sheltered to encourage saving for retirement are subject to different limits and rules, and they are not penalized for withdrawal prior to retirement. Some sheltering devices, such as TFSAs and housing, exempt all forms of capital income from taxation, while others, such as RRSPs, RPPs, and the GST/HST/QST systems, implicitly tax rents and all returns to risk. As we argue below, taxing capital income preferentially is desirable. However, it should be done in a coherent manner such that some forms of capital income are not unnecessarily favoured, and those that represent above-normal returns are appropriately taxed.

Imperfect and Unnecessary Integration of Corporate and Personal Taxes

As discussed below, the corporate income tax (CIT) is designed to withhold taxes on corporate-source income accruing to shareholders in order to prevent these shareholders from postponing personal tax liabilities by retaining and reinvesting income in the corporation. This backstop role may have been necessary in years past, but it is no longer warranted, for two reasons. First, most shareholder income is sheltered from personal taxation, so withholding taxes on shareholder income at source is not necessary. Most capital income of all but the wealthiest taxpayers can be sheltered, especially with the advent of TFSAs. Recent estimates by Milligan⁵ and the Department of Finance⁶ suggest that if all taxpayers took full advantage of RRSPs, RPPs, and TFSAs, 90 percent of them could shelter all of their capital income, and 70 percent of all capital income could be sheltered. This means that the need for integration is not compelling. Second, to the extent that personal capital income is taxable, the CIT would not be an effective withholding device. With highly open international capital markets, the incidence of the CIT is largely shifted to labour; empirical evidence bears this out. Recent studies estimate that between one-half and three-quarters of CIT changes are shifted to labour.⁷

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

6 "Tax-Free Savings Accounts: A Profile of Account Holders," in Canada, Department of Finance, *Tax Expenditures and Evaluations 2012* (Ottawa: Department of Finance, 2013), 33-48.

7 Kevin A. Hassett and Aparna Mathur, "Spatial Tax Competition and Domestic Wages," December 2010 (<https://dx.doi.org/10.2139/ssrn.2212975>); George R. Zodrow, "Capital

In these circumstances, integration of the PIT and CIT is not warranted. Even if it were, the current instruments for integration—the dividend tax credit and the capital gains exemption—are highly imperfect. For one thing, these instruments apply uniformly to all taxable dividends and capital gains regardless of the extent to which corporate taxes have actually been paid. For another, no dividend tax credit applies to dividends received on sheltered asset returns. Moreover, the capital gains exemption has the additional disadvantage of giving rise to costly tax planning.

A further observation is that in the context of an open economy where the investment and savings sides of the market are separated, the dividend tax credit and the capital gains exemption effectively subsidize personal unsheltered savings.⁸ They cannot be interpreted as a refund of corporate taxes paid on the shareholders' behalf. Some might argue that these arguments do not fully apply to small corporations that do not raise funds on international capital markets, but that argument is not convincing. Even though small corporations might raise all of their funds locally and, often, from owner-operators themselves, local rates of return must comply with rates of return that apply elsewhere in the economy, since creditors always have the option of buying assets whose rates of return are more directly influenced by international markets.

We conclude, therefore, that CIT/PIT integration serves no useful role and this, in turn, has implications for the design of the CIT, to which we turn in the following section.

The Structure of the CIT Is Outdated

The design and rationale of the CIT have changed little since the Carter report, and the same rationale was adopted more recently by the Mintz report.⁹ On the presumption that the intent of the PIT was to tax comprehensive income but that capital gains could be taxed only on realization rather than accrual, there was a perceived need to tax corporate equity income at source so that shareholders could

Mobility and Capital Tax Competition" (2010) 63:4 *National Tax Journal* 865-902; Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, "The Direct Incidence of Corporation Tax on Wages" (2012) 56:6 *European Economic Review* 1038-54; Céline Azémar and R. Glenn Hubbard, "Country Characteristics and the Incidence of Capital Income Taxation on Wages: An Empirical Assessment" (2015) 48:5 *Canadian Journal of Economics* 1762-1802 (<https://doi.org/10.1111/caje.12179>); Kenneth J. McKenzie and Ergete Ferede, "Who Pays the Corporate Tax? Insights from the Literature and Evidence for Canadian Provinces" (2017) 10:6 *SPP Research Papers* [University of Calgary School of Public Policy] 1-21; Clemens Fuest, Andreas Peichl, and Sebastian Siegloch, "Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany" (2018) 108:2 *American Economic Review* 393-418.

8 Robin Boadway and Neil Bruce, "Problems with Integrating Corporate and Personal Income Taxes in an Open Economy" (1992) 48:1 *Journal of Public Economics* 39-66 ([https://doi.org/10.1016/0047-2727\(92\)90041-D](https://doi.org/10.1016/0047-2727(92)90041-D)).

9 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz report").

not shelter income within the corporation by retaining and reinvesting it. That rationale dictated that the base of the CIT should be shareholder income, a principle that is consistent with the Income Tax Act.

Once the withholding rationale is discredited (as discussed above), the use of shareholder income as the CIT base not only is unwarranted but also leads to problematic distortions. Given the openness of international capital markets, domestic investment decisions are effectively segmented from domestic savings decisions. In these circumstances, the CIT serves to distort investment decisions, while integration measures subsidize saving.¹⁰ Two important sources of such distortion are related to the fact that a CIT—if it is based on shareholder income—taxes that part of the normal return to investment that is financed by equity. First, investment is discouraged to the extent that a corporation relies on equity finance as opposed to debt, and that reliance varies across firms and types of capital. The many estimates of marginal effective corporate tax rates bear this out.¹¹ Second, firms are encouraged to use debt rather than equity finance, which increases the possibility of bankruptcies.

The distortions of investment and financing decisions are specific to a CIT that is based on shareholder income. Other CIT bases will give rise to other CIT distortions. For example, firms' decisions about location will depend on average CIT rates, which, unlike marginal ones, will generally be positive for any CIT system. Also, the incentive for profit shifting among countries depends on statutory CIT rates and not on the CIT base, although the ability to deduct interest provides an important vehicle for profit shifting. Finally, the CIT will discourage risk taking to the extent that loss offsetting is imperfect, although that effect might be greater when shareholder income is the CIT base rather than a narrower base that excludes competitive returns to investment, as discussed below.

Small Canadian-controlled private corporations (CCPCs) are liable for the CIT, but in preferential terms. The small business deduction (SBD) offers a reduced tax rate for CCPCs whose taxable income, investment income, and capital do not exceed prescribed upper limits. In addition, owners of CCPCs obtain the lifetime capital gains exemption (LCGE) of over \$800,000. The SBD can be seen as a response to the fact that the income of new small businesses is risky. The tax system does not fully assign a cost to that risk: losses are not refundable and can be deducted against future income only if the firm becomes profitable. Because small firms are taxed on any

10 Bowdway and Bruce, *supra* note 8.

11 For example, Robin Bowdway, Neil Bruce, and Jack Mintz, "Taxation, Inflation and the Effective Marginal Tax Rate on Capital in Canada" (1984) 17:1 *Canadian Journal of Economics* 62-79; Mintz report, *supra* note 9; "Marginal Effective Tax Rates on Business Investment: Methodology and Estimates for Canadian and US Jurisdictions," in Canada, Department of Finance, *Tax Expenditures and Evaluations 2005* (Ottawa: Department of Finance, 2005); Duanjie Chen and Jack M. Mintz, "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" (2015) 8:4 *SPP Research Papers* [University of Calgary School of Public Policy] 1-21.

profits that they earn but cannot fully recoup losses, especially if they go bankrupt, the CIT discriminates against them. The SBD is a partial response. The SBD may also address the difficulty that young, small firms have in obtaining access to credit markets; however, the SBD is of limited use in that regard, since firms that are credit-constrained may not be in a taxpaying position, and therefore lower tax rates provide no relief.

The SBD is not, however, restricted to small growing firms with risky prospects for success. It is available to all small firms, regardless of their riskiness, as long as they remain small. Incorporated professionals are an example of businesses that are eligible for the SBD although they are not particularly risky or credit-constrained and may undertake relatively little investment.

Small business owners also face some disadvantage in sheltering savings for retirement. Although they can invest in RRSPs and TFSAs, their business assets cannot be part of their RRSP or TFSA portfolios. The LCGE enables small business owners to shelter retirement income. In addition, some passive investment income can be sheltered within CCPCs and be subject to preferential rates. As with other devices used to shelter capital income, the limits of the LCGE and passive income sheltering are independent of limits on RRSPs, TFSAs, and other devices. The use of any one sheltering device is subject only to the limits prescribed for that device and is independent of the limits prescribed for sheltering through any other device.

The PIT Rate Structure Is Inconsistent and Inequitable

The progressivity of the PIT depends on (1) the structure of tax brackets and the tax rates, and (2) the various tax credits, both refundable and non-refundable. Progressivity also depends on differential treatment of various elements of the tax base and how such treatment applies at different income levels. Below, we highlight three anomalous features that affect the progressivity of the rate structure in questionable ways.

The first feature concerns the non-refundability of many tax credits, the so-called NRTCs. The concern applies mainly to tax credits that can be viewed as instruments for achieving vertical equity as opposed to tax credits that are intended to influence behaviour or to achieve horizontal equity. For example, deductions for charitable and political contributions arguably serve to encourage taxpayers to make such contributions. There may be some question about the precise design of these deductions, such as their size and how they vary according to the amount of contribution, but their existence can be justified. Similarly, deductions for medical expenses can be justified on the grounds of horizontal equity. Also, the cost-effectiveness of some smaller “boutique” tax credits, such as the one for public transit, can be questioned, but we are more concerned with those NRTCs that mainly affect tax progressivity.

The most important of these NRTCs is the basic personal amount. It is by far the largest NRTC and accounts for roughly two-thirds of the value of all NRTCs. The basic personal amount is equivalent to an equal per capita tax credit to all taxpayers that are eligible to claim it. However, it has less value for those with low taxable

income, and it is of no value to those with no taxable income. The concept of the “basic personal amount”—which dates from the Carter report—recognizes that at least some minimal amount of income is necessary for non-discretionary consumption. Those with no taxable income also have non-discretionary consumption needs, and these could be met if the basic personal amount were refundable. As it stands, the non-refundability of the basic personal amount implies that income tax progressivity is very low at the bottom of the income distribution, contrary to what is recommended in the optimal income tax literature.¹² Similar arguments apply to other NRTCs, most of which are more progressive than the basic personal amount, since their amount declines with either individual or family income. Examples include the spousal exemption, the dependent exemption, and the age exemption.

The second concern involves the structure of NRTCs. The number of NRTCs is large, and many of them are effectively redundant, given other elements of the tax system. The age exemption largely duplicates the pension exemption and the old age security (OAS) system. Similarly, the employment exemption accomplishes an objective similar to that of the Canada workers benefit (CWB). Both give tax credits on the basis of employment, albeit through different structures. Some NRTCs discriminate in favour of some groups for no good reason—for example, the age credit or the credits for volunteer firefighters and homebuyers. Different clawback rates apply to different NRTCs, and the clawbacks are not coordinated, with the result that more than one clawback applies to the same income, which leads to high implicit marginal income tax rates. Finally, some credits are intended to compensate taxpayers for costs incurred or for contributions made and should be deductions rather than credits. The CPP contribution is an example of this type of credit, as are education credits. The case for using credits is strongest when the objective is vertical equity as opposed to the reimbursement of taxpayers for contributions or expenses.

The third concern is that exemptions of some kinds of income are more beneficial to higher-income taxpayers than to other taxpayers. The importance of capital gains (including, notably, capital gains on owner-occupied housing) rises with income level, so the value of the capital gains exemption likewise rises with income. It is true that lower-income individuals can shelter most of their capital income by using RRSPs, RPPs, and TFSAs, but these vehicles are also available to higher-income individuals. The preferential tax treatment of capital gains also influences the choice of the rate structure. The tax rate at the top is constrained by the relatively high elasticity of taxable income at high income levels, part of which is attributable to tax-planning opportunities provided by the capital gains exemption.

As the foregoing has shown, the PIT is characterized by a distinct lack of progressivity at lower income levels, and a narrower base and lower rates than necessary at the top income levels.

12 Matti Tuomala, *Optimal Redistributive Taxation* (Oxford, UK: Oxford University Press, 2016).

The Exclusion of Inheritances from Taxation

One of the most conceptually challenging issues in tax design is the treatment of bequests and inheritances. There is no common international practice. Some countries tax bequests or estates, while others tax inheritances. Others, such as Canada, tax neither. Virtually no countries offer incentives for bequests, despite its being common to give tax credits or deductions for charitable donations. In Canada, bequests are largely ignored in the tax system, with the exception of the deemed realization of capital gains on estates at death, which triggers capital gains taxation that would otherwise be postponed until actual realization at some later date.

A number of key issues of principle arise with respect to the tax treatment of transfers of wealth, both at death and inter vivos. On equity grounds, inheritances are a form of income and ought to be taxed as such, especially given their windfall nature. The issue is whether a bequest given is analogous to consumption by the donors. If it is, a bequest would give simultaneous benefit to donors and recipients, so no credit would be given to donors, but recipients would be taxed. Many reject this form of double-counting,¹³ arguing that taxation should occur only in the hands of the recipient. The Canadian case avoids double-counting, since no credit is given for forgone consumption by donors and no tax is paid by recipients; thus, the two roughly cancel. However, this view is complicated by a further consideration. In the case of large bequests, there is some likelihood that a significant amount of the value of the bequest represents a windfall gain or a rent accruing to the underlying assets. On these grounds, an argument can be made for taxing inheritances in their own right. As well, arguments for breaking up large estates can be made on the grounds of equality of opportunity and the dilution of the power that comes with wealth.¹⁴ According to this view, a tax on inheritances with no relief for donors can be justified.¹⁵

There are also efficiency issues with inheritance taxation. If bequests benefit both the donor and the recipient, there is an externality: donors take into account the altruistic benefits that they obtain for themselves by making a bequest, but not the additional benefit to the recipients. This has led some authors to suggest the subsidizing of bequests on efficiency grounds.¹⁶ In addition, even if there is

13 See Peter J. Hammond, "Altruism," in *The New Palgrave: A Dictionary of Economics*, 1st ed. (1987); and James A. Mirrlees, "Taxation of Gifts and Bequests," unpublished slides for a talk at the Centenary of James Meade Conference, 2007.

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

15 Robin Boadway, Emma Chamberlain, and Carl Emmerson, "Taxation of Wealth and Wealth Transfers," in Stuart Adam, Timothy 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.

16 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.

no double-counting, such that the benefits to donors are ignored, the taxation of inheritances will discourage donations, and this is something that must be taken into account in deciding on tax treatment.¹⁷

Clearly, difficult conceptual issues are involved in determining the tax treatment of bequests and inheritances, and these will apply to other voluntary transfers, too.

SOME PRINCIPLES FOR A MODERN TAX SYSTEM

The literature on the design of an optimal tax system has burgeoned in recent years. Much of it stems from the development of optimal income tax theory and its application to tax policy.¹⁸ Optimal income tax analysis takes a utilitarian approach to tax design: it studies the tax system that optimizes final outcomes, using a social welfare function with standard properties.

The utilitarian approach contrasts with that of the Carter report, which dominated public finance for the first half of the 20th century and was summarized by Musgrave.¹⁹ This approach emphasizes individuals' ability to pay (summarized as "comprehensive income") as the ideal tax base, and it uses the principle of equal sacrifice to guide tax progressivity. The ability-to-pay/equal-sacrifice approach, in contrast to the utilitarian one, emphasizes command over resources (or spending power), rather than utility, as the ideal base, and it takes into account both initial and final positions in determining progressivity.

More recently, the equality-of-opportunity approaches of Roemer²⁰ and of Fleurbaey and Maniquet²¹ have offered another "command over resources" alternative to utilitarianism. These authors emphasize the heterogeneity of individuals, who may differ in characteristics over which they have no control, such as innate ability and family background, as well as in characteristics over which they may have control, such as preferences. The ideal tax-transfer system ought to compensate individuals for differences in given characteristics while letting these individuals assume

17 Helmuth Cremer and Pierre Pestieau, "Wealth Transfer Taxation: A Survey of the Theoretical Literature," in Serge-Christophe Kolm and Jean Mercier Ythier, eds., *Handbook of the Economics of Giving, Altruism and Reciprocity: Applications*, vol. 2 (Amsterdam: North-Holland, 2006), 1107-34.

18 James Banks and Peter Diamond, "The Base for Direct Taxation," in *Dimensions of Tax Design*, supra note 15, 548-648; Robin Boadway, *From Optimal Tax Theory to Tax Policy: Retrospective and Prospective Views* (Cambridge, MA: MIT Press, 2012); Thomas Piketty and Emmanuel Saez, "Optimal Labor Income Taxation," in Alan J. Auerbach, Raj Chetty, Martin Feldstein, and Emmanuel Saez, eds., *Handbook of Public Economics*, vol. 5 (Amsterdam: North-Holland, 2013), 392-474.

19 Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959).

20 John E. Roemer, *Equality of Opportunity* (Cambridge, MA: Harvard University Press, 2000).

21 Marc Fleurbaey and François Maniquet, *A Theory of Fairness and Social Welfare* (New York: Cambridge University Press, 2011).

responsibility for how they use the abilities and resources made available to them. A critique of utilitarianism as the sole basis for tax design is discussed in Boadway.²²

The tax principles that I outline below combine the utilitarian approach with equality-of-opportunity approaches. I combine the principles that these approaches have in common with the principles that each brings separately to the table. The utilitarian principle dominates my approach, augmented by the equality-of-opportunity principle where the latter is useful. My focus is on tax design as it applies to individuals, though the complementary roles played by corporate and commodity taxation are relevant. The following subsections summarize the set of principles that I use to inform the subsequent suggestions about tax reform.

Individual Income Taxation

The key policy issue in the design of individual income tax is the treatment of capital income. Two alternative frameworks dominate the historical discussion: comprehensive income taxation and personal consumption taxation. The former is associated with the Carter report, while the latter has been advocated by the US Treasury,²³ the Meade report,²⁴ the Economic Council of Canada,²⁵ the president's panel in the United States,²⁶ and the Mirrlees review. An important innovation in the Mirrlees review was to stress the fact that some returns to capital are above the normal competitive return and ought to be taxed under both consumption and comprehensive income taxation. The Mirrlees review's rate-of-return allowance, which proposed taxing returns to shares in excess of a normal rate of return, was a means of imposing such taxation. The use of tax-deferred sheltering—by RRSPs and RPPs, for example—accomplishes the same thing.²⁷

Although the Mirrlees review recognized the importance of including consumption finance by rents, it differed from the advice given to it by Banks and Diamond,²⁸ who argued for partial taxation, at least, of all capital income. Banks and Diamond argued, in particular, for retaining some progressive capital income taxation, but at

22 Boadway, *supra* note 18.

23 United States, Department of Treasury, *Blueprints for Basic Tax Reform* (Washington, DC: US Government Printing Office, 1977).

24 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) (herein referred to as "the Meade report").

25 Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Supply and Services, 1987).

26 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: US Government Printing Office, 2005).

27 An income tax with tax-deferred sheltering of capital income is equivalent, in present-value terms, to consumption expenditures. Tax-prepaid sheltering does not give the same equivalence. It would do so if above-normal returns to capital were included in the tax base, as in the Mirrlees review's rate-of-return allowance.

28 Banks and Diamond, *supra* note 18.

preferential rates compared with the taxation of earnings. Some of the principles discussed below include elements of both the Mirrlees review and Banks and Diamond, and these principles are augmented by a few others. First, given individuals' observable tendency to save too little for retirement and thereby to rely on government support, a case can be made for sheltering capital income in order to encourage saving for retirement. Such sheltering should apply as consistently and comprehensively as possible across various possible sheltering instruments. Second, I explicitly recognize both the importance of taxing above-normal asset returns and the implications that doing so has for sheltering by tax-prepaid vehicles (as opposed to tax-deferred ones). Rents are included as part of accumulated earnings that are taxed when tax-deferred accounts are drawn down, but they are exempt from taxation with tax-prepaid assets. Finally, because the sheltering of capital income is intended to encourage saving for retirement, some penalties for early withdrawal are warranted. These principles are mainly for the purposes of policy guidance. In practice, it will be difficult to achieve all of them fully.

Some other principles relate to personal income taxation more generally. The progressivity of the rate structure needs to be rationalized. This is particularly the case for those at the bottom of the income distribution. The existing system of NRTCs is of little use to the lowest-income persons, and this could be addressed by making NRTCs refundable. Such a reform would be a natural evolution of a system that was last changed in the 1980s, when most tax deductions were converted to credits. More generally, there is a case for rationalizing and simplifying the many existing NRTCs in order to make the PIT more fair and transparent.

A broadening of the tax base, so that all non-sheltered capital income is treated comparably, would enhance fairness at the top. In particular, given the weak case for integration of the CIT and PIT, the preferential treatment of dividends from Canadian corporations and capital gains is not warranted. Eliminating those tax preferences would not only enhance tax fairness but also reduce tax-planning opportunities.

Recent optimal income tax analysis has emphasized the role of participation incentives at the bottom of the income distribution.²⁹ In Canada, the CWB serves that purpose, but it is of limited size. An enhancement of the CWB, combined with the refundability and rationalization of NRTCs, would provide a reasonable basic income guarantee for those with no earnings, and it could be augmented by a larger transfer for those who engage in low-paid employment. As discussed in Boadway, Cuff, and Koebel³⁰ and in Koebel and Pohler,³¹ such a measure could be

29 Emmanuel Saez, "Optimal Income Transfer Programs: Intensive Versus Extensive Labour Supply Responses" (2002) 117:3 *Quarterly Journal of Economics* 1039-73 (<https://doi.org/10.1162/003355302760193959>); Mike Brewer, Emmanuel Saez, and Andrew Shephard, "Means-Testing and Tax Rates on Earnings," in *Dimensions of Tax Design*, supra note 15, 90-173.

30 Robin Boadway, Katherine Cuff, and Kourtney Koebel, "Designing a Basic Income Guarantee for Canada," in Elizabeth Goodyear-Grant, Richard Johnston, Will Kymlicka, and John Myles, (Notes 30 and 31 are continued on the next page.)

the prototype for a more substantial basic income guarantee that the federal government and the provinces could provide collaboratively. At the same time, the benefits of enhancing the CWB can be overstated. Encouraging the participation of the labour market is valuable to the extent that employment is actually achieved, and such achievement depends on the demand side of the labour market. Given the difficulties that low-skilled persons might have in obtaining employment, the premium paid by an enhanced CWB to those who succeed should not be excessively high compared with transfers received by those unable to land a job.

Finally, the tax treatment of unincorporated business income should be similar to that of corporations, a topic to which I turn in the next section. In anticipation, all real business income should be taxed on a cash-flow-equivalent basis so that normal returns are exempt. This implies that personal investments in unincorporated businesses would be fully sheltered unless they are passive investments.

Corporation Income Taxation

The CIT base is an accruals-based measure of shareholder income. Revenues are included, while current costs and accrued capital costs are deducted where the latter include, among other things, interest payments and capital cost allowances. This choice of shareholder income as the base follows from viewing the CIT as a backstop for the PIT. It withholds tax against shareholder income as the corporation earns it, in order to preclude the shareholder from using the corporation as a sheltering device. Given this withholding intent, shareholders are reimbursed by the dividend tax credit and capital gains exemption. I have argued that this rationale is dated. A significant proportion of shareholder income is sheltered at the individual level, and much of the incidence of the CIT is shifted to labour, with the result that withholding is ineffective and integration is unnecessary. Given the segmentation of investment and savings in international markets, the CIT distorts investment decisions regardless of any relief given by integration.

There is ample evidence that a substantial share of corporate income reflects rents or windfall profits.³² Given that fact, a more cogent rationale for the corporate tax is that it is a tax on rents. This view was taken by the Meade report and by the

eds., *Federalism and the Welfare State in a Multicultural World* (Montreal and Kingston, ON: Queen's School of Policy Studies and McGill-Queen's University Press, 2018), 101-29; and Robin Boadway, Katherine Cuff, and Kourtney Koebel, "Can Self-Financing Redeem the Basic Income Guarantee? Disincentives, Efficiency Costs, Tax Burdens, and Attitudes: A Rejoinder" (2018) 44:4 *Canadian Public Policy* 447-57 (<https://doi.org/10.3138/cpp.2018-044>).

31 Kourtney Koebel and Dionne Pohler, "Expanding the Canada Workers Benefit to Design a Guaranteed Basic Income," *Canadian Public Policy* (forthcoming).

32 Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note SDN 11/11 (Washington, DC: International Monetary Fund, May 3, 2011); Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada*, Mowat Research no. 88 (Toronto: University of Toronto, School of Public Policy and Governance, Mowat Centre, April 2014); Power and Frerick, *supra* note 4.

Mirrlees review. The Institute for Fiscal Studies³³ recommended this approach for the European Union, and Boadway and Tremblay³⁴ and McKenzie and Smart³⁵ have advocated it for Canada.

The classic design of a rent tax is a cash flow tax, following Brown.³⁶ The cash flow tax base is total cash receipts less total cash outlays, with no distinction between current and capital expenditures. In particular, investment is expensed, and no further deductions are given for interest or depreciation. Provided that positive and negative cash flows are treated symmetrically—by refundability or carryforward of tax losses with interest—such a tax is neutral with respect to both investment and financing. The Meade report proposed that the cash flow tax should either apply only to real transactions (the R base) or apply to both real and financial transactions (the R+F base) in order to tax the rents earned by financial institutions.

The cash flow tax is the simplest form of rent tax; however, by deducting all costs before revenues are earned, it results in negative tax liabilities for firms that engage in large investments, and it results in the postponement of tax revenues for others. If governments are reluctant to refund tax losses, other options are available that are equivalent to cash flow taxation in present-value terms. Any tax base for which the present value of future deductions from an investment equals the value of investment will be equivalent to cash flow taxation.³⁷ An example of a cash flow-equivalent tax base is the allowance for corporate equity (ACE) tax proposed by the Institute for Fiscal Studies.³⁸ It allows firms to deduct from their corporate tax base a normal rate of return to equity times the amount of their investment that was financed by equity. Assuming that the existing corporate tax base measures shareholder income relatively accurately (so that CCA deductions approximate actual capital depreciation), the allowing of a deduction for the cost of equity financing converts the tax base from shareholder income to above-normal profits, which include both rents and returns to risk. To the extent that the corporation is risk-neutral, because shareholders can diversify their risk, the ACE tax is neutral with respect to investment and financing. The ACE tax has the additional advantage that it is relatively easy to phase

33 Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s, Report of the IFS Capital Taxes Group* (London: Institute for Fiscal Studies, 1991).

34 Boadway and Tremblay, *supra* note 32.

35 Ken McKenzie and Michael Smart, *Tax Policy Next to the Elephant: Business Tax Reform in the Wake of the Tax Cuts and Jobs Act*, C.D. Howe Institute Commentary no. 537 (Toronto: C.D. Howe Institute, March 2019).

36 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), 300-16.

37 Robin Boadway and Neil Bruce, "A General Proposition on the Design of a Neutral Business Tax" (1984) 24:2 *Journal of Public Economics* 231-39 ([https://doi.org/10.1016/0047-2727\(84\)90026-4](https://doi.org/10.1016/0047-2727(84)90026-4)).

38 *Supra* note 33.

in, beginning with the existing CIT.³⁹ It can be applied to both real and financial corporate incomes in order to capture rents from financial intermediation.

A problem with both a cash flow equivalent tax and the existing CIT is that losses that are carried forward are not refunded for firms that go out of business. This is a particular problem for small, growing firms that undertake risky investments and may face credit barriers. Ideally, refundability of tax losses would address the problem, but since refundability is problematic, preferential corporate rates for small corporations is a next-best response. The rate reductions should be targeted to young firms engaged in risky investments rather than to established small firms. One way to ensure this would be to restrict eligibility by a cumulative limit on taxable income (as opposed to the annual taxable income limits that exist currently). Preferential treatment should not be extended to the passive investment income of small firms, whose owners may be high-income persons whose capital income is fully taxable.

An implication of taxing corporations on a rent tax basis is that unincorporated businesses should receive the same treatment as is recommended by the Mirrlees review. This turns small personal businesses into tax-sheltering vehicles that are akin to tax-deferred instruments. There would then be no need for special provisions to shelter family business incomes. Of course, unless there were limits on the ability to shelter income in personal businesses, these businesses would have an advantage over other tax-sheltering devices such as RRSPs, RPPs and TFSAs. Imposing comparable limits on the sheltering of normal capital income via rent tax treatment of family businesses would be administratively complicated.

A final issue is the treatment of foreign-source corporate income. Recently, it was proposed that the US corporate tax be changed into a destination-based cash flow tax.⁴⁰ The destination base would be achieved by deducting the value of exports from a firm's tax base and including imports—a model analogous to that of a destination-based value-added tax. This would effectively transfer a corporation's tax on rents from the countries where the rents originate to those where the final output of the corporation is purchased. The argument for doing this is administrative, since the destination base largely eliminates the incentive for corporations to shift profits to low-tax countries. This would allow the tail to wag the dog. There is no compelling economic or fairness case for allocating rent tax revenues to countries of final consumption. On the contrary, since rents arise from conditions in origin countries, such as resource endowments or legal and market institutions, it makes more sense for the rents to be taxed where they originate. A territorial approach to corporate

39 Other forms of cash flow equivalent taxes exist. One is the resource rent tax implemented temporarily in the Australian mining industry by the Commonwealth. See Boadway and Tremblay, *supra* note 32, for a description of this tax.

40 Alan Auerbach, Michael P. Devereux, Michael Keen, and John Vella, *Destination-Based Cash Flow Taxation*, Oxford University Centre for Business Taxation Working Paper no. 17/01 (Oxford: University of Oxford, Said Business School, Centre for Business Taxation, January 2017).

tax liability is reasonable, and it is the one that I propose. Of course, enforcement of the territorial approach is challenging, given the ability of firms to shift profits, and this approach remains a work in progress.

Sales Taxation

The GST/HST/QST system is a major component of the tax mix. The federal GST is, roughly speaking, a proportional tax on consumption. The HST is an imperfect consumption tax, since many provinces have not opted into it. For those that have not, business inputs are taxed, which leads to production inefficiency.⁴¹ The main consequence of sales taxation for tax policy results from its taxing of consumption rather than income. As mentioned above, this implies that the tax system favours normal capital income over labour income. (Rents are implicitly taxed under general sales taxation.) This is consistent with the optimal income tax suggestion that capital income be taxed preferentially. Given this preferential treatment, there is no further need—apart from a desire to encourage saving for retirement—to treat capital income preferentially through the income tax system. To the extent that capital income is still taxed too heavily relative to earnings, the mix between the GST/HST/QST and the income tax could be changed.

The tax system relies on the income tax to achieve progressivity. There is no compelling reason to make sales taxation more progressive by favouring goods consumed by low-income persons. Progressivity is more efficiently achieved through the income tax system, by the use of both the rate structure and refundable tax credits.⁴²

Inheritance Taxation?

Inheritance taxation has emerged as an area of policy interest. Recent evidence has emphasized the growth in wealth inequality and the extent to which inequality is transmitted across generations. Piketty⁴³ has argued that the growth in asset wealth relative to earnings is a natural consequence of growth, given the tendency for the return on capital to exceed the economy's rate of growth. This disparity is exacerbated by the fact that larger wealth holdings tend to have especially high rates of

41 Michael Smart and Richard M. Bird, "The Impact on Investment of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience" (2009) 62:4 *National Tax Journal* 591-609 (<http://dx.doi.org/10.17310/ntj.2009.4.01>).

42 The Atkinson-Stiglitz theorem says that income taxation is more efficient, for redistributive purposes, than differential commodity taxes if goods are weakly separable from leisure in individual utility functions. Although weak separability may not strictly apply, the administrative costs of adopting differential commodity tax rates likely outweighs any redistributional advantage. See A.B. Atkinson and J.E. Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation" (1976) 6:1-2 *Journal of Public Economics* 55-75 ([https://doi.org/10.1016/0047-2727\(76\)90041-4](https://doi.org/10.1016/0047-2727(76)90041-4)).

43 Piketty, *supra* note 14.

return, a phenomenon that may well reflect the importance of windfall gains or special advantages. On equality-of-opportunity grounds, the Mirrlees review recommended a progressive lifetime inheritance tax separate from income taxation. Although Piketty proposed an annual wealth tax to address inequality, annual inheritance taxation—which applies to an intergenerational transfer only once—seems a more appropriate instrument, as discussed in Boadway and Pestieau.⁴⁴

The case for a tax on cumulative lifetime inheritances, with a moderately high threshold, is applicable to Canada. Taxing inheritances that are above a certain threshold would recognize that some large estates reflect windfall gains. It would also recognize that power and influence accrue to holders of significant wealth.

IMPLICATIONS FOR REFORM OF THE CANADIAN TAX SYSTEM

The discussion above suggests an agenda for tax reform that would lead to a fairer and more efficient tax system, would address the international circumstances that Canada faces, and would correspond with the principles and practices of modern tax policy. I focus on general directions for tax reform without providing the full details.

I propose that the overall personal tax base should include both labour and capital income but that capital income should be taxed more favourably than labour income. This would be analogous to the dual tax systems in the Nordic countries, except that the tax on capital income would be progressive. The Nordic dual income tax system is progressive with respect to earnings, but capital income is taxed at a low linear rate.⁴⁵ A progressive tax on capital income is fairer and captures some associated rents that accrue especially to higher-income taxpayers.

Differential taxation of capital and labour income differs from the comprehensive income taxation of the Carter report, but it would not represent a fundamental change in current practice. The mix of broad-based income taxation with a consumption-based GST/HST/QST implies lower tax rates on normal capital income versus labour income, taxation of above-normal returns on capital, and progressive taxation of capital income. Since neither the capital income tax nor the sales tax systems are completely broad-based, further reform is needed.

In the case of sales taxation, the HST is effectively a tax-deferred sheltering device that exempts normal capital income but includes unexpected or windfall returns to assets. The system does not fully apply in five provinces, four of which maintain inefficient retail sales taxes. A priority for federal tax policy is to continue to pursue HST agreements for provinces that have yet to join.

44 Robin Boadway and Pierre Pestieau, *Over the Top: Why an Annual Wealth Tax for Canada Is Unnecessary*, C.D. Howe Institute Commentary no. 546 (Toronto: C.D. Howe Institute, June 2019).

45 Robin Boadway, "The Dual Income Tax System—An Overview" (2004) 2:3 *CESifo DICE Report* 3-8.

Important exceptions to the uniform capital taxation are exemptions due to either tax sheltering or special treatment of particular types of capital income. Tax sheltering is warranted to the extent that it encourages saving for retirement, but the system of RRSPs, RPPs, and TFSAs has structural deficiencies. Contributions to RRSPs and RPPs together are limited, but their limit is independent of contributions to TFSAs, and vice versa. It is important to recognize that tax-prepaid instruments such as TFSAs and housing differ from tax-deferred instruments such as RRSPs and RPPs. The latter shelter only normal capital income, while the former shelter all capital income, including windfalls; therefore, there is a case for favouring tax-deferred devices over tax-prepaid ones. This suggests that significantly lower limits should be imposed on TFSA contributions than on RPPs and RRSPs. Moreover, given that the rationale for tax sheltering is to encourage saving for retirement on the basis that individuals do not save enough if left to their own devices, some penalty should apply on early withdrawals.

An anomalous form of tax-prepaid sheltering is housing. Returns to housing, which can include windfall capital gains, are fully sheltered without limit. Housing is an important component of intergenerational transfers. It is also an asset that households use to save for retirement. Given this fact, sheltering of housing, like other asset sheltering, should be limited. Since measuring the full imputed returns to housing is difficult, and since housing is to some extent taxed already through the property tax, a pragmatic approach would be to tax capital gains in excess of some threshold. As with other capital gains, deemed realization would apply on death, although this would have to be coordinated with an inheritance tax, which I propose below as a longer-run tax reform.

Three further reforms to individual capital income taxation follow from our proposal that business taxation be reformed into a tax on rents, as discussed below. First, the case for integrating the PIT and CIT is weak, given the estimated shifting of the CIT to labour income earners and the fact that much capital income is sheltered from the PIT. The case becomes even weaker in the light of our proposal to reform the CIT into a rent-based tax. The dividend tax credit largely serves to shelter equity income and encourage saving, so it should be eliminated. In addition, no strong case exists for the capital gains exemption, and it too should be abolished. Although nominal capital gains are taxed, this taxation is offset, at least in part, by the benefits of sheltering, given that accrued capital gains are not taxed until they are realized. This is also consistent with our proposal to tax capital gains from housing above some exemption level. Second, personal unincorporated businesses would be taxed on a rent tax basis, through an approach similar to the one used for corporations (discussed below). This implies that these businesses are sheltered on a tax-deferred basis. Third, the LCGE could be abolished, since its main purpose is to be a tax-sheltering device, which is no longer necessary if business income taxation takes the form of a tax on rents.

Now consider the tax treatment of business income. The intention of the current CIT system is to tax at source income earned by the corporation on behalf of shareholders, in order to preclude the postponing of personal taxation. The tax base of

unincorporated business income accords with the same withholding aspiration. As more shareholder income becomes sheltered at the personal level, and as evidence mounts that much of the CIT is shifted to labour, the withholding rationale loses force. At the same time, the evidence (cited above) indicates that a substantial share of corporate income consists of above-normal returns. This suggests that although the CIT is not needed as a withholding device against shareholder income, it is useful as a device for taxing rents at source. A tax on rents represents an efficient source of tax revenues. A cash flow corporate tax or its present-value equivalent is analogous to a rent tax, where annual cash flows include annual revenues less annual expenditures, including actual investment spending. No further deductions would be given for either the depreciation of assets or the costs of financing, and accounting could be in cash rather than in accrual terms, which would simplify the tax system. Ideally, negative and positive cash flows should be treated symmetrically in order to maintain the neutrality of the CIT, either by the offer of refundability or, more likely, by the carryforward of tax losses indefinitely, with interest. To the extent that corporations are risk-averse, the cash flow tax applies to the risk premium. This cannot be avoided, but its effects can be mitigated by full loss-offsetting.

A tax that is analogous to cash flow taxation in present-value terms is the ACE tax discussed above. It differs from the current system by allowing a cost-of-finance deduction using a normal cost of finance for all equity-financed investments, as well as by allowing tax losses to be carried forward with interest. It has the advantage of being a fairly straightforward reform of the existing system, but it has two disadvantages. It retains accrual accounting, and it requires the choice of a normal cost of finance for the cost-of-equity deduction.

Cash flow taxation or its equivalent removes the distortions that the existing tax system imposes on the extent of investment and the form of financing of the firm. However, it does not eliminate the effect of the CIT on corporate location or on the shifting of profits. These depend on the average tax rate and the statutory tax rate, respectively. The recent proposal by Auerbach, Devereux, Keen, and Vella⁴⁶ for a destination-based cash flow tax was intended to remove the incentive for corporations to locate their profits in a tax-favoured country. However, the destination principle would entail that rents generated by the attributes and institutions of one country would accrue to countries where final sales happen to be made, and this violates reasonable tax principles. Our preference would be the territorial taxation of corporate profits, with tax compliance and enforcement being pursued by other means. This would be consistent with the system toward which the United States is moving.

The cash flow principle would also apply to small businesses, both corporations and unincorporated businesses. A convincing case can be made for the preferential treatment of CCPCs, with targeted provisions. Small corporations that are new and

46 *Supra* note 40.

growing are typically highly risky. They have significant probabilities of being unsuccessful, and they face credit constraints. The CIT can exacerbate these problems to the extent that loss-offsetting is imperfect. If governments are willing to allow tax losses to be carried forward and offset only against future income, unsuccessful firms that go out of business with tax losses on their books will face a disadvantage. The tax system will tax positive gains but may not refund losses, so the tax system increases riskiness. In these circumstances, taxing small businesses at preferential rates reduces the disadvantage in ways that other incentives, such as faster investment writeoffs, do not. Thus, the SBD is a useful instrument, but it should be designed to target small, growing firms and not established ones that face little risk. To achieve this, eligibility for the SBD should be subject to a cumulative income limit rather than simply an annual one. As well, the carryforward of losses should be with interest, and of long duration. To further address the financing and riskiness issues faced by small firms, consideration could be given to allowing refundability of at least some of the costs of hiring labour by firms eligible for the SBD.

Other details of corporate tax design have been discussed elsewhere—for example, the taxation of natural resource rents and the harmonization of natural resource taxes and the CIT; tax incentives for research and development; and the tax treatment of patent income.⁴⁷

Now consider PIT progressivity. Despite the progressive rate structure, overall progressivity is undermined at the top by exemptions from the tax base and by an absence of progressivity at the bottom. The proposals above for reforming the taxation of capital income—especially the elimination of the capital gains exemption and dividend tax credit, and the taxation of large housing capital gains—would significantly improve progressivity at the top. At the bottom, I would propose a three-pronged reform of NRTCs. First, consolidate those credits that serve mainly a redistributive role, such as the age and pension credits, the employment credit, and several minor credits. Some of these credits are redundant, and others are discriminatory. Second, make them refundable so that they benefit those who need them most. Finally, make them conditional on income. This reform of the NRTCs would represent the beginning of a basic income guarantee, which, if combined with the reform of provincial social assistance systems as proposed by Boadway, Cuff, and Koebel,⁴⁸ would result in a federal-provincial income guarantee of substantial

47 Boadway and Tremblay, *supra* note 32; Robin Boadway and Benjamin Dachis, *Drilling Down on Royalties: How Canadian Provinces Can Improve Non-Renewable Resource Taxes*, C.D. Howe Institute Commentary no. 435 (Toronto: C.D. Howe Institute, September 2015); Robin Boadway, “The Canadian Corporate Income Tax at 100 Years of Age: Time for a Change?” in Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds., *Income Tax at 100 Years: Essays and Reflection on the Income War Tax Act* (Toronto: Canadian Tax Foundation, 2017), 9:1-27; and Robin Boadway and Jean-François Tremblay, “Policy Forum: The Uneasy Case for a Canadian Patent Box” (2017) 65:1 *Canadian Tax Journal* 61-72.

48 Boadway, Cuff, and Koebel, “Designing a Basic Income Guarantee for Canada,” *supra* note 30.

size. This would combine a basic income guarantee with a tax-back rate, and it would be superimposed on the PIT system.

For those economists, such as Kesselman⁴⁹ and Osberg,⁵⁰ who worry that a basic income guarantee would focus too much on providing income for those who choose not to work, the CWB could be enhanced and integrated with refundable tax credits, as described by Koebel and Pohler.⁵¹ As I stressed above, however, the success of the CWB depends on those who choose to participate in the labour force actually finding jobs, so it cannot displace the need for an income guarantee for those who are not employed.

To further improve fairness, general income averaging could be re-instituted. The case for this is apparent, given the recent finding by Garcia-Medina and Wen⁵² that since the mid-1990s, the Canadian tax-transfer system has become less effective at reducing market-induced income volatility. A design feature of income averaging that would have to be chosen would be the number of tax years over which averaging should apply. Since this would be less than a lifetime, self-averaging through the mix of tax-prepaid and tax-deferred sheltering devices would be a useful supplement.

In the long term, inheritance taxation could be revisited. The case for the inheritance tax is partly based on equality of opportunity, especially the extent to which wealth inequality is transmitted across generations. Moreover, a significant proportion of the returns on large estates represent past rents. Introducing an inheritance tax would be a major reform, and it would probably face political obstacles. The Mirrlees review recommended a cumulative lifetime inheritance tax with a sizable exemption level.

SUMMARY

The reforms suggested above are best thought of as reform ideas, in the sense that the full details remain to be worked out. Despite the lack of detailed proposals, I regard these reforms as feasible from an administrative and compliance point of view. To recapitulate, my main ideas for reform are as follows:

- Maintain the system of preferential taxation of capital relative to labour income that is achieved by the combination of comprehensive income and the GST/HST/QST system, and pursue HST adoption by those provinces that retain retail sales taxation.

49 Jonathan Rhys Kesselman, "Can 'Self-Financing' Redeem the Basic Income Guarantee? Disincentives, Efficiency Cost, Tax Burdens, and Attitudes" (2018) 44:4 *Canadian Public Policy* 423-37 (<https://doi.org/10.3138/cpp.2017-064>).

50 Lars Osberg, *The Age of Increasing Inequality: The Astonishing Rise of Canada's 1%* (Toronto: Lorimer, 2018).

51 Koebel and Pohler, *supra* note 31.

52 B. Cecilia Garcia-Medina and Jean-François Wen, "Income Instability and Fiscal Progression" (2018) 51:2 *Canadian Journal of Economics* 419-51 (<https://doi.org/10.1111/caje.12326>).

- Tax all capital income except tax sheltering that encourages saving for retirement.
- Maintain lower contribution limits on TFSAs relative to RPPs and RRSPs.
- Penalize withdrawals from sheltered savings plans before retirement.
- Tax capital gains on owner-occupied housing beyond some threshold.
- Eliminate the integration of the PIT and CIT by abolishing the dividend tax credit and the capital gains exemption, as well as the LCGE.
- Use the territorial principle to tax all business income based on rents, and allow the carryforward of losses with interest.
- Retain the SBD, but impose a cumulative income limit.
- Combine NRTC's that serve vertical equity into a single refundable and income-tested credit.
- Enhance the CWB and integrate it into the reformed system of refundable tax credits.
- Institute general income averaging.
- In the long run, contemplate a cumulative lifetime tax on inheritances.

The revenue consequences of these proposals are ambiguous. In previous studies, partial implementation of some of these reforms was found to be roughly revenue-neutral. For example, Boadway and Tremblay⁵³ found that the combination of a move to a rent-based CIT and the elimination of integration measures was roughly revenue-neutral. In addition, Boadway, Cuff, and Koebel⁵⁴ showed that a basic income guarantee could be financed by making NRTC's both refundable and income-contingent and by using revenues from provincial welfare systems.

53 Boadway and Tremblay, *supra* note 32.

54 Boadway, Cuff, and Koebel, "Designing a Basic Income Guarantee for Canada," *supra* note 30.

Navigating Disruption: The Politics of Business Tax Reform as Two-Level Game

Geoffrey Hale*

PRÉCIS

L'auteur aborde la politique de l'imposition des sociétés et de la concurrence fiscale internationale comme une série de jeux à deux (et parfois à multiples) niveaux qui s'enchaînent dans les débats plus vastes sur la concurrence internationale pour les investissements et la distribution des coûts et des avantages fiscaux au Canada. Se fondant sur plusieurs théories des relations internationales (néo-institutionnaliste, choix publics, et réaliste), l'auteur explore l'évolution du régime d'imposition des sociétés au Canada et la compare avec celle d'autres grands concurrents pour les investissements internationaux, en particulier les États-Unis — changements qui s'inscrivent dans un effort plus vaste pour équilibrer et intégrer les objectifs contradictoires et les objectifs qui se chevauchent des politiques économiques nationales et internationales. L'auteur résume le contexte historique et contemporain de la concurrence fiscale internationale, en particulier en ce qui concerne le fractionnement du revenu, les défis macroéconomiques et microéconomiques de l'arbitrage fiscal, et les compromis qu'implique la gestion de la politique fiscale nationale. L'auteur conclut en présentant les options possibles pour maintenir la souplesse fiscale et politique tout en réagissant efficacement à la concurrence fiscale croissante, comme l'incarne la réforme fiscale américaine de 2017 et d'autres changements politiques semblant indiquer une baisse de l'engagement politique à assurer un paradigme de l'économie ouverte chez les principaux partenaires commerciaux du Canada.

ABSTRACT

The author addresses the politics of business taxation and international tax competition as an interactive series of two- (and sometimes multi-) level games embedded in broader debates over international competition for investment and the distribution of fiscal costs and benefits within Canada. Drawing on several international relations theories (neo-institutionalist, public choice, and realist), the author explores the evolution of Canada's business tax system in relation to the evolving systems of other major competitors for international investment, especially the United States—changes that are occurring as part of a wider effort to balance and integrate competing and overlapping objectives of domestic and international economic policies. The author summarizes the historical and contemporary context for international tax competition, particularly with respect to

* Of the Department of Political Science, University of Lethbridge (e-mail: geoffrey.hale@uleth.ca).

income shifting, macro- and micro-challenges of tax arbitrage, and the tradeoffs involved in managing the domestic politics of taxation. The author concludes by identifying the options available for maintaining domestic fiscal and policy flexibility while responding effectively to growing tax competition, as embodied in the US tax reform of 2017 and other shifts in policy that point to declining political commitment to an open economy paradigm among Canada's major trading partners.

KEYWORDS: CANADA-US ■ CORPORATE INCOME TAXES ■ FOREIGN INVESTMENT ■ INTERNATIONAL TAXATION ■ TAX COMPETITIVENESS ■ TAX NEUTRALITY

CONTENTS

Introduction	668
Tax Policies as Two- (or Multi-) Level Games	670
Foreign Investment and International Tax Competition	676
The Evolving Context for International Tax Competition	679
US Tax Reforms of 2017: Consequences for Cross-Border Tax Competition	686
Conclusion: Evolving Canadian Tax Policies for an Uncertain World	690

INTRODUCTION

A central challenge in the structuring of Canada's taxation system has been to attract and retain international corporate investment, including the promotion of regionally and globally competitive Canadian businesses, while reducing incentives and opportunities for tax arbitrage (including both adverse income and cost shifting) by both Canadian- and foreign-based corporations.¹ During his career, Tim Edgar addressed these issues in connection with both incoming and outgoing investment in the context of wider international and domestic policies.²

International fiscal competition occurs when governments deliberately structure or design tax systems, in detail or as a whole, in order to enhance or preserve their jurisdiction's relative attractiveness as a destination for capital investment and other mobile factors of production, including highly skilled individuals. They do so in response to similar actions by other governments or to the organizational and operational decisions of companies seeking to minimize their tax liabilities within

1 Arguably, federal tax policies in the 2006-2017 period were designed to promote income shifting to Canada, including the location of head offices and other operations in Canada, rather than promoting capital import neutrality.

2 For example, Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) 51:3 *Canadian Tax Journal* 1079-1158; Tim Edgar, *Interest Deductibility Restrictions and Inbound Foreign Investment*, research report prepared for the Advisory Panel on Canada's System of International Taxation (Ottawa: Department of Finance, October 2008); and Tim Edgar, "Outbound Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes," in Arthur J. Cockfield, ed., *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010), 60-83.

the law. Accordingly, such competitive action may be proactive, defensive, or a combination of both.

Since the 1990s, successive federal governments in Canada have embraced an “open economy paradigm”³ aimed at the navigation of cross-cutting political and economic interests, domestic and international, in order to enhance Canadians’ economic opportunities. A major objective of this paradigm has been to promote the competitiveness of Canadian businesses in the context of North American and broader international market integration, notwithstanding the growing constraints on this element of globalization in recent years. The concept of competitiveness may reflect (1) aggregate measurements of taxation and its impact on after-tax returns on investment, or (2) key sector-specific metrics of disproportionate relevance to particular industries.

Of course, governments pursue this objective alongside other key political and economic goals, particularly the goal of domestic fiscal sustainability—that is, keeping overall levels of taxation and spending in approximate balance in order to finance the provision of essential public services at levels consistent with maintaining economic growth and improved living standards, and with constraining or reducing public debt relative to gross domestic product (GDP). More explicitly political goals of the open economy paradigm include facilitating Canadians’ adaptation to changing social and economic realities, promoting national resilience in the face of periodic political and economic shocks, and (not the least of these goals) sustaining a broad enough distribution of the benefits of economic growth to secure a government’s periodic re-election. As a result, although the prevailing (if not always observed) norms of tax policies differ in their forms of neutrality and other measures calculated to enhance economic efficiency, the tax system itself exists to serve broader clusters of public policy objectives that are often deeply embedded in public expectations and patterns of economic activity.⁴

In this paper, I address the challenges of business taxation as an interactive series of two- (and sometimes multi-) level games, embedded in broader debates over international competition for investment and the distribution of fiscal costs and benefits within Canada. I draw on a mixture of international relations theories (neo-institutionalist, public choice, and realist) of two-level games in international economic relations to explain the evolution of Canada’s business tax system in relation to the systems of other major competitors for international investment—in particular, the United States. I summarize the historical and contemporary context of international tax competition, particularly as it relates to (1) income shifting,

3 David A. Lake, “Open Economy Politics: A Critical Review” (2009) 4:3 *Review of International Organizations* 219–44, at 224–31 (<https://doi.org/10.1007/s11558-009-9060-y>); and Richard M. Bird and J. Scott Wilkie, “Tax Policy Objectives,” in Heather Kerr, Ken McKenzie, and Jack Mintz, eds., *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012), 2:1–39, at 2:24–25.

4 For a discussion of major structural elements of the tax system as tantamount to conventional elements of an economic constitution, see Geoffrey Hale, *The Politics of Taxation in Canada* (Peterborough, ON: Broadview Press, 2001), at 64–87.

(2) the evolution of Canadian business tax policies in response to macro- and micro-challenges of tax arbitrage, and (3) the challenges of managing the politics of taxation during a period of political and economic uncertainty possibly unrivalled since the 1970s. These three issues have become particularly pressing with the long-deferred reaction to international tax competition that the United States has taken in the Tax Cuts and Jobs Act (TCJA) of 2017, and with other policy shifts that point to a declining political commitment among Canada's major trading partners to an open economy paradigm.

TAX POLICIES AS TWO- (OR MULTI-) LEVEL GAMES

The extent of North American and wider international economic interdependence reinforces the intermestic dimension of Canada's tax system—that is, the blurring of traditional distinctions between primarily domestic and international policies⁵ (including but not limited to business taxation policy) that reflects “interlinkages between all parts of the tax system.”⁶ Scholars of international political economy note certain parallels between the efforts of different governments—particularly the governments of democratic countries—to manage international economic and security relationships. Political leaders and their senior officials enjoy a degree of autonomy in international relations. However, they also face significant domestic institutional and political constraints⁷—not the least of which is the reality that major firms and other investors are independent actors whose interests may overlap with, but remain distinct from, those of their countries of formal residence. The relative success of a national government's international economic policies—whether these policies are (1) unilateral, (2) the product of tacit policy convergence through various forms of parallelism, or (3) the product of explicit negotiations—depends significantly on that government's capacity to achieve some degree of alignment between the interests of major economic actors, the national interests, and that government's ongoing relationships with other governments. However, the definition of “national interests” is heavily conditioned by the structure of national political

5 Bayless Manning, “The Congress, the Executive and Intermestic Affairs: Three Proposals” (1976) 55:2 *Foreign Affairs* 306-24 (<https://doi.org/10.2307/20039647>).

6 Michael Keen, Li Liu, and Peter Harris, “Taxing Business in a Changing World,” in *Canada: Selected Issues*, IMF Country Report 18/222 (Washington, DC: International Monetary Fund, June 28, 2018), 4-31, at 18.

7 Robert D. Putnam, “Diplomacy and Domestic Politics: The Logic of Two-Level Games” (1988) 42:3 *International Organization* 427-60; Helen V. Milner, *Interests, Institutions, and Information: Domestic Politics and International Relations* (Princeton, NJ: Princeton University Press, 1997); and Eugénia da Conceição-Heldt and Patrick A. Mello, “Two-Level Games in Foreign Policy Analysis,” in *Oxford Research Encyclopedia of Politics* (Oxford: Oxford University Press, 2017) (<https://doi.org/10.1093/acrefore/9780190228637.013.496>).

institutions, including the capacity of a given structure to secure the consent or acquiescence of formal and informal veto holders or blocking coalitions.⁸

In this context, efforts to manage fiscal and trade relations and the interactions of national regulatory systems (among other systems) help to create a series of two- and multi-level games embedded within broader governance processes that combine relations among governments, transnational actors, and varied domestic interests inside and outside governments.⁹ The restructuring of business tax systems, whether undertaken in conjunction with broader tax reforms, as during the 1980s, or in response to changing international and domestic business practices, as during the 2000s, typically requires a balancing of competing goals involving both external and domestic factors.¹⁰

At its simplest, the concept of international economic relations as two-level games is rooted in the interdependence of international and domestic political and policy processes in participating countries—interdependence with one another and with largely market-driven economic processes and relationships.¹¹ At one level, governments seek to manage their ongoing interactions with other national or central governments—and with other international economic actors—to mutual advantage within relatively stable legal and economic arrangements. These processes are punctuated by the periodic negotiation or revision of bilateral or multilateral agreements. At a second level, however, tax policy and other major national regulatory processes remain primarily national because of asymmetries of power, institutional arrangements, the relative interdependence or vulnerability between and among countries, the primacy of domestic legislative authority, and senior policy makers' desire to maintain control of their respective policy agendas.

The greater the political visibility or prospective economic impact of significant changes to tax policies (whether these changes arise from domestic or international considerations or from a mixture of both), the greater the relative importance of the second level of the game—that is, the level at which governments seek to create, with respect to proposed changes, a supportive consensus with public opinion and key domestic stakeholders (or, at least, seek to create the conditions necessary to

8 Edward D. Mansfield and Helen V. Milner, *Votes, Vetoes, and the Political Economy of International Trade Agreements* (Princeton, NJ: Princeton University Press, 2012); and Geoffrey Hale, "Regulatory Cooperation in North America: Diplomacy Navigating Asymmetries" (2019) 49:1 *American Review of Canadian Studies* 123-49 (<https://doi.org/10.1080/02722011.2019.1570956>).

9 Putnam, *supra* note 7; Milner, *supra* note 7; and Geoffrey Hale, "Transnationalism, Transgovernmentalism and Canada-US Relations in the Twenty-First Century" (2013) 43:4 *American Review of Canadian Studies* 494-511 (<https://doi.org/10.1080/02722011.2013.858757>).

10 Hale, *supra* note 4, at 38 et seq.

11 The degree of politicization of these relationships depends on the extent to which they are intertwined with national security considerations (as with nuclear materials and export controls over defence-related technologies) or with the relative power (and related electoral calculations) of central and subnational governments over particular economic sectors as instruments of economic development, distributive politics, or both.

diffuse prospective or actual opposition). Writing almost 40 years ago, David Good observed that insiders responsible for federal tax policy “make tax policy by anticipating the outside world and, to the extent desirable and feasible, by accommodating tax policies to their anticipations.”¹² The greater the technical complexity (or relative obscurity) of actual or proposed measures, the greater the relative autonomy of bureaucratic policy makers,¹³ as long as these policy makers enjoy the confidence and support of their political “masters.” Federal Department of Finance officials have substantially increased their engagement with major stakeholders and other attentive actors, institutionalizing their consultation processes since the political fiasco of the 1981 tax reform budget.¹⁴ Since that time, these officials have also convened periodic advisory panels, which usually involve both private and (former) public sector experts on particularly technical or controversial issues, as with the Advisory Panel on Canada’s International System of Taxation (2007-8).¹⁵

However, these debates are typically confined to a tax policy community composed of (1) economists and other policy professionals within the Department of Finance, (2) the select group of tax lawyers, accountants, and academic economists with whom the policy professionals interact, and (3) other “attentive actors” generally interested in particular segments of tax policy rather than in the system as a whole. Good’s observation that “[a]ttentive actors . . . are separate and isolated components . . . distinguished from each other by a highly particularized interest in taxation”¹⁶ appears to be as true as it ever was, particularly in highly technical, specialized fields such as international taxation. Broader public engagement generally occurs only when the debate becomes politicized as a result of divisions within the tax policy community or as a result of policy makers’ failure to anticipate adequately the disruptive effects of proposed policy changes on entrenched interests or ordinary citizens.¹⁷ Two-level games focused on particular policy initiatives may turn into multi-level games when they affect competing sets of institutional interests and objectives within governments that are interacting with competing sets of corresponding economic and/or societal interests.

Policy makers and disciplinary experts within the tax policy community seek to balance (1) the institutional objectives of maximizing overall revenues (as opposed to maximizing revenues from particular sources) in ways that are least disruptive to economic activity with (2) competing governmental and societal interests and objectives

12 David A. Good, *The Politics of Anticipation: Making Canadian Federal Tax Policy* (Ottawa: Carleton University, School of Public Administration, 1980), at xi.

13 Eric A. Nordlinger, *On the Autonomy of the Democratic State* (Cambridge, MA: Harvard University Press, 1981).

14 Hale, *supra* note 4, at 162-74.

15 Advisory Panel on Canada’s International System of Taxation, *Final Report: Enhancing Canada’s International Tax Advantage* (Ottawa: Department of Finance, December 2008).

16 Good, *supra* note 12, at xii-xiii.

17 Good, *ibid.*; and Hale, *supra* note 4.

(including the government's prospects of periodic re-election).¹⁸ Good has described these balancing processes as "the politics of anticipation."¹⁹ Savoie and others have characterized them as the institutionalized competition of "guardians and spenders."²⁰ Within this framework, the "guardian" role of the Department of Finance, particularly its tax policy branch, is largely defensive—whether in anticipating and limiting risks of tax arbitrage and other unintended consequences of prospective tax policy decisions, or in reacting to aggressive tax arbitrage and avoidance strategies used to exploit past policy decisions or to leverage modest policy anomalies into much broader fiscal crevasses.²¹ Other governments face similar challenges, including the relative centralization or diffusion of responsibility for oversight of comparable policies across governments, differences in the legal or institutional processes to be navigated, and the presence of prospective veto players whose consent must be negotiated either by governments or through cross-national policy coalitions.²²

However, international tax policies of particular governments are typically embedded within and largely dependent on the structures of national tax policies, as noted above. The major features of a government's international tax policy are relatively durable, and they are shaped by domestic institutions, slowly evolving balances of economic and social interests, and political and bureaucratic perceptions

18 Three elements of this internal debate—in which advocates of the "open economy" paradigm within the Canadian tax policy have come to conclusions that differ from prevailing outlooks in the United States—are the following: (1) the role of corporate income taxation ("withholding tax" and "backstop" as opposed to primary instrument of redistribution), (2) the ultimate incidence of capital taxation (its eventual distribution among workers, consumers, and shareholders), and (3) the efficiency effects or "deadweight loss" of different forms of taxation in different economic settings. Richard M. Bird and Thomas A. Wilson, "The Corporate Income Tax in Canada: Does Its Past Foretell Its Future?" (2016) 9:38 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-32; Geoffrey Hale, "Cross-Border Fiscal Competition and Tax Reform," paper presented to the Association of Canadian Studies in the United States, Las Vegas, October 20, 2017; and Geoffrey Hale, "Institutions Matter: Fiscal Competition and Tax Reform in the United States and Canada," paper presented to the Western Social Sciences Association, Houston, April 7, 2018.

19 Good, *supra* note 12.

20 Donald J. Savoie, *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press, 1990); and David A. Good, *The Politics of Public Money*, 2d ed. (Toronto: Institute of Public Administration of Canada and University of Toronto Press, 2014).

21 The two most notorious examples of such exploitation in recent memory are probably the scientific and research tax credit (SRTC) fiasco of the mid-1980s and the spectacular growth of income trusts between 1999 and October 31, 2006 (the date of Finance Minister Jim Flaherty's pre-emption of this technique outside the real estate sector). Current Finance officials point to the rapid growth of self-incorporation by members of professional firms, which prompted the federal government's controversial efforts to contain access to small business tax preferences in 2016 as a growing form of tax arbitrage. Alexandra Posadski, Eric Atkins, and David Parkinson, "Small Business, Big Trouble," *Globe and Mail*, September 16, 2017; and Keen et al., *supra* note 6, at 5-6.

22 Hale, *supra* note 8; and Mansfield and Milner, *supra* note 8.

of national, institutional, and political (self-)interest.²³ Pantaleo and Smart observe that “Canada uses all three patterns [of international taxation]: worldwide, territorial, and remittance basis (or deferral) . . . depend(ing) on the nature of both the taxpayer and the income.”²⁴ Notwithstanding significant structural reforms in the 1980s, the central elements of Canada’s existing tax system were designed during a period of relatively limited international interdependence, although the formally worldwide character of its business tax system has evolved into a “*de facto* territorial form of international taxation for active (business) income.”²⁵

The growth of Canada’s interdependence with the North American and global economies since the 1980s has reinforced cross-cutting forms of fiscal and tax competition at several levels in allocating the costs and benefits of government activities—competition between citizens (or “residents”) and governments, between individuals and corporations (as well as large and small firms), between national and foreign governments, and among their citizens, who benefit to varying degrees from different kinds of international investment. In some cases, as discussed in the next section of this paper, major tax policy changes have accompanied or followed fundamental changes in Canada’s international relationships—most notably, the negotiation of the Canada-US Free Trade Agreement in 1986-87 and the subsequent rapid growth in both inbound and outbound stocks of foreign direct investment relative to GDP. In other cases, these tax policy changes have been responses to incremental changes in the international policy environment—for example, changes in marginal tax rates, thin capitalization rules, and the debates over whether (and how) to restrict the deductibility of arm’s-length interest payments on the international transactions that were the object of much of Tim Edgar’s research.²⁶

Changes to domestic tax policies in Canada and in its major trading partners, especially the United States, create policy externalities, both for other governments and (particularly) for businesses that often incorporate tax considerations into their allocation of investments, organization of supply chains, and choice of transactional forms across jurisdictional boundaries²⁷—a “bottom-up” form of tax competition. Cockfield has observed that growing international economic integration, combined with differences in national tax rules, has increased competition between national

23 Hale, *supra* note 4, at 63-87. See Douglas G. Hartle, *The Revenue Budget Process of the Government of Canada: Description, Appraisal, and Proposals*, Canadian Tax Paper no. 67 (Toronto: Canadian Tax Foundation, 1982); Savoie, *supra* note 20; and Good, *supra* note 20.

24 Nick Pantaleo and Michael Smart, “International Considerations,” in *Tax Policy in Canada*, *supra* note 3, 12:1-48, at 12:4.

25 Keen et al., *supra* note 6, at 7; compare Simon Richards and Dylan Gowans, “Corporate Income Taxes in Canada: Revenue, Rates and Rationale,” *HillNotes*, March 21, 2017 (<https://hillnotes.ca/2017/03/21/corporate-income-taxes-in-canada-revenue-rates-and-rationale/>).

26 Edgar, *Interest Deductibility Restrictions*, *supra* note 2; and Edgar, “Outbound Direct Investment,” *supra* note 2.

27 Edgar, “Corporate Income Tax Coordination,” *supra* note 2, at 1081.

governments and multinational firms by encouraging the latter to “shift the location of their investments and operations to countries that impose relatively lower . . . tax burdens,”²⁸ and to engage in tax arbitrage between and among countries through sophisticated tax-planning, financial, and transfer-pricing strategies.²⁹

As a result, governments have become increasingly sensitive to the use of income shifting and other forms of tax arbitrage to reduce their tax bases—a major concern raised by the 1997 report of the Technical Committee on Business Taxation (“the Technical Committee”). Federal tax policies since 2000 have been aimed at reducing Canada’s vulnerability to such activities, creating a relatively favourable environment for internationally competitive Canadian companies, and welcoming inward foreign investment (outside a handful of protected sectors).³⁰

The multi-level game of tax competition functions within a dynamic environment characterized by a mixture of intergovernmental competition, cooperation in navigating differences between national tax systems, and evolving strategies of adaptation to changing fiscal and other competitive conditions by Canadian- and foreign-based multinational corporations (MNCs), with implications for investment flows, employment, and government revenues. National governments may cooperate selectively to limit both double taxation and the arbitrage that results in tax base erosion, both of which result from tax competition and differences among national tax systems. Such cooperative arrangements may take the form of “hard law,” as in bilateral tax treaties, or of “soft law” that is dependent on integration with national legal systems, such as the recent Organisation for Economic Co-operation and Development (OECD) multilateral convention³¹ and its International VAT/GST [value-added tax/goods and services tax] Guidelines of 2017.³² Even so, Arnold notes that such measures are “essentially products of domestic law . . . that affect cross-border transactions,”³³ as with many other forms of international regulatory cooperation.³⁴

28 Arthur J. Cockfield, “Introduction: The Last Battleground of Globalization,” in *Globalization and Its Tax Discontents*, supra note 2, 3-17, at 5.

29 Ibid., at 6; and Edgar, “Corporate Income Tax Coordination,” supra note 2.

30 Geoffrey Hale, *Uneasy Partnership: The Politics of Business and Government in Canada*, 2d ed. (Toronto: University of Toronto Press, 2018), at 291-315.

31 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement the Tax Treaty Measures To Prevent Base Erosion and Profit Shifting, released November 24, 2016.

32 Organisation for Economic Co-operation and Development, *International VAT/GST Guidelines* (Paris: OECD, April 12, 2017).

33 Brian J. Arnold, “Canada’s International Tax System: Historical Review, Problems and Outlook for the Future,” in *Canada’s International Law at 150 and Beyond*, Paper no. 8 (Waterloo, ON: Centre for International Governance Innovation, February 2018), 1-12, at 1-2.

34 Anne-Marie Slaughter, *A New World Order* (Princeton, NJ: Princeton University Press, 2004).

As a result, Canadian governments have tended toward the incremental adaptation of domestic tax policies to changing international conditions. High-profile measures, such as the elimination of capital taxes on non-financial corporations (2002-2008) and phased reductions in corporate tax rates (2006-2012), have been combined with broader reductions in personal income or consumption tax rates that are intended to maintain a rough balance between levels of personal and business taxation, and with other measures intended to meet broader fiscal targets, such as balanced budgets or the gradual reduction in federal-net-debt-to-GDP ratios.

FOREIGN INVESTMENT AND INTERNATIONAL TAX COMPETITION

[T]he main policy challenge [in tax reform] is to develop effective international tax rules and processes within what is essentially a non-cooperative government setting.³⁵

International tax competition takes place in different dimensions because of differences in the structures of national tax systems (and related domestic political expectations) and differences in the national rates of taxation for different types of economic activity. Governments may engage in tax competition in numerous ways: by setting marginal tax rates below those of major competitors, by privileging various forms of economic activity, or by altering tax structures—for example, by creating territorial tax structures that tax domestic but not active offshore business income.

Policy makers must decide how to integrate or prioritize different forms of tax neutrality—that is, the application of equal or similar tax rates to businesses (and other taxpayers) that are in similar circumstances. In principle, governments may seek to pursue capital import neutrality (CIN), in which foreign-based and domestically based firms are taxed at similar rates on business operations in the same jurisdiction; or capital export neutrality (CEN), in which the foreign-source income of domestically based MNCs is taxed at rates comparable with the rates applied to income from their domestic business activities.³⁶ CIN is typically associated with source-based or territorial tax systems, as well as with a “level-playing field” between domestic businesses and affiliates of foreign-based firms.³⁷ CEN is associated with residence-based or worldwide tax systems and, in principle, with the pursuit of global production efficiency in the international allocation of capital.³⁸

35 Cockfield, *supra* note 28, at 8.

36 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), at 6:3-4; Advisory Panel on Canada's System of International Taxation, *supra* note 15, at 12-13; and Jane G. Gravelle, *Reform of U.S. International Taxation: Alternatives*, CRS Report RL34115 (Washington, DC: Congressional Research Service, August 1, 2017), at 3-7.

37 Michael P. Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, research report prepared for Advisory Panel on Canada's International System of Taxation (Ottawa: Department of Finance, July 2008), at 4-5 and 9-10.

38 *Ibid.*, at 6.

In practice, many countries, including Canada, have hybrid systems that recognize the difficulty, if not the impossibility, of achieving capital import and export neutrality simultaneously.³⁹ The growth in international economic integration and the expansion of MNCs based in multiple countries, including Canada, have led to the spread of a third concept of neutrality that supports source-based (territorial) taxation of active business income. The objective of this form of neutrality—namely, capital ownership neutrality (CON), sometimes called “market neutrality”—is that “[t]axes should not distort competition . . . between any companies operating in the same market.”⁴⁰ Canadian governments seeking to promote internationally competitive, Canadian-based MNCs in the absence of effective coordination of international taxation regimes have embraced CON for active business income, if not without controversy among champions of other normative tax principles within the tax policy community.⁴¹ At the same time, these governments have used evolving foreign accrual property income (FAPI) rules to preserve their capacity to tax passive international income by limiting the conversion of active to passive income of Canadian-based firms’ foreign affiliates.

However, as noted above, Canadian governments face cross-cutting pressures in managing international tax competition, pressures that impose limits on their effective autonomy. At the level of domestic politics, these governments are constrained by public expectations (expectations rooted in normative principles of vertical equity) that corporate income taxation should contribute to public services, income transfers, and other redistributive functions. Three major policy considerations have disciplined policy makers’ responses to these pressures. First, there is strong economic evidence that in relatively small, open economies, higher taxes on capital have relatively high adverse effects on economic growth.⁴² Second, there is widespread recognition among Canadian tax economists (unlike US economists) that a sizeable share of capital taxation is ultimately borne not primarily by shareholders but by workers (in the form of lower wages) and by consumers (in the

39 Pantaleo and Smart, *supra* note 24, at 12:4; and David A. Weisbach, *The Use of Neutralities in International Tax Policy*, Coase-Sandor Institute for Law & Economics Working Paper no. 697 (Chicago: University of Chicago Law School, Coase-Sandor Institute for Law and Economics, August 2014).

40 Devereux, *supra* note 37, at 11.

41 For example, Arnold, *supra* note 33, at 11, criticizes the deductibility of interest on funds loaned to foreign affiliates of Canadian-based firms to generate active business income that is effectively tax-exempt in Canada as a “dubious policy of subsidizing offshore investment by Canadian multinationals.”

42 Maximilian Baylor and Louis Beauséjour, *Taxation and Economic Efficiency: Results from a Canadian CGE Model*, Working Paper 2004-10 (Ottawa: Department of Finance, November 2004); and Kevin Milligan, *Tax Policy for a New Era: Promoting Growth and Fairness*, Benefactor’s Lecture 2014 (Toronto: C.D. Howe Institute, November 2014).

form of higher prices).⁴³ Third, although the statistics vary across types of businesses, available data indicate that more than half of business tax costs are incurred through profit-insensitive taxes.⁴⁴ The Technical Committee suggested that these tensions should be managed by more closely aligning profit-insensitive taxes with the benefits received by the businesses that pay them.⁴⁵ However, the enthusiasm with which federal officials resorted to user fees during Ottawa's fiscal restructuring of the 1990s led Finance Minister John Manley in 2002, following strong pressure from business groups, to impose strong parliamentary checks on the introduction of new user fees. These restrictions were relaxed only with the 2017 federal budget.⁴⁶

Second, Canada's relatively open, trade-dependent economy has long constrained governments' taxing of mobile factors of production by enforcing effective corporate income tax (CIT) rates that are relatively competitive, particularly in comparison with the US rates.⁴⁷ These constraints were decisive in Canada's shift to value-added

43 *Report of the Technical Committee on Business Taxation*, supra note 36, at 1:3; Jonathan R. Kesselman and Ron Cheung, "Tax Incidence, Progressivity and Inequality in Canada" (2004) 52:3 *Canadian Tax Journal* 709-89; Bird and Wilkie, supra note 3; Robin W. Boadway and Jean-François Tremblay, *Modernizing Business Taxation*, C.D. Howe Institute Commentary no. 452 (Toronto: C.D. Howe Institute, May 2016); and Kenneth J. McKenzie and Ergete Ferede, "Who Pays the Corporate Tax? Insights from the Literature and Evidence for Canadian Provinces" (2017) 10:6 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-26.

44 The CIT's share of total business taxation varies widely with cyclical levels of corporate profitability and shifts in the overall federal-provincial tax mix. The CIT's share of total business taxation increased from 22 percent in 1995 to about 37 percent in 2015, and to 43 percent in 2016. *Report of the Technical Committee on Business Taxation*, supra note 36, at 2:19; and Peter Van Dyck and Andrew Packman, *Total Tax Contribution and the Wider Economic Impact: Surveying Canada's Leading Enterprises* (Toronto: PricewaterhouseCoopers and the Business Council of Canada, 2018) (<https://thebusinesscouncil.ca/publications/2018ttc/>).

45 *Report of the Technical Committee on Business Taxation*, supra note 36, at 1:7 and 1:10-11.

46 For discussion of the User Fees Act, SC 2004, c. 6, and the effective constraints that it imposed on the expansion of user fees by the federal public service before its replacement by the Service Fees Act, SC 2017, c. 20, section 451, see Connie Hache, "Financing Public Goods and Services through Taxation or User Fees: A Matter of Public Choice?" (PhD dissertation, University of Ottawa, School of Political Studies, 2015) (<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.1032.3659&rep=rep1&type=pdf>). A 2017 Senate report criticized the Service Fees Act for "removing all meaningful transparency and consultations" from proposed increases in user fees. Andrew Griffith, "Bill C-44 Division 21: Risks and Implications of the Service Fees Act," brief to Senate Committee on National Finance, at 2 (https://sencanada.ca/content/sen/committee/421/NFFN/Briefs/C-44__Brief_e.pdf).

47 Canada. Department of Finance, *The Tax Systems of Canada and the United States: A Study Comparing the Levels of Taxation on Individuals and Businesses in the Two Countries* (Ottawa: Department of Finance, November 1978) (released with the November 16, 1978 federal budget); and Canada, "Role of Marginal Effective Tax Rates in Canadian Tax Policy," presentation to MENA-OECD Investment Program, Paris, January 2009 (www.oecd.org/mena/competitiveness/42031384.pdf); and Hale, supra note 30, at 302-11.

taxation since the early 1990s, gradually followed by the shift to sales tax harmonization in the six provinces east of Manitoba, which contributed to sharply lower marginal effective tax rates (METRs) in participating provinces.⁴⁸ However, a trans-ideological taxpayers' revolt,⁴⁹ which resulted in the reversal of a harmonization agreement in British Columbia in 2010, along with the continuing public resistance to higher consumption taxes reflected by widespread political opposition to rising carbon taxes, demonstrate the practical political limits of such a strategy, especially if it is introduced without equivalent fiscal compensation to taxpayers.⁵⁰

Third, efforts to reduce corporate taxes in response to wide international trends (and in response to the efficiency arguments noted above) are constrained domestically by public expectations that such tax reductions will be matched or exceeded by comparable tax reductions for individuals and households, with due attentiveness to distributive considerations. Since the political fiasco of Allan MacEachen's tax reform budget of 1981, Canadian political leaders have typically been unwilling to pursue substantive tax reform initiatives unless they can be packaged as broadly based tax reduction for most Canadian taxpayers.⁵¹ Moreover, in Canada, unlike the United States, substantial changes to federal tax policies involving tax reduction have typically been conditional on fiscal sustainability, whether such sustainability is based on continued economic growth or strict spending discipline. These constraints help to explain the relatively targeted character of initial federal responses to US business tax reforms of 2017 in Canada's economic statement of November 2018.⁵²

The Evolving Context for International Tax Competition

Whether in setting marginal tax rates or making adjustments to major business tax incentives, Canadian governments have always been sensitive to international tax

48 Hale, *supra* note 30, at 302-5.

49 George Malcolm Abbott, "The Precarious Politics of Shifting Direction: The Introduction of a Harmonized Sales Tax in British Columbia and Ontario" [2015] no. 186 *BC Studies: The British Columbia Quarterly* 125-48 (<https://doi.org/10.14288/bcs.v0i186.185567>).

50 The Trudeau government has tacitly recognized this reality, responding to growing political resistance to the introduction of carbon taxes in several parts of Canada, by crafting its carbon tax "backstop" for provinces that withdraw from or refuse to participate in the federal scheme to recycle most revenues to residents of provinces to which the scheme will apply. See "For the Liberals, a Spoonful of Sugar Helps the Carbon Tax Go Down," *Globe and Mail*, October 24, 2018. Federal support for "emissions-intensive trade-exposed" (EITE) industries reflects similar efforts to mitigate the competitive effects of introducing carbon taxes in the absence of comparable actions by Canada's major trading partners. Sarah Dobson and Jennifer Winter, "Assessing Policy Support for Emissions-Intensive and Trade-Exposed Industries" (2018) 11:28 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-44.

51 The introduction of the federal GST in 1990 was the exception that has proved the rule. Finance Minister Michael Wilson made the tax visible at point of sale in order to discourage his successors from raising it in future (conversation with author, 1994), whatever its effects on the Mulroney government's prospects for re-election.

52 Canada, Department of Finance, *Investing in Middle Class Jobs: Fall Economic Statement 2018* (Ottawa: Department of Finance, November 2018).

competition, particularly as it affects investment and employment in major Canadian industries.⁵³ At the same time, these governments have acted repeatedly, albeit often with limited success, to limit the erosion of Canada's income and consumption tax bases by various forms of tax arbitrage. These factors reflect major elements of the "macro," sectoral, and "micro" dimensions of tax competition.

Although the scale of Canada's relative international interdependence has fluctuated, the maintaining of competitive effective tax rates for traded sectors has been a major objective of Canadian policies for many years. Ottawa's approach to CIT rate-setting strategies and to restrictions on income-shifting practices has generally been defensive—a response to incremental trends (or periodic tax reforms) in other countries. Since 1989, Ottawa has been more innovative in addressing competitive issues related to consumption taxes—in large measure because of competitive pressures and opportunities created by the absence of a national sales tax in the United States.

Federal and provincial governments have also sought to address competitiveness issues in managing the evolution of environmental taxation, whether in paralleling US federal and/or state policy initiatives before 2010⁵⁴ or the former's subsequent federal inaction on carbon-pricing measures. The Trudeau government's decision to implement (without corresponding US action) a national carbon-pricing strategy in response to Canada's 2017 Paris Accord commitments illustrates the numerous challenges of balancing environmental objectives, competitiveness issues, and trade-offs imposed by Canada's decentralized federal system and regionally diversified energy endowments.

Canada has tracked effective US tax rates, particularly for manufacturing, to varying degrees since the 1970s, although this was done more as an informal than a formal policy goal until the Harper government committed itself in 2006 to achieving "the lowest tax rate on new business investment in the [Group of Seven] G7."⁵⁵ Successive efforts to reform the antiquated federal sales tax, culminating in its replacement by the federal GST in 1990, sought to limit progressive base erosion while achieving neutrality in the tax treatment of domestic and imported goods and services in an economy characterized by the growing disaggregation of business activity.⁵⁶ Major tax reforms in the United States and Great Britain, which significantly reduced marginal income tax rates for individuals and businesses in the

53 *The Tax Systems of Canada and the United States*, supra note 47; *Report of the Technical Committee on Business Taxation*, supra note 36; and "Role of Marginal Effective Tax Rates in Canadian Tax Policy," supra note 47.

54 Geoffrey E. Hale, "Canada-US Relations in the Obama Era: Warming or Greening?" in G. Bruce Doern and Christopher Stoney, eds., *How Ottawa Spends, 2010-2011: Recession, Realignment, and the New Deficit Era* (Montreal and Kingston, ON: McGill-Queen's University Press, 2010), 48-67.

55 Canada, Department of Finance, *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: Department of Finance, October 2006), at 14 and 73-78.

56 Hale, supra note 4, at 207-23.

mid-1980s, created both demonstration effects and political imperatives for other industrial countries, including Canada.⁵⁷ More recently, the rapid growth of digital commerce has created challenges in the enforcement of VATs on cross-border commerce, and it has intensified debates over registration requirements for large-scale offshore vendors.⁵⁸

Canada continues to have one of the world's most open economies, as illustrated by the relative importance of international trade and investment as a share of the country's GDP, and this increases the relative importance of Canada's tax competitiveness and fiscal sustainability. Two-way trade accounted for 64 percent of Canada's GDP in 2017, the fourth-highest percentage in the Group of Twenty (G20) after Germany, Korea, and Mexico.⁵⁹ At 90.1 percent of GDP, Canada's total stock of outward foreign direct investment (FDI) is the largest among G20 nations, as is the total value of Canada's inward FDI, based on the OECD definition of "equity" plus net loans to enterprises in foreign economies that result in at least 10 percent ownership of foreign affiliates. Keen et al. estimate that US-based multinationals have generated about 15 percent of CIT revenues in recent years⁶⁰—a figure that is subject to significant erosion depending on the effectiveness of Canadian federal responses to recent US tax reforms.

Table 1 outlines outward and inward stocks as shares of GDP for Canada and the world's largest economies between 2005 and 2017. Table 2 points to longer-term trends in inward and outward FDI, using Statistics Canada's equity-based measurement. Differences between the two benchmarks illustrate the relative importance of related-party debt in the structuring of foreign affiliates.

Canada's average outward and inward flows of FDI in the 2008-2017 period have also been among the largest of G7 and G20 countries, averaging 3.7 and 2.6 percent of GDP, respectively, between 2008 and 2017 (substantially above the G7 averages of 1.9 and 1.2 percent, respectively).⁶¹ However, non-tax considerations—not least the global takeover boom of 2005-2007 and the ebb and flow of international energy investments (or disinvestments in 2016-17)—have typically played larger roles in

57 Ibid., at 192-98; and United States, Congressional Budget Office, *Corporate Tax Rates: International Comparisons* (Washington, DC: Congressional Budget Office, November 2005).

58 Bruno Basalisco, Jimmy Gårdebrink, Martina Facino, and Henrik Okholm, *E-commerce Imports into Canada: Sales Tax and Customs Treatment* (Copenhagen: Copenhagen Economics, March 2017); PricewaterhouseCoopers, *Rise in Canada's De Minimis Threshold: Economic Impact Assessment* (Toronto: Retail Council of Canada, December 2017); Rosalie Wyonch, "Competitive Digital Taxation for Federal Budget 2019," C.D. Howe Institute *Intelligence Memo*, December 12, 2018; and Jack Mintz, "Who Dares To Tax the Flix?" *Financial Post*, January 22, 2019.

59 World Bank, "Trade (% of GDP)," 2018 (<https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS>).

60 Keen et al., *supra* note 6, at 28, note 7.

61 Organisation for Economic Co-operation and Development, "FDI Flows," 2019 (<https://doi.org/10.1787/99f6e393-en>).

TABLE 1 Outward and Inward Direct Investment: Canada in International Context

	Outward			Inward		
	2005	2011	2017	2005	2011	2017
	<i>percentage of GDP</i>					
Canada	59.2	49.9	90.1	54.6	48.2	65.2
United Kingdom	49.1	65.6	61.7	31.2	43.9	61.2
European Union	34.6	48.0	66.5	29.9	38.4	57.4
Germany	29.1	38.1	43.5	22.6	26.3	25.8
United States	27.8	29.1	40.4	21.5	22.6	40.5
Japan	8.3	15.2	30.7	2.1	3.7	4.1
China	2.8	5.6	12.3	20.6	25.2	24.3

Note: Boldface indicates the highest percentage in a year.

Source: Organisation for Economic Co-operation and Development, “FDI Flows,” 2019 (<https://doi.org/10.1787/99f6e393-en>).

TABLE 2 Canada’s Outward and Inward Foreign Direct Investment

	1990	2000	2005	2011	2013	2017
	<i>percentage of GDP</i>					
Canadian direct investment abroad	14.2	32.3	31.9	38.3	41.0	52.4
Foreign direct investment	18.9	28.9	28.1	35.6	36.3	38.6

Sources: Statistics Canada, table 36-10-0008-01 (formerly CANSIM table 376-0051), “International Investment Position, Canadian Direct Investment Abroad and Foreign Direct Investment in Canada, by Country, Annual,” and table 36-10-0222-01 (formerly CANSIM table 384-0038), “Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual”; and author’s calculations.

these developments than tax considerations, with two major exceptions discussed later in this section.

Although both the United States and Canada raised taxes during the 1990s as part of broad budget-balancing strategies, the 1997 Technical Committee report noted that Canada’s METRs were substantially above international norms, creating both opportunities and incentives for income shifting through the accumulation of debt financing in Canadian operations of multinational firms. A key structural challenge in limiting income shifting is that Canada’s income tax system (like that of the United States before 2018) makes financing expansion through debt “inherently tax-preferred to equity.”⁶²

62 Keen et al., *supra* note 6, at 10. At the same time, the capacity to shelter retained earnings in (small) Canadian-controlled private corporations creates an inherent bias toward retained earnings financing. This bias is reinforced by the typically more generous spread between general corporate and small business tax rates in most provinces (except Quebec)

The committee identified several areas in which Ottawa could engage in base broadening and limit opportunities for tax arbitrage (for example, by the tightening of thin capitalization ratios) while functioning within “international norms.” However, the committee also recommended continuing the effective exemption of active business income from foreign affiliate taxation, but with tighter restrictions on the deductibility of interest in Canada used to finance international interaffiliate transactions.⁶³

The Technical Committee’s most significant long-term impact was to draw attention to the importance of *aggregate* business taxation, in the form of METRs, on international capital flows. Although the Chrétien and Martin governments began to reduce Canadian METR levels to the levels of other major industrial countries, with phased CIT and capital tax reductions after 2000, the Harper government formalized this process between 2007 and 2012 by introducing major reductions to marginal CIT rates and providing provinces with incentives to harmonize their sales taxes with the GST. As a result, Canada’s average corporate METR fell from 43 percent in 2000 to 26.5 percent in 2013.⁶⁴

Canadian governments have gradually, if perhaps belatedly, tightened thin capitalization rules since the 1980s: they reduced permitted debt-to-equity ratios from 3:1 (in 1987) to 2:1 (in 2000), following the Technical Committee report; and to 1.5:1 in 2012, following the Advisory Panel report.⁶⁵ In addition, disallowed interest paid by non-resident investors is taxable as dividends under the terms of relevant tax treaties.⁶⁶ However, successive governments have preferred incremental changes and the expansion of anti-avoidance measures to major structural changes such as those suggested by Tim Edgar—for example, suggestions that Canada follow the example of Australia, New Zealand, and the United Kingdom in applying thin capitalization rules to arms-length borrowing, or that Canada significantly limit restrictions on deductibility of interest borrowed by Canadian-based multinationals to lend to foreign affiliates.⁶⁷

and in the federal tax system. Average provincial small business rates outside Quebec were 10.3 percentage points below comparable general corporate rates in 2018, compared with 4 percentage points in Quebec in 2018 (4.9 percent in 2019), and, for the federal spread, 5 percentage points in 2018 (6 percent in 2019).

63 *Report of the Technical Committee on Business Taxation*, supra note 36, at 1:4, 3:26, and 6:11–30.

64 Chen and Mintz define METRs as “the portion of capital-related taxes paid as a share of the pre-tax rate of return on capital for marginal investments”: Duanjie Chen and Jack M. Mintz, “The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda” (2015) 8:4 *SPP Research Papers* [University of Calgary, School of Public Policy] 1–19.

65 Supra note 15.

66 Evelyn Moskowitz, *Financing Issues: The Thin Capitalization Rules* (Ottawa: Canadian Bar Association, May 29, 2010), at 3–4, note 7 (www.cba.org/cba/cle/PDF/Tax10_Moskowitz_FinancingIssues_ThinCapitalizationRules_paper.pdf); and John M. Campbell, “Thin Capitalization Regime,” *International Tax Newsletter*, November 2012 (www.millerthomson.com/en/publications/communiques-and-updates/international-tax-newsletter/november-2012/thin-capitalization-regime/).

67 Edgar, “Outbound Direct Investment,” supra note 2.

The issues of interaffiliate financing and the deductibility, in Canada, of funds borrowed for investment abroad has been reinforced by the scale of outbound FDI in international financial centres and other low-tax jurisdictions, particularly because dividends from such affiliates are often tax-exempt in Canada.⁶⁸ For example, Bermuda and four other Caribbean tax havens have accounted for an average of 16.5 percent of outward Canadian FDI and for 2.3 percent of inward FDI since 2013, reflecting the frequent use of these countries as venues for international financial transactions.⁶⁹ The 2007 federal budget announced plans (hereinafter referred to as “section 18.2”)⁷⁰ to restrict, by 2011, so-called double-dip transactions involving the use of funds borrowed in Canada to “obtain at least two interest deductions on the amount of money borrowed” through foreign affiliates located in low-tax jurisdictions.⁷¹ Strong corporate resistance to this measure—given the persistence of measures favourable to “tax-efficient” interaffiliate financing by foreign affiliates of US, British, and Dutch-based MNCs (among others),⁷² the onset of the global financial crisis, and (possibly) the record number of foreign takeovers of major Canadian firms in 2007-8—convinced the Advisory Panel on Canada’s International System of Taxation to recommend the withdrawal of the measure in its final report.⁷³ In response, Finance Minister Jim Flaherty rescinded section 18.2 in his February 2009 budget. This incident suggests that the nature of international tax competition effectively limits the capacity of relatively small countries such as Canada to introduce major structural changes to their international taxation systems without some degree of coordination with (or clear demonstration effects of policy changes made by) major economic powers without the risk of increasing relative financing costs for these countries’ resident MNCs.

A second cross-cutting challenge to the achievement of international tax equity is a by-product of domestic tax changes within Canada. The Chrétien and Martin

68 François Lavoie, *Canadian Direct Investment in “Offshore Financial Centers”* Statistics Canada catalogue no. 11-621-MIE (Ottawa: Statistics Canada, March 2005); and Brian Mustard, “Canada’s System of International Taxation: A Look Back, a Look Forward” (2013) 61, special supp. *Canadian Tax Journal* 257-70.

69 Statistics Canada, table 36-10-0008-01 (formerly CANSIM table 376-0051), “International Investment Position, Canadian Direct Investment Abroad and Foreign Direct Investment in Canada, by Country, Annual.”

70 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

71 Office of the Auditor General of Canada, *Report of the Auditor General of Canada to the House of Commons* (Ottawa: Office of the Auditor General of Canada, December 2002), chapter 11, at exhibit 11.3. See also Canada. Department of Finance, *Explanatory Notes relating to the Income Tax Act, the Excise Act, 2001, and the Excise Tax Act* (Ottawa: Department of Finance, February 2009), at clause 7 (www.fin.gc.ca/drlég-apl/biafeb09n-eng.asp); and Edgar, “Outbound Direct Investment,” supra note 2.

72 The Netherlands accounted for 11.2 percent of outward Canadian FDI stocks in 2017, and Luxembourg for another 6 percent—percentages that are disproportionately high in relation to the status of these countries as European trading partners. Statistics Canada, supra note 69.

73 Supra note 15, at 50-53; and Mustard, supra note 68, at 259.

governments' gradual phaseout of Income Tax Act restrictions on international investments by pension funds and other retirement savings vehicles in the early 2000s (combined with prudential pressures for diversification of their investments) contributed to the rapid growth of offshore investments by major public sector (and other) pension funds. Foreign holdings of Canada's 10 largest pension investment managers were estimated at 55.4 percent of their \$1.2 trillion of assets under management in 2014.⁷⁴ The economic interactions of pension fund investments with tax policies (particularly for offshore investments), and the variety in ownership structures, are sufficiently complex to deter broad generalizations about their economic effects.⁷⁵ The sizable role played by tax-exempt investors in both domestic and international capital markets⁷⁶ significantly constrains the expanded taxation of active business income by foreign affiliates of Canadian MNCs without risking significant issues of horizontal equity. At the same time, the Canada-US tax convention allows for reciprocal exemptions from withholding taxes on cross-border investment income paid to non-resident pension funds.⁷⁷

However, concerns over the sheltering of investment income in foreign tax havens in recent years have given governments in many major industrial countries a shared interest in limiting the erosion of their personal and CIT bases and increasing their effectiveness in combatting outright tax evasion. The OECD base erosion and profit shifting (BEPS) project, inaugurated in 2013, has benefited from three major factors critical to overcoming previous political and bureaucratic obstacles to intergovernmental cooperation. First, the unilateral action of the US Congress in passing the Foreign Account Tax Compliance Act (FATCA) of 2010 required foreign

74 Boston Consulting Group, *Measuring Impact of Canadian Pension Funds* (Toronto: BCG, October 2015), at 11 (http://image-src.bcg.com/Images/Measuring-Impact-of-Canadian-Pension-Funds-Oct-2015_tcm79-39773.pdf). By 2018, the proportion of offshore investments was substantially larger (85 percent) for the Canada Pension Plan Investment Board (CPPIB) and for Quebec's Caisse de Dépôt (64 percent). See Esteban Duarte, "Overseas Shopping Protects AAA Rating," *Financial Post*, April 23, 2019.

75 Vijay Jog and Jack Mintz, "The 30 Percent Limitation for Pension Ownership in Companies: Policy Options" (2012) 60:3 *Canadian Tax Journal* 567-608, at 581-86.

76 Jog and Mintz, *ibid.*, at 584, note that in 2004 "[t]ax-exempt investors [held] 40 percent of total [Canadian] corporate assets, Canadian taxable investors [held] 20 percent, and the remainder [were] held by non-residents." Conversely, the "top 10" Canadian pension investment funds accounted for almost 60 percent of the stock of Canadian direct investment abroad in 2014: Boston Consulting Group, *supra* note 74. Rosenthal and Austin estimate that retirement accounts and plans held 37 percent of taxable holdings in US "C" corporations in 2015, foreign residents about 26 percent, US household investors (including partnerships) 24.2 percent, and non-profit organizations about 4.9 percent. However, passthrough vehicles now account for more than half of taxable US business income. Steven M. Rosenthal and Lydia M. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock" (2016) 151:7 *Tax Notes* 923-34.

77 Jack M. Mintz and Stephen R. Richardson, "Not Just for Americans: The Case for Expanding Reciprocal Tax Exemptions for Foreign Investments by Pension Funds" (2014) 7:34 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-25.

financial institutions to provide the Internal Revenue Service with information on accounts held by US clients. These provisions—effectively a policy reversal intended to preserve US policy discretion (also known as “sovereignty”) outside constraints imposed by previous multilateral processes—provided a model for the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes in its framing of model tax information exchange agreements (TIEAs) and, ultimately, a model for the 2017 multilateral convention, in order to enable participating countries to combat aggressive tax planning without triggering domestic US concerns over the erosion of domestic sovereignty.⁷⁸

The BEPS project and TIEAs rely on amendments to existing tax treaties and the implementation of varied national laws, a reliance that is consistent with traditional conventions of horizontal (“soft law”) international cooperation.⁷⁹ Accordingly, the BEPS project and TIEAs limit the political challenges of harmonizing diverse national legal institutions—a traditional barrier to international tax policy cooperation—while enabling expanded cooperation through transgovernmental networks to enhance the enforcement of domestic tax laws. The BEPS process has also enabled the Canada Revenue Agency to facilitate its international enforcement by requiring country-by-country disclosure of Canadians’ international corporate income and transactions, including the disclosure of investment funds and data on transfer pricing, along with the exchange of information among national tax collection authorities since 2016.⁸⁰

US Tax Reforms of 2017: Consequences for Cross-Border Tax Competition

Major structural changes to the US tax system, which were approved by Congress in 2017, have resulted in both significant CIT rate reductions and many technical tax policy innovations that have changed the competitive environments for investment and tax planning in Canada and other countries. Passage of the 2017 TCJA on a party-line vote followed several years of debates over whether US CIT rates had become uncompetitive relative to those of major trading partners and investment destinations.⁸¹ Many observers expressed concerns that the US residence-based (worldwide) CIT system had provided US-based MNCs with significant incentives for income shifting—particularly through the use of corporate inversions to shift

78 Arnold, *supra* note 33, at 9.

79 Slaughter, *supra* note 34.

80 Organisation for Economic Co-operation and Development, *Action 13: Country-by-Country Reporting Implementation Package* (Paris: OECD, 2015); and Canada Revenue Agency, “Guidance on Country-by-Country Reporting in Canada,” November 23, 2018 (www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4651/guidance-on-country-by-country-reporting-canada.html).

81 Hale, “Cross-Border Fiscal Competition and Tax Reform,” *supra* note 18.

their head offices to other countries (see figure 1), including Canada—notwithstanding periodic efforts to tighten anti-avoidance rules.⁸² Table 3 contrasts the composition of financial sources of US outbound FDI with the composition of financial sources of US inbound FDI in 2016, showing the much higher proportion of intracompany debt in the latter.

The TCJA reduced top US federal marginal CIT rates from 35.3 percent (39 percent, when average state tax rates are included) to 21 percent, and it reduced average combined METRs from an average 35.3 percent to 18.9 percent, with significant sectoral variations, eliminating a previous average Canadian advantage estimated at 14.2 percentage points across sectors and provinces.⁸³ It converted the US tax system from its previously worldwide (residence-based) structure, with credits for foreign taxes paid and deferral of taxes on non-repatriated profits, to a broadly territorial system, with one-time transitional taxes that are based on deemed repatriation of liquid and illiquid assets earnings and are payable over eight years.⁸⁴

More significantly for ongoing tax competition, the US tax reform creates substantial incentives for the repatriation and attraction of capital to the United States and for moving the costs of income shifting and other tax-planning measures to other countries, thus suggesting the tactics used in strategic trade policies rather than the mere pursuit of CIN.⁸⁵ Indeed, the TCJA may be the most aggressive exercise in many years in tax competition and engineering designed to increase domestic investment and international income shifting, although some of its sharp edges may be blunted by phaseout periods on particular measures, growing fiscal exigencies, and partisan shifts in coming years. Macroeconomic incentives for the reallocation of international investment are reinforced by Congress's decision to fund "permanent" business tax rate reductions by increasing deficits (and, implicitly, by increasing

82 Michelle Clark Neely and Larry D. Sherrer, "A Look at Corporate Inversions, Inside and Out" (2017) 25:1 *Regional Economist* [Federal Reserve Bank of St. Louis] and Donald J. Marples and Jane G. Gravelle, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, CRS Report no. R43568 (Washington, DC: Congressional Research Service, September 25, 2014). The 2016 anti-avoidance regulations designated any "foreign acquiring company" as a domestic entity if 80 percent or more of its equity is held by former US owners of the business (or of multiple firms acquired in "serial" transactions), with other penalties applying to firms with 60 percent or more US ownership. Paul Seraganian, Jennifer Lee, William Corcoran, and Ramin Wright, "Major U.S. Anti-Inversion Regulations Impact Canadian Companies Both in and out of the Inversion Sandbox," April 11, 2016 (www.osler.com/en/resources/cross-border/2016/major-u-s-anti-inversion-regulations-impact-canad/).

83 Jack Mintz and Duanjie Chen, *The U.S. Corporate Effective Tax Rate: Myth and the Fact*, Tax Foundation Special Report no. 214 (Washington, DC: Tax Foundation, February 2014); and P. Bazel and J. Mintz, "Canadian Policy Makers Consider Response to U.S. Tax Overhaul," *Tax Policy Trends*, October 2018 [University of Calgary, School of Public Policy], 1–2.

84 Erica York, *Evaluating the Changed Incentives for Repatriating Foreign Earnings*, Tax Foundation Fiscal Fact no. 615 (Washington, DC: Tax Foundation, September 27, 2018).

85 Jack Mintz, *Global Implications of U.S. Tax Reform*, EconPol Working Paper 08/2018 (Munich: Ifo Institute, March 2018); and Keen et al., supra note 6.

FIGURE 1 Completed US Corporation Tax Inversions, 1982-2017

Source: Zachary Mider, “Tracking Tax Runaways,” *Bloomberg.com*, March 1, 2017 (www.bloomberg.com/graphics/tax-inversion-tracker).

TABLE 3 Composition of Financial Sources of US Direct Investment Abroad and Foreign Direct Investment in the United States, 2016

	US direct investment abroad	Foreign direct investment in US
	<i>percent</i>	
Equity capital	10.0	53.0
Reinvested earnings	95.8	20.4
Intracompany debt	−5.8	26.6

Source: James K. Jackson, *U.S. Foreign Direct Investment Abroad: Trends and Current Issues*, CRS Report no. R21118 (Washington, DC: Congressional Research Service, June 29, 2017), at 4.

international borrowing given relatively low US savings rates), rather than by off-setting rate cuts with more extensive base broadening or by substantially increasing US federal spending in separate budgetary actions. Mintz and others have noted several elements in the TCJA that are of critical importance to Canadian businesses in both Canada and the United States:

1. the expensing, through 2022, of investment in assets with expected lifespans of less than 20 years, with plans for phasing out these measures by 2027;
2. the accelerated (five-year) amortization of research and development expenditure;
3. an exemption for dividends received from foreign affiliates with at least 10 percent ownership by the US parent (a measure that parallels existing Canadian policies);

4. a new base erosion anti-avoidance tax (BEAT) on the adjusted taxable income of foreign affiliates operating in the United States, with significant restrictions on related-party transfers; and
5. new global intangible low-taxed income (GILTI) tax rules on both foreign and domestic income of US-based multinationals.⁸⁶

These measures are partly offset by limits on the deductibility of interest expenses to a maximum of 30 percent, excluding real estate investments—with the additional effect of discouraging income shifting through increased debt financing of the US affiliates of foreign-based multinationals. Taken together at a macro level, these measures have eliminated the Canadian METR advantage over most sectors. They have created significant incentives to shift investments, particularly in intellectual property, to the United States, and to reallocate debt financing to other countries, including Canada.

The GILTI rules have been described as a “foreign minimum tax” on “super-normal” (over 10 percent) investment returns—sometimes labelled “excess profits.”⁸⁷ They are designed to limit the sheltering in low-tax jurisdictions of profits generated by US technology industries, in particular, which account for a disproportionate share of US exports and services trade. These rules also complement US strategic trade policies, including tighter intellectual property rules negotiated under the US-Mexico-Canada Agreement (USMCA) of October 2018.⁸⁸ Some observers suggest that these measures are also intended to pre-empt or “guide” prospective outcomes of OECD discussions of digital taxation, including but not limited to the outcomes related to international apportionment of taxes on major global technology firms, many of which originate in the United States.⁸⁹

Ideological and partisan polarization in Washington makes the durability of these measures after 2020 an open question. However, the cumulative effect of what certain observers have described as the “weaponization of uncertainty”⁹⁰ in international trade and economic relations creates an ongoing threat to Canada’s investment climate and competitiveness. Fiscal countermeasures announced by Finance Minister Bill Morneau in November 2018 matched the TCJA’s provision for the expensing of capital investment in assets with expected lifespans of less than 20 years, and the subsequent phasing out of these measures by 2027. Morneau also

86 Mintz, *supra* note 85, at 3-4.

87 Bazel and Mintz, *supra* note 83.

88 Junyi Chen, “USMCA (NAFTA 2.0): What’s New for Intellectual Property in Canada,” October 12, 2018 (www.blaney.com/articles/usmca-nafta-20-whats-new-for-intellectual-property-in-canada).

89 G. Charles Beller, “GILTI: ‘Made in America’ for European Tax—Unilateral Measures and Cooperative Surplus in the International Tax Competition Game” (2019) 38 *Virginia Law Review* 271-313.

90 For example, see Meredith Crowley and Dan Ciuriak, *Weaponizing Uncertainty* (Toronto: C.D. Howe Institute, June 19, 2018), at 7.

announced the tripling of initial depreciation rates for a range of other assets in order to address assorted issues of supply chain competitiveness within Canada. Taken together, these measures are expected to reduce average federal METRs from 17.0 to 13.8 percent (see figure 2).

Ottawa's November 2017 measures are a stopgap, comparable with, if more extensive than, provisions for accelerated depreciation introduced by the Harper government following similar US measures approved by Congress as part of the Obama administration's 2009 stimulus bill. However, because the likelihood of partisan gridlock in Congress following the 2018 midterm elections limits the prospects for much US policy innovation before the 2020 presidential elections, Canada has time to consider options for a broader range of policy measures to sustain its competitiveness in an evolving global environment.

CONCLUSION: EVOLVING CANADIAN TAX POLICIES FOR AN UNCERTAIN WORLD

The broader federal strategy for international tax competitiveness, a strategy that crystallized over the decade following the Technical Committee report of 1997 and was subsequently implemented under the Harper government, was contingent on a broader domestic strategy—aimed at fiscal sustainability, debt reduction, and widespread improvements in domestic living standards—that paid careful attention to distributive considerations. Various scholars have suggested broader blueprints for comprehensive or structural corporate tax reforms.⁹¹ However, historical experience suggests that any such undertaking is likely to be too economically and politically disruptive to reward any government that has the temerity to initiate it within the extended time frame required for effective policy design and implementation, unless fiscal conditions permit broadly based tax reductions for most individuals and businesses. Proposals for major changes in overall levels and distribution of taxes must begin with the tax system as it is, not as we might wish it to be in the best of all possible worlds.⁹²

The existing tax system is embedded within the economic lives and expectations of Canadians—often in contradictory ways, as demonstrated by the recent political fiasco over the Trudeau government's proposed restrictions of 2016-17 on access to the small business deduction.⁹³ Levels of public trust in political, economic, and academic elites are sufficiently tenuous that politically sustainable tax reform depends, as it always has, not merely on revenue neutrality but on achieving a consensus of affected societal interests whose consent is contingent on there being

91 For example, see Milligan, *supra* note 42; Chen and Mintz, *supra* note 64; Boadway and Tremblay, *supra* note 43; and Kenneth McKenzie and Michael Smart, *Tax Policy Next to the Elephant: Business Tax Reform in the Wake of the US Tax Cuts and Jobs Act*, C.D. Howe Institute Commentary no. 537 (Toronto: C.D. Howe Institute, March 2019).

92 Hale, *supra* note 4, at 27.

93 Posadski et al., *supra* note 21.

FIGURE 2 Corporate METRs Across G7 Countries: Impact of US Tax Reforms (2017) and Canadian Responses (2018)

Source: Canada, Department of Finance, *Investing in Middle Class Jobs: Fall Economic Statement 2018* (Ottawa: Department of Finance, November 2018), at 59.

broadly distributed reductions in overall levels of taxation without the disruption of valued public services.⁹⁴ However, tax and spending measures must be kept in a rough balance to ensure fiscal sustainability in the face of ongoing demographic trends in aging.

To achieve public consent to significant tax policy changes while maintaining the overall competitiveness of Canada's tax system (the two-level game that has been the focus of this article), the government that emerges from the upcoming federal election should set broad policy goals that recognize the interaction of various elements of the tax system, including, but not limited to, corporate and international tax levels.

There are two keys to maintaining the balance between competitiveness and public consent. First, governments should use the personal tax system as their principal tool for addressing issues of distributive equity, while making incremental changes to the corporate tax system that contribute to greater efficiency, growth, and business competitiveness. Second, in the Canadian context, the government

94 Edelman Canada, "2018 Edelman Trust Barometer: Canada," February 2018 (www.edelman.ca/sites/default/files/2018-02/2018-Edelman-Trust-Barometer-Canada_ENGLISH.PDF); Proof Inc., "CanTrust Index 2019: Canada Is Seeing Cracks in the Foundation of Trust," April 2019 (www.getproof.com/thinking/the-proof-cantrust-index/); and Hale, *supra* note 4, at 26-27.

should continue the recent years' trend of maintaining competitive METRs for Canadian businesses relative to major global competitors while (1) redressing major sectoral anomalies that undermine competitiveness and (2) incrementally extending measures to limit base erosion in a way that is consistent with broader international norms.

To achieve these objectives, the Department of Finance should

- maintain levels of accelerated depreciation that are broadly competitive with US levels, while attempting to limit distortions in their application across industry sectors;
- align profit-insensitive taxes on businesses more closely with the costs of providing related public services, subject to transparent justification of direct costs and services;
- review patent box models that could encourage innovation in Canada, reviewing them on the bases of expert analyses of evolving models in other industrial countries;⁹⁵
- consider expansion of the thin capitalization rules to include arm's-length debt transactions in the financing of foreign affiliates of Canadian-based firms, subject to careful examination of the effects of such measures in other countries;
- limit competitive pressures from "carbon leakage" by monitoring the impacts of carbon taxation in order to balance ongoing progress toward overall reductions in carbon emissions with the mitigation of impacts on particularly "trade-exposed" industries;
- limit base erosion and address the growing challenge of offshore internet commerce by tightening GST/HST (harmonized sales tax) requirements for offshore vendors, with a reasonable de minimis threshold, following Quebec, Saskatchewan, and the recent *Wayfair*⁹⁶ decision in the United States.

Purposeful incrementalism of this sort, which addresses aggregate levels of taxation while identifying sectoral opportunities for and vulnerabilities to international tax competition, is likely to be more practically achievable and sustainable than theoretically ambitious approaches that have the potential to disrupt existing economic relationships and trigger substantial political conflict.

95 For example, see John Lester and Jacek Warda, "An International Comparison of Tax Assistance for R&D: 2017 Update and Extension to Patent Boxes" (2018) 11:13 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-33.

96 *South Dakota v. Wayfair, Inc.*, 585 US (2018).

The Future of the Progressive Personal Income Tax: How High Can It Go?

Kevin Milligan*

PRÉCIS

L'auteur se fonde sur la théorie économique et les données probantes pour appuyer l'idée d'examiner les taux d'imposition sur les revenus élevés. À cause des réactions comportementales aux taux plus élevés, il se crée une limite supérieure; au-dessus de cette limite, la perte de recettes découlant des réactions comportementales dépasse le gain des recettes provenant du taux plus élevé. Cependant, il est possible de hausser cette limite par une application plus rigoureuse, et cette limite peut varier en fonction de considérations autres que fiscales telles que les variations dans l'offre et la demande de travailleurs hautement qualifiés. Ce cadre de travail laisse penser que si l'on souhaite augmenter les recettes au Canada en fixant des taux plus élevés, il faudra prendre d'importantes mesures pour hausser la limite supérieure.

ABSTRACT

The author draws on economic theory and evidence to build the case for considering boundaries for the high-income tax rate. Because of behavioural responses to higher rates, an upper boundary arises; above it, the revenue loss from behavioural responses outweighs the revenue gain from the higher rate. However, this upper boundary can be pushed upward through stronger enforcement and may vary with non-tax considerations, such as shifts in the demand for and supply of highly skilled workers. This framework suggests that if higher rates are to raise revenue in Canada, serious measures must be taken to increase the upper boundary.

KEYWORDS: INCOME TAXES ■ PROGRESSIVE TAXES ■ INCOME REDISTRIBUTION

CONTENTS

Introduction	694
Empirical Context of Income Tax Progressivity in Canada	695
Theory and Evidence Concerning High-Income Taxation	699
The Theory of Top-Income Taxation	700
The Empirics of Top-Income Taxation	702

* Of the University of British Columbia Vancouver School of Economics (kevin.milligan@ubc.ca). Prepared for the conference "Re-Imagining Tax for the 21st Century: Inspired by the Scholarship of Tim Edgar." I thank conference participants for their helpful comments.

What Influences the Diamond-Saez Upper Limit?	704
Real Responses to Top Tax Rates	705
Avoidance Responses to Top Tax Rates	707
Assessment	709
Conclusion	709

INTRODUCTION

The progressive personal income tax is at the centre of tax progressivity. It provides the most important counterweight to regressive elements in the rest of the tax system and in market-determined pretax incomes. While the case can be made that other taxes may produce a progressive effect in some circumstances, the sheer scale of the income tax makes its impact on progressivity dominant.¹ For those who have strong redistributive tastes, the income tax is a natural tool. But even for those with more laissez-faire attitudes toward the distribution of income, the progressive income tax is vital. Those who are not predisposed to redistribute might entertain a more modest goal of fiscal proportionality—everyone paying an equal share of his or her income. To meet even this more modest goal of overall proportionality, however, a progressive personal income tax is necessary in the face of other regressive fiscal elements.

How progressive should the income tax be? While the answer to this question is best left to each citizen's own social philosophy, economists can offer useful advice to inform citizens about the likely impacts of strong progressivity. In particular, the theoretical and empirical model of Diamond and Saez provides an attractive way to frame the debate over the progressivity of the Canadian income tax.² In the Diamond-Saez framework, the tax rate for top earners is pushed as high as it can go to maximize tax revenues. With this high point as the anchor, the progressivity of the rest of the income tax then follows. The framework delivers a clear upper limit on the top personal income tax rate, which can help to guide public debate.

In this article, I apply the Diamond-Saez framework to Canada's taxation system, covering recent theoretical developments, empirical findings, and policy actions. I then discuss how the responsiveness to taxation may vary according to circumstances, concentrating on recent developments in Canada. I conclude with policy advice for those seeking either to enhance or to attenuate high-income tax rates.

Before implementing this plan, however, I begin with an empirical overview of the history and current manifestation of income tax progressivity in Canada.

1 For example, Richard Bird and Michael Smart, "Taxing Consumption in Canada: Rates, Revenues, and Redistribution" *Finances of the Nation* feature (2016) 63:2 *Canadian Tax Journal* 417-42, make the case that Canada's goods and services tax is not regressive when considered against a base of consumption rather than income. However, because of the regressivity of excise taxes, consumption taxes as a category remain regressive.

2 Peter Diamond and Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" (2011) 25:4 *Journal of Economic Perspectives* 165-90.

EMPIRICAL CONTEXT OF INCOME TAX PROGRESSIVITY IN CANADA

The history and present state of the progressivity of the income tax in Canada is presented below in five figures to provide a context for the discussion. In these figures, the tax rates are generated using the Canadian Tax and Credit Simulator (CTaCS) on percentiles of the income distribution drawn from the 2015 Canadian income survey and adjusted for inflation in each year shown.³ The figures are focused on the case of a single resident of British Columbia, age 40, in order to avoid the complexities of spousal and retirement tax and benefits, and show the combined federal and provincial rates.

Figure 1 provides the marginal tax rate on employment income at each income level from \$0 to \$225,000 in 2019, both for an individual without children and for an individual with two children. In the case of the individual without children, the core bracket and rate structure can be seen clearly at incomes above \$50,000. At lower income levels, the phase-in and phaseout of refundable tax credits affect the marginal tax rate. For example, the initial dip and peak is driven by the Canada workers' benefit, which is phased in and then out at low income levels. Subsequent phaseouts of the goods and services tax credit and the climate action tax credit also shape the curve at lower income levels. In the case of an individual with children, the phaseouts of refundable credits with respect to children (such as the Canada child benefit) dominate the statutory brackets.

Two main lessons can be learned from figure 1. First, much of the variation in rates at lower- and middle-income levels is affected by refundable tax credits rather than statutory rates. Second, while there is some increase in rates at income levels above \$100,000, the progressivity is modest.

I next turn to the history of income tax marginal progressivity from 1962 to 2019, again with reference to a single individual resident in British Columbia. It is important to emphasize that the definition of taxable income changes substantially over this period, particularly as a result of the tax reforms of 1972 and 1988, which affected both the ability to avoid taxes and the average effective tax rate paid as a percentage of total income. However, with this caveat in mind, it is nevertheless informative to consider how income has been taxed over this 58-year period.

Figure 2 shows the marginal tax rate on earnings at different percentiles of the income distribution, ranging from the 10th percentile at the bottom to the 99.99th percentile at the top. There were substantial changes in 1972 and 1988 that broadened the tax base and allowed for lower rates for most earners. For top earners, the rate fell from a peak of 82 percent in 1970 to under 50 percent by 1988. Throughout

3 See Kevin Milligan, "Canadian Tax and Credit Simulator: CTaCS," database, software, and documentation, version 2019-1 (<http://faculty.arts.ubc.ca/kmilligan/ctacs>). The simulations use market income plus taxable government transfers as the income measure. I take individuals between the ages of 18 and 59 to avoid the special circumstances involved in the taxation of pensions and retirement income.

FIGURE 1 Marginal Tax Rate on Earned Income in British Columbia, 2019

Note: Calculations use CTaCS 2019-1. The children are aged five and eight.

most of the 1990s, there was no difference between those at the highest percentiles and those at the 95th percentile. Since 2016, higher rates on the top 1 percent at both the federal and the provincial level in British Columbia have pushed the top rate back to just under 50 percent. Interestingly, the rate for the median earner has stayed relatively constant at between 24 and 29 percent since 1967.

It is important to distinguish between marginal and average rates. When the burden of a given tax regime is being assessed, what matters is the overall tax burden as a proportion of the tax base. For the personal income tax, this is best measured by comparing the income tax paid to the total income, which is a measure of the average tax rate. While the average rate is most relevant in assessing tax burdens, changes in the marginal tax rate are one of the main tools that affect average rates. Therefore, progressive marginal rates are an important means of delivering progressive average rates.

With these distinctions between average and marginal rates in mind, I examine the average rate over time for an individual who has different types of income. The denominator is formed by taking the individual's total income, at different income levels, in the following proportions: 40 percent interest, 40 percent dividends, and 20 percent capital gains. Over time, the inclusion rate for capital gains and the effective rate on dividends (net of gross-up and credit) vary considerably, and therefore differing proportions of capital gains or dividend income are taxable. In this way, the calculation provides average effective tax rates on a given basket of income as the taxable income base varies over time.

Figure 3 illustrates these average effective rates for a single taxpayer from 1962 to 2019 in British Columbia. Here, as in figure 2, the average tax burdens in terms

FIGURE 2 Marginal Tax Rates in British Columbia, 1962-2019

Note: Calculations use CTaCS 2019-1. The percentiles of the income distribution are drawn from the 2015 Canadian income survey and adjusted for inflation each year.

of marginal rates have decreased for the highest earners, but have done so less sharply. The 1972 reform, which led to the inclusion of capital gains and introduced the gross-up and credit system for dividends, had a much smaller impact on average effective rates than on marginal rates because the base was expanded at the same time as the rates dropped. Since 2006, average effective rates for the highest earners have increased.

The previous analysis pertains to British Columbia only. Figure 4 depicts the evolution of the top marginal rate from 1988 to 2019 in five selected provinces. The broad trend was toward higher top rates in the 1990s, lower rates in the 2000s, and a return to higher rates over the past few years. The magnitude of change varies, and the timing is slightly different, but the broad trends are fairly common throughout the jurisdictions.

Figure 5, which draws on data from the Organisation for Economic Co-operation and Development (OECD), shows the top income tax rate in OECD countries in 2017. The rate for Canada used here is the rate from Ontario, 53.53 percent. In several OECD countries, social security contributions and value-added tax rates can each exceed 20 percent, and therefore income tax rates may not be indicative of the total marginal financial burden. Nevertheless, using this measure Canada has the sixth highest top marginal income tax rate of the 34 countries shown, exceeded by Sweden, Denmark, Japan, Greece, and France.

FIGURE 3 Average Effective Tax Rates in British Columbia, 1962-2019

FIGURE 4 High-Earner Marginal Tax Rates in Five Selected Provinces, 1988-2019

Note: Calculations use CTaCS 2019-1.

FIGURE 5 Top Income Tax Rates in OECD Countries, 2017

Source: OECD Tax Database, table I.7 (www.oecd.org/tax/tax-policy/tax-database.htm).

Top income tax rates in Canada today are lower than those that prevailed in earlier decades, but they have risen slightly in recent years. Provincial trends have largely reinforced federal rate changes. In the international context, Canada's highest income tax rates fall within the top half of the rates for all OECD countries, but not within the five highest rates. A movement toward higher top income tax rates would defy neither historical Canadian fiscal practice nor contemporary international fiscal practice. The same can be said of a movement in the opposite direction.

THEORY AND EVIDENCE CONCERNING HIGH-INCOME TAXATION

To understand how high the top tax rates can and should go, I employ the framework of Diamond and Saez. This framework sets the top tax rate at the level that maximizes government revenues from high earners, exhausting all revenue potential by finding the point of balance between the mechanical increase that higher rates yield from a fixed tax base and the erosion of the base through behavioural responses. The progressivity schedule then works from that point to determine tax rates at lower income levels. In this way, the revenue-maximizing tax rate for high earners is the anchor of the progressivity of the income tax system.

In this section, I review the development of theory and empirical evidence on top-income taxation, especially over the last 20 years, describing the evolution of theory from James Mirrlees to the recent work of Emmanuel Saez and his co-authors. Following that, I discuss empirical evidence about how top earners respond to taxation, which informs the application of theory to practice.

The Theory of Top-Income Taxation

The modern optimal income tax theoretical framework derives from the Mirrlees model.⁴ In this model, the tax authority needs to raise revenue for public purposes and can tax the earnings of individuals with differing (but unobservable) abilities. Individuals choose how much to work, with an eye to ensuring that their after-tax pay is sufficiently remunerative to compensate for forgone leisure. The tax authority puts a social weight on each individual's outcomes and decides who should be taxed lightly and who should be taxed heavily to maximize society's well-being by balancing work, leisure, and trade-offs among individuals.

In this model, it might seem natural to expect high tax rates for those with the greatest ability to pay when the social weighting puts more emphasis on redistribution from low-ability to high-ability people. However, the well-known result from the Mirrlees framework defies this expectation: the model implies that the highest-ability person should be placed in a tax bracket with a zero marginal rate.

The logic is as easy to follow as the result is surprising. Imagine an equilibrium with a positive tax rate on the highest-ability person and the government's revenue need being satisfied at current tax rates. If this equilibrium were perturbed by installing a new zero-rated tax bracket starting at the top-ability individual's current income level, she might work a bit more while leaving the already-satisfied revenue requirement untouched. Assuming a positive social weighting on this individual, the perturbation is preferred to the initial equilibrium because she is better off, nobody else is worse off, and the government's coffers remain unchanged.

Peter Diamond made an important advance in the theoretical understanding of high-income taxation.⁵ Recognizing that the Mirrlees "zero at the top" result pertained only to the very highest-ability person, Diamond considered a different technical assumption about how ability may be distributed throughout the population. Instead of having a finite person with the highest ability, Diamond asked what happens if ability is not bounded, but continues to grow as the number of people moves toward infinity.⁶ With this seemingly innocuous change in the mathematical assumption, the model now yields a U-shaped optimal tax schedule, with rates rising from middle to higher incomes. This presents an intriguing reversal of the "zero at the top" result and provides an exciting path forward for linking theory to practice.

At approximately the same time, Piketty and Saez realized that a framework similar to Diamond's can yield optimal income tax rates on high earners that are

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

5 Peter A. Diamond, "Optimal Income Taxation: An Example with a U-Shaped Pattern of Optimal Marginal Tax Rates" (1998) 88:1 *American Economic Review* 83-95.

6 See N. Gregory Mankiw, Matthew Weinzierl, and Danny Yagan, "Optimal Taxation in Theory and Practice" (2009) 23:4 *Journal of Economic Perspectives* 147-74, for a critical discussion of the Pareto distribution assumption for top earnings that underlies the Diamond approach.

described fairly simply by the distribution of skills and an elasticity—the responsiveness of earnings to tax rates.⁷ Saez simulated tax schedules under differing assumptions about social weights and elasticities, finding U-shaped schedules, but with fairly flat rates once earnings exceeded \$150,000. Therefore, while firmly establishing the theoretical credibility of a progressive rate schedule, these simulations did not provide much justification for strongly progressive rates through the ranks of the highest earners.

The last piece of the Diamond-Saez economic framework for progressive taxation involves the concept of the elasticity of taxable income (ETI), which quantifies how much taxable income changes when tax rates go up or down. Previous economic modelling focused on labour supply responsiveness to taxes, whereas the ETI framework is more general and captures other forms of real response (such as investment or mobility), as well as responses of income through avoidance or evasion. The theoretical development of the ETI concept started with work by Martin Feldstein and was refined by Saez, Slemrod, and Giertz.⁸

The theoretical implication for taxes on top earners from this ETI framework emphasizes that there is a tax rate above which the reduction of tax revenue through a behavioural response (such as avoidance or labour supply) is greater than the mechanical effect of higher rates yielding extra tax revenue on declared income. The precise value of this revenue-maximizing tax rate is an important policy question, but the noteworthy advance is the theoretical grounding for a revenue-maximizing rate on high earners.

Diamond and Saez built on this point in laying out their framework. They noted that if a very small (or zero) social weight is put on the last few dollars of income received by the highest earners, then the government's task should be to push the tax rate high enough to maximize tax revenue from the highest earners. The rest of the progressive tax schedule follows from this point, anchored in the theory and empirics of the ETI. In this way, the Diamond-Saez framework provides an ETI-determined top tax rate as an upper limit to the range of top tax rates that are relevant for policy consideration.

An absence of social weight on high earners may be viewed as an unsavoury assumption. Feldstein finds it “quite amazing” that high earners should be viewed as no more than “revenue producing property of the state,” and suggests that the assumption that little social weight should be put on anyone is “repugnant.”⁹ At

7 See Thomas Piketty, “La redistribution fiscale face au chômage” (1997) 12:1 *Revue française d'économie* 157–201; and Emmanuel Saez, “Using Elasticities To Derive Optimal Income Tax Rates” (2001) 68:1 *Review of Economic Studies* 205–29.

8 Martin Feldstein, “Tax Avoidance and the Deadweight Loss of the Income Tax” (1999) 81:4 *Review of Economics and Statistics* 674–80; and Emmanuel Saez, Joel B. Slemrod, and Seth H. Giertz, “The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review” (2012) 50:1 *Journal of Economic Literature* 3–50.

9 See Martin Feldstein, “The Mirrlees Review” (2012) 50:3 *Journal of Economic Literature* 781–90, at 783.

its root, this is a return to the age-old debates about any kind of utilitarian social calculus that involves interpersonal comparisons of well-being. I cannot resolve this debate, but I note that tastes and views do vary across the population.

Others argue that the ETI-determined maximum may be too low. Lockwood, Nathanson, and Weyl argue that high-earning professions produce negative externalities, and low-earning ones tend to produce positive externalities.¹⁰ High tax rates therefore act as a Pigouvian correction. Saez and Zucman argue that there are negative democratic externalities of plutocratic income concentration, professing that leaving such a concentration unaddressed will “risk killing democracy.”¹¹ Again, the argument is Pigouvian. Finally, Piketty, Saez, and Stantcheva show that salary bargaining by top corporate executives may be influenced by top tax rates since the return to bargaining is low if tax rates are high.¹² Their model suggests that the more bargaining matters, the higher the top tax rate should be. Any of these three reasons could justify top tax rates that exceed the ETI-determined maximum.

To summarize, the Diamond-Saez framework is supported by two main pillars. The first is an empirically determined top tax rate, derived from evidence about the ETI to maximize the revenue haul from top earners. The second is a values-driven assumption about the social weighting placed on the marginal consumption of high earners. If this weight is very low, there is minimal social cost to taxing high earners with only revenue maximization in mind.

The benefit of this framework comes from the boundaries that it provides for public debate on the contentious issue of income tax progressivity. If there were an agreed-on best estimate of the appropriate ETI, then the Diamond-Saez top rate provides a starting place from which people can adjust the top tax rate according to their views about the proper social weight to put on high earners.

The Empirics of Top-Income Taxation

The ETI is the centrepiece of the Diamond-Saez theoretical framework for top-income taxation. Do we have good estimates of the ETI for Canada? The important starting place for this brief review of the empirical evidence comes from work by Slemrod and Kopczuk.¹³ They emphasize that the ETI is not an immutable constant

10 See Benjamin B. Lockwood, Charles G. Nathanson, and E. Glen Weyl, “Taxation and the Allocation of Talent” (2017) 125:5 *Journal of Political Economy* 1635–82.

11 See Emmanuel Saez and Gabriel Zucman, “Alexandria Ocasio-Cortez’s Tax Hike Idea Is Not About Soaking the Rich: It’s About Curtailing Inequality and Saving Democracy,” *New York Times*, January 22, 2019 (www.nytimes.com/2019/01/22/opinion/ocasio-cortez-taxes.html).

12 See Thomas Piketty, Emmanuel Saez, and Stefanie Stantcheva, “Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities” (2014) 6:1 *American Economic Journal: Economic Policy* 230–71.

13 See Joel B. Slemrod and Wojciech Kopczuk, “The Optimal Elasticity of Taxable Income” (2002) 84:1 *Journal of Public Economics* 91–112; and Wojciech Kopczuk, “Tax Bases, Tax Rates and the Elasticity of Reported Income” (2005) 89:11–12 *Journal of Public Economics* 2093–2119.

but instead a partial reflection of the availability and ease of avoidance and evasion opportunities. For this reason, we should not expect the ETI to be the same across time, place, and fiscal institutions. These important caveats are considered in detail in the next section. Nevertheless, it is useful to understand the range of potential values for the ETI to inform the discussion.

Saez, Slemrod, and Giertz provide a thorough review of the methodologies and estimates found by researchers in the United States. They emphasize the importance of considering long-run responses and settle on a central estimate for the ETI of 0.25. This estimate means that a 1 percent increase in the top tax rate leads to approximately a 0.25 percent decrease in taxable income. It is this estimate that forms the basis of Diamond and Saez's calculation of a top tax rate of 73 percent in the United States. I return to this calculation below.

For Canada, Milligan and Smart use aggregated tax filer data to estimate the responsiveness of the shares of income received by high-income tax filers to tax rates that vary by province and year from 1988 to 2011.¹⁴ Their main estimate for the top 1 percent income share is an elasticity of 0.69, meaning that a 1 percent increase in the top tax rate leads to a 0.69 percent drop in the share of income received by tax filers in the top 1 percent.

Several caveats should be considered when one is interpreting this result. First, the result is relevant from the point of view of provincial tax rates because the estimated responsiveness may reflect interprovincial income shifting, which means that the federal elasticity may be much lower.¹⁵ Second, the estimate reflects the tax avoidance (and real responsiveness) of that period, which may or may not be relevant in other periods when the economic environment and institutions may be different. Third, the elasticity of total income, not taxable income, is estimated. Kopczuk's results imply that the ETI would likely be higher than the Milligan-Smart estimate of the total income elasticity. Finally, the estimated elasticity of the more exclusive top 0.1 percent of the population is higher still, suggesting that higher tax rates aimed at the very highest earners may face stronger headwinds. There are of course other Canadian estimates of the ETI, as surveyed by Alexandre Laurin.¹⁶ The Milligan-Smart estimates are in the same range as others, although methodologies and time periods vary.

14 See Kevin Milligan and Michael Smart, "Taxation and Top Incomes in Canada" (2015) 48:2 *Canadian Journal of Economics* 655-81.

15 This point is emphasized further in Kevin Milligan and Michael Smart, "An Estimable Model of Income Redistribution in a Federation: Musgrave Meets Oates" (2019) 11:1 *American Economic Journal: Economic Policy* 406-34, who build a model of interjurisdictional shifting and tax avoidance.

16 See Alexandre Laurin, "Shifting the Federal Tax Burden on One-Percenters: A Losing Proposition," C.D. Howe Institute e-brief 222 (Toronto: C.D. Howe Institute, December 3, 2015).

These estimates can be transformed into revenue-maximizing tax rates using a simple formula.¹⁷ The formula depends on only two parameters. The first parameter is the ETI, which reflects the responsiveness of reported income to the tax rate, and therefore a higher ETI means a lower revenue-maximizing top tax rate. The second parameter is alpha, which depends on how concentrated income is among top earners. If income is concentrated, the yield from a higher top tax rate is greater. The higher alpha is, the less concentrated income is. Therefore, with higher alpha comes a lower revenue-maximizing top tax rate.

Table 1 reveals how these two parameters affect the revenue-maximizing tax rate. For the United States, the appropriate alpha derived from income statistics is approximately 1.5. Using the Saez, Slemrod, and Giertz preferred long-run estimate of 0.25 yields the top tax rate of 72.7 percent that is featured in the article by Diamond and Saez. For Canada, the appropriate alpha is approximately 1.8. The Milligan-Smart elasticity estimate of 0.69 reflects provincial tax rate changes over short-run periods. However, table 1 indicates that if the actual long-run ETI in Canada were 0.5, the revenue-maximizing tax rate would be 52.6 percent—not far from the prevailing top tax rate in most provinces.

These calculations may not be greeted warmly by enthusiasts for higher top rates in Canada. However, the cautions and caveats discussed above must be taken seriously, and determining the relevant elasticity to use for a contemporary policy change is not straightforward. In the next section, I advance this argument by examining the overall responsiveness of income to tax rates and considering evidence and policy developments with respect to each potential response and its place in contemporary debate.

WHAT INFLUENCES THE DIAMOND-SAEZ UPPER LIMIT?

The responsiveness of income to tax rates is at the core of the Diamond-Saez framework. If the elasticity is relatively low, the progressivity of the tax system is anchored at a high rate. In contrast, if the elasticity is high, the revenue-maximizing top rate decreases. While a range of empirical estimates are available, understanding the influences and context that inform the relevant elasticity is of critical importance. Some factors may push the revenue-maximizing rate higher; others may push it lower. Some factors are under the direct control of government; others are not.

In this section, I discuss empirical evidence and contemporary policy developments that affect the responsiveness of income to tax rates, with specific reference to Canada. The section is organized into two parts, the first concerning real economic responses, and the second addressing avoidance responses.

17 See Kevin Milligan, “The Progressivity of the Canadian Personal Income Tax,” in Bev Dahlby, ed., *Reform of the Personal Income Tax in Canada* (Toronto: Canadian Tax Foundation, 2016), 97-141, for the derivation of this formula. The revenue-maximizing tax rate (τ^*) is a function of the ETI (e) and the income distribution parameter alpha (α). These are combined as follows:

$$\tau^* = \frac{1}{1 + e\alpha}.$$

TABLE 1 Revenue-Maximizing Top Tax Rates (Percent)

ETI	Alpha						
	1.4	1.5	1.6	1.7	1.8	1.9	2.0
0.10	87.7	87.0	86.2	85.5	84.7	84.0	83.3
0.25	74.1	72.7	71.4	70.2	69.0	67.8	66.7
0.50	58.8	57.1	55.6	54.1	52.6	51.3	50.0
0.75	48.8	47.1	45.5	44.0	42.6	41.2	40.0

Real Responses to Top Tax Rates

The responses to higher taxes that affect real underlying economics behaviour have the most direct impact on efficiency. Here, I consider labour supply along with mobility and residence.

The core choice in the Mirrlees model and much of the theoretical literature on optimal taxation is between labour and leisure. Therefore, how top income tax rates affect the labour supply choices of high earners is clearly an important question. To the extent that high earners are engaged in positional competition—to be the best in their field and vanquish others—taxes may have little impact on labour supply. Everyone may want the trophy no matter its size. However, other top professionals who contemplate accepting a new client or embarking on a new project may reject the work if it is insufficiently remunerative after taxes are taken into account.

Evidence that directly addresses the labour supply of top earners is scarce. Moffitt and Wilhelm examined high-earning men before and after the US Tax Reform Act of 1986, which substantially lowered their tax rates.¹⁸ They found no evidence of an increase in hours worked.

Another potential dimension of real response is mobility and residence. When taxes rise, news reports and anecdotes fill with stories of people who consider leaving the country because of the fiscal affront.¹⁹ For the mobility decision, it is average tax

18 Robert A. Moffitt and Mark O. Wilhelm, “Taxation and the Labor Supply Decisions of the Affluent,” in Joel B. Slemrod, ed., *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (Cambridge, MA: Harvard University Press, 2000), 193–239.

19 See, for example, Kevin Libin, “How High-Tax Canada Is Driving Away Billionaire Entrepreneurs Like Murray Edwards,” *Financial Post*, March 28, 2016 (<https://business.financialpost.com/opinion/the-tax-climate-refugee-murray-edwards>), who tells of a Canadian billionaire who immigrated to London from Calgary, reportedly because of new higher taxes at the provincial and federal levels. Similar tales arose in France in 2013–14 in response to a temporary 75 percent top tax rate, with actor Gérard Depardieu famously taking up residence in Russia. However, see Hannah Murphy and Mark John, “France Waves Discreet Goodbye to 75 Percent Super-Tax,” *Reuters Business News*, December 23, 2014 (www.reuters.com/article/us-france-supertax-idUSKBN0K11CC20141223). Murphy and John report that there was in fact no large exodus of people from France.

burdens rather than marginal ones that matter because all of the taxable dollars move with the person who migrates. Moreover, mobility depends not just on the overall tax burden but also on public services and life's amenities in different jurisdictions. Taxes are therefore only one consideration.

The evidence on taxes and mobility is mixed. Kleven, Landais, and Saez found that European football stars are affected by tax when choosing to migrate, although it seems likely that professional athletes are more mobile and tax-sensitive than other professions.²⁰ Young et al. found only weak evidence of millionaire migration between US states in response to tax differences.²¹ When it comes to innovators, however, the evidence is stronger. Moretti and Wilson, and Akcigit, Baslandze, and Stantcheva showed that state taxes affect the mobility of star scientists and inventors in the United States, while Akcigit et al. found that the international mobility of inventors depends on taxes as well.²² However, Bell et al. presented evidence that top inventors are more influenced by childhood exposure to innovation and that tax incentives are unlikely to matter.²³

For Canada, two additional factors might be considered when this international evidence on migration and taxes is being weighed. Both of these factors relate to Canada's proximity to the United States. First, in the market for executive talent, it may be necessary to match US salaries in US dollars, if potential talent is concerned about the price of consumption in US dollars. Stephen Gordon has presented evidence that Canadian top income shares align very closely with US top income shares when exchange rates are taken into account.²⁴ This suggests that higher Canadian taxes may lead to higher Canadian pre-tax incomes if matching US offers is important. Second, the recent trajectory of immigration policy in Canada and the United States has gone in opposite directions, with Canada taking a more open stance and

20 See Henrik Jacobsen Kleven, Camille Landais, and Emmanuel Saez, "Taxation and the International Migration of Superstars: Evidence from the European Football Market" (2013) 103:5 *American Economic Review* 1892-1924.

21 See Cristobal Young, Charles Varner, Ithai Z. Lurie, and Richard Prisinzano, "Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data" (2016) 81:3 *American Sociological Review* 421-46.

22 See Enrico Moretti and Daniel J. Wilson, "The Effect of State Taxes on the Geographical Location of Top Earners: Evidence from Star Scientists" (2017) 107:7 *American Economic Review* 1858-1903; Ufuk Akcigit, Salomé Baslandze, and Stefanie Stantcheva, "Taxation and the International Mobility of Inventors" (2016) 106:10 *American Economic Review* 2930-81; and Ufuk Akcigit, John Grigsby, Tom Nicholas, and Stefanie Stantcheva, *Taxation and Innovation in the 20th Century*, NBER Working Paper no. 24982 (Cambridge, MA: National Bureau of Economic Research, 2018).

23 See Alexander M. Bell, Raj Chetty, Xavier Jaravel, Neviana Petkova, and John Van Reenen, *Do Tax Cuts Produce More Einsteins? The Impacts of Financial Incentives vs. Exposure to Innovation on the Supply of Inventors*, NBER Working Paper no. 25493 (Cambridge, MA: National Bureau of Economic Research, 2019).

24 See Stephen Gordon, "The Incidence of Income Taxes on High Earners in Canada," *Canadian Journal of Economics* (forthcoming).

the United States attempting to put up a literal wall. In particular, initiatives such as Canada's global skills strategy, which offers a two-week window for visa processing, have led to a surge in the immigration of highly skilled individuals.²⁵ These stark differences in the openness to immigration may temper the tax sensitivity of migration decisions.

Avoidance Responses to Top Tax Rates

Beyond responses through real economics choices, higher tax rates on top earners can elicit an increased propensity to explore avoidance and evasion opportunities. One type of avoidance is tax shifting, meaning that income is shifted from a higher-tax to a lower-tax channel through accounting or financial transactions that have minimal bearing on the actual underlying economic nature of the activity generating the income. I begin here by discussing tax shifting with reference to international evidence and recent Canadian policy changes.

Differing tax rates across provincial borders provide one such opportunity to shift income. Milligan and Smart have developed a theoretical and empirical framework to study income shifting, finding that higher interprovincial shifting increases the desirability of federal government control of income taxation.²⁶ Trusts, whose residence can be established in low-tax provinces, are commonly used as a mechanism to shift income. However, both court rulings and government policy have tightened the residence requirements for trusts in recent years, making trusts less easily accessible for the purpose of income shifting.²⁷

Income can also be shifted among tax bases within a given jurisdiction, a technique most easily seen in shifts that occur between individual and corporate tax bases. In Canada, Wolfson and Legree and Wolfson et al. provide evidence of substantial shifts from the personal income tax base to private corporations.²⁸ This evidence coincides with evidence from Norway, where Alstadsæter et al. found that

25 See Natalie Wong, Theophilos Argitis, Natalie Obiko Pearson, and Erik Hertzberg, "Canada Says 'Give Me Your MBAs, Your Entrepreneurs,'" *Bloomberg Businessweek*, January 2, 2019, for stories and data on the wave of technology-sector and student migration into Canada.

26 See Kevin Milligan and Michael Smart, *supra* note 14.

27 In 2012, the Supreme Court of Canada decision in *Fundy Settlement v. Canada*, 2012 SCC 14, reaffirmed the importance of management and control in determining trust residence. In 2015, these principles were applied in *Discovery Trust v. Canada (National Revenue)*, 2015 CanLII 34016 (NLSC), a case concerning provincial trust residence in which the court approved the tax residence of the trust in Alberta, a low-tax jurisdiction. With respect to policy, the Canada Revenue Agency published a new income tax folio in 2016 that incorporates the recent court rulings on trust residence. See *Income Tax Folio S6-F1-C1*, "Residence of a Trust or Estate," November 24, 2015.

28 See Michael Wolfson and Scott Legree, "Private Companies, Professionals, and Income Splitting—Recent Canadian Experience" Policy Forum (2015) 63:3 *Canadian Tax Journal* 717-37; and Michael Wolfson, Mike Veall, Neil Brooks, and Brian Murphy, "Piercing the Veil: Private Corporations and the Income of the Affluent" (2016) 64:1 *Canadian Tax Journal* 1-30.

accounting for income accruing within closely held firms has a substantial impact on the measured incomes of high earners.²⁹ Clarke and Kopczuk, however, determined that part of the surge in US individual top incomes can be attributed to flowthrough business income shifting from corporate to personal tax returns as the tax incentives change over time.³⁰

The Canadian government's private corporation tax proposals in 2017 aimed to lower the attractiveness of shifting income from one tax base to another by limiting income splitting to family members (through curtailing the availability of income sprinkling) and by decreasing access to tax-favoured retained earnings inside private corporations. However, by further lowering the small business tax rate, the incentive to find new ways to shift income from individuals to private corporations may have increased.

A third form of shifting occurs in an international context. Gabriel Zucman documented the extent of global personal and corporate income and wealth held through tax havens.³¹ Using data from leaked banking records, Alstadsæter, Johannesen, and Zucman estimated that those in the top 0.01 percent of Scandinavian households evade 25 percent of their tax bill by making use of tax havens.³² Canadian evidence concerning offshore tax shifting is scarce, however.

Slemrod and Kopczuk emphasize that governments have some power to control and influence the extent of these three forms of tax shifting.³³ To some degree, the elasticity of avoidance is a choice variable of the tax authority, which can be affected by changes in legislation and improvements in enforcement.

For example, in the 2016 budget, the Canadian government announced an increase in funding for the Canada Revenue Agency of \$444 million over five years with the object of preventing tax avoidance and evasion; an additional \$524 million was announced in the 2017 budget. Extra revenue from the 2016 spending was booked at \$2.6 billion and from the 2017 spending was booked at \$2.5 billion.³⁴ If

29 See Annette Alstadsæter, Martin Jacob, Wojciech Kopczuk, and Kjetil Telle, *Accounting for Business Income in Measuring Top Income Shares: Integrated Accrual Approach Using Individual and Firm Data from Norway*, NBER Working Paper no. 22888 (Cambridge, MA: National Bureau of Economic Research, December 2016).

30 See Conor Clarke and Wojciech Kopczuk, "Business Income and Business Taxation in the United States Since the 1950s," in Robert A. Moffitt, ed., *Tax Policy and the Economy*, vol. 31 (Chicago: University of Chicago Press, 2017), 121-59.

31 See Gabriel Zucman, "Taxing Across Borders: Tracking Personal Wealth and Corporate Profits" (2014) 28:4 *Journal of Economic Perspectives* 121-48.

32 See Annette Alstadsæter, Niels Johannesen, and Gabriel Zucman, "Tax Evasion and Inequality" (2019) 109:6 *American Economic Review* 2073-2103.

33 See Slemrod and Kopczuk, *supra* note 13.

34 See the Canada, Department of Finance, 2016 Budget, March 22, 2016; and Canada, Department of Finance, 2017 Budget, March 22, 2017.

these revenue projections are accurate, it appears that there was considerable scope for the government to increase enforcement with respect to high earners in Canada.

Is extra revenue from enforcement likely? Alstadsæter, Johannesen, and Zucman report evidence from Norway suggesting that anti-evasion efforts raised extra revenue and did not result in the substitution of legal forms of tax avoidance.³⁵ This finding is consistent with Joel Slemrod's argument that increased enforcement informs delinquent taxpayers that they are being monitored by the tax authority and leads to increasing compliance across all the taxpayers' activities.³⁶

Assessment

From looking at either real responses or avoidance responses, it is clear that ETIs estimated before 2015 may need to be updated to accord with recent events. The evidence of increased immigration by highly skilled individuals, particularly in the technology sector, is strong. In addition, the increase in resources flowing into tax administrations and focusing on high earners, along with tax measures that diminish the opportunity for tax avoidance, mean that it may now be more difficult to shift income than it was in the past. Both of these factors create a lower sensitivity of taxable income to tax rates.

How much to discount or update estimated parameters is a matter of judgment. However, there is arguably still room to increase top tax rates in Canada beyond the prevailing levels. Reviewing table 1, it would be necessary to argue that changes in the economy and tax administration have decreased the ETI all the way to 0.25 to justify a top rate as high as 69 percent. Such an argument may be stretching the point, but a more moderate ETI estimate of 0.4 does justify a top rate of 58 percent.

The value of the Diamond-Saez framework in this assessment is to provide concrete numbers for the top-rate debate. That is, if someone wants to propose a 58 percent top rate for Canada, it is easy to point to the necessary ETI (0.4) and ask the proposer to justify why in 2019 such an ETI is appropriate.

CONCLUSION

In this paper, I have made the case for considering the progressivity of the personal income tax within the Diamond-Saez framework. I have reviewed the path to the development of the theory and the manner in which empirical evidence about the ETI is fed into the model to deliver an upper limit on the high-earner tax rate. I have then discussed empirical evidence concerning the ETI from the United States and Canada and showed the range of estimates.

35 See Annette Alstadsæter, Niels Johannesen, and Gabriel Zucman, *Tax Evasion and Tax Avoidance*, Working Paper (Berkeley, CA: UC Berkeley, 2018) (<http://gabriel-zucman.eu/files/AJZ2018b.pdf>).

36 See Joel B. Slemrod, "Tax Compliance and Enforcement," *Journal of Economic Literature* (forthcoming).

Finally, I have examined potential responses to higher tax rates, ranging from labour supply and migration to tax avoidance through income shifting. An important conclusion arising from this analysis is that the ETI—and thus the top marginal tax rate delivered by the Diamond-Saez framework—is not an immutable parameter; rather, the ETI changes with circumstances and can be affected by a government's choices about tax legislation and enforcement.

There are lessons here for those who favour more progressivity of income taxes for high earners. Any proposal to further increase high-income progressivity should be accompanied by a credible plan to improve tax policy legislation and enforcement with an eye to lowering the effective ETI. Equally, it is important for the high-income taxation skeptics to reasonably acknowledge the impact of efforts to shut down tax shelters, increase enforcement, and facilitate more effective high-income taxation.

A Supplemental Expenditure Tax for Canada

Victor Thuronyi*

PRÉCIS

Un impôt supplémentaire sur les dépenses (*supplemental expenditure tax* [SET]) pourrait être levé à des taux progressifs en plus de l'impôt sur le revenu, et les taux de l'impôt sur le revenu pourraient être réduits en conséquence. Le SET est un impôt à la consommation progressif sur les flux de trésorerie qui a été proposé initialement par Nicholas Kaldor en 1955. Son adoption faciliterait la réforme et la simplification de l'impôt sur le revenu, en imposant par exemple les gains en capital aux mêmes taux que le revenu ordinaire, et elle permettrait de supprimer l'impôt minimum de remplacement. Cet impôt peut être conçu de manière à ce que l'on exige peu d'autres renseignements que ceux déjà recueillis aux fins de l'impôt sur le revenu.

ABSTRACT

A supplemental expenditure tax (SET) could be imposed at progressive rates in addition to the income tax, and income tax rates lowered correspondingly. The SET is a progressive cash flow consumption tax originally proposed by Nicholas Kaldor in 1955. Its enactment would facilitate income tax reform and simplification—for example, by taxing capital gains at the same rates as ordinary income—and would enable the alternative minimum tax to be repealed. It could be designed so as to facilitate compliance with little additional information required beyond what already has to be gathered for income tax purposes.

KEYWORDS: ALTERNATIVE MINIMUM TAX ■ CASH FLOW ■ CONSUMPTION TAXES ■ PROGRESSIVE TAXES ■ TAX REFORM ■ TAX SIMPLIFICATION

CONTENTS

Introduction	712
What Is the SET?	713
How the SET Can Help the Income Tax	713
Progressivity	714
How the SET Can Enhance Progressivity and Fairness	715
The SET and Tax Diversification	717

* MA (1977) University of Cambridge; JD (1980) Harvard University.

Can an SET Be Well Defined?	717
In General	718
Specific Design Elements	718
Jurisdictional Basis	718
Income	718
Deductions	719
Treatment of Debts	719
Treatment of Cash	720
Housing	720
Other Consumer Durables	721
Averaging	721
Carryover of Exemption	721
International Aspects	722
Family Unit: Gifts and Bequests	723
Housing and Other Personal-Use Property	723
Anti-Abuse	724
Transition	725
Conclusion	727

INTRODUCTION

This paper explores whether a supplemental expenditure tax (SET) might be appropriate for Canada.¹ My conclusion is that an SET, if properly implemented, would support the following policy goals:

- to make our tax system more progressive,
- to provide for appropriate revenue diversification, and
- to introduce a broad-based tax, based on ability to pay, that would facilitate the reform of the income tax (especially taxation of capital gains as ordinary income).

The debate in the academic literature on income versus consumption taxation has focused on whether the income tax should be replaced by a consumption tax. Discussion has centred on which tax is better. Further reflection on the mechanics and politics of replacing an income tax with a consumption tax suggests that this is a false choice. It is quite unlikely that the income tax will ever be replaced by a consumption tax. This is partly because the transition arrangements for such a replacement would be quite difficult to fashion and would be controversial, particularly those having to do with the corporate income tax. A more fruitful approach is to think of a consumption tax being implemented as a supplement to the income tax. Viewed thus, an SET would not be an antithesis to the income tax, but rather a

1 This paper borrows from Victor Thuronyi, "A Supplemental Expenditure Tax," in Geerten M.M. Michiels and Victor Thuronyi, eds., *Tax Design Issues Worldwide* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2015), 3-34.

complement to it. The SET would leave the income tax as the mainstay of a progressive tax system, imposed at rates that are progressive but not unduly high.

WHAT IS THE SET?

The SET discussed in this paper would be a standard personal expenditure tax based on cash flow (that is, cash receipts, with a deduction allowed for net investments). Such a tax would be vastly simpler than the current income tax. To determine their SET liability, taxpayers would use the same information as they use for the regular income tax, with a few modifications. The general basis would be cash flow. Thus, items of income would be taken into account when received. A deduction would be allowed for any investments when they were made. This would include business investments. However, some items would be left out of account in order to simplify administration and compliance. Thus, certain borrowing would be excluded (mortgage debt, primarily); a deduction would be allowed for net savings; and includable receipts would be somewhat more extensive than they are under the income tax. Personal deductions² would generally be the same as under the regular income tax.

Instead of replacing the income tax, the SET would be levied in addition to it. Because it would entail a large personal exemption, it would be paid only by a relatively small segment of taxpayers. The various arguments about whether the income tax should be replaced by an expenditure tax do not necessarily apply to the SET. The SET should be regarded as a tool that could facilitate income tax reform and could therefore strengthen the income tax. For that reason, those familiar with the literature's longstanding debate over income tax versus expenditure tax should look afresh at whether the SET is desirable. It raises different issues than those raised by the standard debate.

HOW THE SET CAN HELP THE INCOME TAX

The income tax suffers from a number of problems. Because different forms of income are taxed under different rules (for example, only 50 percent of capital gains are taxed), there is a distortion of economic decisions.³ Income tax is only loosely tied to ability to pay.

The SET offers a possibility of rescuing the income tax. Bolstered by the SET, the income tax could be maintained at lower tax rates and in a reformed configuration, such that different types of income would be taxed, so far as possible, under the same rules. Low rates are important to this result, because distortions inherent in the income tax increase as the tax rate increases. The SET itself would be a neutral way of taxing consumed income, since it would apply on an even-handed basis to various types of income. The combination of an SET and the income tax would

2 For example, child-care expenses or moving expenses.

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

therefore be a more robust tax than the current law provides for. Under the new provision, the income tax/SET would be imposed at whatever combined rates were considered appropriate from the point of view of progressivity and revenue needs.

Although adding the SET to the income tax would not be a simplification, a simplification benefit would result if the SET allowed rates to be reduced and capital gains to be taxed in the same way as other income. The alternative minimum tax (AMT) could probably also be repealed, which would further simplify the system.⁴

The current federal rate structure involves top tax brackets of 26, 29, and 33 percent, while provincial rates can be as high as 25.75 percent (as in Quebec). With an SET, one could envisage a top federal rate as low as 25 percent, plus a top provincial rate of perhaps 10 percent, with the remaining progressivity coming from the SET. In order to get the top combined federal and provincial rate down to 35 percent or so, the provinces would probably have to take the lead in reducing their top income tax rates. The SET would then supply the extra progressivity that some provinces desire. Under this kind of structure, the SET would have to start kicking in at a point where personal expenditure was \$150,000 or so, perhaps even lower. From an administrative point of view, it would be desirable for the SET personal exemption to be the same for federal and provincial purposes. This would ensure that individuals would be liable for the SET, for provincial tax purposes, only if they were also liable for it for federal tax purposes. The SET might involve a single flat rate at the federal level, with provinces imposing one or two rates, depending on how progressive they wanted to be.

PROGRESSIVITY

The importance of progressivity has been articulated well by Neil Brooks.⁵ He envisioned the income tax as contributing to distributive justice and sharing the burden of the state fairly. He argued for “a return to the priority of justice and progressivity”⁶ at a time when the attention of policy analysts had shifted to efficiency concerns. Brooks noted that this had happened despite a “staggering increase in inequality”⁷ over the past 20 years, accompanied by “conspicuous consumption”⁸ by the super-rich. He noted that there were different views of government’s distributive role. His own view was that government’s role in redistribution has to do not

4 See Peter W. Hogg, Joanne E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 6th ed. (Toronto: Thomson Carswell, 2007), at 475 (where it is argued that the alternative minimum tax does not fulfill an important policy role under current law).

5 See Neil Brooks, “A Restatement of the Case for a Progressive Income Tax,” in John G. Head and Richard Krever, eds., *Tax Reform in the 21st Century: A Volume in Memory of Richard A. Musgrave* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2009), 275-351.

6 *Ibid.*, at 279.

7 *Ibid.*

8 *Ibid.*

only with relieving poverty but also with “narrowing the gap between the rich and the poor”⁹—that is, reducing the income of the rich in order “to achieve a more equal distribution of resources.”¹⁰

Brooks rejected the view that the distribution of income in society is presumptively fair. He argued that reducing inequality has multiple benefits, given that a high degree of income inequality

- reduces income mobility;
- leads to an increase in crime;
- is detrimental to public health;
- leads to greater inequality in educational attainment;
- negatively affects the sense of well-being of low-income individuals (owing, among other things, to conspicuous consumption by the wealthy);
- is destructive of social capital;
- undermines political support for the free market; and
- may negatively affect economic growth.

Given the choice between an income tax and a consumption tax, Brooks favoured the income tax as better achieving redistributive goals. He did not, however, focus on the SET. I will argue that the SET is an effective way to achieve the values that Brooks has been championing.

HOW THE SET CAN ENHANCE PROGRESSIVITY AND FAIRNESS

The argument favouring the SET is a practical one. It rests on the premise that the income tax does not function well in practice and that it would be difficult to repair the income tax within its own terms. A fix for the income tax would require a reduction in rates,¹¹ which would cost revenue and make the tax less progressive. According to my proposal, the SET would be available to supplement the income tax through progressive rates on the wealthy, thus making up for the revenue loss and reduced progressivity that result from lower income tax rates. The SET therefore would fulfill the goals of making the tax system more progressive; it would do so not on its own merits but by allowing the income tax to function better and become a more stable part of the revenue system.

There is a kind of natural limit to how high income tax rates can go before they are put under undue pressure. This limit is in the range of 30 percent. For the purposes of simplification, it is desirable to set rates on all kinds of income at the same

9 Ibid., at 288.

10 Ibid., at 290.

11 A key reason for this is that income tax reform would call for taxing capital gains the same as ordinary income. But if this were done, realized capital gains would be subject to tax at very high rates, which is distortionary.

rate schedule. Some types of income are particularly difficult to tax at rates much above 30 percent. These types of income include many forms of capital income (due to the mobility of capital), corporate income (due to the ability of corporations to shift income to tax havens), and capital gains (because taxpayers tend not to realize gains if rates are higher). In Canada, even if we take into account the combined federal and provincial rates, capital gains are taxed at a rate below 30 percent, given that 50 percent of capital gains are excluded. By contrast, an SET could be adopted without difficulty at top rates of 20-30 percent if needed, thereby leading to a top tax rate in excess of 50 percent. An SET would thus make possible a tax system more progressive than the one we have at the moment. Indeed, it would allow whatever degree of progressivity that politicians would be willing to agree to. The combination of an SET and the income tax would therefore be more robust in the achievement of vertical equity than the income tax alone is, and such a combination would more closely accord with the potent redistributive vehicle that Neil Brooks favours.

The SET would also help achieve horizontal equity. In terms of the income tax, horizontal equity calls for any dollar of income to be taxed at the same rate, no matter what its source or nature. Because of concerns about the mobility of capital, many income tax regimes throughout the world today have given up on horizontal equity and are taxing capital income at lower rates than they are taxing earned income. With the SET, this approach would no longer be needed. All income could be taxed at moderate rates that top out at about 30 percent. Additional progressivity could be provided by the SET. Importantly, each dollar of income or consumption, no matter what its nature, would be taxed at the same rate, thus satisfying the criterion of horizontal equity.

As a side benefit, the taxation of all income under the same rate schedule would allow the rules of the income tax to be simplified, thereby reducing compliance costs. (For example, the rules governing the distinction between income and capital gains could be relaxed.) The combination of SET and income tax would make for greater economic efficiency than the income tax provides on its own. The greater efficiency of the SET-cum-income tax would make it a better vehicle for redistribution, because it would have a lighter effect on the economy and therefore would be easier to adopt, from a political perspective. (It cannot be said that high tax rates would discourage small businesses, since any amounts reinvested in the business would not be subject to current tax under the SET.)

As a new tax, the SET could be enacted without the many tax expenditures that are attached to the income tax. Of course, legislatures could add tax expenditures to the SET, but these could be limited. In some cases, tax expenditures under the income tax would already cover the situation. In the case of the credit for charitable contributions, for example, given that this credit already exists, the enactment of the SET would not raise any additional issues. Some income tax expenditures—for example, various savings incentives—are designed to reduce the tax on capital income. Because the SET would not tax the normal return to capital, it would remove the need for savings incentives. From a fairness standpoint, the SET would be preferable to a prepaid type of consumption tax, because above-normal returns to

capital would be taxed. Finally, some provisions under the SET might be somewhat ambiguous concerning the status of certain expenses as tax expenditures. Problems may arise under the SET that do not arise under the income tax, and they may need to be addressed. For example, the question whether the expenses of a political campaign are part of the SET base may arise. The SET might include a rule allowing a deduction for such expenses, perhaps with various limits and conditions. Would this be a tax expenditure, or would it simply reflect a judgment on the part of Parliament that these expenditures are not properly taxable? Either way, there are likely to be a few rules of this kind under the SET. I don't see this as particularly problematic. In evaluating the likely complexity of the new tax, one can anticipate that some number of such special rules might be required. My view is that such rules would be relatively small in number, for the reasons stated above, and that the added complexity arising from such rules would not be substantial.

One of the most important functions for any tax is to raise revenues. In this regard, the SET would provide an appropriate complement to the income tax, allowing the combined taxes to raise substantially more revenue than the income tax alone. The amount of revenue raised could be adjusted from time to time through a change of the SET rates and exemption amounts.

THE SET AND TAX DIVERSIFICATION

Although a lot of writing about tax is theoretical, tax design is largely a practical discipline; practical considerations often predominate over theoretical considerations. One manifestation of this practical emphasis is tax diversification. A diversity of revenue sources is often preferable to one tax or a minimal number of taxes. This principle may seem counterintuitive, given that a multiplicity of taxes involves increased compliance costs. Certainly compliance costs should be borne in mind and should temper the tendency to adopt multiple tax instruments. That said, several diverse taxes are usually harder to avoid than a single tax. Moreover, every tax will be imperfect because it is impossible to design a perfect tax. The remedy is to keep the rates of each tax moderate in order to avoid the imposing of a high tax in a situation where such imposition is unfair. Given the imperfections of an income tax, combining this tax with an SET and keeping the rates of both taxes moderate would make for a fairer system and a system that makes it harder to avoid or evade tax.

CAN AN SET BE WELL DEFINED?

Because an SET would be new, one might be concerned that defining the tax base would be difficult and confusing. I hope to show below that it would be feasible to define the SET base in a fairly simple way, and that this tax would not impose an undue compliance burden. The key to success in this respect would be to set a fairly high threshold for the tax, so that the great majority of taxpayers would not have to deal with it. As discussed above, the threshold might be set in the range of \$100,000 to \$150,000 so that it would fit in with the existing federal and provincial rate schedules.

In General

The SET would be a cash flow tax (that is, cash receipts, with a deduction allowed for net investments). Such a tax would be substantially simpler than the current income tax, although it would involve some design issues and new elements, as outlined below.¹² In a broad sense, the SET would be very similar to the income tax, except that includable receipts would be defined more broadly than under the income tax and the SET would not tax income until the income was consumed (generally, investment would be deductible).

To determine their SET liability, taxpayers would use the same information as they use for the regular income tax, with a few modifications. The general approach would be a cash flow approach. Thus, items of income would be taken into account when received. A deduction would be allowed for any investments when they were made. This would include both financial and business investments. Borrowing would generally be included in taxable receipts; a deduction would be allowed for net savings; and receipts would be somewhat more broadly included than under the income tax. Even though the tax base is personal expenditure, the base would be legally defined as income less specified deductions.

Appropriate levels for the SET exemption, or for the rates of the SET, would depend on the whole tax policy picture. The SET rates and exemption could be determined at the end of the process of designing a tax reform bill, in order to attain the desired distributional and revenue results. In very general terms, however, I would envisage setting the SET exemption at a rather high level (probably between \$100,000 and \$150,000), so that only a small percentage of taxpayers would pay this tax. The SET would be a return-based tax that would be implemented with an additional schedule on an income tax return and would be administered as part of the income tax.

Specific Design Elements

Jurisdictional Basis

Like the income tax, the SET would apply to individuals who are residents. It would not apply to corporations or partnerships. Distributions from those entities would, however, be included in the SET tax base of the distributees. This inclusion would not require particularly complex calculations, since all that would be needed is the amount of cash distributions—an amount that would be relevant for regular income tax purposes as well.

Income

Income would be defined much as it is under the regular income tax law. Thus, income would include wages, interest, dividends, royalties, and the like. A major

12 Except as otherwise noted, I follow the design recommendations for the expenditure tax set out in Michael J. Graetz, "Implementing a Progressive Consumption Tax" (1979) 92:8 *Harvard Law Review* 1575-1661.

difference between the SET and the income tax is that, with the former, the proceeds of sales would be fully taxed when received—that is, not only the gain but also the entire sales proceeds would be includable in taxable receipts. These would be accounted for on a cash basis; thus, for example, instalment sales would be taxed as cash was actually received, not at the time the sale took place.

Fringe benefits present much the same issues under an expenditure tax as under the income tax. Accordingly, one could expect the same solutions; that is, if a particular item were taxed as a fringe benefit under the income tax, it would be taxed in the same way under the SET. An example would be the use of an employer-provided automobile.

Deductions

In general, special deductions would be the same as for the income tax. For example, the deduction for support payments under section 60 (and the corresponding inclusion in income) would apply in the same way for the SET as for the regular income tax.

A deduction would be allowed for life insurance premiums, whether for term insurance or insurance that had an investment component. In other words, all life insurance would be treated like savings. The reason for this treatment would be to avoid having to make distinctions among different kinds of life insurance policies. (All life insurance has a certain degree of investment value.) Correspondingly, life insurance payouts would be taxable to the beneficiary of the policy when they were received.¹³

Treatment of Debts

Under the SET, as a general rule, all borrowing proceeds would be included as taxable receipts, and a deduction would be allowed for interest and principal paid on loans. If the borrowing proceeds were used for investment, an offsetting deduction would be allowed.

The only exception to the general rule would be for home mortgages, auto loans, and loans for other consumer durable items that were purchased with debt secured by the item. In these cases, the taxpayer would be taxed on amounts used to pay off the loan, because no deduction would be allowed for principal or interest payments made. Under this approach, consumption expenditures would be taken into account for tax purposes approximately at the same time that the taxpayer enjoys the benefits of the consumer durable.

Forgiveness of loans the proceeds of which were included in taxable receipts would not be taxed. In contrast, forgiveness of mortgage debt, auto loans, and loans used to acquire consumer durables would be taxed (since the loan proceeds were not taxed). Note, however, that there would not likely be much SET liability from the taxation of loan forgiveness, given the high threshold. Because of the threshold,

13 Ibid., at 1611-13.

most people in a position to have their consumer debt forgiven would not be subject to the SET in the first place. If the amount of loan forgiven were large, provision could be made in the law for spreading the taxable amount over several years, in order to allow taxpayers to make use of the threshold. Otherwise, a taxpayer generally below the threshold might get bumped up into being taxable in the year when a large mortgage loan was forgiven.

Treatment of Cash

In principle, cash could be tracked under the SET, but the simpler approach would be not to do so. This would mean, for example, that when an investment asset was liquidated and cash proceeds were obtained, the cash would be included in the SET base at the time of receipt as personal expenditure. The particular time that the taxpayer used the cash to pay for consumption items would be irrelevant.

The suggested treatment of cash would allow taxpayers to engage in a certain amount of self-help averaging. A taxpayer who wanted to increase the SET base for a year could do so by liquidating an investment and receiving cash. By contrast, a transfer of cash into an investment account would reduce the tax base for that year. Chequing accounts could be treated the same as cash, so there would be no need to report balances in these accounts, or additions to or withdrawals from them. In addition to this legitimate averaging opportunity that would arise from liquidating investments, there would be an opportunity to evade tax by failing to declare cash receipts and then transferring the cash into an investment account. The result of such evasion would be a reduction of the tax base, beyond what could occur under the income tax through a failure to declare cash income. Manoeuvres of this kind should raise a red flag for audit, but it highlights the fact that audit capacity would need to be there in order for the SET to succeed. Investments held in a brokerage account would present no evasion opportunity, because sales would be reported to the Canada Revenue Agency. (There would be no additional reporting requirement, because these transactions would already have been reported.)

Housing

To understand the treatment of owner-occupied housing under the SET, consider first the typical case of a home that is mortgage-financed. A purchase money mortgage used to buy a residence¹⁴ would be left out of debt account (in other words, the borrowing proceeds would not be taxable and repayments would not be deductible). In the case of someone buying a home with cash or putting up a substantial down payment, it would be unfair to treat the entire amount as expenditure, for SET purposes, in the year that the house is purchased. (Bunching all of this expenditure into one year would tend to place the taxpayer into a higher tax bracket than usual.) The remedy would be to allow the taxpayer to amortize the expenditure over some lengthy period, say 20 to 30 years (interest should be charged on the outstanding

14 Including a second home, as well as collectibles and the like, *infra* note 19.

balance; in effect, the taxpayer would be put on the same footing as if a mortgage had been used). The taxpayer should be allowed to notionally pay off all or part of the outstanding balance at any time, such that this amount would be included in the SET base. This would put the taxpayer on a footing similar to that of someone who financed with a mortgage and could achieve this tax result by paying off all or part of the mortgage. It would be advantageous for a taxpayer to do this in any year in which there is an unused exemption amount under the SET.

Other Consumer Durables

If a taxpayer purchased a consumer durable, the transaction would not lead to a substantial amount of consumption for the year in an economic sense, given that annual consumption should include only the value of the use of the durable for the year in question, not the entire value of the durable. From a legal point of view, however, the entire purchase price, absent a special rule, would be part of taxable expenditure for the year, because the SET would treat the entire consumption as occurring in the year of purchase.¹⁵ As with housing, the case of consumer durables purchased with debt could be dealt with by ignoring the debt-financed part of the transaction. The debt could be excluded from receipts, with no deduction allowed for loan repayments. As a result, loan repayments could be taxed as consumption as they were made. This is the same rule as applies to debt-financed owner-occupied housing. As with housing, one could also amortize the cost of substantial consumer durables (for example, those that cost over \$10,000) that were purchased with cash over a period of years.

Averaging

An argument can be made for averaging under an SET. In a number of situations, the taxpayer might incur substantial expenses for reasons largely beyond the taxpayer's control. These could be items such as medical expenses, legal fees, or tuition. If these expenses caused taxable expenditure to be higher than normal, the tax consequence might be considered unfair. An averaging rule could address this concern. Such a rule would, however, introduce complexity to the system. The complexity would involve both definitional issues and administrative burdens for both taxpayers and the tax administration when it comes to keeping track of carryovers from one year to the next. The added complexity of an averaging rule could be minimized by limiting the rule to expenditures that are relatively large as a portion of taxable expenditure. The simplest approach would be to include no averaging rule.

Carryover of Exemption

The specific form of SET that I am proposing raises an averaging problem that is somewhat different from the averaging problem that exists under a broader consumed-income tax. The large annual threshold (probably on the order of \$100,000 to

15 The same approach is taken by the value-added tax/goods and services tax.

\$150,000) means that taxpayers with relatively low amounts of consumption in a given year would “waste” that year’s exemption. This could be dealt with by allowing taxpayers to file the information on expenditure with their return even if they were not subject to the SET for the year in question, and to carry over the unused exemption. Although this would involve a record-keeping burden, the burden would not be major, particularly for taxpayers with relatively simple financial affairs. If this option were not allowed, taxpayers would have the incentive to accelerate consumption into low-expenditure years (for example, by purchasing consumer durables rather than investments). This distortion would not make sense as a matter of policy. Administration of the rule might be simplified by limiting the amount that could be carried over and by limiting the period of time for the carryover (otherwise, returns that were many years old might have to be audited in the tax year when the carryover was used, at which point much of the applicable information might no longer be available). It would probably also make sense to allow an unused exemption to be transferred to a spouse, similar to the way in which medical expenses can in effect be transferred between spouses. Such an allowance would mean that if one spouse were earning below the exemption level and the other spouse were earning above that level, the lower-earning spouse could transfer the unused exemption to the higher-earning spouse, who might then not have to pay any SET or would have a higher exemption. Transfer between spouses would raise fewer administrative issues than carryover from one year to another, because the unused amount would be used up in the same year, and it would not be necessary to go back to prior years.

International Aspects

Rules would be needed to avoid the double taxation of residents who earned amounts from foreign sources and paid foreign tax. This could be done either by allowing a credit against SET for foreign-income tax paid, or exempting from the SET base amounts of consumption that were financed by foreign-source income. For the purposes of the foreign tax credit limitation (assuming that the foreign tax credit remains in its current form), the SET should be considered as part of the income tax. Under this approach, the foreign tax credit does not pose any difficulties for the SET. Admittedly, the result would end up being rough and ready, particularly where a substantial amount of taxable expenditure was financed out of income of previous years. The formula for the foreign tax credit limitation does not take into account whether that previous income was domestic or foreign-source, or what tax rates it bore. Likewise, under the SET, if the taxpayer were to incur foreign income tax but save a substantial portion of the current year’s income, with the result that the current year’s domestic tax was low, the formula would reduce the foreign tax credit available. To calculate the foreign tax credit more precisely—in a way that coordinated the different approaches of foreign and domestic tax law—would, however, introduce needless complexity.

In respect of non-residents, the SET would simply not apply, since the jurisdictional scope of the tax would extend only to residents. Non-residents would continue to be taxed under the income tax on their domestic-source income.

An individual who would be subject to the SET at a high marginal rate might have a tax incentive to retire abroad, if he or she were intending to continue at a high consumption level (or if the individual engaged in a high level of savings during the individual's earning years, savings that the individual intended to consume during retirement). It might be appropriate to provide rules requiring expatriating individuals to continue to pay SET for a period of years, particularly if the amounts involved would be substantial. The policy issues are similar to those for an exit tax under the income tax, and one would expect the SET rules to track the exit tax rules for the income tax.¹⁶

Family Unit: Gifts and Bequests

I assume that gifts and bequests would not be taxed to the donor. In other words, they would not be treated as part of the donor's consumption. The donor would accordingly receive a deduction for a cash gift. This—combined with a generous exemption—would create an obvious tax-avoidance opportunity. A wealthy individual could transfer assets to his or her children, who could use them to purchase consumption goods and services. To prevent this opportunity, it would make sense to include in the SET base of the parent any consumption by minor children. In most cases, there would not be anything to report, because most children typically do not liquidate financial assets in order to pay for their consumption. The proposed rule would not apply once the child attained majority. For this situation, one would probably need an anti-avoidance rule providing that a purported gift would be disregarded to the extent that the gift was used to provide a consumption benefit to the donor. This rule would not, of course, catch everyone; this weakness in the SET raises a good argument for not relying on an expenditure tax exclusively, and it indicates why it would be a good strategy to combine the SET with the income tax. Even if the donor could avoid the SET by making gifts, manoeuvres of this kind would not avoid income tax.

Assuming that a deduction were allowed for gifts, rules would be needed to police the boundaries of this deduction. For example, gifts to corporations and other entities that do not qualify for the charitable deduction under the income tax should not be deductible. Importantly, this category would include political contributions. The resulting inclusion of political contributions in the donor's tax base is a strength of the SET. The only deductible gifts should be those made to individuals. Even these deductible gifts need to be restricted, since one would not want to allow deductions for gifts to a politician, or gifts to a person who provided services to the taxpayer.

Housing and Other Personal-Use Property

In the long term, the principal residence, if purchased after the effective date, would be entirely tax-paid. To the extent that the principal residence was purchased with cash, the cost would be included in the SET base in the year of expenditure (or

16 See subsection 128.1(4).

would be spread over several years; for special rules that might be provided in this regard, see the foregoing discussion of averaging). To the extent that the purchase was financed with debt, no SET deduction would be allowed for repayments of principal or interest. Upon sale, the entire proceeds should be exempted (see the discussion below, under the heading “Transition,” for the treatment of housing purchased before the effective date). The same treatment should apply for sales of other personal-use property.

Rules would be needed to deal with property that was purchased with a mixed personal-use and investment purpose. This kind of property consists of either immovable property or movable property such as antiques, collectibles, and art. A simple but tough rule would be to treat all such property as consumption expenditure. The simplest rule would be to exempt from tax the proceeds on the disposition of such property. Any tax on the gain would be excessive according to consumption tax principles (except to the extent that the gain is attributable to sweat equity).

This approach would require treating as personal-expenditure property any property that is in fact used for personal purposes, as well as property that is held for investment or used in a business if the property constitutes fine art, a collectible, or an antique. Immovable property (such as a vacation home) that is available for use by the taxpayer or members of the immediate family (a spouse, or children 18 and under) would be treated in the same way as personal-expenditure property. Proceeds from rental of the property should be exempted. Thus, for example, if a vacation home were purchased partly with cash and partly with debt, the debt would be excluded (as consumption debt), and the cash payment for the home would be included in the SET base. Suppose that rental income were used to pay interest on the debt, property taxes, repairs, and so forth. All of these amounts would simply be ignored for SET purposes. There would be no need for the taxpayer to keep track of the number of rental days or the amount of rental income received. In other words, there would be a (possibly modified¹⁷) yield exemption treatment for this kind of asset. (The same principle could be applied to artwork, a yacht, race horse, or other property that is treated as personal-expenditure property: any income from renting the property could be ignored.)

Anti-Abuse

One fairly obviously necessary anti-abuse rule would provide that a purported gift to a third party will be disregarded to the extent that the gift is used to provide a consumption benefit to the donor.

Another abuse situation might consist of the purchase of a yacht, car, airplane, real property, or similar item by a corporation, trust, or other entity. The corporation might be owned, at least in part, by the potential user of the property, who might then lease it from the corporation. If the user of the property had bought

17 Modified, if inflation-adjusted gains on disposition are taxed. (One reason for doing this is to capture any sweat equity by the taxpayer that results in increased value of the property.)

it himself, the expenditure would have been part of the SET base.¹⁸ In principle, it would be possible to police the amount of rental charged, but this is unlikely to be effective because of potential disputes about the fair value of the rental, particularly in situations where the property was also rented to others for part of the time. A possible anti-abuse rule would impute to the user the purchase of personal-use property by a corporation or other entity (including an individual acting as an accommodation party). The purchase amount could be included in the expenditure tax base of the user in the year of purchase. An exception would be made for bona fide rentals by publicly held companies (for example, if someone rented a car from a company engaged in automobile leasing). Although the suggested anti-abuse rule would be harsh, this harshness would be justified because there would be little bona fide non-tax reason for entering into such an arrangement. The existence of a tough anti-abuse rule of this kind should stamp out these kinds of transactions, with the result that it would not be necessary to actually apply the rule very often.

TRANSITION

If the existing income tax were completely replaced by an expenditure tax, there would be a need for transition relief. The classic case would be that of the taxpayer who has saved up during a working life and is just about to retire when the expenditure tax is introduced. Suppose that the taxpayer's savings are in high-basis assets. Under the income tax, the taxpayer could draw down these assets without additional tax. Under an expenditure tax, however, this taxpayer would face paying tax again. This situation would call for giving the taxpayer relief for consumption that was financed out of tax-paid assets.

In the case of the SET, however, the transition situation would be somewhat different. The SET would be designed to be an additional tax—that is, imposed in addition to the regular income tax (hence its name: the *supplemental* expenditure tax). Its incidence could be intended to fall partly on existing wealth, and partly on wealth accumulated after the effective date, to the extent that either was consumed. This seems fair. The income tax would continue. Taxpayers holding wealth at the time of the SET's introduction would benefit from any reduction of income tax rates that took place at the same time that the SET was introduced. The taxpayer in the example above would not pay any more income tax on assets that were liquidated to finance consumption. The SET payable would therefore not duplicate income tax already paid. The imposition of a one-time tax burden on existing capital would, in other words, be part of the politically accepted strategy.

Although general transition relief should therefore not be needed, a few specific transition rules would be required to avoid unfairness in particular cases. One such rule would apply to consumer durables, particularly housing. Someone buying a house after the effective date with borrowed funds would pose no particular problem. Given that the loan would be kept out of account, the result would be that interest

18 See above, under the heading "Other Consumer Durables."

and principal on the loan would be included in the tax base as the loan was repaid. This would provide an advantage to those who already owned housing, but the advantage would be limited: no deduction for interest on existing housing would be available for SET purposes. The unfairness would apply to those who had saved up but not yet purchased a house as of the effective date. If no transition rule were provided, these prospective buyers would be seriously disadvantaged in comparison with someone who had purchased a house with cash just before the effective date of the SET. To address this disadvantage, an exemption could be provided (subject to an appropriate limitation) for the purchase of a principal residence within a specified period (for example, one year) after the effective date, in the case of someone who did not own such a residence. (The exemption would apply only to amounts paid in cash. Any amounts in excess of the exemption limit would be eligible for averaging via amortization of the purchase price, as explained above.)

A special rule would also be needed for disposals of the principal residence after the effective date, in the case of a residence purchased before the effective date. Assume that under current law, gain on the disposition of the principal residence is excluded. Suppose that someone sells a principal residence that qualifies for the gain exclusion after the effective date. This could apply for SET purposes as well.

In addition, a transition rule should be considered for those who, before the effective date, purchased an unusually large house. Such individuals would be advantaged as compared with those who bought housing with income earned after the effective date, since the latter would be taxed on these amounts. For these individuals, there would be an undue preference if no account were taken of the existing asset as of the effective date. Accordingly, in the case of homes worth more than a specified amount, it would make sense to include in the SET base an estimated rental value.¹⁹ I recognize that this would involve some valuation issues and that it would be possible to get along without this rule, but some such rule would seem to be appropriate, as a matter of fairness.

Apart from amounts invested in a principal residence (subject to a possible limitation, as discussed above), the SET would constitute a levy on existing capital. The burden of this tax would, however, depend on the taxpayer's consumption choices: it would become due only for consumption at a luxury level. As long as the taxpayer (or the taxpayer's heirs) spent at or below the level represented by the SET exemption, no tax would be due.

Initial cash balances as of the effective date would be taxed (with an appropriate *de minimis* exclusion). Cash balances for this purpose would include whatever type of chequing account or other bank balances are treated the same as cash (that is, not taken into account) for SET purposes generally.

19 Compare Nicholas Kaldor, "Alternative Theories of Distribution," (1955) 23:2 *Review of Economic Studies* 83-100, who proposed including in the expenditure tax base the annual rental charge on housing. The approach suggested here differs from Kaldor's in that it applies only to pre-effective-date housing and applies with a threshold, so that only more expensive houses are affected. The value of a second home should also be included in the calculation.

Although they are not without their difficulties, the transition rules described above are far more modest than the transition rules that would likely be required if the existing income tax were completely replaced by a consumed-income tax. The difficulty of transition is often cited as one of the principal problems of a cash flow tax.²⁰ The SET would largely avoid these problems.

CONCLUSION

Adding an SET to the Canadian income tax would allow top income tax rates to be reduced. It would allow the elimination of the 50 percent deduction for capital gains, so that realized capital gains would be taxed on the same basis as other income. The reduced income tax rates would reduce the distortions of the income tax. The resulting system could be made more progressive than the current law, by appropriately setting the rates and exemption level for the SET.

20 See Mitchell L. Engler and Michael S. Knoll, "Simplifying the Transition to a (Progressive) Consumption Tax" (2003) 56:1 *SMU Law Review* 53-82, at 54.

Extranational Taxation: Canada and UNCLOS Article 82

Micah Burch*

PRÉCIS

L'auteur examine l'imposition du « revenu extranational » (le revenu qui provient de l'extérieur des frontières géographiques de la souveraineté nationale d'un pays) sous l'angle de l'expérience du Canada de l'article 82 de la Convention des Nations Unies sur le droit de la mer.

ABSTRACT

The author considers the taxation of “extranational income” (income that arises outside the geographical borders of any country’s national sovereignty) through the lens of Canada’s experience with article 82 of the United Nations Convention on the Law of the Sea.

KEYWORDS: INTERNATIONAL TAXATION ■ MARITIME LAW ■ SOVEREIGNTY ■ SPACE ■ NEXUS ■ MINERAL RESOURCES

CONTENTS

Introduction	729
Current Taxation of Extranational Income	730
National Space, Extranational Space, and the Common Heritage of Humankind	735
UNCLOS, Article 82, and Canada	742
Extranational Taxation?	747
Conclusion	752

INTRODUCTION

This paper considers the taxation of “extranational income” (that is, income that arises outside the geographical borders of any country’s national sovereignty) through the lens of Canada’s experience with article 82 of the United Nations Convention on the Law of the Sea (UNCLOS).¹ Extranational income presents a

* Senior Lecturer, University of Sydney Law School.

1 United Nations Convention on the Law of the Sea, concluded at Montego Bay, Jamaica, on December 10, 1982, entered into force in 1994, 1833 UNTS 396. The large majority of the

unique international tax law challenge that is not adequately addressed by existing tax rules and has gone largely unanalyzed. In this paper, I explore how such income should be taxed, and I entertain the possibility that an extranational taxing regime is justified by the international law principles applicable in geographic areas beyond national jurisdiction (colloquially referred to as the “common heritage of mankind” [CHOM]).

Arguably, the only existing fiscal mechanism to manifest this concept is the scheme under UNCLOS article 82, which deals with the equitable sharing of the value of non-living resources mined from certain areas of the seabed. Although no country has yet triggered the regime’s obligations under the convention, it appears that Canada will be the first country to do so in the near future because of its commercial exploitation in an area covered by article 82. This paper uses Canada’s nascent experience to evaluate the article 82 regime as an illustrative example of extranational taxation.

Below, I identify the problems with taxing extranational income under the current rules. In the section following, I discuss the geographical delimitation between areas under national sovereignty and the global commons, and the application of the CHOM principle to the latter. Next, I describe the UNCLOS article 82 regime and its application to Canada. The final sections discuss the characterization of the article 82 regime, normatively and theoretically, as an extranational tax.

CURRENT TAXATION OF EXTRANATIONAL INCOME

The century-old international income tax infrastructure rests upon two fundamental assumptions: that taxing jurisdiction is an indivisible component of national sovereignty, and that the geographical location of economic activity (along with the taxpayer’s residence) is the essential determinant of which competing national sovereign shall exercise its rightful taxing authority over a particular item of income. Technological advancement and globalization, along with the sophisticated tax planning that such developments allow, have focused attention on this infrastructure’s increasing obsolescence; one may observe that both of the assumptions mentioned above are under question by academics and policy makers alike. Michael Graetz, discussing US domestic tax law, illustrates the problem with the now-familiar concept of “stateless income”:²

[The] fundamental rules . . . were put in place during the formative period—1918 through 1928—for international income taxation, a time when the world economy was very different. Recent years have witnessed, for example, the rise of e-commerce, the expanded use of financial derivatives, . . . the increased mobility of capital, a rise in

world’s nations have ratified the treaty, including all of the major economies, with the notable exception of the United States.

2 Stateless income, as the originator of the term explains, “can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries

the use of tax-haven[s] . . . and more sophisticated cross-border legal and financial arbitrage, all of which have helped render archaic (or easily manipulated) the long-standing core concepts used worldwide to implement international income tax arrangements and policies. International income tax law is now composed of legal concepts and constructs that no longer reflect the economic realities of international business, if they ever did.³

The international tax community has been explicitly grappling with this problem of stateless income for the last decade or so, culminating in the Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project. Stateless income is the product of tax planning, and it arises from the interaction of different countries' domestic and treaty-based tax rules. As such, it is a synthetic creature of the law and is of concern to the international fiscal community, for good reason. BEPS and other responses to such transnational tax problems inevitably and incrementally chip away at one or both of the bedrock assumptions mentioned above.

Although stateless income has rightly set the agenda for re-examining foundational assumptions of tax policy, there has been little analysis of extranational income, which in some way provides a purer analytical lens through which to view the changing valence of the concepts of tax jurisdiction and source. Extranational income (de facto stateless income) does not pose the same fiscal threat as de jure stateless income, but technological progress and globalization are making the issue increasingly relevant in economic terms. And although extranational income and stateless income are different, there is more than linguistic similarity between the two phenomena: they similarly drive tax transnationalism by highlighting the increasingly problematic nature of the interaction between (1) traditional notions of independent national taxing jurisdictions and (2) source rules that rely on physically locating economic activity.⁴ Stateless income (which is something of a misnomer)

without shifting the location of externally-supplied capital or activities involving third parties." Edward D. Kleinbard, "Stateless Income" (2011) 11:9 *Florida Tax Review* 699-773, at 702 (emphasis omitted). Kleinbard's article is credited with coining the term "stateless income" to describe the general tax malfeasance perpetrated by multinational enterprises. The income is "stateless" because it is derived "from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company." *Supra*, at 701. This type of income is sometimes called "nowhere income." See, for example, John A. Swain and Walter Hellerstein, "State Jurisdiction to Tax 'Nowhere' Activity" (2013) 33:2 *Virginia Tax Review* 209-68 (regarding the source of income for US state tax purposes).

3 Michael J. Graetz, "The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 54:3 *Tax Law Review* 261-336, at 315-16.

4 Professor John Prebble notes that "all countries place geographical limits on the income that they tax. . . . Countries are defined primarily by reference to geography, a discipline that deals with physical phenomena. Certainly, countries are so defined for tax purposes. Income, on the

demonstrates the problem that income can be sourced in *any* country; extranational income demonstrates the problem that income can be sourced in *no* country. They are both transnational issues that require transnational solutions.

Extranational spaces are not tax law voids; a hodgepodge of substantive international tax rules apply to extranational income. These various rules (found in domestic tax law and tax treaties) include (1) rules of general applicability, such as those regarding worldwide taxation, the source of business profits and location of permanent establishments,⁵ the source of services income, the source of royalties,⁶ and the treatment of “other” income;⁷ (2) industry-specific rules, such as the international transport rules found in article 8 of the OECD model, and rules relating to income from communications and natural resources; and (3) even some rules specifically addressing extranational income, such as the “space and ocean activity” source rules under US Internal Revenue Code (IRC) section 863(d).⁸

The rules in the second and third categories take some account of the special nature of extranational income, and both the article 8 rule and the US space and ocean activity rules default to residence taxation (for lack of a better alternative).⁹ However, given the nature of extranationally sourced income (and the types of taxpayers

other hand, is not a physical phenomenon . . . [it] is an abstract concept And yet source rules, a crucial aspect of the juridical concept of income, are based on this contradiction [I]ncome can no more have a physical source than can, say, patriotism or capitalism.” John Prebble, “Ectopia, Tax Law and International Taxation” [1997] *British Tax Review* 383-403, 385-86. See also Phillip Genschel, “Globalization and the Transformation of the Tax State” (2005) 13:S1 *European Review* 53-71, at 60 (<https://doi.org/10.1017/S1062798705000190>), proposing that the notion of “a ‘natural nexus’ between tax base and a particular territory has always been a fiction.” Kleinbard decries the fact that one implication of the phenomenon of stateless income is the “dissolution of any coherence to the concept of geographic source.” Kleinbard, *supra* note 2, at 701. Nevertheless, the main focus of BEPS is to tax cross-border income “where economic activity is conducted, and value is created.” See, for example, Miranda Stewart, “Transnational Tax Law: Fiction or Reality, Future or Now?” Working Paper prepared for NYU Tax Policy and Public Finance Colloquium, March 29, 2016, at 29.

- 5 See, for example, *Deputy Commissioner of Income Tax v. PanAm Sat International Systems Inc.* (2006), 9 SOT 100 (Delhi ITAT), regarding whether telecommunications satellites in orbit above a country’s territory can constitute a permanent establishment of their owners.
- 6 See Kleinbard, “Stateless Income,” *supra* note 2.
- 7 For example, Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (Paris: OECD, November 2017), article 21 (https://doi.org/10.1787/mtc_cond-2017-en) (herein referred to as “the OECD model”).
- 8 Internal Revenue Code of 1986, as amended, section 863(d). Treas. reg. section 1.863-8, entitled “Source of income derived from space and ocean activity under section 863(d).” A space and ocean activity includes activities conducted in space, in Antarctica, and on or in water outside the jurisdiction of the United States or any other country. For US tax law purposes, the source of income from a space or ocean activity is generally determined by the residence of the person deriving such income.
- 9 OECD model, *supra* note 7, article 21, relating to “other income” also defaults to residence taxation.

likely to earn it), the suitability of residence (or “place of effective management” [POEM]) taxation is belied by a consideration of shipping income, which is the primary type of extranational income to explicitly warrant special consideration.¹⁰

Article 8 of the OECD model, dealing with income from international transport activities, has a distributive rule that may be traced back to the 1920s and the early days of the League of Nations, and, as such, it is the original and only exception to the set of general distributive rules that are based on the difficulty of locating and apportioning income from an activity. The feature of the activity of international transport that warrants exceptional treatment (and exclusive tax jurisdiction) was said to be the difficulty of allocating profits to the multiple jurisdictions that are inherently involved in international transport. The 1925 Resolution of the Technical Experts of the League of Nations advised that shipping income should be taxed otherwise than under the business profits rules, “in view of the very particular nature of [shipping] activities and the difficulty of apportioning the profits, particularly in the case of companies operating in a number of countries.”¹¹

Until recently, the default solution offered by the OECD model was to attribute exclusive taxing rights to the state of the place of effective management; however, in light of the fact that most recent treaties (including all treaties of Australia, the United States, and Canada) grant taxing rights to the residence country, the OECD recently changed its model to reflect the reality of residence taxation.¹²

Either way, the electivity of such exclusive taxing rules has become a tool for evasion.¹³ Shipping companies (increasingly taxed only on the basis of residence)

10 See Richard Vann, “Current Trends in Balancing Residence and Source Taxation,” in *Current Trends in Balancing Residence and Source Taxation in BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015), 367-92, at 378: “The non-taxation of international shipping income came about through a combination of the nature of the activity and two international tax rules which made sense ex ante but did not prove robust in preventing avoidance ex post. In one sense shipping income is sourceless or perhaps more accurately is mainly sourced on the high seas and so in the context of the world effectively operating an exemption system for relief of double taxation at the corporate level in relation to non-domestic business income it is not surprising that there is no source or residence tax.”

11 League of Nations, Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations, League of Nations document no. F.212 (Geneva: League of Nations, February 7, 1925), resolution 1, at paragraph C(2)(a). See, generally, Guglielmo Maisto, “The History of Article 8 of the OECD Model Treaty on Taxation of Shipping and Air Transport” in Kees van Raad, ed., *Comparative Taxation—Essays in Honour of Klaus Vogel* (London, UK: Kluwer Law International, 2002), 83-110.

12 See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (Paris: OECD, July 2014), commentary on article 8, at paragraph 1(2): “Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.”

13 See Vann, supra note 10, at 378: “[U]nfortunately the residence/PoEM tests for corporations have little substance compared to the PE-type tests in establishing where actual operations occur so that it was easy to establish residence/PoEM of a shipping company wherever desired.”

have moved to tax havens,¹⁴ and developed countries have had to lure them back by essentially replacing income tax with (minimal) tonnage taxes.¹⁵

With respect to non-residents, furthermore, the “difficulty of allocation” rationale is not entirely satisfying, in that the problems of allocating international transport income are quantitatively rather than qualitatively different from the problems of allocating income from many other activities (and that is why, perhaps, we have BEPS). The OECD model and commentary in other areas do not deviate from concurrent taxation default rules that are based on difficulties in allocating income.¹⁶

14 See, for example, Yoshifumi Tanaka, *The International Law of the Sea*, 2d ed. (Cambridge, UK: Cambridge University Press, 2015), at 152-57; Vann, *supra* note 10, at 378: “Shipping havens (where little or none of the actual shipping operations was based) quickly developed which have turned out to be countries generally without tax treaty networks.”

15 See Vann, *supra* note 10, at 379: “In recent years virtually, every major developed country has given up on trying to tax shipping income. Most have now introduced tonnage taxes or some equivalent which mean that no or trivial residence tax is levied on the income of a resident shipper from international operations.” Canada does not have a tonnage tax (and instead imposes regular income tax on shipping and aircraft operations), but, like many other countries, it has for a long time exempted the shipping (and aircraft) income of a non-resident who is from a country that provides reciprocal relief to Canadian residents. See paragraph 81(1)(c) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended; John J. Lennard, “Canada,” in Guglielmo Maisto, ed., *Taxation of Shipping and Air Transport in Domestic Law, EU Law and Tax Treaties* (Amsterdam: IBFD, 2017), 291-321, at 294-96.

16 Interestingly, a comment to this effect with regard to activities in space has been removed from the OECD commentary. The 2008 update to the OECD commentary removed the following comment on article 7, paragraph 1(4): “There have been, since the 1950s, rapid developments of activities in space: the launching of rockets and spaceships, the permanent presence of many satellites in space with human crews spending longer and longer periods on board, industrial activities being carried out in space, etc. Since all this could give rise to new situations as regards the implementation of double taxation conventions, would it be desirable to insert in the Model Convention special provisions covering these new situations? Firstly, no country envisages extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory. Consequently, space could not be considered as the source of income or profits and hence activities carried out or to be carried out there would not run any new risks of double taxation. Secondly, if there are double taxation problems, the Model Convention, by giving a ruling on the taxing rights of the State of residence and the State of source of the income, should be sufficient to settle them. The same applies with respect to individuals working on board space stations: it is not necessary to derogate from double taxation conventions, since Articles 15 and 19, as appropriate, are sufficient to determine which Contracting State has the right to tax remuneration and Article 4 should make it possible to determine the residence of the persons concerned, it being understood that any difficulties or doubts can be settled in accordance with the mutual agreement procedure.” It is not clear whether this comment was removed because it was considered self-evident or because the OECD no longer had confidence in its veracity or usefulness. However, the question that it posed is likely to become germane, since the final frontier of human exploration could soon become the next frontier in international tax policy. (The comment above was originally added on 23 July 1992 and edited on 31 March 1994 to remove a reference in the first sentence to “the prospect in the very near future” of industrial activities being carried out in space.)

What is relevant is the reason for the difficulty of allocating international transportation income: such income is derived from activity conducted largely outside the territory of any country. In this sense, the taxation of international transport income is a useful object lesson in the treatment of extranational income generally.¹⁷ If residence taxation is ineffectual and there is no source country, then what? UNCLOS article 82 and CHOM are instructive.

To the extent that the geographic location of income matters as a basis for allocating international taxing rights (and, despite its shortcomings, there is not an obviously better basis in many cases), the salient feature of extranational income is that it arises in spaces (or with respect to materials) that are subject to the CHOM principle.¹⁸ Whereas it is readily acceptable, according to a number of theories, that income identifiably sourced in spaces subject to national jurisdiction is subject to tax by that jurisdiction, the CHOM concept provides an analogous basis for taxing jurisdiction—that is, the basis of international agreements to manage the exploitation of extranational spaces in ways that benefit all of humankind.

NATIONAL SPACE, EXTRANATIONAL SPACE, AND THE COMMON HERITAGE OF HUMANKIND

In order to determine which income is *not* sourced within anyone's taxing jurisdiction, it is first necessary to geographically delimit the territorial scope of national taxing sovereignty (a matter of international law, each country's domestic law, and tax treaty law).¹⁹ While a country's jurisdiction is often defined self-referentially for tax purposes,²⁰ international law provides nuanced detail regarding this territorial scope.

17 Professor Vann notes the similarity between shipping income and stateless income in this regard as well: "[I]ncome from intellectual property has some similarities with shipping income in that in one sense it is either sourced everywhere or nowhere." See Vann, *supra* note 10, at 379.

18 The concept is not limited to tangible material and physical space; for example, the United Nations Declaration on the Rights of Indigenous Peoples affirms "that all peoples contribute to the diversity and richness of civilizations and cultures, which constitute the common heritage of humankind." See United Nations, General Assembly, "United Nations Declaration on the Rights of Indigenous Peoples," resolution 61/295, September 13, 2007.

19 A straightforward description of national borders and territories (on land, at sea, and in the air) is more interesting than it appears, because a wide range of legal issues are implicated by the endeavour. Before the 2015 legislation that simplified and harmonized the definition of "Australia" for tax purposes, the geographical meaning of "Australia" was found under 13 different Commonwealth acts. Treasury Legislation Amendment (Repeal Day) Act 2015; Income Tax Assessment Act 1997, subdivision 960-T.

20 For example: "The term 'United States' when used in a geographical sense includes only the States and the District of Columbia." See IRC section 7701(a)(9).

Large portions of the earth's oceans are subject to national jurisdiction under international law.²¹ UNCLOS provides for full national sovereignty over territorial waters,²² and limited sovereignty over a country's "continental shelf" and "Exclusive Economic Zone" (EEZ) for purposes relating to environmental activity and the exploration and exploitation of natural resources.²³ In layman's terms, the continental shelf is the part of the ocean floor that comprises part of the continental land mass.²⁴ The EEZ comprises the seabed and waters extending 200 nautical miles out from the country's coast.²⁵

Thus, article 3(1)(b) of the Australia-Canada tax treaty provides that

(b) the term "Canada" used in a geographical sense, means the territory of Canada, including any area beyond the territorial waters of Canada which is an area where Canada may, in accordance with its national legislation and international law, exercise rights with respect to the seabed and subsoil and their natural resources.²⁶

21 Australian tax law defines "Australia" to include enumerated external territories and statutory offshore areas, and it specifically includes the country's continental shelf and EEZ, as authorized by UNCLOS. Income Tax Assessment Act 1997, section 960-505. Section 255 of Canada's Income Tax Act defines "Canada" to include (and to have always included), for the purposes of the Act, "(a) the sea bed and subsoil of the submarine areas adjacent to the coasts of Canada in respect of which the Government of Canada or of a province grants a right, licence or privilege to explore for, drill for or take any minerals, petroleum, natural gas or any related hydrocarbons; and (b) the seas and airspace above the submarine areas referred to in paragraph 255(a) in respect of any activities carried on in connection with the exploration for or exploitation of the minerals, petroleum, natural gas or hydrocarbons referred to in that paragraph."

22 Up to 12 nautical miles out from the coastline. UNCLOS, articles 2 and 3. It is not unheard of for states (particularly non-ratifying ones) to make claims to territorial waters well in excess of the UNCLOS limit, although US domestic legislation adopts the 12-nautical-mile limit. Article 33 confers additional sovereignty over a "contiguous zone" (not more than 24 nautical miles out from the territorial baseline) for the purpose of preventing "infringement of . . . customs, fiscal, immigration or sanitary laws." See UNCLOS article 33(1)(a).

23 See UNCLOS, articles 55-56 and 76-77.

24 A coastal country's continental shelf "comprises the seabed and subsoil of the submarine areas that extend beyond its territorial sea throughout the natural prolongation of its land territory to the outer edge of the continental margin, or to a distance of 200 nautical miles from the baselines from which the breadth of the territorial sea is measured where the outer edge of the continental margin does not extend up to that distance." See UNCLOS, article 76(1). Generally, the point on the coast from which the 200 nautical miles are measured is the "low-water line along the coast as marked on large-scale charts officially recognized by the coastal State." See UNCLOS, article 5.

25 UNCLOS, article 57. The economic significance of the world's EEZs is underappreciated; the economic value, to large coastal countries such as Australia and Canada, of their marine sectors is in the tens if not hundreds of billions of dollars. Global EEZs have extended states' geographical jurisdiction to over 20 percent of the world's oceans (and almost all of the world's fisheries). Canada's EEZ covers 5.6 million km² of ocean.

26 Convention Between Canada and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income done at Canberra on May 21, 1980, article 3(1)(b).

“Australia” is defined in article 3(1)(c) to exclude all external territories except Norfolk Island, Christmas Island, Cocos (Keeling) Island, Ashmore and Cartier Islands, Heard Island and McDonald Islands, and the Coral Sea Islands and includes

any area adjacent to the territorial limits of Australia (including the Territories specified in this subparagraph) in respect of which there is for the time being in force, consistently with international law, a law of Australia dealing with the exploration for or the exploitation of any of the natural resources of the seabed and subsoil of the continental shelf.²⁷

The extent to which a country’s continental shelf might extend beyond the 200 nautical miles of its EEZ (that is, the distinction between where the global commons begin and national boundaries end) has always been contentious under international law and was a matter of great importance leading up to and during the UNCLOS negotiations. In 1958, three different international treaties dealing with the law of the sea were drafted in Geneva in an effort to standardize international seafaring norms.²⁸ Subsequent efforts in the 1970s and 1980s to improve and update the treaties’ incomplete coverage²⁹ culminated in negotiations that ultimately produced UNCLOS, which seeks to establish nations’ rights and responsibilities with respect to their use of and jurisdiction over the world’s oceans.³⁰ The International Seabed Authority was established as an autonomous organization under UNCLOS (and under the 1994 agreement relating to its implementation) to manage, organize, and control, on behalf of humankind as a whole, activities (particularly the exploitation of mineral resources) in “the Area”: the seabed and ocean floor and the subsoil thereof beyond the territorial limits of national jurisdiction.³¹

However, a sticking point during the conferences that led to UNCLOS was the fact that many countries—including, prominently, Canada—maintained that their continental shelf (and thus national sovereignty) naturally extended beyond the arbitrary 200 nautical mile limit (the extended area being the so-called extended

27 Ibid., article 3(1)(a). Both countries’ claims to airspace are questionable in light of the provisions of UNCLOS, but discussion of the matter is beyond the scope of this paper.

28 United Nations, Convention on the High Seas done at Geneva on April 29, 1958, entered into force on September 30, 1962, 450 UNTS 82; United Nations, Convention on the Continental Shelf done at Geneva on April 29, 1958, entered into force on June 10, 1964, 499 UNTS 311; United Nations, Convention on the Territorial Sea and Contiguous Zone done at Geneva on April 29, 1958, entered into force on September 10, 1964, 516 UNTS 205.

29 For example, the Convention on the Territorial Sea and Contiguous Zone did not define the maximum size of a state’s territorial sea claims. See, generally, John Astley III and Michael N. Schmidt, “The Law of the Sea and Naval Operations” (1997) 42 *Air Force Law Review* 119–55.

30 As discussed above, the definitional provisions of the widely accepted treaty provide the template for most of the maritime jurisdictional claims reflected in the major economies’ domestic laws and international agreements, including tax treaties.

31 UNCLOS, article 1, part XI. The seabed covers about 70 percent of the earth’s surface, making the Area the largest terrestrial commons space.

continental shelf [ECS]). There are tens of millions of square kilometres of seabed that potentially fall within this category.

UNCLOS provides a compromise: there is a mechanism by which such areas may be recognized as subject to (limited) national sovereignty, but countries must share a percentage of the value of the exploited resources from such areas to be redistributed equitably to disadvantaged countries. As is more fully discussed in the next section of this paper, there is disagreement as to whether the resulting UNCLOS provisions dealing with ECS areas reflect a compromise with regard to sovereignty or simply enshrine the international law status quo.

The backdrop to this ongoing controversy is the patchwork treaty-based international legal regime that applies to extranational spaces. As a useful shorthand, it is often said that such spaces (and, more specifically, their resources) are subject to the international law concept of CHOM. As a term of art, however, CHOM is used in only two significant international instruments (UNCLOS and the Moon treaty), and its application has been explicitly rejected in other treaties (in large part because the term does not have an agreed-upon definition).

Nonetheless, CHOM has also become a more generic catch-all term for the emergent set of principles that normatively and positively apply to extranational spaces and their resources (such as the idea that common spaces are not subject to national sovereignty and that resources located there are to be maintained and used for the benefit of all humankind).³² This more generic sense of the term is used in this paper (except when noted otherwise), and it refers to the principles that have emerged through the various treaty negotiations and compromises that constitute the international body of law applicable to the geographic commons. As such, the term is useful in considering not only the governance of extranational spaces, but also the theoretical legitimacy of extranational taxation.

By way of illustrating the difference between the generic and technical usages of the term: CHOM has been called “one of the most extraordinary developments in

32 There are multiple variations of the term and its application, in both applicable treaties and the secondary literature. See, for example, Michael W. Lodge, “The Common Heritage of Mankind” (2012) 27:4 *The International Journal of Marine and Coastal Law* 733-42, at 734, in note 3, citing A. Kiss, *The Common Heritage of Mankind: Utopia or Reality*: “[T]he idea of a common interest of mankind can be identified in the development of international agreements across multiple sectors in the second half of the twentieth century, including human rights, cultural heritage, labour, public health, telecommunications, outer space, Antarctica and the environment”; Harminderpal Singh Rana, “The ‘Common Heritage of Mankind’ & the Final Frontier: A Revaluation of Values Constituting the International Legal Regime for Outer Space Activities” (1994) 26:1 *Rutgers Law Journal* 225-50; John E. Noyes, “The Common Heritage of Mankind: Past, Present, and Future” (2012) 40:1-3 *Denver Journal of International Law and Policy* 447-71, at 455. As used in UNCLOS, “CHOM” applies to the natural resources located in the seabed, not the territory itself. Christopher Joyner, review of *The Concept of the Common Heritage of Mankind in International Law*, by Kemal Baslar in (1999) 13:2 *Emory International Law Review* 615-28, at 620.

recent intellectual history,”³³ but it has also been rejected as creating an “international socialist cartel.”³⁴ Indeed, the fact that the term lacks precise legal definition is one of its defining characteristics. At a general level, however, basic principles of CHOM can be observed. Areas and resources subject to the doctrine are (1) not subject to appropriation (sovereign or otherwise), (2) to be used for peaceful purposes, (3) to be conserved, and (4) subject to shared and inclusive management.³⁵ In addition, and most relevantly for this discussion, benefits derived from the exploitation of resources in a common heritage area are to be equitably shared. Of course, even these vague general principles are often compromised and are, at any rate, open to wildly divergent interpretations.³⁶

In particular, the aspects of CHOM that are related to the equitable sharing of the spoils of extranational space are at the crux of the controversy and indeterminacy regarding the term. In its technical and strongest form, CHOM calls for the literal vesting of exclusive ownership rights over natural resources in all of humankind (that is, common ownership). The sharing aspects of CHOM, along with the mandate to share the knowledge and material benefits of the exploitation of such resources in a way that furthers distributive justice, are both novel and controversial in international law.³⁷

A brief history of the development of the CHOM principles will highlight the emergent features of commons governance (sometimes explicitly under the label of “CHOM” and sometimes based on related concepts) that provide the theoretical justification for treaty-based fiscal measures such as the article 82 regime. The first modern set of treaties dealing with the global commons is the 1959 Antarctic treaty system (ATS), whose main agreement is the Antarctic treaty.³⁸ Negotiated at a time when a number of countries had already made sovereign claims over areas of the continent on which they had been active (mainly conducting scientific research), and at a time before the articulation of the CHOM concept, the Cold War-era treaty had arms control and demilitarization as its main concern. Because of a lack of

33 Kemal Baslar, *The Concept of the Common Heritage of Mankind in International Law* (The Hague: Martinus Nijhoff, 1998), at 7.

34 Emilio J. Sahurie, *The International Law of Antarctica* (Dordrecht: Martinus Nijhoff, 1992), at 389. Not all would agree that the two characterizations are mutually exclusive.

35 Jennifer Frakes, “The Common Heritage of Mankind Principle and the Deep Seabed, Outer Space, and Antarctica: Will Developed and Developing Nations Reach a Compromise?” (2003) 21:2 *Wisconsin International Law Journal* 409-34, at 411-13.

36 See section IV below.

37 Noyes, *supra* note 32, at 451.

38 United Nations, The Antarctic Treaty signed at Washington on December 1, 1959, entered into force in 1961, 402 UNTS 71. It was signed by Argentina, Australia, Belgium, Chile, France, Japan, New Zealand, Norway, South Africa, United Kingdom, United States, and the USSR. The treaty now has 53 signatories and applies to the area south of 60 degrees south latitude (with a carve-out for the high seas).

international consensus regarding Antarctic sovereignty claims, the Antarctic treaty is purposefully vague and non-committal on the matter,³⁹ but the preamble declares that the continent is a natural reserve devoted to science and that it is “in the interest of all mankind that Antarctica shall continue forever to be used exclusively for peaceful purposes.”⁴⁰ In order to keep the peace, the ATS permits no mineral exploitation whatsoever: “Any activity relating to mineral resources, other than scientific research, shall be prohibited.”⁴¹

Although the Antarctic regime rejects specific features of the very full CHOM doctrine (especially relating to sovereignty), the prohibition against commercial exploitation and the concern with science and peace demonstrate an important recognition by international law of the collective interest in extranational space—an interest that carries over into outer space.⁴²

International law recognizes that nations enjoy unfettered sovereignty over their “air space.”⁴³ Beyond national air space,⁴⁴ a series of treaties applies to outer space and celestial bodies.⁴⁵ The main treaty identifying freedoms, obligations, and limitations in space—the widely accepted 1967 outer space treaty—declares that

39 Antarctica has the curious attribute of having the unsettled nature of its sovereignty codified in its governing document. Article IV(2) of the Antarctic treaty deals with claims to territorial sovereignty by taking a “snapshot” of the sovereignty claims of parties to the treaty at the time the treaty comes into force. It provides as follows: “No acts or activities taking place while the present Treaty is in force shall constitute a basis for asserting, supporting or denying a claim to territorial sovereignty in Antarctica or create any rights of sovereignty in Antarctica. No new claim, or enlargement of an existing claim, to territorial sovereignty in Antarctica shall be asserted while the present Treaty is in force.” Article IV(I) preserves for party-states previously asserted rights of or claims to territorial sovereignty ((1)(a)), the bases for any such assertions ((1)(b)), and the right to not recognize any other state’s assertions of sovereignty. By its terms, the ATS is in place until 2048.

40 See Antarctic treaty, preamble. Australia claims the “Australian Antarctic Territory,” but statutory definitions of “Australia” for tax purposes do not include the territory. See Income Tax Assessment Act 1997, section 960-505.

41 The Protocol on Environmental Protection to the Antarctic Treaty signed in Madrid on October 4, 1991, entered into force in 1998, 30 ILM 1455, article 7.

42 The ATS was developed more or less concurrently with the birth of the space industry; United Nations, General Assembly, “Question of the Peaceful Use of Outer Space,” December 13, 1958, UNGA res. 1348 (XIII), was among the first official acknowledgments of the common interest of humankind in outer space.

43 Convention on International Civil Aviation signed at Chicago on December 7, 1944, 15 UNTS 295, article 1 (Sovereignty). With respect to the z-axis, there seems to be no law regarding how far down national jurisdiction extends. Presumably, all countries taper down, in country-shaped cones, to a single point in the centre of the earth.

44 Surprisingly, there is no general agreement on the precise delimitation between national airspace and non-sovereign outer space (but the general range is from approximately 60 kilometres to 100 kilometres up).

45 A few countries—for example, the United States and Luxembourg—are taking the lead on setting space policy through domestic legislation.

[t]he exploration and use of outer space, including the moon and other celestial bodies, shall be carried out for the benefit and in the interests of all countries, irrespective of their degree of economic or scientific development, and shall be the province of all mankind.⁴⁶

Further, the outer space treaty was made before the CHOM concept had been expressly articulated,⁴⁷ and although the “province of mankind” concept embodied in this treaty forbids appropriation and the application of national sovereignty,⁴⁸ and although it calls for space to be used peacefully,⁴⁹ the treaty falls short of explicitly calling for the equitable sharing of the benefits derived from space. Instead of calling for communal ownership and redistributive sharing, the outer space treaty manifests the sharing principle of CHOM by providing equal access to the extraterrestrial commons. This is the essential dilemma—the choice between equality of access and equal sharing—facing the management of the global commons.⁵⁰

Coming on the heels of *Sputnik*, the outer space treaty, like the Antarctic treaty before it, was mainly concerned with peace rather than economic exploitation. Its objections to making explicit the sharing principle are related to the strong version of CHOM’s prohibition against exploitation (as in Antarctica) and against the establishment of private rights relating to natural resources in space.

The 1979 Moon treaty,⁵¹ on the other hand, explicitly applies the CHOM principles (including the principle of common ownership) to the moon, to other objects in our solar system, and to their resources.⁵² Supporters of the Moon treaty were concerned that the outer space treaty did not adequately protect the common interest in space. This treaty provides that the exploration and use of nearby celestial

46 United Nations, Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, Including the Moon and Other Celestial Bodies signed at London, Moscow and Washington on January 27, 1967, entered into force October 10, 1967, 610 UNTS 205 (herein referred to as “the outer space treaty”), article 1. Note that the “province of all mankind” applies to activities in space, not space itself.

47 The term came into common usage as a legal concept after it was used by Malta’s ambassador to the United Nations, Arvid Pardo, on November 1, 1967, in a famous speech about the governance of the international seabed. See also United Nations, General Assembly, “Declaration of Principles Governing the Sea-Bed and the Ocean Floor, and the Subsoil Thereof, Beyond the Limits of National Jurisdiction,” December 17, 1970, UNGA Res 2749/24.

48 The outer space treaty, *supra* note 46, article II. But see Declaration of the First Meeting of the Equatorial Countries, December 3, 1976, ITU doc. no. WARC-BS 81-E (1977) (also known as the “Bogotá Declaration”), regarding the mutually recognized claims to sovereignty over the respective geostationary orbits of the signatory equatorial countries.

49 Outer space treaty, *supra* note 46, articles III and IV.

50 See, generally, Elinor Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action* (Cambridge, UK: Cambridge University Press, 1990).

51 United Nations, Agreement Governing the Activities of States on the Moon and Other Celestial Bodies, December 5, 1979, 1363 UNTS 3 (herein referred to as “the Moon treaty”).

52 Moon treaty, *ibid.*, articles 11(3) and 12.

bodies should be carried out “for the benefit and in the interests of all countries, irrespective of their degree of economic or scientific development.”⁵³ The treaty describes a strong form of equitable sharing:

An equitable sharing by all States Parties in the benefits derived from those resources, whereby the interests and needs of the developing countries, as well as the efforts of those countries which have contributed either directly or indirectly to the exploration of the moon, shall be given special consideration.⁵⁴

The Moon treaty’s strong form of the CHOM principle relating to communal ownership and equitable sharing has proved too strong; only a handful of countries, and none of the major space-faring ones, have ratified the treaty. Thus, while a generalized form of CHOM applies to outer space, there is not yet an explicit expression of the sharing principle that offers an acceptable compromise between space-faring nations and other nations. This remains a challenge to space governance as we continue to commercialize space.

UNCLOS, particularly its provisions regarding the seabed in ECS areas, contains an interpretation of the CHOM sharing principle that provides a way forward for governance in extranational spaces—a compromise. The expression of the sharing principle in UNCLOS (embodied in article 82) balances redistributive concerns with equal access and exploitation. The regime is, naturally, a flawed and incomplete set of compromises, but it provides for a form of sharing that is apparently acceptable to developed and developing nations alike. Conceiving of the regime as a tax could help address the shortcomings of its compromise, as illustrated by Canada’s experience with article 82.

UNCLOS, ARTICLE 82, AND CANADA

UNCLOS, the most fully realized agreement to deal with the global commons, was conceived in the shadow of the New International Economic Order (and the Moon treaty); the sharing of the benefits from the exploitation of resources from the world’s seas was contentious, and agreement was elusive. The treaty, signed in 1982, creates a comprehensive regime for various maritime zones (including the high seas, the EEZs, continental shelves, and ECS areas), and it embodies a foundational compromise.⁵⁵

53 Moon treaty, *ibid.*, article 4.

54 Moon treaty, *ibid.*, article 11(7)(d). The Moon treaty was drafted in the midst of the United Nations’ “New International Economic Order” initiative at the 1964 United Nations Conference on Trade and Development, reflecting the push from post-colonialist developing nations for the equitable distribution of resources. The United States objected to such efforts as “international socialism controlled by the third world.” See Baslar, *supra* note 33, at 163. See also United Nations, General Assembly, “3201(S-VI)-Declaration on the Establishment of a New International Economic Order,” May 1, 1974.

55 See *infra* note 62 and accompanying text.

UNCLOS applies various elements of the CHOM principles to the various zones that it creates. The high seas are “free” (particularly with regard to travel and the exploitation of living resources)⁵⁶ and are not subject to collective ownership. But the high seas are not subject to national sovereignty,⁵⁷ either, and are to be “reserved for peaceful purposes.”⁵⁸

On the other hand, UNCLOS subjects the international seabed beyond any country’s continental shelf (“the Area”) to a strong form of CHOM⁵⁹ and establishes the International Seabed Authority (ISA) as the administrator of the deep seabed on behalf of humankind.⁶⁰ Article 140(2) calls for the “equitable sharing of financial and other economic benefits derived from” the natural resources in the Area via the ISA.⁶¹ But these provisions came into force only in 1994, after a supplementary agreement was concluded to modify some of the general financial principles (relating to exploitation of the international seabed) in favour of exploitation and private property rights.⁶²

Nevertheless, ISA has a wide mandate to administer humankind’s ownership of the resources in the Area and to partner with private industry to exploit the Area’s natural resources and generate revenue therefrom. As part of this mandate, ISA is to collect payments under contracts with its industry partners “in connection with activities in the Area” according to a complex set of rules and options.⁶³

ISA has allowed a number of companies to explore the Clarion-Clipperton Zone (in the Pacific Ocean between Mexico and Hawaii). However, as a practical matter, because deep seabed mining in the Area activating any financial obligation is not yet viable, ISA has not yet developed a framework for the execution of its fiscal responsibilities with regard to the Area. Though the financial obligations set out in UNCLOS are similar in form to royalties, ISA regards them as tax-like in nature. In

56 UNCLOS, *supra* note 1, article 87.

57 *Ibid.*, article 89.

58 *Ibid.*, article 88.

59 *Ibid.*, article 136. See, generally, Robin Rolf Churchill and Alan Vaughan Lowe, 3d ed., *The Law of the Sea* (Manchester, UK: Manchester University Press, 1999), at 223; Philip A. Burr, “The International Seabed Authority” (2006) 29:2 *Suffolk Transnational Law Review* 271-88, at 274, note 21.

60 UNCLOS, *supra* note 1, article 137(2). See, generally, Lodge, “The Common Heritage of Mankind,” *supra* note 32. The ISA is charged with licensing exploration and managing the exploitation of mineral resources in the international seabed.

61 See also UNCLOS, *supra* note 1, article 160(2).

62 United Nations, Agreement Relating to the Implementation of Part XI of the United Nations Convention on the Law of Sea of 10 December 1982, adopted on July 28, 1994, entered into force on July 28, 1996, 1836 UNTS 3. See also Lodge, “The Common Heritage of Mankind,” *supra* note 32, at 739. The 1994 agreement is generally considered to have weakened the application of CHOM and the independence of the ISA, mainly in order to appease the United States, which nonetheless ended up not signing UNCLOS.

63 UNCLOS, *supra* note 1, article 171(b); UNCLOS, annex III, article 13.

its most recent discussion paper,⁶⁴ ISA (1) identifies traditional tax policy criteria as the principles guiding the development of a fiscal regime over the Area;⁶⁵ (2) uses corporate tax rates as a comparator;⁶⁶ and (3) identifies the issues of “double taxation,”⁶⁷ transfer pricing, and anti-avoidance.⁶⁸ When this funding regime becomes tangible rather than speculative, Part XI of UNCLOS will provide an intriguing case study of a global tax based on CHOM.⁶⁹

Of more immediate concern is the article 82 fiscal regime applicable to ECS areas. Notoriously short on details, article 82 provides as follows:

Payments and contributions with respect to the exploitation of the continental shelf beyond 200 nautical miles.

1. The coastal State shall make payments or contributions in kind in respect of the exploitation of the non-living resources of the continental shelf beyond 200 nautical miles from the baselines from which the breadth of the territorial sea is measured.
2. The payments and contributions shall be made annually with respect to all production at a site after the first five years of production at that site. For the sixth year, the rate of payment or contribution shall be 1 per cent of the value or volume of production at the site. The rate shall increase by 1 per cent for each subsequent year until the twelfth year and shall remain at 7 per cent

64 International Seabed Authority, *Developing a Regulatory Framework for Mineral Exploitation in the Area: A Discussion Paper on the Development and Implementation of a Payment Mechanism in the Area for Consideration by Members of the Authority and All Stakeholders* (Kingston, Jamaica: ISA, 2015).

65 *Ibid.*, at paragraph 12: “The financial parameters set by the Convention and the 1994 Agreement are relatively simple. Their practical development is much more complex. The principles of efficiency, fairness, simplicity, certainty, flexibility and enforceability as applied to the development of any fiscal regime are equally applicable to the development of the financial mechanism for the Area.”

66 *Ibid.*, at paragraph 20(h).

67 *Ibid.*, at paragraph 56: “[T]oo lenient a financial model in the Area could shift profits toward a national taxing regime at the expense of the CHM”; see also *supra*, at paragraph 57: “[T]here is a question over the treatment of payments made to the Authority by contractors and how these will be treated under national tax systems for the purposes of assessing contractor tax liabilities. This is however a matter for sovereign States to address.”

68 *Ibid.*, at paragraph 64.

69 See Richard M. Bird, *Are Global Taxes Feasible?* Rotman School of Management Working Paper no. 3006175 (Toronto: University of Toronto, Rotman School of Management, July 2017), at 6-7 (papers.ssrn.com/sol3/papers.cfm?abstract_id=3006175): “Others have considered taxing resources recovered from what is often called the ‘global commons’—that is, territory not within national boundaries such as Antarctica, outer space, and, most importantly to date, the oceans. UN (2012), for example, suggested that a Global Undersea Resource Royalty should be imposed on . . . undersea mineral resources extraction.” Professor Bird defines a “global tax” as “a tax imposed not by any one nation but by a group of nations on a regional or . . . worldwide basis,” *supra*, at 2.

thereafter. Production does not include resources used in connection with exploitation.

3. A developing State which is a net importer of a mineral resource produced from its continental shelf is exempt from making such payments or contributions in respect of that mineral resource.
4. The payments or contributions shall be made through the [International Seabed] Authority, which shall distribute them to States Parties to this Convention, on the basis of equitable sharing criteria, taking into account the interests and needs of developing States, particularly the least developed and the land-locked among them.⁷⁰

The fiscal regime in article 82 is a unique extension of the CHOM doctrine;⁷¹ it embodies a conception of CHOM's sharing principle that is a compromise, balancing developed countries' preference for access rights (and private exploitation) against developing countries' preference for common benefit, in the form of a "legal obligation designed to address inequity in a practical way."⁷² Article 82 redistributes some of the value derived from ECS areas and "is widely regarded as having paved the way for agreement to a definition of the outer limits of the continental shelf that struck an acceptable balance between these competing interests."⁷³

The application of article 82 is imminent,⁷⁴ and Canada looks to be the first country whose obligations will be triggered. Equinor Canada (formerly known as

70 UNCLOS, article 82.

71 Michael Lodge, "The International Seabed Authority and Article 82 of the United Nations Convention on the Law of the Sea" (2006) 21:3 *International Journal of Marine and Coastal Law* 323-33, at 332-33; Helmut Tuerk, *Reflections on the Contemporary Law of the Sea* (Leiden, Netherlands: Brill Nijhoff, 2012), at 40. Article 82 is the only provision of UNCLOS involving an incursion into spaces within national jurisdiction.

72 Michael W. Lodge, "The Deep Sea Bed," in Donald R. Rothwell, Alex G. Uedeelferink, Karen N. Scott, and Tim Stephens, eds., *Oxford Handbook of The Law of the Sea* (Oxford, UK: Oxford University Press, 2015), 226-53, at 251. See also Noyes, *supra* note 32, at 462.

73 Harrison, *infra* note 76, at 490. See also Wylie Spicer, "Canada, The Law of the Sea Treaty and International Payments: Where Will the Money Come From?" (2015) 8:31 *SPP Research Papers*, [University of Calgary School of Public Policy] 1-23, at 9 (www.policyschool.ca/wp-content/uploads/2016/03/final-law-sea-spicer.pdf): "UNCLOS balanced the CS [continental shelf] entitlements of coastal states to resource exploitation with the rights of other states to share in the resource benefits of what would otherwise have been the seabed and subsoil of the Area"; Aldo Chircop, "Equity on the Extended Continental Shelf: How an Obscure Provision in UNCLOS Provides New Challenges for Ocean Governance," in *Sustainable Oceans: Reconciling Economic Use and Protection* (Lübeck, Germany: Dräger Foundation, 2013), 36-38, at 37 (https://www.draeger-stiftung.de/fileadmin/user_upload/konferenzen_2013/oceans_report_2013.pdf).

74 Although "[a]rticle 82 has remained largely dormant because to date the anticipated conditions to bring it into effect have not materialized . . . the expectation of resource discoveries holding promise for commercial production on the OCS [outer continental shelf] is realistic." See International Seabed Authority, *Implementation of Article 82 of the United Nations Convention on the Law of the Sea: Report of an International Workshop Convened by the International Seabed*

Statoil Canada) and, potentially, other ventures are about to dig out billions of barrels of oil from Canada's extended continental shelf more than 300 nautical miles off the east coast of Newfoundland.⁷⁵ When this happens, Canada's experience with its article 82 obligations could be precedent setting.

Canada, like all of the states that are party to UNCLOS, has not enacted domestic legislation implementing article 82.⁷⁶ So an important and obvious question is: Who pays?⁷⁷ The state is, of course, the party obligated under UNCLOS, but should the costs actually be passed on to industry?

In keeping with its economy, which is driven by natural resources, Canada has always been one of the nations most sensitive about sovereignty over its ECS. During the debate at UNCLOS's decisive third negotiation conference, Canada was among the "margineers" claiming that the covered ECS areas had always been their sovereign territory (as opposed to nations that saw the recognition of coastal states' ECS claims as being recognized at the expense of the Area, CHOM, and other coastal states).⁷⁸

According to this argument, if article 82 were the price paid for a grant of sovereign access to the extended continental shelf, then a stronger case exists for placing the pecuniary burden on those private entities that take advantage of the access granted; if, on the other hand, article 82 were just a constituent part of the larger UNCLOS agreement, the costs of which are part of the price paid for the overall benefits that UNCLOS would deliver to all of Canada, then the Canadian state should bear the costs. Canadian industry stridently advances the latter interpretation (and its fiscal ramifications).

Nonetheless, while Canada has yet to formalize policy in this regard, notices on maps relating to exploration licences published by the governmental body overseeing offshore petroleum resources contain disclaimers such as the following:

Authority in Collaboration with the China Institute for Marine Affairs in Beijing, the People's Republic of China, 26-30 November 2012, ISA Technical Study no. 12 (Kingston, Jamaica: ISA, 2013), at 41 and 43 (<https://ran-s3.s3.amazonaws.com/isa.org/jm/s3fs-public/files/documents/ts12-web.pdf>).

75 Newfoundland's extended continental shelf is the world's broadest.

76 Rowland J. Harrison, "Article 82 of UNCLOS: The day of reckoning approaches" (2017) 10:6 *Journal of World Energy Law & Business* 488-504, at 490 (<https://doi.org/10.1093/jwelb/jwx022>).

77 See Spicer, *supra* note 73.

78 Harrison, *supra* note 76, at 491-97, in note 15, citing Donald R. Rothwell and Tim Stephens, *The International Law of the Sea*, 2d ed. (London: Hart, 2016). The argument is that article 82 is the "price" for allowing sovereignty over what would otherwise have been part of CHOM. It is unlikely, however, that Canada and other margineers would call article 82 a "compromise" because, from their perspective, the provisions *acknowledged* their long-recognized sovereignty over their ECS rather than granted it. The distinction matters for how the article 82 regime is characterized and, ultimately, for determining who should pay for a country's article 82 obligations (and how).

All interest holders of production licenses containing areas beyond 200 nautical miles may be required, through legislation, regulation, licence terms and conditions, or otherwise, to make payments or contributions in order for Canada to satisfy obligations under Article 82 of the United Nations Convention on the Law of the Sea.⁷⁹

Furthermore, there appears to be an assumption, among other countries that have considered the issue (such as the United States and Norway), that the costs will be passed on to industry (notably, with a credit against royalties or tax otherwise payable, as the case may be).⁸⁰

It thus seems appropriate to think of the article 82 regime as a tax, amenable to the application of tax policy criteria. Such a characterization allows for the design, implementation, and evaluation of the article 82 regime in a way that addresses the concerns of both the state party and the industry that is affected by article 82. Furthermore, as the next section discusses, characterizing the article 82 regime as an extranational tax is also theoretically justified.

EXTRANATIONAL TAXATION?

It must be admitted that, on its face, the article 82 scheme does not meet the traditional definition of a “tax.”⁸¹ Bird has pointed out that, even if it is a tax, no global tax of the type being discussed has ever been imposed, and he offers a convincingly bleak assessment of the future possibility of truly global taxes.⁸² However, in light

79 See the text on the bottom of the map in Canada-Newfoundland & Labrador Offshore Petroleum Board (C-NLOPB), “Southern Newfoundland Region: License Information” (www.cnlopb.ca/wp-content/uploads/maps/snr.pdf).

80 See Harrison, *supra* note 76, at 502-03; Spicer, *supra* note 73, at 16. Under section 5A of New Zealand’s Continental Shelf Act 1964, 1964 No. 28, the minister setting the royalty rate under a licence to exploit the outer continental shelf must have regard to New Zealand’s article 82 obligations.

81 Chircop referred to it as a “downstream fiscal burden.” See Aldo Chircop and Bruce A. Marchand, “International Royalty and Continental Shelf Limits: Emerging Issues for the Canadian Offshore” (2003) 26:2 *Dalhousie Law Journal* 273-302, at 295. The payment is not technically a royalty either, although it is often referred to as such. Indeed, it seems that only those most fearful of it explicitly call it a tax. One of the main reasons the United States has not ratified UNCLOS is its fear of losing tax sovereignty. During congressional hearings on the convention, for example, William Middendorf called article 82 a “step in the direction of international taxing authority.” See “The Testimony of the Honorable William J. Middendorf II on The United Nations Convention on the Law of the Sea Before the Senate Armed Services Committee April 8, 2004,” at 7 (www.globalsecurity.org/military/library/congress/2004_hr/040408-middendorf.pdf). But just because you are paranoid, it does not mean they are not out to get you.

82 Bird, *supra* note 69, at 20: “[M]any proposed global taxes seem to assume that a supranational taxing authority can impose progressive taxes on (or even within) countries to fund activities that will, at least in the first instance, directly benefit people in other countries. Establishing such a supranational tax system on a world basis requires more from the world than the EU has managed to do in half a century.” See *supra*, at 23. See *supra* note 96 and accompanying text.

of the evolving nature of tax sovereignty, the traditional definition of “tax” is due for a reconsideration.

Common-law jurisdictions that lack a comprehensive statutory definition of “tax” (such as Australia, Canada, and the United States) rely on case law, which, rather than arriving at a comprehensive definition, has been focused on characterizing the particular payment at issue by weighing the existence of enumerated positive and negative features.⁸³

The Canadian Privy Council case *Lower Mainland Dairy Products Sales Adjustment Committee v. Crystal Dairy Ltd* is the typical starting point for the positive features: an exaction is a tax if it is compulsory, enforceable by law, imposed by a public authority, and for a public purpose.⁸⁴ Numerous cases have identified negative criteria: a tax is not arbitrary, is not a payment for property or services, and is not in the nature of a penalty.

But this list of relevant features was never intended to be exhaustive, and subsequent case law and scholarship show that it does not provide the most meaningful guidance on what is and is not a tax, and why. For jurisprudential and policy purposes, the criteria provide neither certainty nor clarity: most of them are neither necessary nor sufficient, and collectively they evince no apparent binding principle.⁸⁵ For example, depending on the facts, taxes do not need to be “compulsory,”⁸⁶ imposed by a governmental or public body,⁸⁷ or raised for a public purpose.⁸⁸

Bowler-Smith and Ostik propose a more functional and purposive definition of “tax,” one that obviates the need for considering procedural features (since they

83 See, for example, the discussion of restricting the legislative power to tax, in Miranda Stewart and Kristen Walker, “Australia—National Report” (2007) 15:2 *Michigan State International Law Review* 193–245; Max Bessell, Karen Burford, and Scott Henderson, “What Latham CJ Really Said About Taxation!” (1999) 11 *Corporate and Business Law Journal* 143–63.

84 *Lower Mainland Dairy Products Sales Adjustment Committee v. Crystal Dairy Ltd*, [1933] AC 168, at 176. In Australia (which is similar to Canada in this respect), the accepted “general statement of positive and negative attributes” sufficient to make an exaction of money a tax is that it is compulsory, for a public purpose, enforceable by law, and not for services rendered. *Air Caledonie International v. Commonwealth*, [1988] HCA 61, at paragraph 5. Presumably, the non-inclusion of negative criteria previously mentioned is not significant in light of the facts of the case.

85 Mark Bowler-Smith and Huigenia Ostik, “On the Meaning of ‘Tax’” (2018) 33:3 *Australian Tax Forum* 601–19.

86 The term “compulsory” as Bowler-Smith and Ostik note, “connotes a wide range of control, including situations where there is an absence of a legal obligation to pay,” *ibid.*, at 613. See, for example, *Attorney-General (NSW) v. Homebush Flour Mills Ltd* (1937), 56 CLR 390 (HCAU).

87 It is not “essential to the concept of a tax that the exaction should be by a public authority.” *Australian Tape Manufacturer’s Association Ltd v. Commonwealth*, [1993] HCA 10, at 13.

88 *Air Caledonie International v. Commonwealth*, [1988] HCA 61, at 6: “[T]here is no reason in principle . . . why the compulsory exaction of money under statutory powers could not be properly seen as taxation notwithstanding that it was by a non-public authority or for purposes, which could not properly be described as public.”

are not intrinsic to a payment's character as a tax but rather are matters related to sovereignty more generally and are appropriately dealt with by constitutional and administrative law) and whose terms encapsulate the negative indicia: "a compulsory transfer of value imposed primarily for a redistributive purpose."⁸⁹ This definition is useful because its focus on the unique purposes of taxation allows clarity, transparency, and coherence of tax policy. Like all formulations of the concept of tax, it includes a focus on the use for which the payment is to be put.

The explicit inclusion of a redistributive purpose is controversial, but it gets at the heart of the purpose of tax. Indeed, it is arguable that redistribution is "the main function of a government."⁹⁰ While redistribution via tax in the domestic setting is not a radical idea,⁹¹ redistribution "has not proved to be a persuasive argument for global taxes"⁹² because redistribution at the international level would require the ceding of national tax sovereignty to a supranational authority.⁹³ In order for a global tax to transcend resistance to redistribution and the concomitant ceding of tax sovereignty, there must be the "necessary political foundations for such ideas."⁹⁴

Some of these political foundations are being laid by international treaties relating to the commons, as reflected by the tangibility of the article 82 regime. The acceptance of basic CHOM principles in the global commons indicates that redistribution is not only acceptable but also integral under certain circumstances (if manifested in an acceptable way); at the same time, the historical arc of tax sovereignty is bending toward globalism.

With regard to redistribution, it is common under international law, outside of the tax context.⁹⁵ And although taxation might not be the optimal way to undertake

89 Supra note 85, at 601.

90 Bowler-Smith and Ostik, supra note 85, at 617: "Therefore, if the state chooses to take money from one person and give to another," that's a proper public purpose. See, generally, supra.

91 Richard M. Bird and Eric M. Zolt, "Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries" (2005) 52:6 *UCLA Law Review* 1627-95.

92 Bird, supra note 69, at 24. See supra, at 29: "[G]lobal initiatives to redistribute funds in a major way from rich to poor countries, let alone to extend taxing authority to an international body to deal with global externalities, seem unlikely to succeed."

93 Since "countries have little appetite for giving up fiscal sovereignty or for explicitly redistributive fiscal arrangements, most global tax proposals had little or no prospect of success" (Bird, supra note 69, at 1) and, "[b]ecause the prospect of a meaningful fiscal union at the world level is even bleaker, explicitly redistributive global taxes are likely unachievable" (supra, at 32). See also Allison Christians, "Sovereignty, Taxation, and Social Contract" (2009) 18:1 *Minnesota Journal of International Law* 99-153, at 151: "We may not yet (or ever) be in a position to discuss whether countries have a duty to redistribute income or otherwise seek global distributive justice though globally-oriented tax policy choices."

94 Bird, supra note 69, at 30.

95 See, for example, Aileen E. Nowlan, "Stumbling Towards Distributive Justice" (2012) 12:1 *Chicago-Kent Journal of International and Comparative Law* 101-139, at 138: "The breadth of areas for which international law redistributes resources should put to rest the question of whether '[w]e should rarely observe treaties that redistribute wealth from one state to

redistribution, it does seem to be among the more politically feasible ways of doing it, as is shown by its common use in domestic tax systems and its usefulness as an acceptable compromise solution to the issue of sharing the benefits of CHOM.

With regard to tax globalism, the lack of a world government⁹⁶ and the “overwhelming weight of existing perceptions about the bounds of the state”⁹⁷ have meant “until recently, unequivocal resistance to multilateralism and a single world tax order.”⁹⁸

But the evolution of the international tax architecture suggests a gradual acceptance of global taxation mechanisms. Many have observed the historical trend, in international tax and global tax reform, away from a singular focus on national taxing jurisdiction and toward extranational tax administration and authority. This trend towards multilateralism, transnationalism, and convergent efforts to respond to perceived shortcomings in the international tax system is aptly demonstrated by the BEPS project. The substantive results of policy coordination might be questioned,⁹⁹ but the *process* of attempted policy coordination that animates the BEPS initiative, along with established and increasing administrative cooperation and multilateralism (especially with regard to information sharing), demonstrates a trend toward global action.¹⁰⁰ The OECD, as Christians has said, “is signalling a major conceptual shift away from the conventional view that equates sovereignty with complete state autonomy over tax matters,”¹⁰¹ in recognition that the “sovereign autonomy over taxation is increasingly inconsistent with a global economic

another’” (quoting Eric A. Posner and Cass R. Sunstein, “Climate Change Justice” (2008) 96:5 *Georgetown Law Journal* 1565-1612, at 1575).

96 It is often said that a solution to international tax’s conundrums is not possible short of having a world government. Philipp Genschel and Thomas Rixen, “Settling and Unsettling the Transnational Legal Order of International Taxation,” in Terence C. Halliday and Gregory Shaffer, eds., *Transnational Legal Orders* (New York: Cambridge University Press, 2015), 154-83, at 157: “The only way to simultaneously mitigate international double taxation and tax competition is to pool tax sovereignty internationally.”

97 Allison Christians, “Human Rights at the Borders of Tax Sovereignty,” Working draft, 2017, at 2 (<https://ssrn.com/abstract=2924925>).

98 *Ibid.*, at 11. See also Bird, *supra* note 69, at 33: “There is little political support for global income or wealth taxes, and no world government to implement them.” Consider, for example, the coordination of international policy that the BEPS project is attempting, and consider information sharing (for example, FATCA, TIEAs, multilateral information-sharing agreements).

99 As Graeme Cooper notes, “The BEPS project would, it was said, establish ‘a fundamentally new set of standards designed to establish international coherence in corporate income taxation.’ . . . [M]any of the items in the Action Plan are better described as tinkering.” Graeme S. Cooper, *Coordinating Inconsistent Choices—The Problem of Hybrids*, Legal Studies Research Paper no. 14/108 (Sydney: Sydney Law School, December 2014), at 1.

100 Bird, *supra* note 69, at 2: “The fact that many regional and international organizations exist and are financed shows that the reluctance of nation-states to reduce their fiscal sovereignty does not mean there is no scope for global action.”

101 Christians, “Sovereignty, Taxation, and Social Contract,” *supra* note 93, at 101.

reality.”¹⁰² Tax sovereignty is not inviolable, and international tax development is increasingly carried out transnationally (including through delegating the making of norms to international NGOs).

The phenomenon of stateless income gets credited with driving an emergent extranational element in the international tax regime, but the issue of extranational income analogously manifests the challenges that face the current international tax order. Like stateless income, extranational income is a transnational problem requiring a transnational approach. Although the challenge of stateless income is a practical one that has a bearing on the integrity of the international tax order, extranational income demonstrates the theoretical justification for a taxing regime beyond that of the state.

The nation-state’s power to tax is generally a background assumption in tax scholarship,¹⁰³ but there is a growing scholarly literature that describes, with more nuance, “which relationships between a government and a potential taxpayer normatively justify taxation.”¹⁰⁴ In a series of compelling papers analyzing the justifications for tax sovereignty, Christians lays out an account of a taxing sovereignty limited and defined by considerations beyond simply the sovereign’s own authority: its obligation to respect the fundamental rights that lie at the heart of international law (such as human rights), and its rights and obligations via membership in the international community.¹⁰⁵

In this paper, I have taken Christians’s essential points out of their specific analytical context (that is, the context of theoretical restrictions on national tax sovereignty) and extended them to a discussion of justifications for an extranational tax regime in the global commons.¹⁰⁶ It is in the context of abstaining from harmful tax competition, for example, that Christians identifies the need for sovereign states to take account of their responsibility to the international community, but “[t]he implications of these ideas may reach far more broadly than their architects envisioned. In identifying sovereign duty in a specific context, the OECD is explaining the existence of, or perhaps even creating, a global tax community.”¹⁰⁷

102 Ibid., at 99.

103 See, for example, Christians, “Human Rights at the Borders of Tax Sovereignty,” supra note 97, at 5, and accompanying text; Brian J. Arnold, *Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States*, Canadian Tax Paper no. 90 (Toronto: Canadian Tax Foundation, 1991), at 7.

104 See, for example, Christians, “Human Rights at the Borders of Tax Sovereignty,” supra note 97, at 1; Diane M. Ring, “What’s at Stake in the Sovereignty Debate?: International Tax and the Nation-State” (2008) 49:1 *Virginia Journal of International Law* 155-233.

105 Christians, “Human Rights at the Borders of Tax Sovereignty,” supra note 97; and Christians, “Sovereignty, Taxation, and Social Contract,” supra note 93.

106 Christians’s analysis does not de-centre the nation-state; she notes, in fact, that the “OECD’s approach to harmful tax competition may be interpreted as an implicit claim that states are the primary repositories of a responsibility to working toward creating a global economic order.” See Christians, “Sovereignty, Taxation, and Social Contract,” supra note 93, at 152.

107 Christians, “Sovereignty, Taxation, and Social Contract,” supra note 93, at 148.

States already go to great lengths to voluntarily give up tax sovereignty in the service of being members of this community and of making the international tax system work. There is an “implicit social contract” regarding “global community tax standards” that demands adherence to universal principles and respect for fundamental rights (specifically, human rights) in taxation.¹⁰⁸

The relationship between sovereign and subject must be limited and defined, “guided by some universal principles about what people owe and are owed as citizens of the world.”¹⁰⁹ This relationship must be “an expression of the individual’s consent to the jurisdiction,” and it is (imperfectly) captured by concepts of “nexus,” such as residence and source.¹¹⁰ Christians develops a nexus model, in the context of national tax sovereignty and its interaction with fundamental rights, that is based on the “membership principle” in which one affirmatively declares one’s membership in the community.¹¹¹ Even this conception of “nexus” admits of the importance of “place.”

Indeed, it is a truism of all theories of nexus that “where stuff happens matters”—there is something special about place, especially extranational space. Various treaties formalize consensual membership in the international community subject to CHOM at the national level. Conducting activities in extranational spaces that are difficult to access, and the inherent otherness of the space, puts one on notice that they are subject to special rules.

A corollary, then, of the justifications for restrictions on national tax jurisdiction is that one can also make the case for the use of extranational taxation to fill the void. Thus, it is argued that in the context of extranational space such as the seabed, the collective rights embodied in the principles of CHOM are the rights that form the basis of the “social contract” applicable in extranational commons (as made explicit, in this case, by UNCLOS). In the same way that individual rights define national tax sovereignty, common rights define (and justify) extranational tax sovereignty.

CONCLUSION

The practical and political hurdles to true global taxation are, as Bird has detailed, huge and perhaps insurmountable.¹¹² But the general trend of international taxation, including recent efforts to combat harmful tax competition and stateless

108 Ibid., at 103 and 111. See also Christians, “Human Rights at the Borders of Tax Sovereignty,” *supra* note 97, at 5: “[T]he sovereign state’s decision to rely on taxation as the primary means of raising money should be viewed as an admission that its own power is self-evidently and intrinsically limited by the countervailing force of individual rights.”

109 Christians, “Sovereignty, Taxation, and Social Contract,” *supra* note 93, at 151.

110 Christians, “Human Rights at the Borders of Tax Sovereignty,” *supra* note 97, at 19.

111 Ibid., at 15 and 26.

112 While any tax is by its very nature redistributive, it remains to be seen whether the article 82 regime will satisfy the other requirements for a viable global tax identified by Bird (transparency,

income, is toward transnational approaches to transnational issues. Furthermore, extranational taxation is normatively justified by the CHOM sharing principles and by expansive, purposive conceptions of “tax” and “tax sovereignty.”

During the UNCLOS negotiations, fiscal measures like the one in article 82 proved to be an effective compromise between (1) developed countries, which want private enterprise to be able to access and exploit the commons, and (2) developing countries, which want to be able to share in the spoils from places and resources that, under international law, belong to all of humankind. This compromise manifestation of the CHOM sharing principle is an illustrative proto-tax, theoretically justified by theories of how tax sovereignty and rights interact and the special international law status of the extranational places to which CHOM applies.

Canada has long recognized the importance of extranational spaces.¹¹³ As one commentator put it, almost 40 years ago, “The question remains, however, could international tax law one day have to deal with an international tax?”¹¹⁴ Canada’s experience with article 82 is about to answer that question.

linkage to national administration, and being widely beneficial). Bird, *supra* note 69, at 27–29. Though the article 82 regime’s application is imminent, it is rife with interpretive and practical uncertainties, including but not limited to the nature and calculation of payments, the administrative process, and the recipient countries. In the Canadian context specifically, there are federalism problems relating to federal-provincial maritime resources agreements. See Harrison, *supra* note 76, at 497.

113 Elizabeth Riddell-Dixon, “The Seven-Decade Quest to Maximize Canada’s Continental Shelf” (2014) 69:3 *International Journal* 422–43.

114 A. Peter F. Cumyn, “Can Canada Levy Tax on the Continental Shelf?” (1981) 4:4 *Canada-United States Law Journal* 165–70, at 170.

FINANCES OF THE NATION

TAX EXPENDITURES IN CANADA—HISTORICAL ESTIMATES AND ANALYSIS

John Lester*

The “Finances of the Nation” feature presents annual surveys of provincial and territorial budgets and data-driven analyses of taxation and public expenditures in Canada. This series is a successor to the annual monograph titled Finances of the Nation (and, previously, The National Finances), published from 1954 to 2013 by the Canadian Tax Foundation.

The key data sets prepared for the Finances of the Nation project are available for download at <https://financesofthenation.ca>.

In this article, John Lester describes the federal tax expenditures database developed as part of the Finances of the Nation data portal. He also uses the database to analyze trends in federal tax expenditures over a 21-year period ending in 2019 and to identify the beneficiaries and the activities supported by these measures.

KEYWORDS: TAX EXPENDITURES ■ SUBSIDIES ■ TAX INCENTIVES ■ ECONOMIC DEVELOPMENT ■ SOCIAL POLICY ■ PUBLIC FINANCE

CONTENTS

Introduction	755
The Finance Canada Estimates	757
Definition of the Benchmark	757
Categories of Tax Expenditures	758
Estimation Methodology	759
The Finances of the Nation Database	762
Flags for Certain Tax-Based Spending Measures	764
Summing the Estimates	765
Trends in Tax-Based Spending	767
Concluding Remarks	772

INTRODUCTION

This article describes the federal tax expenditures database developed by Alexander Hemel and John Lester as part of the Finances of the Nation data portal, sponsored by the Canadian Tax Foundation. The article also illustrates how the database can be used to explore trends in federal tax expenditures and to examine who benefits and what activities are supported.

* Of the School of Public Policy, University of Calgary (e-mail: john.lester@ucalgary.ca).

Although Finance Canada has been preparing estimates of the revenue forgone from tax expenditures since 1980, comprehensive estimates for income taxes and sales taxes begin in 1989. Since 2016, Finance Canada has provided rolling eight-year estimates of tax expenditures in an Excel spreadsheet. Finance Canada will also supply a digital compendium of tax expenditure estimates published in documents up to 2014. The Finances of the Nation database (hereinafter referred to as “the FOTN database”) has been developed by concatenating the Finance Canada data, ensuring that the final estimates for each measure are retained and that name changes are captured. The database described in this article includes data from 1999 to 2019;¹ the next version will extend the data back to 1988. The database will be updated annually to incorporate the information in Finance Canada’s most recent report on federal tax expenditures.

Finance Canada distinguishes between structural and non-structural tax measures. Structural measures are implemented to improve the fairness and simplicity of the tax system; they address such issues as avoiding double taxation, promoting horizontal or vertical equity, and recognizing costs incurred to earn taxable income. Non-structural measures are implemented to achieve economic development and social policy goals, such as promoting investment and providing income support. Non-structural measures are similar to spending programs. Distinguishing between structural and non-structural measures is useful, and the distinction is maintained in the FOTN database, although we use the term “tax-based spending” instead of “non-structural.” Finance Canada does not include refundable tax credits in its non-structural component, noting that these measures are now included in program spending and revenues. However, the tax expenditure accounts are the only place where cost estimates for refundable credits other than the Canada child benefit can be found. As a result, the default option in the FOTN database is to include all refundable credits except the Canada child benefit and its predecessor program, the child tax benefit, in tax-based spending. Users can easily define tax-based spending to exclude the refundable credits.

Within the tax-based spending category, we identify measures that raise tax design issues or for which the appropriate benchmark tax system is difficult to determine. These measures relate to the taxation of income from capital, of housing, and of income earned in Canada by non-residents, and the tax treatment of public service bodies, such as universities and hospitals. In 2019, the total cost of tax-based spending measures, including selected refundable credits, was \$125 billion. The revenue cost of the measures singled out for special consideration was \$82 billion, leaving about \$42 billion in adjusted tax-based spending in 2019. We think that the measures identified for special consideration are more likely to be reviewed in the context of tax reform than in a deficit-reduction or expenditure-control exercise. As a result,

1 The most recent data are from the Finance Canada tax expenditure report published on April 16, 2018: Canada, Department of Finance, *Report on Federal Tax Expenditures—Concepts, Estimates and Evaluations* (Ottawa: Department of Finance, 2018) (herein referred to as “the 2018 tax expenditure report”).

our analysis of tax expenditures focuses on adjusted tax-based spending. Other analysts may prefer to work with the complete set of tax-based spending data, which is the default option in the database.

The main findings of our analysis are the following:

1. Adjusted tax-based spending fluctuated around a 16 percent share of aggregate tax revenue from 1999 to 2019. Expressed as a share of gross domestic product (GDP), tax-based spending trended down from 1999 to 2013 but has been relatively stable since then.
2. The dollar value of measures with an economic development objective grew little from 1999 to 2017; enrichment of the small business deduction in 2018 and 2019 accounts for almost all the net growth since 2017. In contrast, the cost of measures with a social policy goal has grown at a brisk pace since 1999.
3. The small business deduction accounts for about half of the cost of economic development measures in 2019. Measures favouring research and development (R & D) and entrepreneurship raise the small business share to almost 70 percent of the total cost of economic development initiatives.
4. Measures providing income support account for about a third of the cost of social policy initiatives. Seniors are the largest beneficiary of this income support, accounting for about 70 percent of the total. Support for food purchases and support for health each account for about a sixth of the cost of social policy measures.

This article is organized as follows. The second section describes the Finance Canada estimates. It includes a discussion of the benchmark used to identify tax expenditures, a review of Finance Canada's classification scheme, and a discussion of measures without cost estimates. The third section describes the FOTN database. It explains the rationale for identifying certain measures for special consideration and discusses the issues raised by aggregating the tax expenditure estimates. The fourth section reviews trends in tax-based spending and discusses how benefits are distributed, by beneficiary and activity. Brief concluding remarks are provided in the last section.

THE FINANCE CANADA ESTIMATES

DEFINITION OF THE BENCHMARK

Finance Canada's income tax expenditures are defined relative to a benchmark described as a variant of the Haig-Simons comprehensive income base.² Notable

2 The Haig-Simons comprehensive income base includes worldwide income from all sources: labour income, capital income (including imputed income from owner-occupied housing and consumer durables), the imputed value of household services, and transfers between taxpayers, such as gifts and inheritances.

exclusions from the base are non-market transfers of income and property; implicit income from non-market activities such as household services and imputed rent on owner-occupied dwellings; and income received as compensation for a personal loss. The benchmark recognizes that governments and their Crown agents have constitutional immunity from taxation.

The benchmark income tax base for businesses and individuals resident in Canada is defined as worldwide market income plus government transfers to individuals. Income is taxed as earned, on accrual. The benchmark includes recognition of expenses incurred to earn business or property income but not expenses incurred to earn employment income. Business expenses are deductible as incurred; reserves for contingent liabilities are not deductible. The cost of a capital asset is deducted over its useful life; this cost is assumed to be accurately captured by the capital cost allowance rates prescribed in the Income Tax Act,³ unless the asset is identified as being depreciable at an accelerated rate. Business and capital losses not deducted in the year in which they are incurred can be carried over to subsequent periods. The unit of taxation is an individual person or a corporation that exists as a separate legal entity. Payments to non-residents are assumed to be taxable in Canada.

The income tax benchmark includes most measures implemented to avoid double taxation. Indexation of tax brackets for inflation is considered part of the benchmark. On the other hand, the benchmark excludes most measures implemented to improve tax fairness and to reduce administration and compliance costs. Notable exceptions are related to the use of a holding company to defer taxes on passive investments.

The goods and services tax (GST) benchmark base consists of all goods and services consumed in Canada. The GST is applied at all stages of the production process, using a system of input tax credits to ensure that only value added is taxed at each stage. Certain entities, such as governments and non-profit organizations, cannot claim input tax credits; this exclusion is considered to be part of the benchmark. Although governments and their agents enjoy constitutional immunity from taxation, in the interest of simplicity immunity is frequently waived. The existing treatment of governments and their agents is generally considered to be part of the benchmark. In contrast, for public service bodies (municipalities, universities, colleges, schools, and hospitals—collectively referred to as “the MUSH sector”), the benchmark assumption is that they should be subject to GST.

CATEGORIES OF TAX EXPENDITURES

In response to recommendations from the auditor general, Finance Canada revamped its tax expenditure publication in 2016. Prior to 2016, measures were grouped into tax expenditures and memorandum items, which were part of the benchmark. The publication now uses three groups: tax expenditures, tax measures other than tax expenditures (the former memorandum items), and refundable tax

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).

credits. Refundable tax credits are in a separate group in recognition of their classification as direct spending in 2012. The measures selected for inclusion in the “other” category are thought to be of “particular interest from a tax policy perspective.”⁴ This group includes measures that promote tax fairness and measures that implement intergovernmental tax arrangements, as well as social security “taxes” and the basic personal amount. As noted in the introduction, tax expenditures are identified as structural or non-structural measures.⁵ The structural category consists of measures “whose main objective is internal to the tax system,”⁶ such as promoting tax fairness or simplicity. The non-structural category consists of measures implemented to achieve economic development and social policy objectives. They are often described as tax preferences or concessions.

Finance Canada’s decision to include structural and selected benchmark measures in its tax expenditure report recognizes that the benchmark tax system is arbitrary, so some ambiguity in defining tax expenditures is unavoidable. For example, the basic personal amount and the non-taxation of guaranteed income supplement and allowance benefits both provide support to low-income individuals, but only the latter is considered a tax expenditure. Providing estimates of the tax revenue forgone from the basic personal amount and other benchmark items allows analysts some flexibility in defining tax expenditures.⁷ As a result, the selected benchmark measures included in the Finance Canada tax expenditure report are also part of the FOTN database.

ESTIMATION METHODOLOGY

The cost of a tax expenditure represents the amount of tax revenue forgone as a result of the measure, calculated on a cash flow basis. The cost of most income tax measures is estimated using “microsimulation” models of personal and corporate income tax—that is, it is based on individual taxpayer data. The models calculate the impact of eliminating a measure assuming that the taxpayer makes use of all deductions and credits in the counterfactual scenario. Finance Canada maintains an input-output model to calculate the amount of GST payable on detailed expenditure categories. This model is used to calculate the cost of exemptions and zero-rating, while the cost of rebates is determined from administrative data.

Finance Canada estimates the amount of tax revenue forgone for each measure assuming that all other measures remain in effect. It is also assumed that taxpayers do not change their behaviour in order to minimize the tax consequences of eliminating a specific measure. For example, the cost of the partial inclusion of capital gains is developed assuming that removal would have no impact on the observed

4 2018 tax expenditure report, *supra* note 1, at 6.

5 Tax measures other than tax expenditures are considered structural measures.

6 2018 tax expenditure report, *supra* note 1, at 29.

7 A useful addition to the benchmark category would be the amount of revenue gained by imposing a progressive rate structure.

value of realized capital gains. However, an increase in the effective tax rate on capital gains is likely to cause taxpayers to realize a smaller amount of capital gains. As a result, the estimated tax revenue forgone is likely to be substantially higher than the amount that the government would realize by changing the inclusion rate. In other words, the cost estimates are purely mechanical and should not be treated as a forecast of how eliminating a specific measure would affect government revenues.

In 2019, there are 146 non-structural measures in effect. However, 23 of these measures apply to both personal and corporate income tax liabilities, so there are 133 unique measures in effect.⁸ Cost estimates are not published for 41 of these measures. Timing preferences account for about 40 percent of the measures with no cost estimate. These measures cover accelerated capital cost allowances for capital assets, immediate deductibility of R & D expenditures⁹ and training costs, and various income deferrals, particularly for capital gains.

By definition, timing preferences affect when tax revenue is received, not the amount. For example, for the purchase of a given asset, accelerated capital cost allowances reduce tax revenues initially, but result in additional revenue when the value of the deduction falls below what would have been available under the standard rate. As discussed in Finance Canada's 2012 tax expenditure report,¹⁰ if rising amounts of assets are purchased each year, the net cash flow cost can be positive for many years, since the negative impact from purchases in prior years takes time to build up. Finance Canada presents illustrative cash flow costs for vessels, mining assets, and clean energy assets.¹¹ The analysis shows the cost of current-year and prior-year purchases separately, noting that elimination of the measure would affect costs associated with current-year purchases only. For example, in 2009, the revenue forgone as a result of current-year purchases of mining assets was \$151 million, while prior-year purchases raised revenue by \$144 million. An alternative approach is to take the difference in the present values of the standard and accelerated allowances. The present value or current-year cost of accelerated depreciation of machinery and equipment used in manufacturing was approximately \$160 million in 2017.¹²

8 When counting the number of non-structural measures in effect in 2019, measures that have not been costed are counted once, even if they apply to both personal and corporate income tax. This reduces the overall count by 12 measures. In addition, the four withholding tax measures apply to both personal and corporate income tax, but estimates are provided for the total only.

9 R & D is considered a capital asset, although it is not identified as such in the Act.

10 Canada, Department of Finance, *Tax Expenditures and Evaluations 2012* (Ottawa: Department of Finance, 2013), at 49-60.

11 Ibid. See the 2018 tax expenditure report, *supra* note 1, at 24-27, for a more general discussion of how to estimate the cost of timing preferences.

12 Expenditures on machinery and equipment used in manufacturing and processing are eligible for a 50 percent straightline tax depreciation rate. The present value of this accelerated depreciation allowance for a \$1 expenditure is 91 cents. The present value of the standard

Income exclusions account for about a quarter of the missing estimates. These measures cover the non-taxation of active business income earned by foreign affiliates and the deductibility of expenses incurred to invest in these foreign affiliates; the non-taxation of income earned and expenditures made by status Indians and Indian bands on reserves; and a number of other measures affecting smaller amounts of income. In a prior study, Lester¹³ presented illustrative calculations suggesting that the cost of allowing interest expenses incurred to support investment in foreign affiliates to be deducted from taxable income in Canada was about \$2.3 billion in 2016. If the active business income of foreign affiliates were taxed in Canada, firms would get a credit, or possibly a deduction, for taxes paid in the host country. The tax revenue forgone by exemption would have been small from about 2005 to 2018, since Canada's corporate income tax rate at that time was low relative to rates in host countries, particularly the United States. The large US corporate income tax reduction in 2018¹⁴ raised the cost of this policy substantially.

The revenue cost of non-taxation of income earned by status Indians on reserve is likely to be several hundred million dollars. In 2015, there were approximately 134,000 status Indians living on reserve with market income totalling \$3.3 billion. The distribution of income was such that an average federal tax rate of 6 to 10 percent would be plausible, implying federal taxes ranging from \$185 to \$310 million.¹⁵

The remaining measures without cost estimates, representing about 30 percent of the total number without estimates, cover a wide range of circumstances, including non-taxation of registered charities, non-deductibility of advertising expenses in foreign media, and the tax treatment of farm savings accounts. The amount of revenue forgone through these measures is likely to be small.

allowance—a 30 percent rate on a declining balance—is 83 cents. The present value of the fiscal cost is the difference between the two, multiplied by the applicable tax rate, 15 percent. In 2017, the manufacturing sector invested \$13.022 billion in machinery and equipment. The fiscal cost of accelerated depreciation, adjusted for the time value of money, was therefore approximately \$160 million over the useful life of the equipment ($0.08 \times [0.15 \times \$13.022 \text{ billion}] = \160 million). This estimate is based on a 5 percent discount rate; a higher rate would increase the cost.

13 John Lester, "Business Tax Incentives for Economic Development: Do They Work?" in Bev Dahlby, ed., *Reforming the Corporate Tax in a Changing World* (Toronto: Canadian Tax Foundation, 2018), 117-54, at 139-40.

14 The US corporate tax reduction was one of the reforms implemented by the Tax Cuts and Jobs Act, Pub. L. no. 115-97, enacted on December 22, 2017.

15 The source for the data in this paragraph is Statistics Canada, *Aboriginal Population Profile, 2016 Census*, Statistics Canada catalogue no. 98-510-X2016001 (Ottawa: Statistics Canada, 2018). The illustrative average tax rate was calculated using the simulated personal income tax rates available on the Finances of the Nation data portal.

THE FINANCES OF THE NATION DATABASE

Finance Canada's report on federal tax expenditures presents data for rolling eight-year intervals. Estimates for the current year and one year in the future are provided. Estimates for the first four years are based on final tax data; for the next two years, on preliminary tax data; and for the last two years, on forecasts of the tax data. Finance Canada also provides the data in an Excel spreadsheet, with all measures tagged by category, group, subject, and tax. The weakness of the digital presentation is that the historical data are never extended beyond six years. The main value added of the FOTN database is to extend the data back to 1989.

Finance Canada will supply, upon request, an Excel spreadsheet containing the data presented in each of the tax expenditure publications prior to 2014. Estimates were prepared in 1980, 1985, 1992-1995, and 1997-2014. A complete set of estimates is available starting in 1989. Note, however, that the data are presented as published; preparing a consistent time series involves accounting for changes to the names of measures, grouping estimates for each measure by year, and retaining only the final estimates for each year.

When setting up the FOTN database, our goal was to use all the data prepared by Finance Canada and keep the essential features of its current classification scheme. Measures in the FOTN database can be allocated to the four Finance Canada categories, although we have used different category names (as shown in table 1). We have retained the term "structural" to cover measures that are internal to the tax system. We considered two labels for the "non-structural" category. Our preferred choice was the term "tax expenditures" because it brings to mind measures that are close substitutes for direct spending. While this narrower definition of tax expenditures is used in some jurisdictions, notably the United States and British Columbia, deviating from current federal practice may cause some confusion. Consequently, we adopted our second choice, the expression "tax-based spending," to replace "non-structural."¹⁶ We use the term "benchmark measures" instead of the cumbersome "tax measures other than tax expenditures."

Structural measures are classified by type of tax and objective—for example, to achieve horizontal or vertical equity, cost recognition, or simplicity. Non-structural measures are classified by general objective—social policy or economic development—and are identified by type of tax, the first-round beneficiary of the tax measure, and the type of activity supported. The classification into economic development and social policy categories is based on the stated objectives of the measure. The Finance Canada publication offers much the same information, but in the digital version measures are classified only by category, type of tax, and subject (which is similar to the activity classification in the FOTN database).

16 The term "tax-based spending" as a substitute for "non-structural" was introduced in John Lester, "Managing Tax Expenditures and Government Program Spending: Proposals for Reform" (2012) 5:35 *SPP Research Papers* [University of Calgary School of Public Policy] 1-38 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2321923).

TABLE 1 Classification of Tax Measures by Finance Canada and in the Finances of the Nation (FOTN) Tax Expenditures Database

Category		FOTN	Objective	Beneficiary	Activity	Tagged measures ^a
Finance Canada						
Tax measures other than tax expenditures		Benchmark	Equity, simplicity, cost recognition, intergovernmental relations			
Structural		Structural				
Non-structural		Tax-based spending, including most refundable tax credits ^b	Social policy	All individuals, employees, renters, low-income individuals, other targeted individuals, industry	Income support; charitable and voluntary; food purchase, health, housing, education, culture	Capital income, housing, non-resident income earned in Canada, MUSH, refundable tax credits
			Economic development	Small business; all industry; farming and fishing; oil, gas, and mining; other targeted industry; employees	Investment, innovation, entrepreneurship, financing, regional development, exports	

MUSH = municipalities, universities, schools, and hospitals.

a Measures in these groups have been tagged to allow flexibility in their classification, as discussed in the text.

b Excludes refundable child benefits, which are included in the public accounts and the main estimates as a major transfer.

FLAGS FOR CERTAIN TAX-BASED SPENDING MEASURES

In principle, the tax-based spending category should consist of measures that are reasonably close substitutes for program spending. In practice, however, it includes a substantial number of measures that raise tax design issues or for which equally plausible interpretations of the benchmark would result in reclassification as structural measures. As noted in the introduction, these measures address the taxation of capital income, of housing, and of income earned in Canada by non-residents, and the tax treatment of the MUSH sector.¹⁷ Changes to measures in these categories are more likely to be discussed in the context of tax reform intended to improve the efficiency of the tax system than in the context of a deficit-reduction or expenditure-control exercise. Measures in these categories are tagged so that they can easily be given special treatment by users of the FOTN database. The default option is to include these measures in the tax-based spending category.

A cogent case can be made that most forms of capital income are subject to a form of double taxation; as a result, exemption of capital income could be considered part of a benchmark defined in terms of comprehensive income. Consider a business that introduces an innovation that increases profits and dividends, which are taxed. The shares of the company increase in value, reflecting the present value of the increased profit stream. If the shares are sold, the capital gain is taxed, causing the increased income arising from the innovation to be taxed as it accrues and again when it is received.¹⁸ In addition, personal income is taxed once when it is earned and again when it is saved and generates investment income, which could be considered double taxation.

The Finance Canada benchmark treats housing as a current expense, but not in a consistent fashion. As a current expense, purchases of housing would be subject to GST, so the rebates provided are correctly considered a preference. In contrast, if purchasing a house represents a current expense, it is hard to justify the inclusion of taxation of the capital gain in the benchmark. An alternative benchmark that would be more consistent with a comprehensive income approach would be to treat housing as an investment; this would involve allowing a deduction for the purchase price of the house, taxing the net imputed income from the asset, imposing GST on the imputed rent, and taxing the capital gain when the house is sold.

Deviations of withholding taxes on income earned in Canada by non-residents from the statutory 25 percent rate are in the tax-based spending category. However, adopting residence-based taxation of income is an equally plausible benchmark, particularly given that Canadian residents are taxed on their worldwide income. Further, the actual rates imposed are the result of bilateral negotiations that consider,

17 Also see Lester, *supra* note 16.

18 See Jack Mintz and Stephen R. Richardson, "The Lifetime Capital Gains Exemption: An Evaluation" (1995) 21, supplement *Canadian Public Policy* S1–S26, for a more detailed discussion.

among other factors, the tax treatment of income earned by Canadians in the treaty partner country.

It is useful to flag the tax treatment of the MUSH sector because views may differ on the definition of the government sector.

We treat refundable tax credits differently than Finance Canada, which presents these measures for information only and does not include them in its definition of broadly defined tax expenditures. Following the adoption of a Public Sector Accounting Board standard in 2012, the cost of refundable credits is added to program spending and budgetary revenues. However, the tax expenditure report appears to be the only place where the cost of each measure is presented. The main estimates (part 1) show child benefits, which is the sum of the Canada child benefit and the child disability benefit, both of which are refundable credits. The public accounts (volume 2, table 2a) show the refundable tax credits broken down into children's benefits and other.

In the FOTN database, we include all refundable tax credits in tax-based spending except the Canada child benefit and its refundable predecessor, the child tax credit. The rationale for this approach is that since only child benefits are explicitly identified in the main estimates and the public accounts, other refundable credits would not necessarily be included in either a review of program spending or a review of tax expenditures. Excluding the Canada child benefit, there were six refundable credits in effect in 2019, costing approximately \$3.6 billion (table 2).

The total amount of tax revenue forgone from tax-based spending measures is projected to be about \$125 billion in 2019 (table 3). When the measures flagged for special consideration are excluded, the projected total cost falls to \$42 billion. Measures related to the taxation of capital income, such as tax preferences for retirement savings and the partial inclusion of capital gains on non-residential property, account for more than half of the total tax revenue forgone.

SUMMING THE ESTIMATES

Summing the costs of individual measures to obtain the total amount of tax revenue forgone raises two issues. First, the sum of the costs of individual measures, which are calculated assuming that all other measures remain unchanged, does not accurately capture the cost of eliminating all measures at once. The direction of bias is difficult to determine a priori, since the sum understates the true cost of measures in some circumstances but overstates it in others. For example, if a taxpayer has more deductions than necessary to reduce taxable income to zero, considering the measures separately understates their true cost if elimination of any single measure results in positive taxable income.¹⁹ In addition, assessing the impact of measures

19 With total income of \$1,000 and deductions of \$800 and \$500, taxable income would increase from zero to \$200 and \$500, respectively, if the deductions were eliminated sequentially, and to \$1,000 if they were eliminated simultaneously.

TABLE 2 Refundable Credits Included in the Finances of the Nation Tax Expenditures Database

	2015	2016	2017	2018	2019
	<i>\$ millions</i>				
Enhanced scientific research and experimental development investment credit	1,290	1,260	1,360	1,395	1,455
Canada workers' tax benefit	1,160	1,180	1,180	1,180	1,430
Canadian film or video production tax credit	260	270	295	310	320
Refundable medical expense supplement	150	155	160	165	170
Film or video production services tax credit	150	145	155	160	165
Atlantic investment tax credit—refundable portion	20	20	20	20	25
Children's fitness tax credit—refundable	210	140			
Total	3,240	3,170	3,170	3,230	3,565

TABLE 3 Decomposition of Tax-Based Spending, 2019

	<i>\$ billions</i>
Tax-based spending	123.4
Less measures related to	
Capital income taxation	64.9
Tax treatment of housing	6.6
Non-resident withholding taxes	6.5
Taxation of the MUSH sector	3.9
Equals	
Adjusted tax-based spending	41.6

MUSH = municipalities, universities, schools, and hospitals.

that reduce taxable income separately will understate their combined impact because income-induced increases in marginal tax rates will not be captured.

On the other hand, summing the individual costs of tax credits will overstate the cost of simultaneous elimination since some low-income taxpayers will not be able make use of all credits available to them. The interaction effects between income exclusions and tax credits are ambiguous. Higher taxable income allows low-income taxpayers to use more credits, but other taxpayers will experience tax credit reductions as their taxable income rises.

Finally, summing the individual tax expenditures relating to the GST overstates the cost of maintaining all the measures. Some entities supplying goods and services in a non-commercial context benefit from both an exemption from GST on their

sales and a rebate of GST paid on their purchases. The cost estimates for exemptions and rebates calculated by Finance Canada are not independent: the rebate has no cost in the absence of the exemption since without the exemption the entity would be able to claim a refund for the GST paid on its purchases. As a result, adding the two cost estimates overstates the cost of maintaining both by the amount of the rebate.²⁰

The second issue raised by presenting the aggregate value of tax expenditures is that the total will be understated because, as discussed earlier, cost estimates are not available for all measures. On average, from 1999 to 2019 about 30 percent of the measures in effect have not been costed. While the amount of tax revenue forgone is substantial for some of these measures, the missing elements are likely to be a small share of the total value of tax-based spending measures. Missing values will represent a higher share of adjusted tax-based spending: the largest measure, cross-border interest deductibility, could account for almost 6 percent of adjusted spending in 2019.

TRENDS IN TAX-BASED SPENDING

A decomposition of tax-based spending from 1999 to 2019 is shown in figure 1. The estimates are expressed as a percentage of GDP. Measures related to the taxation of capital income are highly variable over the period, fluctuating around approximately 2 percent of GDP. Most of the variability arises from registered pension plans and registered retirement savings plans. The revenue forgone from these plans is the net effect of a deduction for contributions, non-taxation of investment income earned in the plans, and taxation of withdrawals. The first and last elements are reasonably stable, but changes in interest rates and equity values cause large year-to-year swings in the value of investment income earned in the plans. The revenue loss associated with tax-free savings accounts has risen relative to GDP since the measure was introduced, reaching 0.1 percent of GDP in 2019. Its share should continue to rise over time. Measures related to the tax treatment of housing also exhibit some variability, largely owing to movements in house prices, which affect the cost of not taxing capital gains on the sale of principal residences.

Excluding the volatile capital income taxation component, tax-based spending has been a relatively stable share of GDP since 2009. In 2019, the measures flagged for special consideration reduce tax-based spending from 5.4 percent to 1.8 percent of GDP.

Figure 2 shows the evolution from 1999 to 2019 of tax-based spending, excluding measures related to the taxation of capital income, of housing, and of income earned by non-residents in Canada, and the MUSH sector. Relative to program spending, adjusted tax-based spending was on a downward trend from 1999 to 2009 but has been relatively stable since then. A key reason for this pattern is a sharp

20 See the 2018 tax expenditure report, *supra* note 1, at 20–21, for a discussion of this point and other aspects of interaction effects among tax expenditures.

FIGURE 1 Decomposition of Tax-Based Spending as a Percentage of GDP

GDP = gross domestic product.

FIGURE 2 Adjusted Tax-Based Spending Relative to GDP, Program Spending, and Tax Revenue

GDP = gross domestic product.

deceleration in the growth in program spending from an annual average rate of almost 8 percent up to 2009 to about 2.5 percent starting in 2010. Measured relative to GDP, tax-based spending was on a downward trend until 2013 but has been relatively stable since then. The downward trend was interrupted from 2006 to 2010 owing to enrichment of the small business deduction, elimination of the high income tax rate for resource industries, and the introduction of new measures, including the temporary home renovation tax credit in 2009. The number of unique measures in effect (with estimates of tax revenue forgone) rose from 66 in 2005 to 73 in 2010. Tax-based spending fluctuated around a 16 percent share of tax revenues over the 1999-2019 period.

The rest of this section provides a historical perspective on the objectives, beneficiaries, and activities supported by adjusted tax-based spending. With respect to objectives, we distinguish between measures with economic development goals and measures with social policy goals. Measures with an economic development goal are, at least in principle, implemented with the expectation that they will result in improved economic performance. Measures with a social policy goal involve income transfers and support for activities deemed socially desirable. Some of the activities supported, such as health outcomes, have an indirect positive effect on economic performance.

The overall cost of measures with an economic development objective was little changed in nominal terms from 1999 to 2017 (figure 3). Elimination of the special low rate for manufacturing (achieved through a reduction in the general income tax rate) reduced the cost of economic development measures by almost \$2 billion from 1999 to 2004. On the other hand, elimination of the special high rate on resource income put upward pressure on costs in 2006 and 2007. No major new economic development initiatives were announced over the period. Much of the variability in the overall cost is due to tightening or enrichment of the small business deduction, which accounted for just over 37 percent of the total cost of economic development initiatives on average from 1999 to 2017. A substantial rise in the total cost of economic development initiatives is projected for 2018 and 2019, largely owing to enrichment of the small business deduction.

In contrast, the cost of social policy measures grew at an average annual rate of 4.5 percent over the period. Two major measures were implemented in 2007: the working income tax benefit (with a cost of \$0.5 billion in 2007, rising to \$1.4 billion in 2019) and pension income splitting (with a cost of \$0.9 billion in 2007, rising to \$1.4 billion in 2019). In addition, estimates of the tax revenue forgone became available for the GST exemption for purchases by charities (\$0.8 billion in 2005) and for the exemption for scholarship, fellowship, and bursary income in 2013 (\$0.2 billion in 2005). Three further changes caused the aggregate value of social policy measures to fluctuate from 2008 to 2015:

FIGURE 3 Adjusted Tax-Based Spending by Major Objective

1. The methodology for calculating the cost of not taxing benefits from private health and dental plans was revised to recognize that if these benefits were taxable, they would be eligible for the medical expense tax credit. This change was implemented in 2013; it reduced the cost estimates going back to 2008 by approximately \$1 billion each year.
2. The home renovation credit, in effect for 2009 only, cost \$2.3 billion.
3. The short-lived family tax cut cost \$1.6 billion in 2014 and 2015.

There were 41 unique measures with an economic development goal in effect in 2019. Official cost estimates are available for only 20 of these measures. Further, the top 10 of these measures account for 98.3 percent of the aggregate value of economic development measures in 2019 (table 4). Small business is the main beneficiary of economic development measures, accounting for almost 70 percent of the total in 2019. Industrial targeting (farming and fishing; oil, gas, and mining; and other) accounts for about 8.5 percent of tax revenue forgone in 2019. Investment, via the small business deduction, is the main activity supported by economic development measures, accounting for half the total value. Innovation (the scientific research and experimental development tax credits) accounts for about a quarter of the aggregate cost of economic development measures. Entrepreneurship (20 percent of the total) is supported by the capital gains exemptions, the employee stock option deduction, the labour-sponsored venture capital corporations credit, and the deduction of allowable business investment losses.

There were 67 unique measures with a social policy goal in effect in 2019. Official cost estimates are available for 52 of these measures. Social policy measures are less concentrated than economic development measures, but the top four measures account for about half of the cost of social policy initiatives in 2019 (table 5). The

TABLE 4 Economic Development Measures, 2005-2019
(2019 Ranking, Millions of Dollars)

	2005	2015	2019	
			\$	Share (%)
Preferential tax rate for small businesses	3,300	3,255	6,325	50.1
SR & ED investment tax credit				
Non-refundable	1,496	1,350	1,580	12.5
Refundable	1,224	1,290	1,455	11.5
Lifetime capital gains exemption				
Small business shares	430	760	855	6.8
Farming and fishing	255	615	760	6.0
Employee stock option deduction	945	685	740	5.9
Atlantic investment tax credit	401	290	235	1.9
Film or video production services tax credit	105	150	165	1.3
Labour-sponsored venture capital corporations credit	125	90	165	1.3
Flowthrough share deductions (mining, oil, gas, and renewable energy)	440	85	130	1.0
Apprenticeship job creation tax credit		97	102	0.8
Deduction of allowable business investment losses	41	50	40	0.3
Logging tax credit			26	0.2
Foreign convention and tour incentive program			15	0.1
Corporate mineral exploration and development tax credit			10	0.1
Rollovers of investments in small businesses . . .			10	0.1
Top 10 total			12,410	98.3
Top 16 total	8,762	8,717	12,613	99.9
Economic development total	8,417 ^a	8,884	12,620	100.0

SR & ED = scientific research and experimental development.

a Includes negative measures totalling \$793 million.

largest single measure, zero-rating of basic groceries, accounts for 17 percent of the total cost of social policy initiatives. The age credit accounts for 13 percent, while the charitable donations credit and the non-taxation of benefits from private health and dental plans each account for about 10 percent of revenue forgone. The top 15 measures account for 90 percent of tax revenue forgone.

Income support is a key activity supported by social policy initiatives, accounting for about a third of the 2019 cost. Charitable and voluntary activities make up almost 20 percent, and measures supporting food purchases and health both account for about a sixth. About a third of the value of social policy measures is not targeted—that is, measures are available to all individuals, to all employees (for example, non-taxation of benefits from private health and dental plans, and non-taxation of

TABLE 5 Top 15 Social Policy Measures, 2005-2019
(2019 Ranking, Millions of Dollars)

	2005	2015	2019	
			\$	Share (%)
Zero-rating of basic groceries	3,905	4,230	4,930	17.0
Age credit	1,395	3,170	3,830	13.2
Charitable donations tax credit—total	2,258	2,650	2,885	10.0
Exemption from GST for certain residential rent (long-term)	1,445	2,345	2,845	9.8
Non-taxation of benefits from private health and dental plans	2,170	2,580	2,840	9.8
Working income tax benefit	0	1,160	1,430	4.9
Pension income splitting	0	1,165	1,415	4.9
Pension income credit	420	1,170	1,310	4.5
Exemption from GST for certain supplies made by charities and non-profit organizations	810	1,085	1,250	4.3
Zero-rating of prescription drugs	725	800	935	3.2
Non-taxation of workers' compensation benefits	620	630	665	2.3
Deductibility of charitable donations—other	430	430	470	1.6
Zero-rating of medical and assistive devices	180	350	390	1.3
Exemption of scholarship, fellowship, and bursary income	0	250	370	1.3
Rebate for registered charities	295	320	335	1.2
Top 4 total	9,003	12,395	14,490	50.1
Top 15 total	14,653	22,335	25,900	89.5
Social policy total	16,579	26,856	28,937	100.0

GST = goods and services tax.

workers' compensation benefits), or to all industry (for example, the deductibility of charitable donations). Seniors receive about a quarter of all benefits and 70 per cent of income support (figure 4). Key programs are the age credit, pension income splitting, and the pension income credit. Renters account for about 10 per cent of the benefits from social programs in 2019. Low-income individuals receive about 6 per cent of the value of social policy measures. The largest program is the Canada workers' credit (formerly the working income tax benefit). With the exclusion of major transfers to children from the FOTN database, families benefit from less than 2 per cent of tax-based spending with a social policy objective.

CONCLUDING REMARKS

This article has provided an overview of the FOTN tax expenditure database and illustrated how it can be used to assess trends in tax-based spending and to identify the beneficiaries and activities supported. While the analysis uses a subset of tax-based spending, database users can easily choose which measures to include in their

FIGURE 4 Distribution of the Benefits of Social Policy Measures, by Beneficiary, 2005-2019

analytical work. The database also includes structural and benchmark tax measures, which are likely to be of interest to some researchers. This version of the database covers the period 1999 to 2019; a subsequent version will extend the database back to 1989. The database will be updated annually to incorporate the information in the latest report on federal tax expenditures.

PERSONAL TAX PLANNING

Co-Editors: Brian J. Anderson,* Sonia Gandhi,** Dino Infanti,***
and Jim MacGowan****

DONATION OF PRIVATE COMPANY SHARES

*Brian Janzen**

This article explores planning opportunities related to charitable giving for individuals who hold shares in a family-owned private corporation. Specifically, the authors discuss ways of achieving philanthropic goals, as part of a tax-efficient estate plan, through an inter vivos donation of preferred shares that have been issued by a private corporation in connection with an estate freeze.

KEYWORDS: DONATIONS ■ CHARITABLE DONATIONS ■ GIFTS ■ ESTATE PLANNING ■ PRIVATE COMPANIES ■ PRIVATE CORPORATIONS

* Of Deloitte LLP, Winnipeg (e-mail: bjanderson@deloitte.ca).

** Of KPMG LLP, Toronto (e-mail: soniagandhi@kpmg.ca).

*** Of KPMG LLP, Vancouver (e-mail: dinfanti@kpmg.ca).

**** Of Deloitte LLP, Halifax (e-mail: jmacgowan@deloitte.ca).

PLANIFICATION FISCALE PERSONNELLE

Co-rédacteurs de chronique : Brian J. Anderson,* Sonia Gandhi,**
Dino Infanti*** et Jim MacGowan****

DON D' ACTIONS D'UNE SOCIÉTÉ PRIVÉE

*Brian Janzen**

Cet article explore les occasions de planification liées aux dons de bienfaisance qui s'offrent aux particuliers qui détiennent des actions d'une société privée familiale. Les auteurs expliquent en particulier comment atteindre ses objectifs philanthropiques, dans le cadre d'un plan successoral efficace sur le plan fiscal, en faisant un don entre vifs d'actions privilégiées émises par une société privée dans le contexte d'un gel successoral.

MOTS CLÉS : DONS ■ DONS DE BIENFAISANCE ■ PLANIFICATION SUCCESSORALE ■ ENTREPRISES PRIVÉES ■ SOCIÉTÉS PRIVÉES

* De Deloitte LLP, Winnipeg (courriel : bjanderson@deloitte.ca).

** De KPMG LLP, Toronto (courriel : soniagandhi@kpmg.ca).

*** De KPMG LLP, Vancouver (courriel : dinfanti@kpmg.ca).

**** De Deloitte LLP, Halifax (courriel : jmacgowan@deloitte.ca).

CORPORATE TAX PLANNING

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

CANADIAN INBOUND INVESTMENT AFTER THE MLI

*Nelson Whitmore and Owen Strychun******

The multilateral instrument (MLI), developed by the Organisation for Economic Co-operation and Development and the Group of Twenty as part of the base erosion and profit shifting initiative was signed by Canada and more than 60 other signatories in 2017 and came into force in July 2018. The MLI introduces significant tax treaty changes that may have the effect of materially altering the tax-planning opportunities available for investing in Canada. This article sets out a brief review of the Canadian case law on the application of tax treaties in relation to investing in Canada, a summary of the treaty changes for Canada contemplated by the MLI, and some anticipated effects on the structuring of investments into Canada. The authors focus on the practical issues that taxpayers face in relation to inbound investment following Canada's ratification of the MLI.

KEYWORDS: MULTILATERAL INSTRUMENT (MLI) ■ INVESTMENT ■ TREATY ■ BENEFITS ■ STATUTORY INTERPRETATION ■ GAAR

* Of Couzin Taylor LLP, Edmonton (affiliated with Ernst & Young LLP) (e-mail: derek.g.alty@ca.ey.com).

** Of Thorsteinssons LLP, Toronto (e-mail: bcarr@thor.ca).

*** Of Deloitte LLP, Calgary (e-mail: michael.smith@deloitte.ca).

**** Of Fasken, Toronto (e-mail: csteeves@fasken.com).

***** Of Deloitte LLP, Calgary. We would like to thank Michael R. Smith, Shawn Porter, Stan Ebel, Mark Dumalski, and Charles Taylor for their valuable insights in the preparation of this article.

CURRENT TAX READING

Co-Editors: Robin Boadway, Kim Brooks, Jinyan Li, and
Alan Macnaughton*

Alice Abreu and Richard Greenstein, “Tax: Different, Not Exceptional,”

Administrative Law Review (forthcoming) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3396103)

Unlike some other fields of law, tax law is codified. The Income Tax Act¹ is arguably the most complex legislation in Canada, affecting the lives of almost everyone in the country, directly or indirectly. The pervasiveness of encounters with the tax system and the intimidating technical complexity of the Act make people feel that tax law is different from other kinds of law. Further, the Supreme Court of Canada treats the Act differently from other statutes. In *Canada Trustco Mortgage Co. v. Canada*,² for example, the court said that even though “all statutes, including the Act, must be interpreted in a textual, contextual and purposive way,” “the particularity and detail of many tax provisions” invite a largely textual interpretation.³ In addition, the court said that the provisions of the Act “must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently.”⁴ This approach imposes a “burden of perfection”⁵ on the drafters of the legislation and encourages the use of more prescriptive and detailed provisions—a pressure that will, over time, make the Act even more singular, inviting more textual interpretation in order to achieve certainty and predictability. Is tax law so different as to be exceptional?

In this article, the authors provide an excellent account of why tax law is seen to be different from other fields of law (a perception reflected in American tax scholarship, tax cases, and public attitudes toward taxation), and they argue that the

* Robin Boadway is of the Department of Economics, Queen’s University, Kingston, Ontario (e-mail: boadwayr@econ.queensu.ca). Kim Brooks is of the Schulich School of Law, Dalhousie University, Halifax (e-mail: kim.brooks@dal.ca). Jinyan Li is of Osgoode Hall Law School, York University, Toronto (e-mail: jinyanli@osgoode.yorku.ca). Alan Macnaughton is of the School of Accounting and Finance, University of Waterloo (e-mail: amacnaughton@uwaterloo.ca).

1 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.

2 2005 SCC 54.

3 At paragraphs 11 and 13.

4 At paragraph 12.

5 Charlotte Crane, “The Income Tax and the Burden of Perfection” (2006) 100:1 *Northwestern University Law Review* 171-87, at 171 and 176.

differences thus perceived do not add up to a basis for “tax exceptionalism.” “Tax is law,” the authors conclude.⁶ They applaud the US Supreme Court decision in *Mayo Foundation for Medical Ed. and Research v. United States*,⁷ which declined to carve out an approach to administrative review that is good for tax law alone.

This article has six parts. Following the introduction (part I), part II examines the backgrounds of tax exceptionalism, including the circumstances in which the federal income tax was enacted, the ascendancy of economists and public finance economics, the use of the concept of tax expenditures to “divorce” revenue-raising objectives from other objectives, and the “extraordinarily coercive” nature of the mandatory sharing of resources and personal information with the government.

Part III discusses whether tax law is really exceptional. Looking beyond the possible vanity of tax specialists (a desire to feel special or smart by claiming an exalted status), the authors analyze and challenge three more “serious” arguments for tax exceptionalism: (1) that tax law should pursue no social policies; (2) that the absence of a moral imperative for compliance with tax law increases the need for precision in the law itself, in order to ensure compliance; and (3) that the daunting complexity of tax law legislation requires that it be understood, unlike other legislation, as a compendium of rules that must be strictly interpreted according to their plain meaning. The authors argue that the idea that income tax law consists or should consist of strictly construed rules is incorrect, given that tax law makes wide use of standards.

Part IV explains why differences between tax law and other fields of law do not make tax law unique. In part V, the authors argue that tax exceptionalism is not helpful, and they refer both to scholarly work and to judicial opinions, such as the *Mayo* decision, in order to show why one should apply an issue-by-issue analysis to tax law questions instead of categorically invoking the tax exceptionalism argument. Part VI reiterates the authors’ position that, although tax is different from other fields of law, “each difference should be evaluated in a specific context to determine if tax should be treated differently in that context as a result of the difference.”⁸

Reading this article may prompt Canadian readers, in approaching the interpretation of the Act, to rethink the question of tax exceptionalism.

J.L.

Alex Ladyman, “A Public Law Perspective on Tax Law: The Proposed Power to Remedy Legislative Anomalies” (2018) 16:1 *New Zealand Journal of Public and International Law* 67-99

In New Zealand, a recent law reform proposed to provide the commissioner of inland revenue with a power to remedy legislative anomalies in the Inland Revenue

6 At 49 (SSRN version).

7 562 US 44, at 55 (2011).

8 At 51.

Act by recommending regulations, making determinations, or undertaking administrative actions such as temporarily repealing a law for taxpayers and creating a rule in substitution.⁹ This proposed power is intended to be an interim fix until Parliament is able to amend the legislation, and the exercise of the power is subject to various safeguards. In this article, the author discusses the proposed discretionary power from a public-law perspective. He explores how public-law principles, such as the rule of law, parliamentary supremacy, the separation of powers, good administration, and accountability, should apply to the designing of the safeguards. The author recognizes that discretion is essential for administering the tax system (the New Zealand Income Tax Act 2007 alone is 3,510 pages long!¹⁰) and that the commissioner must use this discretion in balancing (1) the duty to collect the highest net revenue and (2) the need to ensure the fairness and integrity of the tax system. He warns, however, that because the proposed power could create rules in substitution for legislation, it could undermine parliamentary supremacy. The article suggests ways of strengthening the safeguards—for example, by making the commissioner publicly accountable for the use of the remedy power. The central thesis advanced in this article is that tax law should be viewed as public law and that public-law principles are important in the design of tax law.

J.L.

François Vaillancourt and Anna Kerkhoff, “Capital Gains Taxation in Canada, 1972-2017: Evolution in a Federal Setting” (2019) 16:2 *eJournal of Tax Research* 340-61

This paper traces the evolution of the capital gains tax system in Canada from 1972 to 2017, and it evaluates (1) the impact of capital gains on death taxes, (2) the effect of the general lifetime capital gains exemption (LCGE) (the general regime from 1985 to 1995 and the regime available only for small businesses, farmers, and fishers after 1995), and (3) the driving force behind the changes in inclusion rates in 2000. Among the interesting findings and conclusions are the following:

- Capital gains for both individuals and businesses have increased 174 times in nominal terms (and 30 times in real terms),¹¹ and capital gains are concentrated in the hands of the three top income groups.
- Death taxes disappeared following the introduction of capital gains tax, “since one of the main purposes of the death tax was to act as a ‘check’ on the incomes of the wealthy and to make up for tax avoidance choices that were used through an individual’s lifetime.”¹²

9 Bill 72-1, Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters, at clause 9, cited at 68, note 2.

10 At 71.

11 At 342.

12 At 343.

- The general LCGE that applied to all assets is an “inefficient means of stimulating small business investment.”¹³
- The limited LCGE was introduced, among other reasons, to help small business owners and farmers save for retirement, on the grounds that they could not take advantage of registered retirement savings plans (RRSPs), which “often served as a complement to retirement savings for small-business owners and ‘middle’ to ‘high income’ farmers but did benefit ‘low income’ farmers,”¹⁴ and there was no evidence to support the argument that small business owners and farmers cannot make use of RRSPs.
- The LCGE benefits the highest-income group and “is not a very useful policy tool.”¹⁵
- The capital gains tax system, in its current form, “plays a role in ensuring tax fairness in Canada”¹⁶ and could be improved, mainly through indexing for inflation.

J.L.

Jay A. Soled, “Reimagining the Estate Tax in the Automation Era”

(2019) 9:3 *UC Irvine Law Review* 787-828

In this article, Soled makes the case for the US Congress’s imposing a meaningful estate tax in order to raise revenue and reduce wealth inequality in the automation age. He first provides background: (1) the origin, rationale, and design of an income tax that taxes labour more heavily than capital, and (2) the eradication of jobs by automation. He then explains why heavier taxation of capital became necessary when the United States was transformed from an industry-based economy to an automation-based one. At the same time, Soled maintains that, because of the risk of capital flight to tax haven jurisdictions and the deferral of the recognition of capital gains, the taxation of capital income and capital gains under the income tax system is not viable. He proposes instead, as easier to enforce (since taxpayers are less mobile than capital), a broad-based estate tax to function as a tax on deferred or capital income.

Soled’s call for more taxes on wealth or capital joins similar calls by scholars (for example, Piketty)¹⁷ and politicians (for example, US democratic presidential

13 At 346, citing a study by J.M. Mintz and S.R. Richardson, “The Lifetime Capital Gains Exemption: An Evaluation” (1995) 21 supplement *Canadian Public Policy/Analyse de Politiques* 174-92.

14 At 347.

15 At 348.

16 At 359.

17 Thomas Piketty, *Capital in the Twenty-First Century*, trans. Arthur Goldhammer (Cambridge, MA: Belknap Press of Harvard University Press, 2014), at 515; and see Edward N. Wolff, *Top Heavy: The Increasing Inequality of Wealth in America and What Can Be Done About It* (New York: New Press, 1996), for a proposal of an annual wealth tax.

contender Elizabeth Warren).¹⁸ His proposal is US-centric, but the insights in this article have implications for other countries that have economic structures and political systems similar to the United States’.

J.L.

Adam Chodorow, “Lost in Translation” (2019) 97:3 *Taxes: The Tax Magazine* 171-93

This article explores the various loss limitation rules in the US Internal Revenue Code (“the Code”), unpacking the purported mischiefs motivating the introduction of these rules, the design features that arguably made them necessary, and the mechanisms by which these rules attempt to limit losses. Canadian readers should find the article interesting, because the Act contains similar rules.

The article classifies as loss limitation rules those that prevent loss transfers, personal loss deductions, “timing games and tax alchemy”¹⁹ (for example, capital loss limitations), property losses claimed when property is functionally retained, non-economic losses, and corporate losses. It lists the root causes of the problems that the loss limitation rules were designed to address: for example, the realization requirement, the preferential treatment of capital gains, the taxpayer unit, and the treatment of each corporation as a separate taxpayer. Recognizing the unlikelihood that these root causes will be removed, the author suggests that “the best we can hope for is to reform the existing provisions, aim them more directly at the problems they are supposed to address, and make them easier to understand and apply.”²⁰ Given that the rules aimed at individuals appear to be working fairly well, the paper recommends some changes to the rules affecting corporations.

J.L.

Cameron Rotblat, “Chinese State Capitalism and the International Tax Regime” (2018) 10:1 *Columbia Journal of Tax Law* 79-138

China’s recent rise as an economic powerhouse has occurred under a unique system of “state capitalism”: “[W]hile the market forces play a significant role in most sectors, the Party-state continues to function as the leading economic actor through its extensive controls over SOEs [state-owned enterprises].”²¹ In this article, the author claims that such a unique system may lead China to pursue distinctive international tax policies regarding (1) the allocation of taxing rights, (2) tax competition, and

18 See “Senator Warren Unveils Proposal to Tax Wealth of Ultra-Rich Americans,” *Elizabeth Warren: United States Senator for Massachusetts, Press Release*, January 24, 2019 (www.warren.senate.gov/newsroom/press-releases/senator-warren-unveils-proposal-to-tax-wealth-of-ultra-rich-americans).

19 At 177.

20 At 187.

21 At 96.

(3) base erosion and profit shifting (BEPS). He suggests that the continued income taxation of SOEs, many of which receive foreign investment or make investment in foreign countries, means that China will maintain a worldwide system of corporate taxation even though the United States and most other countries have adopted the territorial system. He maintains that the dominant role of SOEs in outbound investment creates “an unusually strong incentive for the Chinese government to encourage SOE managers to minimize the amount of foreign taxes paid through tax planning”²² (for example, by providing tacit state support for international tax planning). He also maintains that China is likely to adopt preferential tax treatment of SOEs through domestic tax legislation and international tax treaties (for example, lower rates of withholding taxes on interest paid to Chinese banks).

J.L.

Craig Eliffe, “The Meaning of the Principal Purpose Test: One Ring To Bind Them All?” (2019) 11:1 *World Tax Journal* 47-76

The principal purpose test (PPT) is a treaty-based general anti-abuse rule and one of four minimum standards adopted by the Group of Twenty/Organisation for Economic Co-operation and Development (G20/OECD) BEPS project.²³ An increasing number of bilateral tax treaties have incorporated the PPT. However, because treaty law is interpreted and applied by tax authorities and courts in individual countries, there is no guarantee that the PPT will be interpreted the same way in all countries. Therefore, although the PPT in theory is international, the PPT in action may remain “state-centric,”²⁴ undermining its policy objective.

In this article, the author argues that the PPT should have an autonomous common meaning, or universal interpretation. To achieve this universal interpretation, according to Eliffe, the tax authorities and courts of all countries need to take a

22 At 123.

23 It is currently contained in article 29(9) of the Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (Paris: OECD, November 2017) (https://doi.org/10.1787/mtc_cond-2017-en); and United Nations, *United Nations Model Double Taxation Convention Between Developed and Developing Countries 2017 Update* (New York: United Nations, 2017). Article 29(9) incorporates article 7(1) of the Organisation for Economic Co-operation and Development, *Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting*, done at Paris, France, November 24, 2016 (herein referred to as “the MLI”) (www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf), which reflects the minimum standard created in the Organisation for Economic Co-operation and Development, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, October 5, 2015) (<https://doi.org/10.1787/9789264241695-en>).

24 At 47.

consistent approach to interpretation—that is, to “interpret the treaty-based PPT rule in good faith in accordance with the ordinary meaning to be given to the terms in the treaty, as well as in accordance with the treaty’s context and in light of its object and purpose.”²⁵ The author discusses what such a textual, contextual, and purposive interpretation of the PPT would entail by considering, for instance, the examples provided by the OECD of the PPT’s application. Since the article does not get into the fundamental causes of a state-centric approach to international taxation in general and to treaty interpretation in particular, it is difficult to see how a consistent technical approach to interpreting the PPT can be realized. Nevertheless, the author raises an interesting question and makes a normative argument for an autonomous common meaning for the PPT as a global standard.

J.L.

Kerrie Sadiq, Adrian Sawyer, and Bronwyn McCredie, “Jurisdictional Responses to Base Erosion and Profit Shifting: A Study of 19 Key Domestic Tax Systems” (2019) 16:3 *eJournal of Tax Research* 737-61

The G20/OECD BEPS project has generated a body of “soft law” in the form of minimum global standards (the substantive activities or nexus requirement for preferential tax regimes, the PPT for preventing treaty abuse, country-by-country reporting by multinational corporations, and dispute resolution through the mutual agreement procedure [MAP]); common practices; and recommendations. In order for such soft law to take effect, it needs to be incorporated into “hard law” in the form of domestic tax law or treaty law. The authors conducted a survey of 19 jurisdictions with respect to the implementation of BEPS measures, and they report their preliminary findings in this article. The jurisdictions surveyed are Australia, Canada, China, Hong Kong Special Administrative Region, India, Indonesia, Japan, Korea, Malaysia, the Netherlands, New Zealand, Nigeria, the Philippines, Singapore, South Africa, Thailand, the United Kingdom, the United States, and Vietnam.

The authors explain that the 19 jurisdictions considered in the survey are a diverse group—members and non-members of the OECD and the G20, with different levels of economic development and various degrees of financial sophistication. Of these 19 jurisdictions, all except the Philippines are members of the BEPS inclusive framework and are committed to implementing the BEPS minimum standards. The findings can be summarized in the following table:²⁶

25 At 76.

26 The paper includes 17 tables, which summarize the data on the implementation of each aspect of the BEPS project as well as other kinds of engagement with the project. This table is based on the information reported in the article.

<i>BEPS minimum standards (or other measures)</i>	<i>Number of jurisdictions that have implemented or are taking actions to implement BEPS minimum standards</i>
Principal purpose test in BEPS action 6 and the MLI	15
Substantial activity standard in BEPS action 5	13
Country-by-country reporting standard in BEPS action 13	17
Dispute resolution standard in BEPS action 14	11

The 19 jurisdictions have implemented other BEPS measures in varying degrees. For example, 12 jurisdictions have taken some form of action to address the challenges of the digital economy analyzed in BEPS action 1; 10 jurisdictions are taking some form of action in respect of hybrid mismatch arrangements, which are addressed in BEPS action 2; 11 jurisdictions have indicated their compliance with the controlled foreign company rules in BEPS action 4; and 15 jurisdictions are responding to the recommendations on transfer pricing in BEPS actions 8-10.

The authors also report on the differences in unilateral responses to the problem of BEPS. For example, Korea, the Netherlands, the Philippines, Thailand, and the United States have not, in response to the BEPS project, adopted unilateral measures to address tax avoidance, while other jurisdictions have adopted such measures. (The United Kingdom and Australia, for example, have adopted the diverted profits tax).
J.L.

Andrés Báez Moreno and Yariv Brauner, *Taxing the Digital Economy Post BEPS . . . Seriously*, University of Florida Levin College of Law, Legal Studies Research Paper series no. 19-16 (Gainesville, FL:

University of Florida, Levin College of Law, 2019) (<https://ssrn.com/abstract=3347503>)

To address the challenges of taxing the digital economy, two main types of proposals have been advanced: new tax instruments, such as the digital services tax in the European Union; and the retooling of existing tax instruments, such as virtual permanent establishment and minimum taxes. This paper proposes a withholding tax on digital transactions. It describes the key advantages of the withholding tax, such as (1) its effectiveness in taxing business-to-business transactions by focusing on base-eroding payments (and thus avoiding ring-fencing); (2) the familiarity of the withholding mechanism; and (3) the enhancement of taxing rights in the source country. The authors also discuss in detail the main design issues of the tax, such as rates and exemptions, and its implications for tax treaties, international trade law, and European law. According to the authors, the withholding tax is a solution superior to the various alternatives because it can be implemented unilaterally or

multilaterally, and because it is feasible, not requiring “wide consensus over a complex web of rules.”²⁷

J.L.

Guglielmo Maisto, Stephane Austry, John Avery Jones, Philip Baker, Peter Blessing, Robert Danon, Shefali Goradia, Johann Hattingh, Koichi Inoue, Jurgen Ludicke, Toshio Miyatake, Angelo Nikolakakis, Frank Portgens, Kees van Raad, Richard Vann, and Bertil Wiman, *Dual Residence of Companies Under Tax Treaties*, International Tax Studies no. 1-2018 (Amsterdam: IBFD, 2018)

The tiebreaker for dual residence of companies in article 4(3) of the OECD model convention and its commentary was revised in 2017.²⁸ The revision replaced the former “place of effective management” (POEM) test with a non-mandatory resolution through the MAP mechanism. For the purposes of the MAP, revised article 4(3) requires the contracting states to consider the POEM in addition to other relevant factors, such as the place of incorporation. In the absence of the MAP, a dual-resident company is not entitled to any relief or exemption, as article 4(3) describes, “except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.” The anti-abuse purpose of this revision is evident, as is the enhanced uncertainty for taxpayers.

In this lengthy article, the authors, who are tax experts in both civil-law and common-law countries, express their concern that the revision may, among other things, cause international double taxation, create legal uncertainty, and grant excessive discretion to competent authorities. In part 2, the authors discuss the difficulty of interpreting the POEM test because of the differences between the domestic laws of common-law and civil-law countries. For example, the application of domestic-law management (central or effective) tests relies on factual circumstances and the legal qualification of facts. Because common-law countries’ rules on the burden of proof (taxpayers bear the burden) may vary considerably from those of civil-law countries (typically, the government bears the burden), the application of the same test for tax residence may lead to different conclusions. The fact-intensive nature of these tests also renders their interpretation inevitably difficult.²⁹

²⁷ At 59.

²⁸ The revised article 4(3) of the Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Full Version 2017* (Paris: OECD, 2019) (herein referred to as “the OECD model convention”) (<https://doi.org/10.1787/g2g972ee-en>) has also been included in article 4(3) of the *United Nations Model Double Taxation Convention*, supra note 22; and article 4 of the MLI, supra note 22.

²⁹ Tax courts’ decisions since 2010 on the tax residence of companies are summarized in the annex of the publication, at 80-84.

In part 3, the authors consider the meaning of POEM under article 4(3) of the OECD model convention and the interpretation of this test by domestic courts by reference to article 3(2) of the OECD model convention. The authors recommend that a new definition of POEM, reliant on substance-based factors, be added to article 4, such that a POEM is defined as a “place where key management and commercial decisions that are necessary for the conduct of the business as a whole are in substance made.”³⁰ Such a treaty definition would create an autonomous meaning of POEM. The authors also recommend revising article 4(3) of the OECD model convention so that a company is deemed to be a resident “only of the State in which the POEM is situated”; if the POEM cannot be determined, the company “shall be deemed to be a resident of the State in which the business or such activity as it conducts is primarily carried on.”³¹

Following a review of treaty practices in part 4, part 5 provides a thorough and critical analysis of the 2017 revision of article 4(3). To begin with, the authors argue that not all dual residence is the result of treaty abuse: dual residence may be the result of oversight or may arise in a variety of contexts, such as genuine mergers of companies, globalization, and industry-specific business models. Even in the case of treaty abuse, the abuse could be addressed by general domestic and treaty-based anti-avoidance rules rather than by the deletion of the POEM tiebreaker in article 4(3). The authors proceed to identify several problems that the application of the revised article 4(3) is likely to pose, such as (1) inaction by the tax authorities when it comes to resolving the dual residence problem, (2) the limitations on judicial remedies for taxpayers, and (3) the implications of this revised provision for other provisions of the treaty.

In their conclusion, the authors reiterate their position that POEM should be maintained as a tiebreaker, since it is used by the majority of tax treaties. If the new article 4(3) is to remain, they suggest ways of reducing certain of its adverse ramifications, such as double taxation and legal uncertainty.

J.L.

Stanley I. Langbein and Max R. Fuss, “The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the ‘Arm’s Length’ Standard” (2018) 51:2 *The International Lawyer* 259-409

Transfer pricing is one of the most difficult areas of international taxation, even though the transfer-pricing rules in over 100 countries purportedly adhere to the arm’s-length principle. Among the reasons for this difficulty is the lack of consensus on the meaning of the arm’s-length principle and the practical challenges in applying it. Transfer pricing has also been one of the most common strategies used by

30 At 27-35.

31 Ibid.

multinational enterprises (MNEs) to shift profits to low- or no-tax jurisdictions and thereby avoid tax in the jurisdictions where business activities take place. It is no surprise that 4 of the 15 BEPS actions have sought to tackle the issue of transfer pricing.³² The goal of these BEPS actions is to align transfer-pricing outcomes with value creation, a goal that is consistent with the overarching goal of the BEPS project—that is, to tax profits where the economic activities generating the profits are performed and where value is created (the “value creation” principle). However, the value creation principle has been controversial.

In this book-length article, the authors defend the value creation principle as having “ancient roots” and as being “consonant with long accepted ideals” of international taxation.³³ They see the value creation paradigm “not as a departure from international norms but as a useful, if not profound, elaboration of it.”³⁴ To demonstrate the ancient roots of value creation, the authors trace three phases in the historical development of transfer-pricing concepts prior to the BEPS project: the initial phase, which established the transfer-pricing regime; the second phase, which featured the articulation of the methods (one-sided) of transfer pricing; and the third phase, featuring the “comparability factors” and functional analysis approach.

Part II of the article shows that during the initial phase, the value creation paradigm was consistent with the overarching goals of the international tax system: (1) the allocation of tax base according to the economic allegiance of the tax base involved (as conceived by the League of Nations in the 1920s), (2) the taxation of business income at source, and (3) the creation of an arm’s-length standard, which was developed in the 1930s and 1940s.

Part III discusses the relation of the value creation paradigm to the changes in the conception of the arm’s-length principle from the 1960s to 1995 (that is, the second phase). The authors detail how the US transfer-pricing regulations, which were finalized in 1968, influenced the original OECD guidelines of 1979, and they conclude that these 1979 guidelines “reflect the beginning of a confusion about the arm’s length standard, treating the standard as a determinative of what constitutes a proper allocation, rather than a principle that aids a larger and precedent idea about allocation.” Part III also shows how changes in the US regulations in the 1980s and early 1990s laid the groundwork both for permitting corporations to shift profit

32 For more information on the BEPS project, see Organisation for Economic Co-operation and Development, *OECD/G20 Base Erosion and Profit Shifting Project: 2015 Final Reports—Information Brief* (Paris: OECD, 2015) (www.oecd.org/ctp/beps-reports-2015-information-brief.pdf); Organisation for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10—2015 Final Reports* (Paris: OECD, October 5, 2015); and Organisation for Economic Co-operation and Development, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD, October 5, 2015).

33 At 263.

34 At 262.

through contractual allocations and for the divergence between the US approach and the OECD approach reflected in the 1995 OECD guidelines (which still followed the US approach adopted in the 1960s). The authors make the point that the 1995 OECD guidelines still reflected the ideal of value creation, though at times in a distorted way.

Part IV shows the post-1995 OECD thinking as it was manifested in three sets of studies relating to (1) allocations of profit under article 7 of the OECD model convention pursuant to the “authorized OECD approach,” (2) restructuring transactions to address the issue of centralized assets and operations in a central entity or developer, and (3) intangibles. The authors suggest that the OECD showed “growing concerns with—[and] an inclination to depart from—aspects of those [US regulations] which create tension with the ideal of value creation.”³⁵ The OECD searched for ways to limit taxpayer discretion and contractual allocations of profit for tax purposes. As the authors note, “That search led ultimately to BEPS, and Action 8-10.”³⁶

Part V examines actions 8-10 of the BEPS report and shows that they were weak in formulating how to localize value creation and “backed away” from the OECD’s earlier reform impulse, which would have greatly increased the emphasis given to rules based on the objective criteria of business operations and diminished the role of circumstances that were within the control of the taxpayers. Nevertheless, part VI argues that the value creation paradigm not only has ancient roots but also offers the best basis for a fair international tax system in the near and intermediate future.

This article warrants multiple readings; it is quite concentrated in its analysis and penetrates deeply into the layers of complexity and confusion about the arm’s-length principle. It may be of particular interest to Canadian readers, as Canadians courts wrestle with the interpretation of the domestic transfer-pricing rules. Some of the most notable points include the following:

- The arm’s-length principle is not an end in itself but rather a means of determining a proper allocation of profits pursuant to a “larger and precedent idea about allocation”—namely, economic allegiance.
- Value creation is a new nomenclature, but it is not a new ideal or goal with respect to the allocation of taxing rights.
- Value creation represents an “international” paradigm while the pre-BEPS arm’s-length standard was US-centric because the OECD guidelines were heavily influenced by the United States.
- The value creation paradigm is grounded in articles 7 and 9 of the OECD model convention, and thus has a solid legal basis.

35 At 265.

36 At 364.

- The situs of value creation remains difficult to establish, but a fixed fractional apportionment method is not appropriate.
- Actions 8-10 of the BEPS report represent the beginning, not the end, of an inquiry into how to localize value creation.
- The controversy among the major economic powers (for example, China and the United States) concerns the compatibility of value creation with the overall international tax order and the continuing viability of an emphasis on contractual allocations.

J.L.

Canada Revenue Agency, *International Tax Gap and Compliance Results for the Federal Personal Income Tax System* (Ottawa: CRA, 2018) (www.canada.ca/content/dam/cra-arc/corp-info/aboutcra/tax-compliance/intrntltxcmplnc-en.pdf)

Canada Revenue Agency, *Tax Gap and Compliance Results for the Federal Corporate Income Tax System* (Ottawa: CRA, 2019) (www.canada.ca/content/dam/cra-arc/corp-info/aboutcra/tax-gap/txgpc2019-en.pdf)

These are the fourth and fifth reports in the Canada Revenue Agency's (CRA's) on-going research project on the tax gap, which is the revenue loss resulting from intentional and unintentional non-compliance with the tax law.³⁷ The CRA formally defines the tax gap as "the difference between the taxes that would be paid if all obligations were fully met in all instances, and the tax actually paid and collected."³⁸ Measures of the tax gap, according to the CRA, can be derived from either top-down or bottom-up methodologies: "Bottom-up methodology generally uses a tax administrator's taxpayer data (e.g., audit results, accounting data, assessment data) to estimate the amount of taxes theoretically owing,"³⁹ whereas "top-down methodology uses independent external data (usually national accounts data) to estimate the tax base, a figure that is then used to calculate a theoretical value of tax that should be paid and collected, by applying the appropriate tax rate to a high level figure."⁴⁰

The best methodology, as the CRA concedes, would be a bottom-up approach that uses a representative sample of taxpayers, randomly selected from a known population and subject to audit. Even when random samples are not possible, bottom-up approaches are generally much more reliable. Data limitations, however, are especially severe with respect to offshore wealth, and hence the CRA's study of

37 See this feature, (2017) 65:3 *Canadian Tax Journal* 831-48, at 831-836, for discussion of two previous reports in the series: "Tax Assured and Tax Gap for the Federal Personal Income Tax System" and "Estimating and Analyzing the Tax Gap Related to the Goods and Services Tax/Harmonized Sales Tax."

38 *Tax Gap and Compliance Results for the Federal Corporate Income Tax System*, at 7.

39 *Ibid.*, at 42.

40 *Ibid.*, at 45.

the international tax gap in the personal income tax largely relies on a top-down approach that was developed by two teams of researchers led by, respectively, Gabriel Zucman of the University of California at Berkeley and Valeria Pelligrini of the Bank of Italy. Broadly speaking, the approach has four steps:⁴¹

- Determine the global stock of hidden offshore wealth by calculating the difference between the declared assets and liabilities of countries published by national statistical agencies (on the basis that assets and liabilities must be equal on a global basis, and that assets not included in countries' totals are more likely to be hidden from tax authorities because the owner's residence has not been tracked).
- Estimate the share of this wealth owned by Canadians—for example, by using Canada's share of offshore bank deposits, recorded portfolio investments, or world GDP.
- Assume a rate of return for each type of asset.
- Apply the highest marginal federal rate while adjusting for the one-half inclusion rate in the case of capital gains.

The result is that the federal tax gap related to hidden offshore investments is expected to lie between \$0.8 billion and \$3.0 billion for the 2014 tax year, which is between 0.6 and 2.2 percent of total personal income tax revenues.⁴²

Overall, the CRA's approach seems reasonable, and therefore the estimates are a valuable contribution to knowledge. Still, one would like to know more about why this analysis was not supplemented with work that uses a bottom-up approach. For example, another study that adopted a generally bottom-up approach, by Gabriel Zucman and his co-authors, used leaked data about accounts at HSBC Private Bank Switzerland (the "Falciani list," or "Lagarde list") and considered whether the data matched the tax returns from Scandinavian authorities of the accounts' beneficial owners, in order to determine whether wealth had been properly reported on income tax returns. (In almost all cases, it had not.) This study's conclusion, based on the assumption that other offshore banks harbour similar amounts of hidden wealth, was that the top 0.01 percent of the richest households ranked by wealth evade about 25 percent of their income tax liability.⁴³ Clearly, this estimate is quite different from the CRA's tax gap estimate, which implies a much lower level of evasion.

41 For more details, see *International Tax Gap and Compliance Results for the Federal Personal Income Tax System*, at 23-27 and at 41-48. Gabriel Zucman has also done pioneering work using the bottom-up approach: in particular, see note 43, below.

42 *Ibid.*, at 4-5.

43 Annette Alstadsæter, Niels Johannesen, and Gabriel Zucman, "Tax Evasion and Inequality" (2019) 109:6 *American Economic Review* 2073-2103, at 2073-4. Reviewed in this feature, (2019) 67:1 *Canadian Tax Journal* 263-79, at 265-69. The advantage of this particular leak is that it contained full beneficial owner data for the accounts.

The CRA is known to have access to this same Falciani data, and apparently it undertook a similar matching exercise for audit purposes.⁴⁴ Thus, it would have been interesting for the CRA to have done a study for Canada like the one that Zucman et al. did for Scandinavia—that is, a bottom-up estimate of the tax gap from offshore bank accounts, developed from the HSBC leak. This may not have been possible, but it is impossible to tell because the report makes no mention of this data source.

The report has other data on T1135 forms⁴⁵ and on internationally focused audits,⁴⁶ but this information is not used to determine the tax gap estimate. One noteworthy statistic is that over 10,000 taxpayers were assessed T1135 penalties in 2017-18, with an average penalty of \$2,600 (for total penalty revenue of \$26.3 million).⁴⁷ Thirty-five percent of the foreign assets reported on T1135 forms were from the United States and 29 percent were from China, with other countries far behind.⁴⁸ There appears to have been more focus on (or at least more success in) enforcing the T1135 obligation than on collecting revenue from internationally based audits: from 2014-15 to 2016-17, only 630 individuals were audited, and only 370 were reassessed, for a total of \$82 million more federal tax.⁴⁹

As noted above, data issues apparently forced the CRA to use a top-down approach for its study of the international tax gap in the personal income tax, and the result is the comparatively low reliability of the estimate produced. In contrast, much more data exist regarding the corporate income tax, which is why the CRA's study of this topic uses bottom-up approaches and produces much more accurate information.

The ideal approach to measuring the tax gap is the one that the CRA used for small and medium-sized enterprises (SMEs), which are defined as corporations with gross revenues below a threshold of \$20 million or \$50 million (depending on the industry sector). This approach was based on a (stratified) random sample of corporate tax returns that had been audited for statistical purposes. The returns were for the year 2011, but the results were projected to the 2014 tax year. The resulting tax gap estimate was between \$2.7 billion and \$3.5 billion.⁵⁰ Federal tax assessed for this group of corporations was \$18.7 billion, so the tax gap was between 14 and

44 Anthony Sylvain, "The CRA's Win Against Undisclosed Offshore Accounts" (2018) 8:4 *Canadian Tax Focus* 12.

45 *International Tax Gap and Compliance Results for the Federal Personal Income Tax System*, at 10-18.

46 *Ibid.*, at 19-23.

47 *Ibid.*, at 11.

48 *Ibid.*, at 14.

49 *Ibid.*, at 20-22.

50 *Tax Gap and Compliance Results for the Federal Corporate Income Tax System*, at 21.

19 percent of revenue.⁵¹ The CRA reports that most of this tax gap arose from unreported or underreported shareholder benefits, such as corporate automobiles and loans to shareholders, although no specific figures are provided. The CRA stresses, using boldface type, that normal CRA audits (conducted not for statistical purposes, but for the purpose of reassessing the taxpayer) recouped much of this money, so the net revenue loss from non-compliance after the impact of CRA activities was between \$1.6 billion and \$2.4 billion,⁵² which is from 9 to 13 percent of total revenue from this group.

A different bottom-up approach was needed for large corporations (that is, any corporation with gross revenue above the level noted above), because random audits are not done for this group; only risk-based audits are available. The problem was how to extrapolate from the results of these audits to the population as a whole; the simple extrapolation that one would use from a random sample would not work, because the audited corporations might not be representative. To solve this problem, the CRA used two different methods to produce tax gap estimates: an “extreme values” method (derived from the method used in the United States and advanced through academic research) and a “cluster analysis” method (developed by the Italian Revenue Agency, but extended by the CRA through its own “unsupervised machine learning technique”).⁵³ The result is a tax gap estimate of between \$1.7 billion and \$2.9 billion for large corporations for the 2014 tax year.⁵⁴ Total revenue from this group was \$22.3 billion,⁵⁵ so the tax gap is between 8 and 11 percent of revenue. Once again, the actual revenue loss is significantly reduced by CRA activities.

A key thing to understand about these corporate tax gap estimates is what they do not take into account: (1) non-compliance that has not been detected by the CRA;⁵⁶ (2) corporations that do not file returns when they are required to do so; (3) non-compliance by non-resident corporations in general, beyond their failure to file (since the report focuses on corporations that are incorporated and filing in Canada); and (4) corporations that do not fully pay their tax by the deadline. A direction for future study is to address the last of these items (that is, payment non-compliance).

A.M.

51 Ibid., at 14. For some reason, the report chooses to express the tax gap as a percentage of federal tax assessed for all corporations regardless of size, deriving a range of 7 percent to 9 percent (*Tax Gap and Compliance Results for the Federal Corporate Income Tax System*, at 21), which would appear to understate the significance of the tax gap for this group.

52 *Tax Gap and Compliance Results for the Federal Corporate Income Tax System*, at 19.

53 Ibid., at 24; more broadly, see *supra*, at 22-25 and 37-41. The CRA deserves to be commended for this original research and for providing an unusually detailed disclosure of its methods.

54 Ibid., at 23.

55 Ibid., at 14.

56 Tax authorities in other countries have often included this in the tax gap through an uplift factor, but the CRA suggests that additional research would be required to determine an appropriate factor for Canada.

Joana Naritomi, “Consumers as Tax Auditors,” *American Economic Review*
(forthcoming)

Third-party reporting is well known to be highly effective in ensuring high rates of compliance with the personal income tax, especially for employment income. This article shows that third-party reporting can also be highly effective in ensuring compliance with value-added taxes (VATs), whose Canadian version is goods and services tax/harmonized sales tax (GST/HST). In this case, the specific compliance problem addressed is the “last mile” problem, which arises from the fact that businesses selling to consumers have an opportunity to evade tax by understating sales, because the purchasers are not seeking to claim input tax credits and therefore are not looking for receipts to show that VAT has been paid.

Sao Paulo, Brazil created an incentive for consumers to request receipts showing their social security number (SSN). (In Brazil, unlike Canada, this is not considered private information.) Firms were required to send all receipts (with or without an SSN) to the government electronically. Consumers then created online accounts that provided them with a small rebate on each purchase (on average, 1 percent of the value) registered to their SSN and reported by the firm to the government. Consumers also received lottery tickets on the basis of such purchases, with prizes ranging from small amounts to US \$500,000. A consumer can also blow the whistle on a firm that has failed to issue a proper receipt (including the SSN) on request or has supplied improper data to the government; the reward to the consumer is a percentage of the fine paid by the firm.

This article studies the effect of this measure, using a difference-in-differences research design that compares the time pattern of sales reported by retail firms (which are expected to be affected by the measure, because they sell to consumers) to wholesaling firms (which are not expected to be affected, because they sell to VAT registrants). The study shows that, as a result of this measure, retail firms increased reported revenue by at least 21 percent over four years. Although there was a loss of revenue because of the payment of rewards and firms’ increased reporting of expenses, tax revenue net of rewards increased by 9 percent. The compliance effect was stronger for firms that face a high volume of consumers. Also, after the first instance of “whistleblowing,” firms reported 14 percent more receipts and 6 percent more revenue.⁵⁷

A.M.

57 For analysis of other such consumer-rewards programs in Bolivia and North Cyprus, see Bahro A. Berhan and Glenn P. Jenkins, “The High Costs of Controlling GST and VAT Evasion” (2005) 53:3 *Canadian Tax Journal* 720-36.

Robin Boadway, Jean-Denis Garon, and Louis Perrault, “Optimal Mixed Taxation, Credit Constraints, and the Timing of Income Tax Reporting”

(2019) 21:4 *Journal of Public Economic Theory* 708-37 (<https://doi.org/10.1111/jpet.12382>)

It is often suggested that VAT exemptions should be replaced by income-tested transfer payments from government. For example, the zero-rating of basic groceries under Canada's GST could be replaced by an enhancement of the GST credit. However, there is a difference in timing between the two systems: VAT exemptions have effect immediately, while income-tested transfers are not received until after the filing of the tax return for that year. Thus, credit-constrained consumers, who either cannot borrow or face high interest rates for borrowing, may prefer the immediacy of the VAT exemption. This article formalizes this argument in terms of optimal income taxation theory.

A.M.

Stephen Gordon, “The Incidence of Income Taxes on High Earners in Canada,” *Canadian Journal of Economics* (forthcoming)

For many years, the literature on tax economics examined workers' response to taxation in terms of taxation's effect on the labour-leisure choice: workers facing high tax rates might find meagre incentive to put in long hours, because they kept so little of the money. This approach was ultimately considered to be unsatisfactory when applied to high-income workers because few such workers actually changed their hours of work. That did not mean there was no response to taxation—merely that the response might be occurring in other dimensions.

One such dimension is cross-border migration. This article examines the theory that there exists a continental (Canada-US) market for high-skill, high-income workers. According to this theory, the existence of such a market, with its implied threat that workers in either country can move across the border, might be expected to cause the after-tax incomes of such workers in Canada to be related to (perhaps even equal to) the after-tax incomes that they could earn in the United States. This theory is challenging to test because data on income by occupation is hard to come by, but the article circumvents this problem by examining incomes at borderlines in Canada and the United States, defined by the following fractiles of the income distribution: top 10 percent; top 5 percent; top 0.5 percent; top 0.1 percent; and top 0.01 percent.

In the article, a regression equation relates Canadian after-tax incomes at these income-distribution points to the similar US after-tax incomes at these points, with a measure of bargaining power as the key parameter to be estimated: if this parameter equals one, Canadian after-tax incomes will move in lockstep with those in the United States; as the parameter moves away from one, the connection between the two sets of incomes becomes looser and looser.

A key problem in statistical work is identification issues: it can be impossible to make any inferences if there is not enough variation in the variables of interest. In

this case, the variation is provided by variations in the Canada-US exchange rate. Thus, for example, the depreciation of the Canadian dollar in the 1980s and 1990s pushed up the value of any given US salary in terms of Canadian dollars, which increased the gains available from migrating to the United States. According to the article's model of a North American labour market, this trend would push up top incomes in Canada as Canadian employers sought to keep their workers.

The parameter values derived from the statistical estimation support the theory that after-tax incomes of top income earners in Canada are closely tied to those in the United States. Thus, an increase in income taxes on top earners in Canada may merely cause their pretax incomes to go up, leaving after-tax incomes the same. In other words, an increase in the top marginal tax rate can, paradoxically, lead to an increase in inequality in Canada (as measured by pretax incomes).

A.M.

Ross Hickey, Bradley Minaker, and A. Abigail Payne, "The Sensitivity of Charitable Giving to the Timing and Salience of Tax Credits" (2019) 72:1 *National Tax Journal* 79-110 (<http://dx.doi.org/10.17310/ntj.2019.1.03>)

Although an individual's charitable donations for a given taxation year produce a non-refundable tax credit, the cash flow effect of the credit is realized only on the filing of a tax return for that year. In particular, charitable tax credits are not included on the CRA's TD1 form and therefore do not affect tax withholding from employment income. Many people have hypothesized that if this delay of from 4 to 16 months in receiving the cash flow benefit could be reduced—perhaps by allowing donations made in the first 60 days of the next year to qualify, as in the case of RRSP contributions—people would make more charitable donations.

This article uses a natural experiment to estimate the magnitude of this response. Donors contributing to the relief efforts for the Haitian earthquake of January 12, 2010 were allowed to claim their donations on the 2009 return for Quebec provincial income tax, but the normal rule—that donors had to wait until the 2010 return to make this claim—applied for federal income tax and for provincial income tax in other provinces.⁵⁸ Thus, differences between charitable donations given by Quebec residents and those given by residents of other provinces can plausibly be attributed to this tax change, at least if one is comparing groups of people in Quebec with those in the rest of Canada who would seem equally likely to give to this cause.

The analysis was done at the neighbourhood level, with neighbourhoods defined according to forward sortation areas used by Canada Post (7,000 households per neighbourhood, on average).⁵⁹ There were two dependent variables to explain: the change in the proportion of donating households (the extensive margin) and the change in the donation per donating household (the intensive margin), with

58 Only donations made before March 1, 2010 were eligible (at 84).

59 At 88.

the change being measured from a time before the earthquake (2007-8) to the time of the earthquake (2009-10). (It appears that donations in 2007 and 2008 combined are being compared with those in 2009 and 2010 combined.) The authors had access only to federal tax return data, not to Quebec tax return data, so any Haitian relief donations by Quebec taxpayers induced by the Quebec tax change may be appearing either correctly on the 2010 federal tax return or incorrectly on the 2009 federal tax return.

The independent variables (control variables), which were essentially used to identify similar neighbourhoods in Quebec versus those in the rest of Canada, were characteristics of the neighbourhood that would influence either the overall level of charitable giving or the neighbourhood's donation response to the Haitian earthquake. For example, a prominent variable that was relevant to the latter concept was the share of residents in the neighbourhood whose primary language was French, given that Quebec and Haiti have this language in common.

The result of this statistical analysis is that the Quebec policy intervention increased the share of households reporting donations by 2 percentage points, and it increased the average donation per donating household by 9 percentage points.⁶⁰ These figures imply that if donors are fully informed about charitable tax credits and have low discount rates, the responsiveness of charitable donations to the after-tax price of giving will be implausibly high (relative to previous findings in the literature). The article suggests, as a possible explanation for these findings, that many people lacked awareness of the tax credits until this Quebec measure.

The article uses these findings to suggest that policy makers consider moving the period for reporting a charitable donation closer to the filing of the tax return. However, two disadvantages of this proposal are not discussed. First, if charitable donations are ever to become part of the CRA's "auto-fill my return" initiative,⁶¹ lead time will be needed between the end of the donation-reporting period and the time when the auto-fill information becomes available, and the suggested policy measure could interfere with that. Second, RRSP contributions are promoted in the press and in advertising 60 days after the end of the year; sharing this period with charitable donations might dilute the promotion of RRSPs and exacerbate the trend toward declining RRSP contributions.⁶²

A.M.

60 At 103.

61 More information is available on the CRA's website: Canada Revenue Agency, "Auto-Fill My Return" (www.canada.ca/en/revenue-agency/services/e-services/about-auto-fill-return.html).

62 See Derek Messacar, "Economic Insights: Trends in RRSP Contributions and Pre-Retirement Withdrawals, 2000 to 2013," *Statistics Canada*, revised February 13, 2017 (www150.statcan.gc.ca/n1/pub/11-626-x/11-626-x2016064-eng.htm).

George K. Yin, “Who Speaks for Tax Equity and Tax Fairness?”: Stanley Surrey and the Tax Legislative Process, Virginia Public Law and Legal Theory Research Paper no. 2019-25 and Virginia Law and Economics Research Paper no. 2019-09 (Charlottesville, VA: University of Virginia, School of Law, August 2019), 71 pages

Stanley Surrey is best known today for his views on equity in taxation and his development of the concept of tax expenditures. However, Surrey served for many years in government and wrote extensively on the tax legislative process in the United States. As described in this paper, Surrey was an advocate for the primacy of the Treasury in this process, as opposed to the elected politicians serving in Congress. He believed that the Treasury was likely to bring a more principled, knowledgeable approach than politicians would, and that the Treasury would give an appropriately high priority to achieving equity. This paper points out that such a “top-down” approach may not always be ideal, since good ideas can come from Congress (and the public). The paper cites the 2017 US tax reform (the Tax Cuts and Jobs Act) as an example of an extreme version of the top-down approach that could have produced a better result had there been more input from outside the Treasury.

A.M.