A Tax Policy Legacy: Tim Edgar’s Contributions to Tax Scholarship and Tax Legislation

Richard Krever*

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Le décès de Tim Edgar en décembre 2016 a porté un coup dur au domaine de la recherche en fiscalité au Canada et dans le monde, en plus d’être une triste perte pour la Revue fiscale canadienne, à laquelle il a contribué pendant plus de trois décennies. Les livres, les articles de revue et les chapitres de livre de Tim couvrent un large éventail de questions de politique fiscale, et ils ont grandement contribué à aider les décideurs politiques, les universitaires et les étudiants à comprendre certains des domaines les plus difficiles du droit fiscal sur le plan conceptuel et technique. Le livre de Tim Edgar sur l’imposition des accords financiers, publié par la Fondation canadienne de fiscalité, est considéré par les décideurs politiques du monde entier comme l’autorité absolue en la matière. Il présente une voie raisonnée pour extraire la composante dette des instruments financiers et l’assujettir à une imposition neutre des gains accumulés. Dans un domaine étroitement connexe, son analyse détaillée des difficultés auxquelles font face les décideurs politiques qui cherchent à appliquer de manière neutre la taxe sur les produits et services (TPS) aux fournitures financières est considérée comme un travail fondamental dans ce domaine, et sa proposition de supprimer la taxe sur les fournitures interentreprises a été adoptée directement en Nouvelle-Zélande et par un mécanisme indirect à Singapour. Le travail de Tim Edgar sur la règle générale anti-évitement est très souvent cité, tandis que sa proposition d’étendre les règles sur la capitalisation restreinte aux investissements à l’étranger a été adoptée en Australie. L’analyse exhaustive de Tim Edgar du système canadien de pseudo-imputation ouvre la voie à une remise en question indispensable du système. Plus le sujet était difficile, plus Tim Edgar l’a étudié en profondeur et l’a disséqué méthodiquement pour arriver à des recommandations éclairées de réforme. Les travaux de Tim Edgar continueront d’être lus, cités et mis en application pendant de nombreuses années.

ABSTRACT

Tim Edgar’s passing in December 2016 dealt a severe blow to tax scholarship in Canada and globally, not to mention being a sad loss for this journal, to which he was a
contributor for over three decades. Tim’s books, journal articles, and book chapters spanned a wide spectrum of tax policy issues and have played a central role in helping policy makers, academics, and students understand some of the most conceptually and technically difficult areas of tax law. Tim’s book on the taxation of financial arrangements, published by the Canadian Tax Foundation, is viewed by policy makers worldwide as the definitive authority on the subject, setting out a principled path to carving out the debt component of financial instruments and subjecting it to neutral accrual taxation. In a closely related area, his detailed analysis of the difficulties confronting policy makers who seek a neutral application of the goods and services tax (GST) to financial supplies is considered to be foundational work in the field, and his proposal to remove the tax from business-to-business supplies has been adopted directly in New Zealand and via an indirect mechanism in Singapore. Tim’s work on the general anti-avoidance rule is cited time and again as a key treatment of the topic, while his proposal to extend thin capitalization rules to outbound investment has been adopted in Australia. Tim’s comprehensive analysis of the Canadian pseudo-imputation system opens the door to a much-needed reconsideration of the system. The more challenging the subject matter, the deeper Tim investigated and methodically dissected the topic to arrive at reasoned recommendations for reform. Tim’s work will continue to be read, cited, and applied in practice for many years.

**KEYWORDS:** GAAR ■ GST ■ FINANCIAL SERVICES ■ THIN CAPITALIZATION ■ DEBT-EQUITY ■ DEBT SUBSTITUTE

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**INTRODUCTION**

Soon after Tim Edgar’s doctoral thesis on the taxation of financial instruments was passed unanimously by his examiners from Harvard and UCLA, with (unusually) no recommendations for additions, modifications, or other substantial changes, the work was published as a book by the Canadian Tax Foundation.¹ This 645-page book was to become one of Tim’s most influential, circulated far beyond the normal reach of the Foundation’s publications. Copies of it would be found on the desks

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of tax policy officials around the globe and would be used time and again by tax designers, as nations adopted comprehensive income tax regimes for financial arrangements. The reports of Tim’s thesis examiners included only one note of possible ambivalence—an observation that the thesis was very long.

Length was a hallmark of Tim’s scholarship. The abstracts for his papers in this journal (granted that these abstracts are provided in Canada’s two national languages) often stretched to a fourth page, and the papers themselves ran up to 75 pages long, the size of a small monograph. The depth of Tim’s scholarship is also reflected in the number of his publications. In addition to publishing, alone or with other authors, 44 journal articles and chapters, Tim co-authored seven editions of a casebook, acted as general editor for a leading looseleaf tax service, and contributed to or co-edited the Current Tax Reading feature in this journal for almost three decades.

Tim’s interests spanned the entire gamut of tax law and policy. The more complex and challenging the area, the more it attracted his attention. Common to several of the areas in which he worked were financial instruments and financial arrangements. The more intricate the instrument or arrangement, the more Tim enjoyed working with them; hedges, futures, derivatives, hybrids, and synthetics were the starting point for some of his best-known publications.

Four topics related to instruments and arrangements account for a notable proportion of his research output: (1) the optimal income tax rules for financial instruments, (2) the most effective responses to avoidance engineered through mismatches between interest expenses and recognized gains, (3) the role of thin capitalization rules in addressing international tax minimization, and (4) the ideal treatment of financial arrangements in a goods and services tax (GST). A fifth research area explored by Tim was the development of a better imputation system. A sixth area, for which he is widely cited, was the design and use of general anti-avoidance rules (GAARs).

**CONSISTENCY IN DIVERSITY**

While much of Tim’s work falls into these six research categories, he produced other significant publications that cover a diverse array of important tax policy issues. A consistent feature of these papers is the extent to which Tim digs into the nuances

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3 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. This paper also featured a four-page abstract.

4 A number of Tim’s papers were co-authored. In this paper, for the sake of simplicity, I refer to all papers in which Tim was involved—whether as a single author or a co-author—as “Tim’s paper.” The notes provide the details regarding co-authors, who deserve credit (or criticism), along with Tim, for the publications reviewed in this article.
and subordinate issues that can affect policy choices. A good illustration of this phenomenon is a chapter that he wrote on the expenses that should be allowed as deductions when individuals’ taxable income is being calculated.\(^5\) The chapter looks at the debates over the borderline between deductible outgoings necessarily incurred in the derivation of gross income and non-deductible personal consumption expenses. The cost of child care is a prime example of such a borderline expenditure, falling on one side of the line or the other depending on one’s perspective.

The conventional legal arguments look at whether such an expense is incurred directly in the course of deriving gross income (in which case it is a deductible expense) or is incurred in order to put the taxpayer in a position to carry out income-earning activities (in which case it is a personal non-deductible consumption expense). Similar arguments, Tim noted, are made in respect of commuting expenses versus the cost of traveling between places of work, and higher education expenses versus continuing education costs that individuals incur to remain in practice or to achieve promotion at work. In applying the strict legal tests, courts tend to characterize the expenses as personal expenses that put taxpayers in a position to derive gross income rather than expenses incurred in the course of deriving that income.

The conventional policy arguments over the deductibility of child-care expenses are somewhat different, focused primarily on questions of volition: Are child-care expenses a consequence of work needs or of a working person’s consumption decision to have a child? Under this test, the expense is most often characterized as a personal expense. Proponents of this view do not object to the recognition of child-care expenses in the tax system; they argue, for example, that it is a tax expenditure to facilitate re-entry into the workforce and to promote equal gender participation in the formal economy. They argue for targeted and equitable tax expenditures, usually settling on tapering refundable credits as the most effective and fairest of these.

Both the legal and policy analysis here is far too simplistic, Tim suggested. The stay-at-home parent derives significant untaxed imputed labour income by providing household child-care expenses directly; in a model income tax, this income, too, would be taken into account. A deduction for the working parent might lead to equitable outcomes as between the two types of parents. On the other hand, the family in which both parents work may have more valuable untaxed imputed income from leisure time, which could throw off any balance achieved by making the costs deductible expenses. The issues, as Tim’s work inevitably reveals, are far more nuanced than is generally recognized, and solutions satisfying all aims can be elusive.

At the same time, Tim suggested that in some cases, it may be preferable to look past distracting technical issues and adopt a simple and blunt instrument to address a problem, if the problem is one of taxpayers exploiting policy solely to minimize tax. An example is found in Tim’s analysis of tax-minimization arrangements deliberately engineered to deliver charitable deductions for gifts of art that is valued at far more than its acquisition cost. In this article, Tim considers carefully proposals for targeted responses to each element of the schemes but concludes that the ultimate motive (reducing taxes for the sake of reducing taxes) justifies a far simpler response—namely, denying the benefit crucial to the success of the scheme: the gift deduction.

Tim’s papers, with only a few exceptions—for example, an early comparison of capital gains taxes across many jurisdictions, which went no further than to suggest that one particular rule looked “curious”—evaluated policy decisions and set out their shortcomings and virtues by reference to benchmark principles. In an article that tested proposed changes to the deemed 21-year realization rule for trusts against higher-level tax objectives, for example, Tim was able to identify convincingly aspects that were “overly generous” and others that were unnecessarily “harsh or restrictive.” Similarly, his suggestions for the optimal tax treatment of returns to outbound debt and inbound debt in a small open economy were constructed entirely with the goal of distortion-free local capital markets.

Tim’s ability to peel away layers of conventional but simplistic assumptions and conclusions is well illustrated in his seminal study of international tax competition and arbitrage. Tax competition, to the extent that it leads to a shifting of the place of investment, yields actual efficiency losses. Tax arbitrage, conversely, is more likely to lead mostly to revenue losses with little efficiency loss, because taxpayers achieve the capital allocation they seek but exploit the inconsistent treatment of economically equal but legally very different arrangements in order to avoid tax on the investment returns. Tim developed and recommended different responses as he worked through the implications of different types of international tax minimization.

One premise underlying Tim’s distinction between tax competition and tax arbitrage is undermined, to some extent, by his proposed responses to the problem of international tax arbitrage. The premise is that the location of actual capital may...
change in response to tax competition. Equally likely, however (if not more so), is that investors will direct capital on the basis of pre-tax rates of return, looking for infrastructure, labour forces, and large markets, for example, and then will shift intangible property and rely on intragroup transactions to divert profits through transfer pricing to lower-tax jurisdictions. One of Tim’s solutions to the problem of revenue lost through arbitrage arrangements—the replacement of separate accounting that incorporates wholly artificial, notional arm’s-length prices with a simple expense formulary apportionment regime to align expenses with actual economic activity—is equally apt for tax competition distortions.

The rationale for formulary apportionment was set out clearly in Tim’s critique of an Organisation for Economic Co-operation and Development (OECD) thought bubble on allocating income to branches. In the course of his analysis, Tim hit upon the fundamental flaw with the traditional water’s-edge methodology that is based on hypothetical arm’s-length prices for transactions between parts of multinational enterprises: the reality is that no business would actually delegate to an unrelated enterprise activities that give rise to the most difficult transfer-pricing cases. The transactions arise precisely because they take place within a single economic enterprise.

Tax scholars regularly evaluate the efficacy and fairness of tax expenditures by reference to direct expenditure alternatives, but it is rarer to see negative tax expenditures analyzed by reference to direct regulatory alternatives. As explicit deviations from neutral consumption taxation, excise taxes intended to modify the price of harmful goods or services such as alcohol, tobacco, and petroleum products by incorporating an element of their social costs into the retail price should be prime candidates for negative tax expenditure analysis. Tim took on the challenge by looking at three possible excise taxes aimed at controlling excessively risky behaviour by financial institutions, comparing the three proposals with the alternative of regulation.

He showed that bank leverage taxes can generate desirable behavioural responses, that higher taxes on returns to risk taking are not needed if bank leverage taxes are used, and that, when the goal is to control overly risky behaviour, regulation is probably better suited than a tax on bonus or performance-based compensation.

Tim took care to distinguish between acceptable and abusive tax expenditures delivered via tax shelters. The former support particular types of investment promoted by the legislature, and a government using tax concessions to subsidize designated activities should welcome the use of tax shelters to funnel cash to the intended beneficiaries and tax benefits back to the investors. An abusive tax shelter, in contrast, is one in which the tax benefits flowing back to the investor are greatly

exaggerated in terms of the actual value of the taxpayer’s investment, with a proportion—often most—of the so-called investment actually comprising funds for which the investor is not actually at risk. Of the different options available to attack the exploitation of abusive shelters, at-risk rules are the most effective response, Tim concluded, and he offered the Canadian rules as an appropriate starting point for designing measures in countries yet to tackle the problem.\textsuperscript{13}

\textbf{FINANCIAL INSTRUMENTS AND ARRANGEMENTS IN THE INCOME TAX}

At the core of much of Tim’s research is the optimal tax treatment, in both the income tax and the GST, of financial instruments and arrangements. His published work on the taxation of returns to financial investments began with an inquiry into the meaning of “interest” on debt for tax-law purposes.\textsuperscript{14} The timing rules applicable to interest—particularly in formats other than simple interest such as compounding interest or original issue discount—were, at the time Tim first wrote about them, accurately described by him as a “complex patchwork quilt.”\textsuperscript{15} This lack of uniformity was attributable, in part, to reliance on the legal definition of “interest” when the term was being interpreted in the legislation. The legal meaning of interest, Tim explained, is a transplanted notion developed by the courts for purposes unrelated to the measurement of economic gain as an indicator of ability to pay taxes. The time was ripe, he suggested, for a different approach in tax law, one that measured and recognized accruing anticipated returns on debt investments as derived annually.

This work led almost intuitively to a broader question: If anticipated accruing gains on debt should be recognized annually, where is the line to be drawn between anticipated gains on financial investments, whether or not they are explicitly labelled as interest, and gains (or losses) wholly attributable to uncontrolled market forces? At an early stage, tax laws adopted rules to recharacterize convertible debt as equity and redeemable preference shares as debt.\textsuperscript{16} By the turn of the 21st century, however, as Tim noted time and again in his writing, tax planners had learned to construct both synthetic debt and equity by combining a host of separate instruments and arrangements, including hedges and options, and an array of new obligations and rights. It was no longer possible to simply identify particular instruments

\begin{itemize}
  \item These rules are reviewed in Edgar, “Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage,” supra note 3.
\end{itemize}
and deem them to be either debt or equity; the tax system had to do as the parties did and consider the combination of arrangements together to see the actual economic effect, in terms of risk, of a multi-element arrangement.

The ability of planners to devise financial arrangements that have the legal attributes of one form and the commercial or economic attributes of another form became one of Tim’s core areas of research over a period of almost two decades. Tim’s studies of financial instruments and arrangements fall into two broad camps. In one type of study, Tim focuses on the principles that should govern the design of a legislative regime that aims to separate debt and equity elements in arrangements composed of both; in the other type, he focuses on attacking avoidance arrangements in respect of particular types of instruments.

Tim’s central work in respect of the broad design issues is his internationally recognized book on financial instruments, published by the Canadian Tax Foundation. As noted earlier, the work was based on his doctoral thesis and soon after publication could be found on the desks of tax designers around the world. A law review paper of Tim’s that was published at the same time, ostensibly aimed at Australian policy makers but equally applicable to their counterparts across the globe, provided a shorter summary of the key points, as did a response to published comments on his work. The thesis and book derived from a string of publications that started with a commissioned book chapter published in 1997, which was followed by a paper on the topic, presented the same year at the Canadian Tax Foundation’s Corporate Management Tax Conference.

This work is anchored in a simple principle: gains on debt instruments (whatever their legal form) yielding expected returns should be assessed on an annual accrual basis, and gains on shares (again, whatever their legal form) that depend on market gyrations should be assessed on a realization basis. His fundamental research showed how financial arrangements such as hybrid and synthetic instruments could be dissected to reveal debt and equity components and how appropriate tax rules could apply to returns from each type of investment.

Tim’s grand vision of a principled, comprehensive, and consistent distinction between debt and equity returns in income tax law has yet to be accepted by policy makers. Owing to a range of political, administrative, and conceptual constraints, even the most ambitious reform initiative will fall short of a model that fully reflects the principles Tim espoused. Tim’s evaluation of one set of legislated rules provides useful insights into the problems and issues that remain or are made more visible by a broader regime for taxing gains derived from financial instruments.22

Attempts to legislate comprehensive responses to the problem are rare. More common are piecemeal and ad hoc responses to different schemes and arrangements as they are identified by tax authorities. The consequence of what Tim termed the “general failure”23 to develop tax rules based on benchmark principles—and the resulting differences in the income tax treatment of interest, dividends, and capital gains—has been the creation of opportunities for arbitrage and tax minimization. The problems have been exacerbated by the growth of alternative structures designed to create after-tax gains with no economic transaction apart from mismatches on different sides of a single transaction. Tim recognized the need for responses to the tax minimization that results from this general failure, and he devoted considerable effort to studying appropriate responses in the absence of a broader principled solution.

Tim's proposed responses to tax avoidance based on financial arrangements varied depending on the nature of the arrangement. An element of risk exposure inconsistent with legal form is the primary attribute shared by two types of arrangements, the first being transactions targeted by older anti-avoidance measures such as “wash sale” rules, “dividend stop-loss” rules, and securities lending rules; and the second being problematic newer instruments and arrangements such as derivative forward agreements, synthetic disposition transactions, and synthetic equity structures. Tim was skeptical of the “legal language” approach used to date in anti-avoidance measures; his preferred solution was rules that characterized arrangements by reference to objective economic tests that established clear risk-exposure borderlines.24

Tim proposed a variety of responses tailored to the specifics of each arrangement, distinguishing straightforward cases of risk transfer—which create a post-tax profit from arrangements that effectively offset each other in economic terms but yield different tax treatments—from those that may yield an actual financial benefit as well as a tax benefit. Tim suggested that targeted measures such as loss-limitation

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rules may be appropriate for cases yielding tax benefits alone (he endorsed a rule based on a “reasonable expectation of profit” test), while reliance on broader anti-avoidance rules may be necessary where a financial transaction is tax motivated but can also show a financial benefit.

Tim’s description of the “complex patchwork quilt” of rules currently used to recognize interest in its different forms applies equally well to the inconsistent array of debt-equity borderlines in tax laws. Often, the outcome is the result of legislative inaction, which leaves courts and administrators to interpret commercial arrangements on the basis of private-law principles with no connection to tax policy. Sometimes, however, the inconsistency is the result of deliberate intervention by the legislature. One example of such intervention cited by Tim is the special rules adopted for “distress preferred shares” and small business development bonds—financial arrangements that are deliberately excluded from principled instrument recharacterization rules. The deliberate failure to treat these instruments in a manner consistent with their actual economic substance constitutes a tax expenditure that yields a particularly inefficient and poorly targeted subsidy. If there is a case for government intervention, better instruments can be found than this tax concession, Tim suggested.

One arrangement that received considerable attention during the period in which Tim wrote was the income trust, a vehicle specifically established to exploit the distinct tax treatment of returns to debt and equity through “redundant securities that are used strictly for the tax saving that they access.” The preferable response to income trusts, Tim suggested, was a targeted rule that defines as equity investments securities that endow holders with all the benefits of the equity for which they are substituted. The conclusion was reinforced by his illustration (which used the example of stapled securities) of how alternative anti-avoidance rules could be circumvented.

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INTEREST FUNGIBILITY

The fundamental premise on which an income tax is built is the measurement of net economic gains, the yardstick of ability to pay. The determination of economic betterment requires taxpayers to deduct from their gross revenue the expenses incurred in deriving those receipts. For the most part, expenses can be tied directly to particular receipts. The notable exception to this general rule is the allocation of interest on borrowed funds used in the course of business or investment. While most expenses yield access to particular goods or services whose use can then be traced, interest is incurred to have access to money, the most fungible of all assets. It is impossible to track each dollar borrowed and, arguably, would be pointless even if it could be done, since taxpayers can easily shift funding sources in order to seemingly align borrowed funds with income-earning activities and equity funds with other investments.

The sensible solution, which is used in most jurisdictions, is to accept that taxpayers are allowed to deduct interest on debt provided that they can show there is an amount invested in taxable activities that is equal to the amount borrowed. A problem arises, however, when borrowed funds are invested in assets that yield both current income and capital gains realized on the disposition of the property, as is the case with, say, rental properties yielding rental income or shares yielding dividend income. Taxpayers seeking an overall profit from the investment expect the combined current income and accruing capital gains to exceed the interest expenses on funds borrowed to fund the acquisition of the asset. The interest may exceed the current income portion of the return, however, with the excess deduction available to shelter other income, including labour or business income.

Many jurisdictions had failed to address the problem of negative gearing or negative leveraging, as it is sometimes called, where interest expenses exceed currently recognized income gains. The conventional tax policy conclusion is that interest incurred to derive accruing capital gains should be capitalized so that it is recognized at the same time the gains are recognized. This can be accomplished by the use of passive loss rules that limit deductions for interest expenses each year to the amount of investment income earned that year, with the excess interest expense carried forward and available for deduction in future years in which there is sufficient investment income, including capital gains, to absorb the deductions. Tim endorsed this approach as a preferred response to the problem.


The opportunities arising from the fungibility of borrowed funds are illustrated well in the case of a company or partnership that uses its own funds and borrowed funds both to make investments and pay expenses incurred in business operations and to fund distributions to shareholders or partners. Interest paid on borrowed funds used to fund dividends or partnership distributions is not incurred in the course of deriving income or in the course of operating a business for the purpose of deriving income. Equally clearly, however, it is not a “personal” expense of the company or partnership and, to this extent, should arguably be recognized as a deductible outgoing. Moreover, given the fungibility of money, it is a legitimate assumption that the company or partnership used its own funds to make distributions and then borrowed to replace the distributed funds. Tim agreed with the Canadian government that in these circumstances, a deduction for the interest is appropriate.33

The challenge of matching interest expenses with assessable income is particularly acute where a taxpayer derives exempt foreign-source income or, via foreign subsidiaries, income that will not be taxed until long in the future, if ever. This was an issue that Tim explored in a number of papers. Tim regarded the mismatch between deductible interest and untaxed or indefinitely deferred taxation of income derived through a subsidiary as a “serious structural deficiency,”34 concluding in these cases that apportionment rules linked to interest deductions are appropriate.35 An alternative approach that he explores elsewhere—one that is compatible, as noted below, with the apportionment rule—is the use of thin capitalization rules for both inbound and outbound debt.

THIN CAPITALIZATION AND EXPLOITATION OF THE DEBT-EQUITY DISTINCTION

Derived directly from Tim’s interest in corporate finance and financial interest was his apprehension about international and domestic thin capitalization and allied arrangements. The problem, as Tim pointed out time and again, is the different treatment of debt and equity, with the latter subject to one level of tax and the former subject to a partial imputation credit unrelated to the tax actually paid by the company on its profit.

A range of schemes have been and are being used to recharacterize investments to exploit the debt-equity distinction. The differential treatment has prompted thin capitalization of Canadian subsidiaries by foreign investors and thin capitalization


of domestic companies investing abroad and locally. Typical of Tim’s approach to solving tax problems, his analysis of these arrangements started not with the manifestation of the problem—thin capitalization—but, rather, with the root causes and, significantly, the wide variations in investor characterization that affects the causes and, consequently, the solutions. He points out, for example, that a reasoned response to the problem should distinguish between direct foreign investment, for which tax is a concern secondary to labour supply, infrastructure, and market, and portfolio investors, concerned only with their after-tax returns.\(^\text{36}\) The latter group, representing completely mobile capital, is able to push back to the borrowers withholding taxes or other imposts levied on interest paid to non-resident investors. Optimal tax theory suggests that interest paid to foreign direct investors can be fully taxed, while no tax should be levied on portfolio lenders.

Because interest expenses are deductible in most cases, the only tax levied on foreign direct investors will be an interest withholding tax, in all cases far less than the income tax levied on company profits, which is most often coupled with a further withholding tax on those profits when they are repatriated as dividends. The incentive for thin capitalization is obvious. Thin capitalization rules, denying deductions for interest on debt that is deemed to be excessive under the rules, are an equally obvious response, one found across advanced economies.

Several aspects of the Canadian rules struck Tim as odd. In a jurisdiction in which some of the largest investors, pension funds, are completely exempt from tax, it would be logical, Tim suggests, to extend the rules to domestic investors. It would be equally logical, Tim notes, to extend the rules to interests in partnerships and trusts. And, finally, it would be logical to apply them to both inbound and outbound investment in order to prevent domestic investors from using fully deductible debt to fund foreign investments that often yield untaxed returns.\(^\text{37}\)

It is, however, not the only solution. Subjecting tax-exempt bodies, such as pension funds, to tax and shifting from Canada’s pseudo-imputation system (which provides non-refundable credits for a notional tax) to a true imputation system (in which credits are provided for actual tax paid by a company) would establish parity between returns on debt and equity, removing any need for thin capitalization rules for domestic investors in respect of domestic investments.

**IMPUTATION**

The Canadian imputation system is a remarkably unique phenomenon, a creature of political compromises on the selective implementation of reforms proposed by

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the Carter commission\textsuperscript{38} and responses to international pressures that are built on the foundation of a company income tax riddled with tax expenditures. The juxtaposition of these factors and the many after-the-fact attempts to come up with plausible technical rationales for the “investor welfare” elements of the program fascinated Tim from an early stage in his career and prompted a number of papers. Tim’s analysis is comprehensive, reviewing every element of the imputation system and setting out the technical rationale offered and the tax expenditure explanation for the concessional elements of the rules.\textsuperscript{39} For example, the restriction of imputation credits to resident taxpayers appears to be an illogical rule intended to encourage Canadians to invest in Canadian companies by providing a higher after-tax return than can be realized by non-resident investors, thus allowing Canadians to outbid non-residents investing on the basis of actual economic performance. Substituting Canadian investment for foreign investment in this way may actually reduce the opportunities for productivity gains and efficiency gains that would follow a truly competitive market for capital.

Successful models for full imputation systems that address all of the so-called technical rationalizations for the Canadian rules can be found elsewhere, lending support to the suggestion that the Canadian design is best analyzed as a set of seemingly badly targeted tax expenditures—although, as Tim suggested, this is not an unambiguous conclusion.\textsuperscript{40} One of the most significant factors supporting the “tax expenditure” characterization is the complete absence of any correlation between tax paid by a company and credits provided to shareholders in Canada’s so-called imputation system. Tim analyzed in depth the merits and possible drawbacks of one solution, the former (operative at the time Tim wrote about it) UK advanced corporation tax (ACT) system, which ensured that every dollar (or pound, in the UK case) of imputation credit is matched by a dollar of company tax paid on the profits from which dividends are paid. Tim concluded that the ACT would be a model imputation system in many respects but would not be appropriate for Canada, given the probability that Canada’s tax treaties would require it to pay refunds to foreign shareholders.

Interestingly, Tim did not consider the alternative franking system that is used in countries such as Australia and New Zealand, which also limits imputation credits to actual company tax paid on distributed profits but avoids the international taxation implications of the Canadian system. The franking system eliminates the need for refunds to foreign shareholders, which is a significant advantage over the Canadian system.

\textsuperscript{38} Canada, Report of the Royal Commission on Taxation, vols. 1-6 (Ottawa: Queen’s Printer, 1966-67).


problem. In Australia’s case, this is done by exempting franked (that is, already fully
taxed) profits from withholding tax so that the only tax payable by non-residents is
withholding tax on unfranked dividends that are paid from untaxed profits (and thus
are not entitled to any credits). In this way, non-resident shareholders have the same
entitlement to dividend tax credits as resident investors—zero on unfranked divi-
dends. Since franked dividends (paid from fully taxed profits) are exempt from
withholding tax, non-residents have no basis for claiming that treaties require Aus-
tralia to provide them with imputation credits.
Significantly, in a jurisdiction such as Australia, where pension funds are subject
to tax, the benefits of imputation credits are available to lower-income persons who
have employer-paid deposits in pension funds (compulsory under Australian law),
thus precluding one of the criticisms levelled at the Canadian system: that imputa-
tion benefits accrue mostly to higher-income investors.

**GST AND FINANCIAL INTERMEDIATION**

An issue that captured Tim’s attention for well over a decade was the optimal treat-
ment of financial intermediation—the services of a bank—in a GST. Unlike the cost
of most other supplies, where an explicit fee is charged for services provided by a
supplier, the cost of financial intermediary services is an implicit cost, embedded
in the spread between interest paid to depositors and that charged to borrowers.
Although it was once suggested that the intermediation service provides no con-
sumption benefit to borrowers, the key proponent of this view later recanted, and it is now generally agreed that a financial intermediary service provides a valu-
able service to both depositors and borrowers.

Tim’s analysis, not surprisingly, digs deep into the economics of the industry,
leading him to a number of conclusions that some might find surprising. He sug-
gests, for example, that concerns over the opportunities for manipulation that arise
if pure intermediary services are untaxed and all other financial services are taxed
may be exaggerated, given the competitive pressures that mitigate these opportu-
nities. The experience of jurisdictions such as South Africa, which exempts pure
intermediary services and subjects most other financial services to full taxation,
lends some support to his conclusion.

Tim was also concerned with the efficiency consequences—the social cost of
the inefficient allocation of resources—that result from the vertical integration
prompted by the current Canadian rule that treats financial supplies as exempt

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41 Harry Grubert and James Mackie, “Must Financial Services Be Taxed Under a Consumption
42 Harry Grubert and Richard Krever, “VAT and Financial Services: Competing Perspectives on
43 Ewen McCann and Tim Edgar, “VAT Treatment of Interest and Financial Services with
It is often argued that because the rule leaves banks with no right to claim input tax credits on acquisitions, the banks have an incentive to source inputs internally. While the efficiency costs of vertical integration are, to be sure, a legitimate concern, a different concern has prompted other jurisdictions to provide to financial institutions making exempt supplies some relief, namely the impact of vertical integration on competition. The present system favours large institutions that are able to construct their own (for example) software support and administrative support systems, which provide these institutions with tax-free services while smaller institutions, with limited economies of scale, are forced to outsource these acquisitions, incurring unrecoverable GST in the process. In a jurisdiction with a significant concentration of banks facing limited competition, any tax rule that imposes higher costs on smaller competitors should be a concern.  

Tim revisited a number of times the question of how a GST based on a credit-invoice model could apply to financial intermediary supplies that were provided with no explicit price attached. The challenge is to design a system that would ensure that non-business borrowers incurred the same tax on financial intermediary services as they did on other consumption acquisitions, while registered businesses were relieved of a tax burden on supplies they received. One proposal found in Tim’s 2001 paper on the subject addressed the second goal. Tim suggested that zero-rating intermediary supplies to registered businesses would be the simplest way to remove tax from bank-to-business supplies, a proposal that was subsequently adopted by New Zealand, with Singapore achieving an arguably similar outcome via a different mechanism.  

One important issue considered in a number of Tim’s papers on the subject of GST and financial supplies was the theoretical arguments and practical considerations raised by different cash flow models for taxing financial services. The focus of Tim’s work, and that of the many scholars whose works he studied, was on borrowers—the persons receiving loans that could be used to procure goods or services intended for personal consumption or business use. For every dollar borrowed, however, there must be a dollar deposited on the other side of the financial intermediation arrangement. Absent from most of the literature in the field is a recognition of the importance of designing a GST solution that also treats the deposit or lending side of GST transactions appropriately. There is no consumption


45 It is for this reason that Australia, for example, allows financial institutions to partially claim input tax credits on the acquisition of a select list of inputs.

by lenders or depositors; rather, they have chosen to defer consumption in a way that allows borrowers to accelerate their consumption before they have resources available to fund acquisitions. By definition, a charge for services that is based on the spread between depositors and borrowers will be borne to some extent by both parties. For the depositors, the cost is the cost of savings, not consumption, and in a benchmark GST system, the supply would be a zero-rated supply, not an exempt (input taxed) supply.

**GAAR**

Another key topic addressed in Tim’s publications is the role of a GAAR in a modern income tax. Just as the adoption of the Charter of Rights and Freedoms in 1982 fundamentally altered Canadians’ understanding of the limits of provincial and federal powers under the Canadian Constitution, the adoption of GAAR in 1988 has profoundly changed Canadians’ perceptions of tax avoidance and the limits of otherwise sanctioned tax-effective behaviour.

Tim published two substantial works on GAAR: a 37-page chapter in a book on anti-avoidance in Canada, following two Supreme Court of Canada decisions on GAAR;\(^{47}\) and, a year later, a comprehensive 72-page article in the *Virginia Tax Review*\(^{48}\) that built on and incorporated substantial parts of the earlier work. Several years later, in the *Canadian Tax Journal*, he penned a short introduction to a Policy Forum feature on GAARs.\(^{49}\)

The first of these publications, which provided a catalogue of different types of tax avoidance and analyzed the possible role of a GAAR in respect of each, had a limited impact; dealing with a parochial Canadian issue and appearing in a volume by a local Canadian publisher, the work was never likely to have a significant international circulation. In contrast, the article in the *Virginia Tax Review*, which built on and greatly expanded the ideas set out in the book chapter, has been read and used by many scholars. Many citations of the article have been tangential references in non-tax articles that cite it for its descriptions of economic and legal principles.\(^{50}\)

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Other citations are found in articles on tax issues other than avoidance and a GAAR, to distinguish the issues addressed in those papers from the question of tax avoidance. The most important citations, however, have been in articles on GAAR, with the papers containing many references to Tim's journal article.

Tim treated tax avoidance in the same manner he did financial instruments. He first identified the problem to be addressed—tax avoidance—and then set about to dissect the issue to identify its component elements and develop in a scientific manner rules that would counter each element. The approach was developed in his initial book chapter on the subject and then transferred to, and refined in, his journal article.

Tim described three types of tax avoidance in his journal article, though his initial list, in the book chapter, sets out five, including changes in real behaviour.


and tax evasion. Tax evasion comprises illegal actions such as non-disclosure of receipts and fraudulent claims for deductions—activity conventionally classified as criminal evasion as opposed to abusive, but legal, tax avoidance. Tax avoidance is entirely legitimate behaviour—undertaking a transaction or adopting a structure that enjoys a deliberately intended reduction in tax burden, such as a tax concession. The economy as a whole may suffer excess burden or deadweight losses from the distorted behaviour, but the taxpayer, by a voluntary behaviour choice, has presumably enjoyed a personal net fiscal benefit as intended by the legislature.

Tim described the three remaining types of tax avoidance as tax avoidance “in law”, transactional substitution, the creation of tax attributes, and the transfer of tax attributes.

Transactional substitution does not involve a change in “real” behaviour—the taxpayer carries out the commercial arrangement always intended—but, rather, a change in the arrangement’s form or structure in order to shift from one tax rule to another. Instead of lending money by way of a deep discount loan, for example, the taxpayer enters into a repo arrangement involving a purchase of an asset combined with a required repurchase at a higher price by the “borrower.” Instead of making a loan, the taxpayer extends funds and receives redeemable preference shares, and so on.

The “creation of tax attributes”—the second type of avoidance identified by Tim—refers to transactions with appearances for tax purposes that do not reflect their overall substance. A lease premium labelled “consideration” for locational goodwill is merely a form of prepaid rent, for example.

Tim’s third category—“transferred tax attributes”—refers to arrangements that are used to shift tax benefits from one taxpayer to another. An example of transferred tax attributes is a sale-and-leaseback transaction by a taxpayer that is in need of debt financing and holding assets that could be used as collateral for a loan. If the taxpayer is unable to fully utilize tax concessions such as accelerated depreciation that are available from ownership of the collateral assets, it can substitute a sale-and-leaseback arrangement for a loan with collateral to transfer the tax concession to a lender that is able to use it.

judicial doctrines alone cannot solve the problem of avoidance; Brian M. Studniberg, “Minding the Gap in Tax Interpretation: Does Specificity Oust the General Anti-Avoidance Rule Post-Copthorne?” (2012) 38:1 Queen’s Law Journal 209-57, at 242, setting out the argument that the GAAR should be designed in light of the institutional competencies of the judiciary.


54 Edgar, “Designing and Implementing a Target-Effective General Anti-Avoidance Rule,” supra note 47, at 228.

The starting point for Tim’s analysis was an assumption that he could mathematically find the points at which the benefits-versus-risk scale tipped toward avoidance and there was a possibility, if not a probability, that taxpayers would engage in avoidance arrangements. A model GAAR would then be aimed only at taxpayers in likely-to-avoid environments.

Tim trod carefully when recommending GAAR refinements, conceding risks and difficulties with each proposal. Use of an “economic substance” test, he said, might do no more than “muddy further the statutory morass that has congealed around” the distinction between acceptable and abusive tax avoidance. Still, he suggested, such a test could play a role in combatting particular types of avoidance if targeted effectively.

GAARS that use a “primary business-purpose” test (a description that would include the Canadian GAAR) suffer from a defect, Tim claimed—namely, the phenomenon of “over-inclusiveness” that, ironically, weakens the scope of the provision as courts read it down, to a point at which it suffers from “under-inclusiveness.” But this test, too, Tim argued, can play a role in a well-designed GAAR.

Tim’s model GAAR is thus based on theories of different types of tax avoidance, and it consequently requires courts using different interpretive approaches when evaluating different types of transactions in light of the GAAR. The Achilles heel of such a GAAR, perhaps, is that it authorizes courts to brush aside taxpayer’s legal arrangements while leaving the judiciary to decide when it is appropriate to do so. Whatever the test might be, it ultimately remains an adjudicator’s responsibility to determine when the test is met.

Consider the current GAAR, for example: the application of the rule depends on a finding by a court that the primary reason for an arrangement was tax avoidance, not a bona fide commercial objective. The primary purpose of almost all transactions, however, is commercial if the elements of the impugned scheme are considered in their entirety—the Duke of Westminster wants to pay his gardener and have his trees trimmed; a trucking company wants to borrow money from a bank; a bank wants to sell the shopping plaza that it acquired on a foreclosure on a delinquent loan. The commercial benefits of the transactions could be enhanced, quite clearly, if (1) the Duke could pay the gardener from pre-tax income, (2) the trucking company could reduce its interest expense by shifting some unused deductions to the lender, and (3) the foreclosing bank could shift tax losses to reduce its commercial losses on the loan. But a non-commercial primary purpose emerges only if the tax-avoidance transactions are extracted from the larger commercial scheme.

56 Ibid., at 880.
57 Ibid., at 893.
59 Canada Trustco Mortgage Co. v. Canada, 2005 SCC 54.
60 Mathew v. Canada, 2005 SCC 55.
On its own, each step in an avoidance scheme is legitimate and legal. Whether the scheme is an abuse of the law must be determined in the context of the broader commercial arrangement in which it occurs. This is a judgment call, often a very difficult one. A range of views exist on the responsibility and the ability of judges to draw lines in the sand, and it is not unusual for the highest jurists in the land to disagree on whether any particular arrangement amounts to tax avoidance. Tim does not see this as an insurmountable problem. The principal role of the judiciary, he says, “would be the proper characterization of the fact pattern presented by a particular transaction, with the appropriate policy result following from this characterization.” Somehow, the courts will get it right. It’s a nice theory.

THE LEGACY
Tim Edgar’s tax interests were truly catholic; his publications spanned the spectrum of tax policy and tax law. His intended audience was primarily policy makers, and he clearly reached this group. His publications on income tax and financial arrangements, and GST and financial intermediation, in particular, are central reference points for many.

Why did this body of work become so influential? The answer lies in Tim’s remarkable skills at unravelling the most intricate arrangements and technical issues and then using fundamental benchmark principles to evaluate the outcomes. The more complex the subject, the deeper into it Tim would delve in order to expose the subject’s basic elements, which could then be addressed through the use of foundational tax policy concepts.

Tim’s academic prose will no doubt be read and cited long into the future, but his most significant legacy will be the laws that reflect his analysis and proposals. It is a legacy deserving of honour.

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61 See, for example, Neil Brooks, “The Responsibility of Judges in Interpreting Tax Legislation,” in Graeme S. Cooper, ed., Tax Avoidance and the Rule of Law (Amsterdam: International Bureau of Fiscal Documentation, 1997), 93-129, arguing that judges should undertake the creative process of law making when there are gaps in the legislation; Kim Brooks, “The Ethical Tax Judge,” in Robert F. van Brederode, ed., Ethics and Taxation (Singapore: Springer Nature Singapore, 2020), 397-412 (https://doi.org/10.1007/978-981-15-0089-3), arguing that judges should not be bound by constraints of precedent when interpreting tax cases where the result would be inconsistent with the broad objectives of the tax law; and Studniberg, supra note 52, arguing the courts should step back and leave it to Parliament to address avoidance problems.

62 In Lipson v. Canada, 2009 SCC 1, for example, three Supreme Court of Canada judges dissented from the conclusion of the other four judges.
