Rectification of Tax Mistakes Versus Retroactive Tax Laws: Reconciling Competing Visions of the Rule of Law

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Abstract
This article examines the potential conflict between the right of the provinces to determine property rights, including the equitable right of rectification, and the federal government’s right to enact retroactive tax legislation. It poses a hypothetical question: Does rectification provide the appropriate remedy for the “unfairness” of retroactive legislation to taxpayers who intend and plan their transactions to minimize or avoid tax?

The article reviews the trend toward the judicial broadening of rectification remedies in tax cases, as well as perspectives on reliance on the rule of law to determine if and when rectification would be appropriate. The authors conclude that, in certain circumstances, a provincial court could and should rectify a tax plan to counter the

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effects of a retroactive tax that does not target abusive tax planning, such as Quebec’s proposed (and subsequently withdrawn) tax increase aimed at high income earners.

**KEYWORDS:** Income Taxes ■ Courts ■ Rectification ■ Retroactive ■ Equity ■ Rule of Law

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## INTRODUCTION

In the past decade, the equitable remedy of rectification has emerged as a powerful tool to redo tax transactions in Canada. Rectification orders, issued by provincial superior courts, now far exceed a mere correction of inadvertent drafting mistakes and often have significant tax consequences. Courts have broadened the remedy to accept that taxpayers should be able to seek a rectification order to amend documents in circumstances where they can demonstrate that the transaction as intended would

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1 Traditionally rectification is applied to written instruments. If by mistake the terms of a written instrument do not accord with the true intention of the parties to an agreement, equity allows the instrument to be rectified to accord with that intention. The four requirements for rectification are a prior agreement, a common intention, a final document that did not properly record the intention of the parties, and a common or mutual mistake: *Armstrong v. Armstrong* (1978), 22 OR (2d) 223 (HC). In this article, “rectification refers to a legally effective retroactive change to, or annulment of, a transaction or event, or the way in which it was (by reason of the effect of the contractual or other legal factors involved) effectuated or done, all with a view to changing the related tax effects”: Nathan Boidman, Nicolas X. Cloutier, and Edwin G. Kroft, “Breaking Bad: ‘Remediation’ and Tax Plans Gone Wrong—Judicial Attitudes” (2010) vol. 58, special supp. *Canadian Tax Journal* 141-48, at 142. In some legal jurisdictions, such as the United States, the term “reformation” is sometimes used instead of rectification.

2 Taxpayers may in some circumstances remedy a transaction by way of corporate resolution without seeking a rectification order. See, for example, *Ticoney v. The Queen*, 2012 TCC 310, where Pizzitelli J opined that a rectification order would be unnecessary to correct a directors’ resolution with respect to the issuance of shares, contra *Windclare Management Services Ltd. v. Canada (Attorney General)*, 2009 CanLII 18234 (ONSC). In *Windclare*, the court was persuaded
not have triggered unwanted tax consequences. The judicial orders are considered binding on revenue authorities insofar as they determine property rights.\(^3\)

On the other hand, Canadian federal courts accept that retroactive tax (and other) laws are generally constitutionally permissible.\(^4\) As a result of the doctrine of parliamentary supremacy, tax laws can be given a retroactive effect that trumps a taxpayer’s earlier reliance on the laws that were in place when the taxpayer engaged in tax planning. A consequence of retroactive tax legislation can be an increase in a taxpayer’s tax liability—despite the taxpayer’s clear intention and honest and reasonable attempt to engage in tax planning to avoid this result.

One outcome is a clash of judicial perspectives: provincial courts and their vision of an equitable rule of rectification versus federal law (as interpreted by the Tax Court, the Federal Court of Appeal, and the Supreme Court of Canada) and the view that tax laws can have a retroactive effect. Both are “rules of law,” but of course the provincial view arguably undermines the federal view, since tax law applies after private-law rights have been determined by the province.\(^5\) Is this an acceptably “fair” outcome? Does rectification provide the appropriate remedy for the “unfairness” of retroactive legislation to taxpayers who intend and plan their transactions to minimize or avoid tax?\(^6\)

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\(^3\) See Dale v. Canada, [1977] 3 FC 235 (FCA).

\(^4\) The most recent pronouncement by the Supreme Court of Canada on this issue was the 2005 case of Imperial Tobacco, where the court employed language almost definitively ousting the possibility of successfully challenging retroactive legislation on the basis of the rule of law. Ultimately, the court spoke of “[t]he absence of a general requirement of legislative prospectivity” and held that “retrospectivity and retroactivity do not generally engage constitutional concerns”: British Columbia v. Imperial Tobacco Canada Ltd., 2005 SCC 49, at paragraphs 71-72.

\(^5\) We will not discuss in this article whether it is appropriate for a superior court to grant rectification when and if the order interferes with the jurisdiction of a specialized tribunal or another court. Tax matters are within the exclusive jurisdiction of the Tax Court of Canada and the federal courts. In Orman v. Marnat Inc., 2012 ONSC 549, the Ontario Superior Court refused to dismiss the rectification application on the basis of jurisdiction. Notwithstanding that decision, case law supports jurisdiction as a valid ground for denying rectification. See, for example, GLP NT Corp. v. Canada (Attorney General), 2003 CanLII 41554 (ONSC). As a result, if the taxpayer confined its arguments to the administrative tax reassessment procedures, it would have to challenge the reassessments via an appeal to the Tax Court of Canada (section 169 of the Income Tax Act), and it is questionable whether a provincial court would grant rectification. Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).

This article examines this question and the jurisprudence with respect to rectification orders and retroactive legislation in Canada. The analysis suggests that the equitable remedy of rectification—as well as broader categories of the law of mistake—might be deployed by taxpayers (through provincial court orders) to redress the impact of retroactive tax laws when they intrude on a taxpayer’s reasonable expectations and do not target tax planning that is perceived to be abusive. Perhaps in anticipation of such a challenge, when the Quebec Taxation Act was amended retroactively to May 9, 2006, the amendment also provided that no rectification orders would be respected that would avoid the imposition of Quebec tax under the new amendment.

The matter is particularly topical in light of recent events, as well as developments in the case law. Consider, for example, the now-withdrawn proposal by the Quebec government to retroactively tax high income earners within the province. Under the earlier proposal, individuals with income over $130,000 would be subject to retroactive tax rate increases. The result for an individual in Quebec who gifted her cottage property, thus generating additional taxable income, was that she could be subject to the higher retroactive marginal tax rates. Could she seek equitable relief to set aside the gift (in this case rescission) on the basis that she had made a mistake

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7 This view is consistent with the recent observation that, given that the normative power of the rule of law constrains the actions of Parliament “only in the sense that they must comply with the legislated requirements as to manner and form (that is, the procedures by which legislation is to be enacted, amended and repealed),” there should be a compensating notion that taxpayers can effectively also ignore the rule of law (aided by a court) by rewriting their contracts on a retroactive basis with effect as against third parties. See Boidman et al., supra note 1, at 145-46. Note that while we focus in this article on federal income tax laws and their potential retroactive effect, retroactive tax laws in other areas, such as Canada’s federal consumption tax (the goods and services tax), have been identified as a major area of concern. See Muhammad Abbas and Arthur J. Cockfield, “Canada,” in Thomas Ecker, Michael Lang, and Ine Lejeune, eds., The Future of Indirect Taxation: Recent Trends in VAT and GST Systems Around the World (The Hague: Kluwer Law International, 2012), chapter 4, at 109 and 111.

8 The amendment was in respect of the notorious “Quebec truffle” (see infra note 98). The effect of such a provincial law would obviously not bind courts in other provinces. The federal government could begin to similarly try to insulate its own retroactive laws from rectification orders by provincial courts. As discussed in this article, provincial courts normally have the power to render decisions concerning private-law transactions that take place within the province, and federal legislation may not have the jurisdiction to limit powers of rectification. A discussion of how these potential conflicts in federal-provincial constitutional law could play out is beyond the scope of this article.

9 On September 22, 2012, the newly elected Quebec government proposed to increase the tax rates for incomes above $130,000 a year; the proposal was slated to be retroactive to January 1, 2012. After significant political opposition, the government abandoned the retroactive aspects of the tax hikes. See “Retroactive Tax Hike Is Indefensible,” editorial, Montreal Gazette, September 27, 2012; and “The PQ’s Retroactive Tax on Affluence Is Damaging and Unfair,” editorial, Globe and Mail, September 27, 2012.
concerning the tax liability associated with the cottage transfer. Could she seek rectification of the transaction in favour of an instalment sale that would leave her taxable income below the proposed high income earner threshold? While the Quebec proposal involved provincial rather than federal taxation, and was subsequently abandoned, in this article we discuss whether rectification could have been used to defeat the impact of this sort of retroactive tax law. We also touch on rectification in the context of the potential liability that may fall on personal representatives as a result of retroactive legislation—in particular, the proposed retroactive provisions in the federal non-resident trust rules, initially introduced in 1999, reintroduced in a notice of ways and means motion tabled in October 2012, and since enacted as law.

The discussion that follows is divided into four parts. Part one begins by setting out some of the judicial perspectives and tax policy concerns surrounding rectification remedies, and shows how courts have developed different views on rectification in tax cases and non-tax cases. In particular, provincial courts have broadened rectification in tax cases to the point where they accept that contracts can be rewritten to give effect to a taxpayer’s intention to avoid taxes, irrespective of potential revenue losses to the fisc.

Part two of the article presents various perspectives on retroactive tax laws and shows how, despite fairness and rule-of-law concerns, Canadian federal courts accept retroactive tax legislation that trumps the earlier honest and reasonable intentions of taxpayers, in large part to guard against real or potential revenue losses.

Part three explores doctrinal limits on the use of rectification remedies to challenge retroactive tax laws, as well as the question of whether provincial courts would or should make rectification orders to counter retroactive tax legislation.

Part four concludes that rectification remedies, as well as the law of mistaken assumptions more generally, could be deployed to limit the impact of retroactive tax laws to situations that focus on inhibiting abusive, potentially “GAARable” tax planning that leads to undue revenue losses, as well as situations where taxpayers did not hold an honest and reasonable belief that their earlier tax-planning efforts complied with all relevant tax laws. We conclude, therefore, that rectification could have been used to reduce the impact of the Quebec government’s earlier proposal to retroactively tax high income earners within the province.

10 Winclare, supra note 2.

11 Bill C-48, Technical Tax Amendments Act, 2012, SC 2013, c. 34; royal assent June 26, 2013. Bill C-48, as passed, closely follows the provisions in the October 2012 notice of ways and means motion (Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Excise Tax Act and Related Legislation, October 24, 2012). For further discussion, see infra note 87 and the related text.

12 That is, tax planning that may be subject to challenge under the general anti-avoidance rule (GAAR) in section 245 of the Act.
THE BROADENING OF RECTIFICATION ORDERS IN TAX MATTERS

The Juliar Case

In law, rectification is a form of equitable relief, available for judicial correction of an instrument or contract that, by an error in writing, does not reflect or is not consistent with the true intentions of the parties. Since rectification restores a truth to an instrument's expression, it acts in time from the point of formation of the instrument forward. A frequently cited version of the general principle that is often quoted in Canadian cases is found in Snell's Equity:

There will be cases where the terms of the instrument do not accord with the true agreement between the parties: a term may have been omitted, or an unwanted term included, or a term may be expressed in the wrong way. In such cases, equity has the power to reform, or rectify, that instrument so as to make it accord with the true agreement. What is rectified is not a mistake in the transaction itself, but a mistake in the way in which that transaction has been expressed in writing. "Courts of Equity do not rectify contracts; they may and do rectify instruments purporting to have been made in pursuance of the terms of the contract."13

Until recently, there were few cases in Canada in which the matter of rectification was considered in a tax-related transaction, and in those cases, the application for rectification met with little success. In fact, by the mid-1990s the arguments against rectification in tax matters were reasonably well settled.14 As stated by the Ontario Court of Justice in Bramco,

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14 The arguments against the use of rectification in a tax context were identified in a 1994 decision of the Ontario Court of Justice (General Division), Commercial List, 771225 Ontario Inc. v. Bramco Holdings Co. (1994), 17 OR (3d) 571 (Gen. Div.), and debated in the appeal court's decision in the same matter: (1995), 21 OR (3d) 739 (CA). In a corporate reorganization undertaken to secure an income tax advantage, a land transfer tax liability of $1.7 million on a purchase of land was triggered, rather than the liability of $84,745 that the parties had intended. A rectification order was sought to substitute a different purchaser. The Ontario Court of Justice dismissed the application. The court did not consider that the remedy of rectification could allow a corporation not initially intended to be a party to the transaction to be substituted for the originally intended party. The Ontario Court of Appeal also dismissed the appeal. The majority referred to the “well-known rule that equity and tax laws are ‘strangers’ and that in taxing statutes there is no room for equity” (ibid., at 742, citing Mendel v. MNR, 65 DTC 114, at 122 (TAB)). The majority further observed (ibid.) that granting equitable relief to avoid an unanticipated tax disadvantage under the provincial Land Transfer Tax Act “as the direct result of a deliberate decision . . . to obtain a tax advantage under the [federal] Income Tax Act . . . would fly in the face of a long line of authority based upon the need for finality and consistency in matters of taxation.”
Although the court would like to be able to assist those who suffer as a consequence of a mistake, particularly where the result is a windfall to the taxing authority, a court of equity may only grant the relief of rectification in very limited circumstances.15

The 2000 decision in *Juliar*16 has changed all that and clearly demonstrates the full power of equity, as wielded by provincial courts, to rectify transactions to remedy unintended tax results. In *Juliar*, a rectification order was issued to unravel a transaction in order to remedy tax results unintended by the parties, notwithstanding that the transaction was a tax-avoidance transaction.17

On the facts, one might sympathize with the taxpayers in *Juliar*. A husband and his wife transferred their shares in a holding company to a second corporation in return for a promissory note. The plan was to effect the transfer without immediate tax liability. Instead, the transaction as structured triggered an immediate and unintended deemed dividend. The taxpayers applied to the Ontario Superior Court of Justice for an order rectifying the transaction to transform it into a tax-free exchange of shares. The rectification order was granted on the basis that the taxpayers had a primary intention from the outset that the transaction would not trigger any immediate income tax consequences and that in order to accomplish this intention, a share-for-share transaction was necessary.18 The court rectified the corporate resolutions of both corporations to substitute shares for the promissory note that was originally issued. On appeal, the Ontario Court of Appeal also accepted that the taxpayers had a common and continuing intention from the outset to transfer shares without immediate tax, and failed to implement the plan because of a mistake of fact.19 Leave to appeal to the Supreme Court of Canada was denied without reasons. Of particular interest is the manner in which the issue was framed by the Supreme Court, in part as follows:

Trial judge permitting rectification of corporate transaction so as to avoid liability for immediate payment of income tax—Court of Appeal affirming decision—Whether Court of Appeal erred in extending principles of rectification by permitting agreement to be rewritten not because agreement incorrectly set down terms of contract, but because consequences of arrangement were undesirable.20

15 *Bramco*, supra note 14 (Gen. Div.), at paragraph 47.


17 Tax avoidance in this context means tax planning to reduce or avoid tax liability within the framework of acceptable tax policy. In some jurisdictions, it is referred to as mitigation.

18 Cameron J found on the evidence “that the Juliars had a common and continuing intention from the outset to transfer their half interest in the business of Juliar Holdings and to do so ‘on a basis which would not attract immediate liability for income tax on the transaction.’” *Juliar*, supra note 16, at paragraph 19.

19 In dismissing the appeal by the Crown, the Ontario Court of Appeal relied on the principles set out in *Re Slocok’s Will Trust*, [1979] 1 All ER 358 (Ch. D.). See infra note 48 and the related text.

The crucial finding in *Juliar* was that the true agreement between the parties was that the transaction would take place *in a manner* that would not attract immediate liability for tax. The Ontario Superior Court of Justice noted that

> [t]he intention to postpone or avoid tax on the transaction was not formed as a result of the assessment by Revenue Canada. It was an intended and fundamental aspect of the transaction from its inception. The purpose of the tax avoidance and maintaining the assets of the business determined the form of the transaction. The Julias expected no other effect.²¹

### The Post-Juliar Cases

The *Juliar* decision was a welcome gift to taxpayers and an immediate concern for revenue authorities.²² Predictably, the rapid transition in Canada from virtually no rectification orders in tax matters to the use of the equitable doctrine to, in effect, rewrite fiscal history has been swift. Many taxpayers have since relied on the *Juliar* decision to secure provincial court judgments to correct tax documents and tax plans with unintended tax consequences, whether immediate or in the future.²³

In *Razzaq Holdings*, an error was made in the reorganization documents that resulted in some erroneous share transfers.²⁴ In granting the rectification order, the court considered the *Juliar* decision and stated that

> [t]he basis of the rectification order [in *Juliar*] was that the result of the transaction was not what the taxpayers had intended as it was shown that they had always intended to transfer their shares without triggering any tax.²⁵

Similarly in *Snow White Productions*,²⁶ the Supreme Court of British Columbia accepted the principles and reasons set out in *Juliar* to order retroactive rectification of agreements so as to conform to the parties’ primary intention that certain tax consequences be achieved. In the court’s view, the facts of the case justified this result. When Snow White Productions Inc. applied for a film tax credit, the claim was denied because the company did not have ownership of the film copyright or a direct contract with the copyright holder as required under the applicable legislation. The court accepted the tax consequences as being not merely incident to the agreement but at the core of the intention underpinning the original agreement.²⁷

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²³ See, for example, McPeake, infra note 31 and the related text.
²⁴ *Re Razzaq Holdings Ltd.*, 2000 BCSC 1829.
²⁵ Ibid., at paragraph 18.
²⁷ The court stated (ibid., at paragraph 24), “I find that it was always the common intention of the parties to obtain the legitimate fiscal advantage of the benefits under the *Income Tax Act* (Canada) and the *Income Tax Act* (British Columbia) which accrue to an ‘eligible production corporation’ in a position to receive an ‘accredited film or video production certificate.’”
Provincial superior courts have continued to expand the scope of the remedy and to reduce the evidence necessary to show the required intent. An excellent example is the 2011 decision in *S & D International*,28 in which the shares of a corporation were owned by three businessmen and their wives. Several errors occurred. First, in order to protect the spouses from a securities commission investigation, the corporation agreed to buy the shares from each spouse for $1,864,778.75. The agreement provided that the corporation could pay the purchase price by transferring land of the same value. The shareholders believed that the fair market value of the land was equal to the cost base for tax purposes. Then all of the land, and not just the land required for the share purchase, was transferred to the wives. The corporation was assessed on the basis that it had disposed of the land at its fair market value of $25,063,038, and the wives were assessed for deemed dividends. The parties compounded their tax difficulties by executing a cancellation agreement and transferring the land back to the corporation, triggering additional tax liability on the disposition.

The Alberta Court of Queen’s Bench exercised its equitable jurisdiction to reduce the consideration given to the wives under the initial transfer agreement, finding that there was a fundamental mistake as to the tax effect of the transactions (that is, it granted rectification). The court also inferred that the parties would have done something else had they been aware of the adverse tax consequences of their documented transaction. In so finding, the judge stated:

> I thus think it is artificial to interpret *Juliar* as requiring that the parties demonstrate that the mistake was a “primary and continuing objective of the applicants from the inception of the transaction.” That circumstance might make the case for equitable relief stronger, but is not a pre-condition to the court granting equitable relief if it had been necessary to achieve a just result.29

The court also granted rescission with respect to the cancellation agreement. According to the court,

> [t]he Applicants were clearly mistaken as to the effect of that transaction, not its basic nature, who the parties were or what the subject matter was. That is sufficient to trigger equitable jurisdiction.30


29 Ibid., at paragraph 83. In the same paragraph, the court states, “I hesitate to place the same strictures around equitable remedies for mistake as there are for common law mistake. Under common law mistake, a party is entitled to a legal remedy in the appropriate circumstances. Equitable relief is always discretionary.”

30 Ibid., at paragraph 106. The court found that rescission was not necessary to address the mistakes made in closing the transaction. These could be addressed in a rectification order that substituted cash for the land initially transferred to the spouses.
Perhaps the most far-reaching decision to date on rectification orders affecting tax matters is the 2012 decision of the British Columbia Supreme Court in *McPeake*.31 This decision also provides an excellent summary of the principles that appear to underlie the remedy in Canada in tax cases.

In *McPeake*, Mr. McPeake established a family trust to distribute the benefits of his property (shares in a software company) to family members as beneficiaries. The trust was used as a vehicle to avoid payment of tax on capital gains. This end was to be achieved by distributing the trust income to the beneficiaries, who in turn were entitled to use the then $500,000 capital gains deduction. It became clear that the plan would fail when the trust was reassessed almost a decade later and an overlooked attribution rule was cited by the Canada Revenue Agency (CRA). An application was sought to rectify the trust document by removing the compromising clauses. In the end, not one but two rectification orders were granted to prevent the unintended tax consequences.

The court’s key findings in relation to the law of rectification can be summarized as follows:

- Rectification is a remedy within the equitable jurisdiction of a superior court.32
- The remedy is restorative, not “retroactive”: it aligns the documents with the true underlying intentions and does not change the essence of the agreement between contracting parties.33
- Rectification operates to correct the documents from inception. “Since rectification restores a truth to an instrument’s expression, it acts, in time, from the point of instrument formation onward.”34
- The onus is on the party seeking rectification to prove that the written instruments do not reflect the true agreement of the parties and “that the aspects to be rectified are mistakes that obstruct the true intentions behind the document’s formation.”35

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32 The court stated (ibid., at paragraph 16), “Rectification is an equitable remedy that courts may apply to various legal documents that stand as instruments expressing intended legal relations. Rectifiable documents can include contracts (*Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.* . . .), land deeds (*771225 Ontario Inc. v. Bramco Holdings Co.* . . .), documents relating to corporate transactions (*Juliar v. Canada (Attorney General)* . . .), and trust deeds (*Rose v. Rose* . . .).”

33 “[Rectification] is to restore the parties to their original bargain, not to rectify a belatedly recognized error of judgment by one party or the other.” *McPeake*, supra note 31, at paragraph 16, quoting *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd.*, 2002 SCC 19, at paragraph 31.

34 *McPeake*, supra note 31, at paragraph 16.

35 Ibid., at paragraph 17.
be more than a general intention, and “what constitutes sufficient specificity of intention varies by context.”36

Tax avoidance is legal and may be supported by rectification.37

The court in McPeake found that there was sufficient evidence to show a specific intention (one that existed when the deed was created and that had continued) to avoid payment of tax on capital gains from the sale of shares by maximizing the capital gains deduction to the beneficiaries. Following the reasoning in Juliar, the court held that the desired tax consequences were not incidental to the trust’s formation but were the reason therefor.

The post-Juliar decisions demonstrate that if the intention of the parties is to put into effect a transaction that avoids tax, yet the parties by some error fail to do that, rectification may be the most appropriate and effective remedy available. Several courts have also confirmed that intention can be inferred from the evidence.38 Perhaps most importantly, provincial court judges have now been unequivocal in their view that a mistake as to the effect of a transaction is sufficient to engage the equitable jurisdiction of the court.39

Not surprisingly, there appear to be few limits as to when orders will be granted in tax cases provided that the requisite intention is found.40 The notable exception is that the remedy cannot be used for retroactive tax planning.41 In the Stone’s Jewellery
decision, rectification was also denied, but for the reason that it did not provide an appropriate remedy. Rescission of the contract or a finding that it was void ab initio at common law was necessary to give effect to the intention of the parties. The facts and the court’s reasons are outlined below.

In *Stone’s Jewellery*, the parties transferred land to four individuals and later to a corporation in transactions that they believed would be tax-deferred. With respect to the transfer to the corporation, the court held that it did not “have the power to direct that the 2006 Transfer proceed on a tax free basis . . . in accordance with the parties’ intentions.” Similarly, rectification was not available to the four individuals with respect to the earlier transaction since the court was “not being asked to rectify the transaction back to its intended form, but to undo the transaction.” Instead, the court applied the common-law doctrine of mistake as it applied to contracts, and found that the transfer to the corporation was void ab initio because it was carried out under the mistaken belief of all the parties that it could be effected on a rollover basis; additionally, the earlier transaction also was void ab initio because it had proceeded on the basis of an (implicit) assumption by the parties that it would not have adverse tax consequences. In the court’s view, the mistake was “as to the effect of the transaction itself and not merely as to its consequences or the advantages to be gained by entering into it.” Strekaf J was clear in her decision that had the contract not been void ab initio, she would have been prepared to exercise her equitable discretion to rescind the transfer agreement to the corporation as well as the initial transfer to the four individuals.

Strekaf J quoted with approval Fridman on *The Law of Contract* with respect to the court’s equitable discretion to grant rescission:

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42 *Stone’s Jewellery Ltd. v. Arora*, 2009 ABQB 656. Another recent example where a rectification order was refused but declaratory relief was provided instead involved a Ponzi scheme. In *Orman*, supra note 5, the two individuals seeking relief were victims who claimed that they had unnecessarily paid income tax on funds received and reported as income. They took the position that the uncovering of the fraud revealed that amounts previously reported as interest payments were actually return of capital, and that payments to them were corporate loans rather than bonuses. They sought an order to rectify the respondents’ corporate records to reflect the actual nature of the payments. The court’s reasoning in rejecting the claim for rectification provides a useful framework for considering the use of the remedy in tax cases. “Rectification is concerned with mistakes in recording the parties’ intent or purpose in their written documents. It is designed to ensure that the parties’ documents express the parties’ purpose at the time the documents were finalized. In this case, at the time the documents were finalized (reporting income), they correctly expressed the parties’ intention: rectification is not available to correct what is a mistake in the underlying purpose that was accurately expressed in the parties’ documents. Rectification is not available to correct erroneous assumptions or beliefs as to what was intended.” Ibid., at paragraph 63.

43 *Stone’s Jewellery*, supra note 42, at paragraph 45.

44 Ibid., at paragraph 68.

The jurisdiction of the courts to grant rescission of a contract on equitable grounds, which involves a restoration of the parties to their original rights and property, extends beyond the situations and circumstances in which, at common law, a party, acting unilaterally, can treat the contract as a legal nullity, and then pursue such common-law remedies as may be available. Although there is a degree of overlap between the common-law right to rescind for fraud, and the equitable jurisdiction of the court to grant rescission of a contract which has been entered into as a consequence of a false representation or some other fraud, the equitable power to order rescission is wider in scope. Indeed, the limits of this jurisdiction have not been fixed. Wherever a court considers, on general equitable grounds, that a contract should not be allowed to stand, and that the request by one party that it be annulled and avoided should be granted, the court has the power to do so. A court of equity can do what is “practically just.”

**Rectification in Non-Tax Cases**

As discussed above, the rectification orders in the tax cases under review were made by provincial superior court judges. The analysis reveals that the key principles applied in the *Juliar* decision and relied on by later courts in granting equitable relief are developing differently from the principles relied on when the remedy was provided by the Supreme Court of Canada in post-*Juliar* non-tax cases.

In *Juliar*, the Ontario Court of Appeal relied on the following principles from *Slocock Will’s Trust* in dismissing the Crown’s appeal:

“The true principles governing these matters I conceive to be as follows. (1) The court has a discretion to rectify where it is satisfied that the document does not carry out the intention of the parties. This is the basic principle. (2) Parties are entitled to enter into any transaction which is legal, and, in particular, are entitled to arrange their affairs to avoid payment of tax if they legitimately can. . . . (3) If a mistake is made in a document legitimately designed to avoid the payment of tax, there is no reason why it should not be corrected . . . to enable the parties to obtain a legitimate fiscal advantage which it was their common intention to obtain at the time of the execution of the document.”

The Supreme Court of Canada cited very different principles in the two non-tax cases since *Juliar*. In *Shafron*, a 2009 application, the court prefaced its analysis of rectification with the following quotation from Lord Denning in *Frederick E. Rose (London) Ltd.*:

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47 Supra note 19, at 363.

48 *Juliar*, supra note 16, at paragraph 33.

49 *Shafron v. KRG Insurance Brokers (Western) Inc.*, 2009 SCC 6. At issue was the wording of a restrictive covenant in an employment contract between Shafron and KRG Insurance Brokers—specifically, the interpretation of the ambiguous phrase “Metropolitan City of Vancouver.” The Supreme Court denied rectification to cure the ambiguity on the basis that there was no evidence that the parties had agreed to anything other than the term found in the agreement, notwithstanding its ambiguity or vagueness.
Rectification is concerned with contracts and documents, not with intentions. In order to get rectification it is necessary to show that the parties were in complete agreement on the terms of their contract, but by an error wrote them down wrongly; and in this regard, in order to ascertain the terms of their contract, you do not look into the inner minds of the parties—into their intentions—any more than you do in the formation of any other contract.50

The court then went on to cite with approval the criteria set out by the Supreme Court in Performance Industries51 (the other non-tax-related decision):

(1) the existence and content of the inconsistent prior oral agreement; (2) that the party seeking to uphold the terms of the written agreement knew or ought to have known about the lack of correspondence between the written document and the oral agreement, in circumstances amounting to fraud or the equivalent of fraud; and (3) “the precise form” in which the written instrument can be made to express the prior intention.52

The court in Shafron concluded that there was “no indication that the parties agreed on something and then mistakenly included something else in the written contract. Rather, they used an ambiguous term in the written contract.”53

While provincial courts pay lip service to the two Supreme Court decisions and the principles on which they rely, the same courts appear quick to distinguish those decisions. For example, the British Columbia Supreme Court considered the Supreme Court of Canada’s view in Shafron in a tax-related case, Fraser Valley Refrigeration.54 The Crown argued that Shafron had changed the law of rectification in Canada with respect to intention. The BC court disagreed:

In Shafron rectification was not available because the plaintiff was attempting to resolve a contractual ambiguity, in circumstances where the parties had not expressed intention,

51 Performance Industries, supra note 33. In that case, at paragraph 31, the Supreme Court summarized the rectification remedy as follows: “Rectification is an equitable remedy whose purpose is to prevent a written document from being used as an engine of fraud or misconduct ‘equivalent to fraud.’ The traditional rule was to permit rectification only for mutual mistake, but rectification is now available for unilateral mistake (as here), provided certain demanding preconditions are met. Insofar as they are relevant to this appeal, these preconditions can be summarized as follows. Rectification is predicated on the existence of a prior oral contract whose terms are definite and ascertainable. The plaintiff must establish that the terms agreed to orally were not written down properly. The error may be fraudulent, or it may be innocent. What is essential is that at the time of execution of the written document the defendant knew or ought to have known of the error and the plaintiff did not. Moreover, the attempt of the defendant to rely on the erroneous written document must amount to ‘fraud or the equivalent of fraud.’”
53 Shafron, supra note 49, at paragraph 57.
54 Fraser Valley Refrigeration, Re, 2009 BCSC 848.
thus there was no mutuality of intent or agreement as to the actual meaning of the ambiguous term. . . . Shafron does not mean that intention is irrelevant to rectification cases. . . . In my view, the Shafron decision did not change the law of rectification.55

The judge went on to add:

In tax cases rectification is granted to rectify documents that are inconsistent with the expressed and agreed tax intent of the parties to a contract. Intent is relevant, because where intent is common and continuing it forms a part of the true agreement between the parties to a contract.56

So while the Supreme Court of Canada appears to be taking a cautious and narrow approach, citing earlier judicial comments that “[t]he power of rectification must be used with great caution,”57 the provincial courts seem fully prepared to grant rectification “once the Court is satisfied that the true agreement between the parties (which is based on the transaction not attracting or at least minimizing income tax) is frustrated.”58

Courts have delineated the scope and applicability of rectification remedies in circumstances other than tax cases. For instance, an order for rectification will not be granted where it would harm the interests of an innocent third party.59 In addition, undue delay or subsequent affirmation of the written agreement can provide the basis for denying rectification orders. Moreover, in the recent pronouncement on rectification in Performance Industries, the Supreme Court of Canada held that the conduct of the adversely affected party (normally the plaintiff) can be taken into account in determining whether it is just to provide equitable relief.60 As discussed

55 Ibid., at paragraphs 39-40.
56 Ibid., at paragraph 41.
58 Di Battista v. 874687 Ontario Inc. (2005), 80 OR (3d) 136, at paragraph 6 (SC).
59 See Wise et al. v. Axford et al., [1954] OWN 822 (CA). Who is the affected third party if rectification is granted? In the tax-related cases, both parties to the contract or arrangement for which rectification is sought are generally in agreement, or at least not in disagreement, about the remedy being sought—namely, tax relief. The party often in disagreement in the tax cases is the fisc.
60 Performance Industries, supra note 33. In this case, the defendant argued that the plaintiff should be denied relief because he did not carefully read the written agreement prior to signing it. The court indicated that, while the plaintiff’s actions should be scrutinized, his want of due diligence could not serve as a defence to rectification in this case. One could argue that, in a rectification case that seeks to address retroactive tax laws, the innocent third party is the government, which is solely interested in collecting revenue from the transaction. The rectification cases, however, scrutinize whether a private bargain should be set aside or modified, and traditionally courts scrutinize only the actions of the parties to the bargain, and so might ignore the interests of third parties such as governments.
later in this article, when interpreting the impact of retroactive tax legislation, courts should similarly scrutinize whether a particular taxpayer seeking equitable relief had an honest and reasonable reliance on earlier tax laws when he or she engaged in tax planning.

Summary
On the basis of the prior analysis, two things are obvious. First, case law is developing independently in tax-driven rectification applications. In all of the decisions since Juliar, the courts have been willing to grant the remedy beyond the narrow circumstances envisaged by the Supreme Court of Canada in non-tax cases. Second, the trend in Canada appears to be toward broadening the grounds for equitable relief within the tax cases. At least two provincial court judges have indicated that they would not have followed the often cited decision in Bramco, where the court would not grant rectification to relieve the taxpayers of the land transfer tax payable as a result of a tax-planned transfer. According to the court, rectification was denied because income tax but not land transfer tax was contemplated at the time of the transaction.

What is also of interest in these cases, starting with Juliar, is the court’s attitude toward the fisc. In Juliar and subsequent cases, the courts have cited with approval the statement from Slocock Wills Trust that “[i]t would not be a correct exercise of the discretion in such circumstances to refuse rectification merely because the Crown would thereby be deprived of an accidental and unexpected windfall.” Provincial court judges also appear in many of the decisions to be at best ambivalent to the interests of the fisc and its right to be added as an interested party to a rectification application.

61 Supra note 14 (leave to Appeal to the Supreme Court of Canada was dismissed without reasons November 2, 1995).
62 Juliar, supra note 21, at paragraph 37 (emphasis added), quoting from Slocock Wills Trust, supra note 19, at 363. Also see, for example, Re: Prospera Credit Union (Matter of), 2002 BCSC 1806, at paragraph 2: “Customs and Revenue Agency’s interest will not be affected other than losing an unexpected windfall by the orders sought.”
63 In Orman, supra note 5, where the taxpayers seeking rectification were the victims of a Ponzi scheme, the judge referred to the parties to the sought-after rectification order as Messrs. Orman and Freed, and to the government as “the Taxman.” The latter form of reference leaves little doubt as to the court’s orientation and the likelihood of a favourable outcome for the taxpayers. The court’s wording is also in stark contrast to other tax decisions where the fisc is generally referred to as “the respondent,” “the Minister,” or “the Canada Revenue Agency” represented by the attorney general of Canada.
64 See the comments in Stone’s Jewellery, supra note 42, where the CRA opposed an application for rectification in respect of a transaction that resulted in an assessment of more than $6 million in income taxes. In her reasons for judgment, Strekaf J stated (ibid., at paragraph 74) “there is no evidence that any third parties who were not involved in the original transaction would be prejudiced.” This may come as a surprise to the CRA.
The one clear judicial limitation on the remedy of rectification is that it should not be used for retroactive tax planning.\textsuperscript{65} There should be no question of retroactive tax planning where a document is amended merely to reflect the original intention of the parties. Does the answer change if rectification is used to correct an error in a transaction itself? On the basis of the \textit{Juliar} decision, it appears not.\textsuperscript{66}

\section*{PERSPECTIVES ON RETROACTIVE TAX LAWS}

\subsection*{The Rule of Law and Retroactive Tax Laws}

The preceding discussion focused on Canadian judicial perspectives on the equitable remedy of rectification; this part of the article broadens the inquiry to consider how another Canadian judicial perspective on retroactive tax laws\textsuperscript{67} deals with taxpayers’ reasonable expectations within the context of perspectives on the rule of law.

The rule of law is considered to be among the most important aspects of a democratic society.\textsuperscript{68} A number of different elements, including principles of certainty and predictability, constitute the rule of law. Freidrich Hayek described the rule of law as follows:

\begin{itemize}
  \item[65] McPeake, supra note 31.
  \item[66] Indeed, it was by focusing the \textit{Juliar} analysis not on whether the parties in fact intended and in fact accomplished a share-for-debt exchange (with albeit unexpected tax consequences), but on whether the parties intended to avoid or defer tax and carried out a transaction that in fact accomplished avoidance or deferral of tax, that the Court of Appeal was able to justify rectification in the circumstances presented in the case. For a good discussion of this issue, see generally Bruce S. Russell and Karen D. Stillwell, “Aspects of Fixing Mistakes in Tax Context: Rectification and Due Diligence,” in \textit{2009 Atlantic Provinces Tax Conference} (Toronto: Canadian Tax Foundation, 2009), 1-46.
  \item[67] There are two main categories of what is sometimes referred to as “retroactive legislation”: (1) laws that operate upon existing rights to alter them from the date of enactment; and (2) laws that provide that as of a past date, the law will be taken to mean what it was not—in other words, legislation that operates as of a time prior to its enactment. In the context of this discussion, we distinguish between these two categories and rely on the distinction made by E.A. Driedger in “Statutes: Retroactive Retrospective Reflections” (1978) 56:2 Canadian Bar Review 264-78, at 268-69. Thus, for the purposes of this article, we consider retroactive legislation to mean legislation that operates as of a time prior to its enactment. In contrast, retrospective legislation operates for the future only. It is prospective, but it imposes new results in respect of a past event. A retroactive statute changes the law from what it was; a retrospective statute changes the law from what it otherwise would be with respect to a prior event. A number of tax and non-tax courts rely on this distinction. See, for example, \textit{Epiciers Unis Metro-Richelieu Inc. Division “Econogros” v. Collin}, 2004 SCC 59, and \textit{Gibraltar Capital Corporation v. The Queen}, 2002 DTC 1601 (TCC). See also the discussion in note 73, infra.
  \item[68] The Supreme Court of Canada has written that the rule of law is a “fundamental postulate of our constitutional structure” that lies “at the root of our system of government.” See \textit{Imperial Tobacco}, supra note 4, at paragraph 57, citing \textit{Runcarelli v. Duplessis}, [1959] SCR 121, at 142, and \textit{Reference re Secession of Quebec}, [1998] 2 SCR 217, at paragraph 70. In \textit{Imperial Tobacco} (supra note 4, at paragraph 61), the court cited supporting views that a breach of the rule of law does not lead to invalidity.
\end{itemize}
[The rule of law] means that government in all of its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge.69

Other legal philosophers such as Joseph Raz, H.L.A. Hart, and Lon Fuller, have identified similar, interrelated concepts in describing the rule of law, such as clarity, publicity, and prospectivity.70 Other observers have also sometimes questioned the desirability of retroactive tax laws on grounds that include fairness and the rule of law.71

For these reasons, within the Canadian legal system there is a presumption against retroactive legislation; under this view, legislation is deemed to generally become effective when it is legislated and remains active until repealed. Edinger72 traces this presumption to Roman law, along with its subsequent adoption by most western legal systems, including those of the United States, the United Kingdom, Australia, and Canada.

The main rationale for opposing retroactive laws—that they change the rules of the game after the game has been played—was discussed in an 1880 paper by William Pratt Wade:

In all retroactive laws there must be an element of surprise, by which persons whose rights are affected are taken unawares. They are called upon to act in a manner different from what they have been led by the settled state of the law to anticipate. So repugnant is such a system of legislation to our nature sense of justice, that it has been stigmatized as more unreasonable than that adopted by Caligula, who was said to have written his laws in a very small character and hung them upon high pillars, the more effectually to ensnare the people.73

**Canadian Judicial Views**

Despite this obvious fairness concern, Canadian law is clear that retroactive laws are generally acceptable, and in tax matters they are considered commonplace.74 In fact, tax laws often have effect from the date of the budgetary announcement, which


70 For discussion, see Benjamin Alarie, “Retroactivity and the General Anti-Avoidance Rule,” in David G. Duff and Harry Erlichman, eds., Tax Avoidance in Canada After Canada Trustco and Mathew (Toronto: Irwin Law, 2007), chapter 8, at 201-2.


73 Cited by Edinger, ibid., at 13.

74 See the discussion in note 67, supra.
typically far precedes the date on which the legislation is passed.\textsuperscript{73} Even when announced in a budget to have immediate effect, retroactive legislation clearly raises the fairness issues identified in the previous section. To many Canadian courts, however, fairness does not appear to be an issue in the context of retroactive legislation.

In its most recent pronouncement on retroactivity, the Supreme Court indicated that “there is no requirement of legislative prospectivity embodied in the rule of law or in any provision of our Constitution.”\textsuperscript{76} The court noted that statutes can have retroactive operation when the statute is clear that such effect is intended.\textsuperscript{77} The only other limit identified is the one placed on retroactive legislation that implicates an individual’s liberty interest: a retroactive criminal law that sought to impose guilt on an individual in respect of prior conduct would be constitutionally impermissible under the Canadian Charter of Rights and Freedoms.\textsuperscript{78}

It could be argued that tax laws bring about potential criminal sanctions and hence a taxpayer’s liberty interest ought to be protected by prohibiting retroactive tax laws. In fact, Canadian courts have previously recognized that an investigation into a taxpayer’s records constitutes a government search that attracts constitutional protections against unreasonable state searches.\textsuperscript{79} Moreover, there is a lengthy tradition in political philosophy (often derived from Lockean perspectives) that views

\textsuperscript{75} There has been considerable confusion in the use of the term “retroactive” in relation to tax legislation. In Gustavson Drilling (1964) Ltd. v. Minister of National Revenue, [1977] 1 SCR 271, an oil company tried to deduct in 1964 drilling expenses incurred prior to 1960. Tax laws passed in 1962 had repealed the right to claim such deductions for tax years following 1962. The majority of the court held that the repealing legislation was not in fact retroactive and that “[n]o one has a vested right to continuance of the law as it stood in the past” (ibid., at 282). The use of the term “retroactive” in this case was what Driedger, supra note 67, would describe as “retrospective.”

\textsuperscript{76} See Imperial Tobacco, supra note 4, at paragraph 69. But see Geoffrey T. Loomer, “Taxing out of Time: Parliamentary Supremacy and Retroactive Tax Legislation” [2006] no. 1 British Tax Review 64-90, at 82 (arguing that some constitutional mechanism should allow the questioning of retroactive tax legislation).

\textsuperscript{77} Imperial Tobacco, supra note 4, at paragraph 72. See Gustavson Drilling, supra note 75.

\textsuperscript{78} Imperial Tobacco, supra note 4, at paragraph 69. See 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, section 11(g) (herein referred to as “the Charter”).

\textsuperscript{79} In addition to state searches for criminal investigation purposes, section 8 of the Charter has also been used to restrict the ability of government officials to seize and disclose tax returns for the purposes of assessing a person’s tax liability. See, for example, Gernhart v. Canada, [2000] 2 FC 292 (CA). In addition, retroactive tax legislation may require a government reassessment and scrutiny of a taxpayer’s private financial situation, which may call for protection under section 7 of the Charter—the provision providing for protection of “life, liberty, and security of person.” Section 7 appears to be becoming increasingly important in Charter privacy analysis. See Ruby v. Canada (Solicitor General), 2002 SCC 75, at paragraph 32: “[T]here is an emerging view that the liberty interest in s. 7 of the Charter protects an individual’s right to privacy.” But see Imperial Tobacco, supra note 4, at paragraph 69 (indicating that section 7 was not engaged by retroactive tax legislation).
state taxation powers—the use of the state’s monopoly of means of violence to relieve a person of part of his or her private property—as among the government’s most intrusive powers.80

Canadian tax courts have at times expressed their reservation with respect to applying retroactive tax legislation:

Retroactive legislation, although within the power of Parliament is legal but undesirable. The inappropriateness of reassessing taxpayers who completed transactions in accordance with the law in force at the time of those transactions without any expectation of adverse retroactive effect is self-evident.81

To guard against abuse, Canadian courts have also adopted a presumption of minimal retroactivity.82 For instance, this presumption was expressed in a 1924 Supreme Court of Canada decision:

[W]here an enactment, admittedly retrospective, is expressed in language which leaves the scope of it open to doubt, and according to one construction it imposes retrospectively a new liability, while upon another at least equally admissible, it imposes no such burden, the latter construction is that which ought to be preferred.83

As discussed subsequently, the presumption of minimal retroactivity may provide provincial courts with sufficient wiggle room to provide equitable relief when retroactive tax laws increase tax liabilities for taxpayers who honestly and reasonably relied on existing tax laws to guide their tax-planning efforts.

Rectification Versus Retroactive Tax Laws

Before proceeding to the next part of the article, which discusses the potential for rectifying arrangements affected by retroactive laws, we pause to consider why provincial courts appear willing to rectify tax mistakes whereas federal courts seem willing to accept the validity of retroactive tax laws, arguably without critically considering the various interests at stake.

On the one hand, provincial courts seem to emphasize business certainty, as well as reinforcement of private rights and reasonable contractual intentions. In addition, these courts seem less deferential to Parliament in that rectification of tax


81 See MIL (Investments) SA v. The Queen, 2006 TCC 208, at paragraph 30.

82 Alarie, supra note 70, at 205.

83 See Kent v. The King, [1924] SCR 388, at 397.
mistakes—even if they were made as a result of errors caused by the taxpayers—leads to a circumvention of federal tax laws and results in revenue losses. On the other hand, federal courts downplay concerns surrounding fairness and business certainty in order to promote the overarching goals of legislative supremacy and, in the case of retroactive tax laws, revenue collection. The federal courts also appear to be more accepting of laws that try to inhibit aggressive tax planning.

Both federal and provincial courts appear to be influenced by their own internal logic and their vision of the appropriate role of the rule of law. Interestingly, both analyze this role in the context of federal tax laws; the provincial courts emphasize how equity and reasonable contractual intentions should at times trump federal tax laws, whereas the federal courts appear more willing to ignore honest and reasonable intentions when they clash with the dictates of retroactive tax laws.

The internal reasoning of each approach would be brought together in a clash if a plaintiff tried to rectify an arrangement or agreement that was adversely affected by retroactive tax laws. Consider the following hypothetical situation. Income tax legislation that contains a retroactive provision, such as the proposed non-resident trust rules, is tabled as a notice of ways and means motion. Prior to the enactment of the legislation, the trust is terminated. The trust files its tax returns on the basis of the existing law, not on the basis of the proposed rules. The proposals are eventually enacted with retroactive effect.

According to the CRA, if notice is given (for example, via a notice of ways and means motion) of proposed legislation that will have a retroactive effective date when enacted, and if a legal representative does not file in accordance with the proposed legislation and distributes the taxpayer’s property that is under the legal representative’s possession or control, the legal representative will be personally liable up to the amount of the distributed property. The reasoning is that the retroactive commencement date of a tax change (relative to its enactment) gives rise to the liability

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84 At this point, we query whether the different court decisions have been influenced by the phenomenon of autopoiesis (where a system is derived from reasoning that is self-referential and recursive). For discussion, see Geraldine Hikaka and John Prebble, *Autopoiesis and General Anti-Avoidance Rules*, Victoria University of Wellington Legal Research Paper no. 31/2011 (Wellington, NZ: Victoria University of Wellington, 2011), at 3 (describing how autopoiesis theory can assist in understanding the nature of income tax law). In this sense, the reasoning of the federal and provincial courts could be described as “operatively closed” since they are both driven by different principles and understandings. Assuming that a plaintiff tries to use rectification to undo the adverse effects of retroactive tax laws, through the judicial system the two autopoietic systems would be able to observe and react to one another in what has been described as a “systems paradigm.”

85 Subsection 159(3) of the Act and the CRA round table presented at the Society of Trust and Estate Practitioners conference, June 2-3, 2011, question 1 (www.step.ca/pdf/snc2011craRoundtable.pdf). This assumes that the personal representative did not or could not obtain a clearance certificate as a result of the open-ended legislative proposals.
before the trust is wound up. Similar logic applies if a corporation that will be affected by retroactive tax legislation is wound up before the legislation is enacted.86

In the case described by the CRA, should the personal representative be able to seek a rectification order to correct aspects of the distribution of trust property that led to tax liability for the trust if retroactive legislation affects the final tax result? Surely it was not the intention of the personal representative to face personal tax liability with respect to the trust assets. Sympathies for the trustee—particularly if that person is not a professional trustee—may be further inflamed by the complexities surrounding the non-resident trust rules, the temporal aspects of which have been anything but clear. In fact, six sets of proposals were introduced between 2000 and 2012, with four different retroactive dates.87 The sixth incarnation was introduced in the March 4, 2010 federal budget, with the effective retroactive date delayed from the originally announced date of 2001 until 2007. This measure, tabled in a notice of ways and means motion on October 24, 2012, has since become law.88

The sheer number and complexity of the legislative proposals with respect to non-resident trusts left even the most seasoned tax professionals uncertain for more than a decade about the tax rules applicable to trust property. During this period, many trustees would no doubt have come under pressure from beneficiaries to make distributions or to wind up the trust under the terms of the trust document. More importantly, personal representatives may have taken steps based on the proposals that resulted in more onerous taxation than would apply under the enacted legislation. Is rectification (or rescission) an appropriate remedy for the personal representative in these circumstances if personal liability results from retroactive tax changes or more onerous liability to the trust? A provincial court, deploying its own internal logic related to the post-*Juliar* cases, could agree that rectification is the appropriate remedy.

86 For an interesting example of a situation where a taxpayer sought to rely on retroactive legislation, see *Edwards v. Canada*, 2012 FCA 330. In *Edwards*, the taxpayer was involved in a charitable donation scheme. In the Tax Court, the taxpayer brought a motion for an adjournment of the hearing pending the enactment of amendments to the Act proposed in Bill C-48 (which are now law: see supra note 11). The amendments, as proposed, would have been retroactive to the date on which they were first announced and may have allowed the taxpayer to claim all or a portion of the denied credit. The Tax Court denied the taxpayer’s adjournment request, although the Federal Court of Appeal allowed it pending passage of the proposed amendments.

87 The saga of the non-resident trust provisions began when the proposed rules were announced in the 1999 federal budget. The first version was introduced on June 22, 2000. The Department of Finance announced that it was seeking comments by September 1, 2000; legislation was to be tabled in Parliament in 2000, which was to become effective as of January 1, 2001. A revised draft was released for public comment on August 2, 2001. A third draft was released as a notice of ways and means motion on October 11, 2002 and specified that the rules would have effect for 2003 and subsequent taxation years. A fourth version was tabled on October 30, 2003 as a notice of ways and means motion to take effect for taxation years beginning after 2002. A fifth version was introduced by the minister of finance on November 9, 2006. Bill C-10 was introduced in 2006 and died while it was before the Senate in 2008.

88 See supra note 11.
RECTIFICATION OF TAX MISTAKES VERSUS RETROACTIVE TAX LAWS ■ 585

USING RECTIFICATION ORDERS TO COUNTER RETROACTIVE TAX LAWS?

In a 2010 article on rectification, Boidman et al. noted:

Where a rectification order is sought as a result of retroactive tax legislation, the doctrine, as an equitable remedy, should be interpreted broadly, should not be constrained by artificial limitations, and should be employed where needed to prevent tax authorities from relying upon written instruments that do not reflect their authors’ clear underlying intentions. As indicated in Amalgamation of Aylwards (1975) Ltd., Re, at paragraphs 38 and 41, rectification remedies may be applied, in appropriate cases, to “novel situations.”

No prior writings appear to have explored this provocative statement. This part of the article takes up the challenge to investigate whether the remedy of rectification—as well as, more generally, the law of mistake—can and should be used to counter the effect of retroactive tax laws. We pose two questions. First, would a provincial court grant a rectification order; and second, should a provincial court grant a rectification order to counter the effects of retroactive tax legislation? We move forward with the debate mindful of the rather colourful language used by Davis J in Mendel, asserting that “[i]t is a well-known rule that ‘Equity and Income Tax are strangers,’” and that “[i]t is thus well recognized that, in taxing statutes, there is no room for equity.”

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89 Boidman et al., supra note 1, at 147-48. In Amalgamation of Aylwards (1975) Ltd., Re (2001), 16 BLR (3d) 34 (NLSC) (a non-tax decision), the court relied on Juliar, supra note 16, to change the format used for an amalgamation. The court also retroactively issued new shares. The decision includes the following: “Juliar v. Canada (Attorney General) . . . permitting rectification of a corporate transaction so as to accord with an original intent to avoid income tax liability, illustrates that the doctrine of rectification may, in appropriate cases, be employed in novel situations in the corporate sphere to ensure that instruments evidencing corporate transactions comport with the real intentions of their creators. . . . In the context of the current case, what is significant about Juliar is that the court was prepared to allow rectification where the mechanism chosen to reach an intended result was mistakenly used. The parties were allowed effectively to restructure the transaction by using a different mechanism, provided of course that the result obtained by the use of the new mechanism was in accordance with the original common intention of the parties. In achieving rectification, the parties were permitted, retroactively, to create new, or modify existing, instruments to achieve their original purpose where the original instruments could not do so as a result of a common mistake, and this was so even though the parties may not have adverted to the appropriateness of the use of the specific mechanism that had originally been mistakenly chosen to effectuate their original intention.” Aylwards, supra, at paragraphs 38 and 41 (emphasis added).

90 Mendel, supra note 14, at 122. Davis J quotes in part from Finlay J in Kliman (HM Inspector of Taxes) v. Winchworth (1933), 17 TC 569, at 572 (KB): “There is no room, of course, in a taxing Act for equitable considerations, if by ‘equity’ the Commissioners meant there, as I suppose they did, considerations of what they conceived would effect a just result in all the circumstances. It is, of course, for the legislature and not for the Courts to consider matters of that sort.”
Would a Canadian Court Rectify Contracts Affected by Retroactive Tax Laws?

In several ways, there is an ill fit between the equitable remedy of rectification and its potential application to retroactive tax legislation.

First, traditionally rectification orders generally apply—as does the common law of mistaken assumptions—to mistakes concerning circumstances believed to be in existence at the time the contract is created. The law of frustration, on the other hand, applies to assumptions concerning future circumstances that prove to be incorrect. In other words, when a taxpayer engages in tax planning, he or she relies on current tax laws to generate a hoped-for tax outcome. The documents hence reflect the accurate and true agreement between the taxpayers at the time the transaction was entered into. Retroactive tax laws occur at some future point, and hence the taxpayer did not make a current mistake. Rather, the taxpayer’s tax plan was “frustrated” by a subsequent event that is more similar to an act of god (or some other unexpected event) that was difficult for the taxpayer to envisage at the time of entering into the transaction.91

The law of mistake (including the equitable remedy of rectification) has developed in a distinct (albeit related) fashion from the law of frustration.92 Hence, a court might refuse to apply a rectification order surrounding a mistake that arose as a result of a tax-law change that occurred in the future. Alternatively, and as explored by the US District Court in Neal, discussed below,93 since a retroactive law operates

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91 The remedy in the case of retroactive legislation would be to allow the taxpayer either to redo the transaction in such a way as to permit the transaction to occur in a manner that would achieve the desired tax effect, or to unwind the transaction. See Di Battista, supra note 58, at paragraphs 6 and 8, where Campbell J makes the following comments: “As set out in Attorney General of Canada v. Juliar . . . once the Court is satisfied that the true agreement between the parties (which is based on the transaction not attracting or at least minimizing income tax) is frustrated, rectification may be permitted to reflect the transaction as intended. . . . The Court must (a) make a finding of unintended mistake; (b) exercise discretion which discretion can include, ‘. . . enabl[ing] the parties to obtain a legitimate fiscal advantage which it was their common intention to obtain at the time of the execution of the document.”

92 It is not our intention to discuss the law of mistake in this article other than in the limited context of pointing out that the doctrine of mistake, like rectification, could have potential application, assuming that a taxpayer enters into a contract with the primary intention and agreement to obtain a specific tax result, but owing to a mistake the tax result is not achieved. For example, many of the cases under discussion involved parties who were not at arm’s length and who both anticipated the same beneficial tax outcome. The mistake was common to both parties. The remedy is to void the contract ab initio, and hence the transaction should be unwound. As discussed, a prerequisite for relief as to mistake at common law is that the mistake is as to existing facts or laws. The circumstances in which a contract will be voidable in equity are wider, and the courts “will afford relief in any case where it considers that it would be unfair, unjust or unconscionable not to correct it.” For a useful discussion of these issues, see Terry S. Gill, “The Tax Advisor’s Tool Box: Repairing Tax Problems,” in 2005 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2005), 14:1–46, at 14-33.

93 See infra note 100 and the related text.
on a fiction (in that the taxpayer runs afoul of a rule that it is deemed to have come into effect at a past date and hence applies to past behaviour), then similarly the state of affairs and the intentions of the taxpayer can be deemed to have occurred at the time the new retroactive tax law takes effect (a law that was unknown to the parties at the time, so that they were mistaken as to its existence). In this way, the law of mistake might be able to address retroactive tax laws under conventional doctrine, in that it assists parties when they were under a mistaken belief as to what they perceived to be the current state of the law (since it turned out not to be what was assumed at the time of the transaction, owing to the retroactive tax law).

Second, on a related point, it is not clear that a court would accept a taxpayer plaintiff’s claim for relief from retroactive tax legislation since the circumstances may not fit within the four traditional requirements for rectification—namely, the existence of a prior agreement, a common intention, a final document that did not properly record the intention of the parties, and a common or mutual mistake.94 With respect to the third requirement, a court may hold that the final document did indeed reflect the intent of the parties and that it is unreasonable to suggest that the taxpayers could not have foreseen subsequent retroactive tax legislation, since such legislation has been deployed in Canada for many decades.

On the other hand, intention is a key element for rectification in tax cases and can apply retroactively. This is not inconsistent with the Supreme Court of Canada’s view of when rectification may be appropriate. In the case of retroactive tax hikes that apply to the general income of individuals, such as that which would have occurred under the now-defunct Quebec proposal, it may be unreasonable to suggest that these individuals should have foreseen this development insofar as Canadian governments have rarely, if ever, deployed these types of retroactive taxes in the past. (For more on this, see the discussion in the next section.) As well, the law of mistake—or more specifically, the law of mistaken assumptions, of which law of rectification forms a part—appears to broadly support relief in many circumstances. Canadian law in this area is often traced to Lord Denning’s 1950 decision in Solle.95 In that case, Lord Denning asserted that there was a long line of precedents that permitted contracts to be set aside on some equitable ground:

A contract is also liable in equity to be set aside if the parties were under a common misapprehension either as to facts or as to their relative and respective rights, provided that the misapprehension was fundamental and that the party seeking to set it aside was not himself at fault.96

94  Armstrong, supra note 1.

95  Solle v. Butcher, [1949] 2 All ER 1107 (CA). Canadian cases that have followed Lord Denning’s view include Toronto Dominion Bank v. Fortin (No. 2) (1978), 88 DLR (3d) 232 (BCSC).

96  Solle, supra note 95, at 1120.
Note, however, that the remedy in these circumstances is one of rescission and not rectification.\(^{97}\)

Although there are no Canadian decisions that have granted a rectification order to counter retroactive tax legislation, Canadian legislation clearly contemplates the potential impact of rectification on retroactive legislation. For example, to counter the tax leakage caused by the infamous Quebec truffle,\(^{98}\) the Quebec Taxation Act was amended retroactively to May 9, 2006. The amendment also provided that no rectification orders would be respected.

The analysis in \textit{Juliar} regarding the effect of the transaction and the parties’ intentions also raises an important issue. What is the real agreement between the parties for which rectification is sought?\(^{99}\) If the agreement is to enable a transaction to proceed in a tax-free manner, regardless of how is to be accomplished, the \textit{Juliar} decision is good authority for the proposition that rectification should be granted to achieve that objective. \textit{Juliar} also provides an argument for untangling a transaction that has been negatively affected by retroactive tax legislation.

\textit{Neal},\(^{100}\) a US District Court decision, although based on unilateral mistake, also supports an equitable claim for rescission in the case of retroactive legislation. In that case, the plaintiff released her contingent reversionary interests in a trust under gift tax legislation, on the basis of her reasonable belief, following the advice of counsel, that a provision then in effect would exact more onerous tax consequences if she did not do so. Congress retroactively repealed the provision, nunc pro tunc. The outcome was that the plaintiff paid gift tax unnecessarily. She sought an order to rescind the release with a view to a refund of the gift taxes paid.

\(^{97}\) We note that rectification as an equitable remedy may provide the appropriate relief where rescission will not. The converse is also true. Rectification will not assist the taxpayer if the issue is that a tax election was not filed or if the transaction cannot be restructured. See, for example, \textit{Stone’s Jewellery}, supra note 42, where the court could not substitute the needed relief (a rollover), but could either void the transaction at common law on the basis of the doctrine of mistake or rescind the contract in equity. As indicated above, the remedies for mistake can be found in both the common law and equity. If the mistake meets the test under common law, the contract is void. If the mistake meets the test in equity, the contract is voidable.

\(^{98}\) The Quebec truffle was an interprovincial tax-planning arrangement promoted by tax practitioners where the result was that no or minimum provincial income tax was paid. The arrangement was facilitated by an election at the federal level, which in most provinces meant that the election was also effective for provincial tax purposes. Because Quebec collected its own taxes, revenue authorities were misled into believing that provincial tax was being paid in another province. An estimated $500 million in tax revenues was lost as a result of the Quebec truffle. See Sylvain Fleury, \textit{Abusive Tax Planning: The Problem and the Canadian Context}, Library of Parliament Background Paper no. 2010-22-E (Ottawa: Library of Parliament, 2010), at 5-8.

\(^{99}\) The point has been aptly summarized by Joel Nitikman, “Many Questions (and a Few Possible Answers) About the Application of Rectification in Tax Law” (2005) 53:4 \textit{Canadian Tax Journal} 941-73.

\(^{100}\) \textit{Neal v. US}, 98-2 USTC paragraph 60,318 (WD PA). The decision was affirmed by the US Court of Appeals, Third Circuit: 99-1 USTC paragraph 60,343.
The plaintiff’s key argument was based on a mistake of law—specifically that the release was executed in reliance on a statute that, in legal effect, did not exist after Congress retroactively repealed the legislation. The government argued that the plaintiff’s release was executed in accordance with the federal law as it existed at the time of the transfers and therefore could not be the result of a mistake of law. The court disagreed, and permitted the taxpayer to rescind her gift and collect her tax refund. Although Neal is a mistake-of-law case, the court is clearly of the view that a mistake as to the future of a law that is later implemented retroactively is not a bar to the granting of equitable relief.

In summary, as one commentator has noted:

[A]ny time the parties intend to achieve a particular tax result and actually consider that tax result, rectification of the transaction as a whole will be permitted even if the executed documents contain the words they were intended to contain and even if the mechanism chosen to obtain the tax result turns out to be the wrong mechanism. There is no true distinction between a mistake as to legal consequences and a mistake as to legal effect [in tax cases]: the court that hears the application must simply be vigilant and ensure that the parties are not merely changing their minds to escape what has turned out to be a plan that they would rather not carry out for commercial reasons.

Should Rectification Be Permitted To Undo Retroactive Laws?

On the basis of Canadian constitutional-law principles, the right of provincial courts to make rectification orders is unambiguous. If one applies basic rule-of-law principles as espoused by Raz, Hart, Fuller, and Hayek, the law should be clear, non-retroactive, stable, fair, and open to adjudication before an independent tribunal. In addition, a tax system should promote institutional integrity and respect the distinct roles of the legislature and the judiciary. A tax system should be structured to uphold core rule-of-law principles. Although the precise content of these principles is the subject of continuing debate, there is consensus that the law should provide certainty for private transactions and respect individual autonomy.

Tax laws apply once private-law rights have been determined. Private-law rights may be affected by equity. Equity is inherently rooted in facts—the particular aspects of a case that render rigid application of legal rules inadequate. The previous analysis shows that the equitable remedy of rectification may be deployed in areas where the parties’ reasonable intent was thwarted by a mistake, including potentially in areas where tax legislation has retroactively changed the reasonable assumptions held by the parties.

101 The following is excerpted from the decision of the District Court, supra note 100, at 86,523: “The government states that in ‘order for a gift to be incomplete because of mistake, a mistake of law must be a present mistake about the state of the law when the gift is made. A mistake about the future of the law or the future of the facts will not cause a gift to be incomplete.’”

102 Nitikman, supra note 99, at 963.
What are the guiding principles for determining whether rectification (or rescission) should be permitted in these circumstances? We have drawn on a number of perspectives to attempt to answer this question.

- **Non-retroactive tax planning.** Rule-of-law principles make it clear that the law should generally be non-retroactive. Judicial reasoning is also clear that the remedy of rectification should not be used for retroactive tax planning. This “would run contrary to the well-established rule in tax cases that the courts do not look with favour upon attempts to rewrite history in order to obtain more favorable tax treatment.” As discussed, there should be no question of retroactive tax planning where a document is amended merely to reflect the intention of the parties to affect a transaction in a tax-favoured manner. This is arguably true even if the unintended tax liability is the result of retroactive legislation.

- **Fairness.** Fairness is a central guiding principle and a substantive goal of our legal order. But what does “fairness” mean in the context of a tax system? If retroactive legislation is considered unfair, is there a fairness argument for rectifying a transaction that has been negatively affected by retroactive tax legislation when the intention of the parties is to effect the transaction in a tax-free manner? If retroactive legislation results in the collection of more taxes instead of a refund to the taxpayer, the CRA would be quick to assert its claim and the court to enforce it.

  However, another fairness argument goes to equal access to the rectification remedy. Rectification orders are made by provincial courts and affect federal taxes. Thus, the remedy may be provided to some but not all taxpayers, depending on the prevailing views of a particular provincial court.

- **Substance over form.** As discussed within the cases, tax legislation is designed to attach fiscal consequences to identifiable and “real” transactions and events. In Canada, tax consequences are generally based on legal substance. For example, the definition of “income” in the federal Income Tax Act is a legal definition that is informed by accounting practice. The legal substance

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103 According to Dworkin, principles are not laws, so it is not necessary to find legislative or judicial authority for them in order to prove their existence. Principles exist independently of laws, although many laws and judicial decisions may be reflections of principles. In a conflict between two competing rules, a principle or principles may assist in tipping the scales one way or another. See Ronald Dworkin, *Taking Rights Seriously* (Cambridge, MA: Harvard University Press, 1978).

104 McPeake, supra note 31.

105 Bramco, supra note 14 (CA), at paragraph 9.

106 Section 3 of the Act.

107 See *Canderel Limited v. The Queen*, 98 DTC 6100 (SCC), holding that the determination of profit is a question of law that may be informed by “well-accepted business principles” that include generally accepted accounting principles (GAAP).
of a particular transaction or relationship is determined by reference to the substantive legal rights and obligations that are created:

The true principle, then, is that the taxing Acts are to be applied in accordance with the legal rights of the parties to a transaction. It is those rights which determine what is the “substance” of the transaction in the correct usage of that term.108

The Canadian tax system includes a general anti-avoidance rule (GAAR) to give effect to substance over form in certain circumstances. Rectification, arguably, also gives effect to the substance of the transaction regardless of its form. For the same reason that there is ongoing debate about establishing clearer guideposts for imposing a GAAR, there may be arguments for establishing similar guideposts to determine when the remedy of rectification may or should be granted in the context of retroactive tax laws.

The role of the judiciary. The tax system should respect the constitutionally distinct roles of Parliament and the judiciary. Parliament may pass retroactive tax laws, but judges have the right to provide equitable relief at their discretion. However, the current law forces judges into a policy-based inquiry in a tax system designed to achieve multiple, broad, and often conflicting objectives. Owing to these complexities, a rectification order may also result in a breach of the rule of law in favour of a taxpayer (for example, by ignoring legislative intent to give effect to retroactive laws), and therefore may by implication be contrary to the rule-of-law expectations of other taxpayers.109 Moreover, on occasion Canadian governments have passed retroactive tax laws to overturn judicial decisions that they were unhappy with, thereby precluding the ability of the taxpayer to arrive at a “fair” outcome through a hearing before an independent tribunal.

Economic efficiency. Lurking in the background of the previous analysis are questions as to whether retroactive tax legislation is economically harmful or beneficial. Proponents of retroactive tax laws often concede that the approach is unfair to taxpayers, but maintain that the overall effect does not unduly harm efficiency interests.110 The obvious goals of most retroactive tax laws are to inhibit abusive tax-planning efforts and to raise revenues from transactions that would otherwise remain tax-free. But do such tax reforms backfire by unduly inhibiting economic activities? Revenue collection will be inhibited to the extent that overall economic activity is reduced, frustrating one of the main goals of retroactive tax laws.


109 Comment by John Prebble of the Faculty of Law, Victoria University of Wellington, New Zealand, in private correspondence to the authors dated July 11, 2012.

On the one hand, proponents of retroactive tax legislation have argued that the approach encourages an overall efficient outcome, and thus taxpayers who are adversely affected by the change should not be compensated. They argue that compensation or grandfathering is normally not required because taxpayers incorporate into their transactions the risk of a future tax-law change.\textsuperscript{111} Thus, the price of a given transaction already takes into account the risk of a future legal change; the greater the aggressiveness of the tax planning, the argument goes, the greater the price (or risk premium) that should be incorporated into the transaction.

On the other hand, Feldstein\textsuperscript{112} and other writers have argued that retroactive tax legislation encourages “inefficient precautionary behavior.” Taxpayers incur costs and take steps to hedge against the risk of future changes that potentially raise their tax liabilities. Under this view, these costs outweigh the perceived benefits derived from retroactive tax legislation. That is, in addition to incurring costs to protect against the risk of “overtaxation” under current tax laws (that is, the risk that the taxpayer’s tax liability will be reassessed), taxpayers incur costs associated with guarding against the risk of “overtaxation” by future tax laws that reach back and alter prior tax laws. This latter risk can significantly increase transaction costs in part because it is so vague and uncertain; it is difficult to hedge against undefined risks. This raises an important question concerning how governments should allocate the risk of unforeseen tax liabilities (and other transaction costs) among differently situated taxpayers.

As explored below, a focus on the difference between targeting perceived planning abuse and targeting general individual income, as well as the risk surrounding the potential magnitude of the loss, suggests that retroactive tax hikes on individual income, such as the now-withdrawn Quebec proposal, can carry significant economic costs. This will be illustrated by comparing the plight between two taxpayers—a corporate taxpayer facing a retroactive tax law that reaches back in time and targets a tax plan that is ripe for a challenge under GAAR, and an individual taxpayer faced with a general retroactive tax increase to her high marginal income.

Transaction cost analysis can help us to understand the economic implications of retroactive tax hikes on these differently situated taxpayers.\textsuperscript{113} As


\textsuperscript{113} For a similar approach, see Avishai Shachar, “From Income to Consumption Tax: Criteria for Rules of Transition” (1984) 97:7 Harvard Law Review 1581-1609, at 1590-99 (discussing which taxpayer should bear the risk of a retroactive tax law); and Graetz, supra note 110 (suggesting that the magnitude of the risk of large losses that cannot be readily insured is an important factor for consideration).
explained by Coase, transaction costs are the costs associated with discerning a price on a given exchange; these costs include costs of negotiating the exchange, preparing the necessary contracts, and creating arrangements to resolve disputes. Coase asserted that these costs are heavily influenced by (formal) legal rules. This results from the fact that an exchange really involves an exchange of rights to perform certain actions (and not merely the trade in particular goods and services), and these rights are largely delineated by law. According to Coase, legal rules should be justified to the extent of their ability to allocate rights to the most efficient right-bearer.

Building on Coase, Calabresi concluded that the optimal tort liability regime is one that minimizes the sum of the cost of accidents and the cost of avoiding accidents. He noted that this regime should generally assign tort liability to the “cheapest cost-avoider,” namely, the party that can minimize negative externalities (harms to third parties) most efficiently. Hence, Calabresi focused to a large extent on who should bear the risk of liability.

From this, we return to our two hypothetical taxpayers, the corporation and the individual taxpayer, to see how they bear risks associated with retroactive tax laws. Those who claim that retroactive tax laws do not harm efficiency interests essentially rely on the view that prices incorporate the risk of legal change, including new retroactive tax laws. With respect to the corporate taxpayer, it has engaged in tax planning of a type that raises the risk of audit and/or retroactive tax legislation to

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114 R.H. Coase, “The Problem of Social Cost” (October 1960) 3 Journal of Law & Economics 1-44, at 15. Coase describes these costs as the costs “to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on.”

115 Ibid., at 15-16 and 43-44.

116 Under the Coase theorem, supra note 114, when rights are well defined and transaction costs are zero, resource allocation is efficient and independent of the pattern of ownership (that is, it does not matter which party assumes liability for the effects on the other party). Coase readily recognized that transaction costs will always exist and thus will play a role in determining how resources are allocated. For discussion, see, for example, Yoram Barzel, *Economic Analysis of Property Rights* (Cambridge, UK: Cambridge University Press, 1997), at 77.


118 Normally, a party that “produces” a harm is in a better position to know what measures to take to reduce harm, and can be the cheapest avoider. Following Calabresi’s views, Logue and Slemrod, supra note 117, at 781, maintain that, with respect to developing an optimal tax remittance regime, tax liabilities should be assigned so as to minimize the overall social costs of compliance and administration, for a given level of achievement of the tax law’s desired distributional and revenue goals.
address the planning (since the corporate taxpayer understands that such legislation has been enacted in the past). In these circumstances, the price of the company to its owners (that is, the share price based on the net present value of the company’s after-tax profits) should reflect information available to investors about this tax future. In other words, the retroactive tax hike is already priced by the market, and investors expect that the potential tax liability of a retroactive tax increase will not unduly affect the firm’s return.

In contrast, consider the hypothetical individual, mentioned in the introduction to this article, who gifts her cottage in Quebec and is faced with retroactive tax laws that apply generally to income, and thus increase the tax liability associated with the gift. Does the valuation of the gift already reflect potential retroactive tax increases to individual income? There does not appear to be any evidence that either the federal government or a provincial government has enacted such a tax in the past, unlike retroactive taxes directed at abusive, potentially GAARable tax planning. Hence, neither the individual nor other participants in the real estate market can hold a reasonable belief that such a tax increase will take place. Moreover, consider the potential magnitude of the loss facing the taxpayer. A taxpayer could dispose of a large asset, such as the gifted cottage, resulting in a gain that subjects the individual to the higher marginal tax rates associated with the retroactive tax law (because capital gains are included in the income tax base), leading to a significantly higher tax bill. Depending on the proposed rates and marginal amounts of income affected by the retroactive tax laws, an individual’s expected retirement savings could be materially

119 Now that the cat is out of the bag, so to speak, and Quebec has attempted to introduce such retroactive tax laws (before subsequently withdrawing them), it is interesting to note how this could vary traditional expectations. The traditional contract between individual taxpayers and the government has been one where the worker is not faced with past-era tax liabilities for his or her income-generating activities (with the exception of those investors who faced reduced returns from retroactive tax increases on corporations that reduced the value of the investments held by these individuals). Both sides trusted in this traditional contract. However, the announcement by the Quebec government of the general retroactive tax hike has placed individual taxpayers in an environment of greater risk, since they will now hold reasonable beliefs that such a retroactive tax hike could occur in the future. That is, these individuals no longer trust in the original contract and, as a result, risk uncertainty is enhanced and the efficiency-reducing activities discussed above are encouraged (for example, a high-income individual could deal with the risk by leaving the province and hoping that another province will not follow suit). In this sense, it no longer matters whether at some point in the future either the current Quebec government or a successor government proposes or enacts a general retroactive hike. Under this view, governments should consider the costs associated with breaking and undermining trust in traditional political promises as part of their analysis of potentially deploying different types of retroactive tax laws. For views on how reductions in trust in contracting lead to higher transaction costs and reduced efficiencies, see Oliver E. Williamson, “Credible Commitments: Using Hostages To Support Exchange” (1983) 73:4 American Economic Review 519-40; Douglass C. North and Barry R. Weingast, “Constitutions and Commitment: The Evolution of Institutional Governing Public Choice in Seventeenth-Century England” (1989) 49:4 Journal of Economic History 803-32; and Avinash K. Dixit, The Making of Economic Policy: A Transaction-Cost Politics Perspective (Cambridge, MA: MIT Press, 1996), at 62-80.
reduced by this new tax liability. Returning to Feldstein’s concern surrounding inefficient precautionary behaviour, high-income taxpayers in Quebec must now incur Coasean transaction costs to identify and potentially defend their tax liabilities against the risk of retroactive taxation on their income. Faced with such a possibility, high-income and other taxpayers may hold assets longer than their productive use, ensure that their sales are spread out over different fiscal periods (to reduce high marginal incomes subject to retroactive taxation), work less to lower their incomes below levels of perceived threat, exit the taxing jurisdiction, or engage in other precautionary behaviour.

When we compare the two hypothetical taxpayers, it is clear that the corporate taxpayer is in a better position to bear the risk of a retroactive tax increase targeting potentially GAARable tax planning. The individual taxpayer is not so well prepared because it is more difficult for her to protect against the risk of a large tax liability at some unforeseen date. Assuming that she has knowledge of past hikes and takes this risk seriously, as suggested above she may engage in behaviour that reduces economic productivity. Moreover, consider the plight of other market participants in a world where retroactive taxes potentially apply to general income; the price of many investment assets will be affected by such a hike. For instance, the price of building a new cottage as well as other assets that generally appreciate in value (such as paintings) could reflect the expected legal change. All of this suggests that governments should take into account the potential adverse economic effects of a retroactive tax increase to general income, which will encourage more efficiency losses than those associated with targeting GAARable planning. A government will need to weigh the value of expected new revenues resulting from the general retroactive income taxes against these economic costs.

Finally, note that the traditional retroactive tax-law regime performs the additional function of trying to deter abusive tax planning, which in itself leads to deadweight losses as economic resources are directed at tax planning instead of, say, investing in technological research. To the extent that these laws achieve this deterrence goal, then retroactive tax laws may promote further efficiencies. In comparison, retroactive taxes that target general income do not deter any economically harmful activities, although they may encourage unproductive activities.

For these reasons, to promote optimal outcomes, assignment of liability for retroactive tax laws should account for the twin goals of revenue collection and deterrence.

120 For instance, Graetz, who argues that retroactive tax laws generally do not lead to efficiency concerns, concedes that the magnitude of the risk of large losses that cannot be readily insured is an important factor in considering whether retroactive tax laws unduly harm economic efficiency. See Graetz, supra note 110, at 1836-37.

121 In fact, it is not clear whether the Canadian government collects any revenues from reassessments arising from retroactive tax legislation—at least, the government does not maintain records of such revenue collection. Even if no significant revenues are collected, retroactive tax laws can be justified on the basis of their prophylactic nature as long as they serve to deter aggressive tax planning.
of abusive tax planning. If a government’s retroactive tax legislation is not limited to targeting abusive, potentially GAARable tax planning, rectification remedies or the law of mistakes could refine the assignment of tax liability to its optimal level.

CONCLUSION

As seen in the development of case law in the area, the judiciary has used its equitable role to provide unprecedented relief giving rise to favourable tax consequences to the taxpayer. This relief is based on the view of the judiciary that it should fix tax mistakes whether they result from the agreement itself or from the form in which the agreement is implemented. Would a provincial court judge permit rectification (or rescission) of a transaction affected by retroactive tax legislation? The answer is, “Maybe.” Should the remedy apply to counter the effects of retroactive legislation? We conclude that the answer is, “Yes—in some circumstances.”

Assuming that there are convincing arguments for making rectification orders, does tax policy dictate additional limits? If so, a host of additional issues must be addressed. For example, if limits are to be imposed on rectification in tax matters, what principles should guide them? Would efforts to formalize principles of equity as they affect tax matters run aground against the tradition’s most central tenet that equity “eschews mechanical rules” and “depends on flexibility”?122 This article does not attempt to answer these broader questions in any comprehensive sense, but rather restricts the analysis to answering the following question: In what situations should it be acceptable for the taxpayer to bear the risk of being adversely affected by retroactive legislation?123

123 The Canadian government developed criteria, in its response to the seventh report of the Standing Committee on Public Accounts, for circumstances in which it may be appropriate to adopt retroactive “clarifying” tax laws. While the criteria focused on potential retroactive changes that seek to clarify the interpretation of tax laws, similar considerations could be taken into account by a provincial court in determining whether to grant rectification in respect of retroactive tax laws. According to the government, clarifying retroactive tax laws should be deployed when
- “the amendments reflect a long-standing well-known interpretation of the law by the Department of National Revenue” (that is, the CRA);
- “the amendments reflect a policy that is clear from the relevant provisions that is well-known and understood by taxpayers”;
- “the amendments are intended to prevent a windfall benefit to certain taxpayers”;
- “the amendments are necessary to preserve the stability of the government’s revenue base”; or
- “the amendments are corrections of ambiguous or deficient provisions that were not in accordance with the object of the Act.”

As touched on earlier, courts accept limits on rectification, including situations where the remedy would harm the interests of an innocent third party, or where there has been undue delay in bringing a claim, as well as the conduct of the plaintiff seeking rectification. The analysis suggests that the equitable remedy of rectification, or possibly a broader category of the law of mistaken assumptions, can and should be brought to bear with respect to some categories of retroactive tax laws:

- Minimal retroactivity implies that retroactive tax legislation should be interpreted in a restrictive fashion.
- Minimal retroactivity implies that retroactive tax laws should be effective only against specifically enumerated transactions that the government perceives to amount to abusive tax planning; that is, when the scope of the retroactive legislation is unclear, it should be interpreted restrictively in such a way as to permit rectification of a taxpayer’s transaction.\(^{124}\)
- In accordance with the Supreme Court’s pronouncement on rectification in *Performance Industries*, discussed above, the conduct of the adversely affected party needs to be taken into account; thus, rectification may be considered to be justified for those taxpayers who can establish that they honestly and reasonably relied on earlier tax laws when ordering their fiscal affairs.

The last criterion would provide relief in many circumstances to taxpayers who had not engaged in abusive, potentially GAARable tax planning to reduce their tax liabilities. First, a taxpayer who deploys a potentially GAARable strategy should have a reasonable belief that the strategy could be subject to audit and/or retroactive tax laws (whereas one who has not deployed such a strategy should have a reasonable belief that he or she would not likely be subject to audit and/or retroactive tax laws). Second, the Canadian federal and provincial governments have thus far focused virtually all of their retroactive tax laws on combatting areas of perceived abuse, and hence taxpayers should not hold reasonable beliefs that these governments will enact retroactive tax laws in other areas such as general revenue-raising measures. On a related final issue, retroactive tax measures that apply generally to high marginal incomes are very difficult to foresee, and force taxpayers to engage in inefficient precautionary behaviour that could unduly harm important economic interests.

For these reasons, we think that a provincial court could deploy its equitable jurisdiction to rectify contracts that are affected by, for instance, a general retroactive tax hike on high-income individuals, such as that proposed (and now abandoned) by the

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\(^{124}\) See also Loomer, supra note 76, at 82 (indicating that constitutional scrutiny of retroactive tax laws could involve “weighing such matters as the legislative objective, the rationality of the means employed, and the degree to which the law affirms or repudiates taxpayers’ expectations”).
Quebec government. The Quebec proposal was not directed at abusive, potentially GAARable tax planning, but rather simply reflected the government’s wish to generate new revenues through a retroactive tax increase aimed at a specific category of taxpayers. The Quebec government would presumably try to protect against judicial intervention by passing legislation that denied the ability of taxpayers to use rectification (as occurred with respect to the Quebec truffle matter). It is unclear how this legislation would affect matters outside the province (as in the case of the hypothetical person in the introduction who gifted her cottage located in, say, British Columbia, which triggered the application of the retroactive tax hike in Quebec). A BC court could hold that the Quebec legislation did not apply within its jurisdiction, and hence that the remedy of rescission or rectification was warranted. The Quebec government would then have to determine whether it would tax the proceeds of a transfer that had not occurred.

125 See the discussion in note 9, supra. An earlier publication by the Quebec tax authorities, which was published prior to the proposed tax hike on high income earners, appears to support the view that retroactive tax laws should be deployed only in narrow circumstances for the purpose of combatting abusive tax planning. See Finances Québec, Aggressive Tax Planning, Working Paper (Quebec: Finances Québec, January 2009), at 50-56.

126 See supra note 98 and the related text.
Awareness and Use of Canada’s Children’s Fitness Tax Credit

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P R É C I S
Cette étude porte sur la connaissance et l’utilisation du crédit d’impôt pour la condition physique des enfants (CICPE) du Canada, et se fonde sur les données des déclarations de revenus des contribuables de 2007 à 2009 ainsi que sur les données d’une enquête nationale qui sonde la perception des parents relativement au CICPE. Les données des déclarations de revenus de Statistique Canada nous permettent d’examiner ce que les contribuables ont fait, alors que les données de l’enquête nationale nous permettent d’étudier dans quelle mesure les Canadiens ayant des enfants de moins de 18 ans connaissaient l’existence du CICPE, leur perception de son importance, et son lien dans leur décision d’inscrire leurs enfants à des programmes d’activité physique organisés. Collectivement, ces deux sources de données offrent un portrait plus complet des personnes qui utilisent le CICPE et aident à déterminer les raisons possibles pour lesquelles d’autres ne demandent pas le crédit.

Lors de l’analyse des données des déclarations de revenus, de multiples procédures de régression logistique ont été utilisées pour examiner les associations statistiques entre l’utilisation du CICPE et les montants demandés au titre de ce crédit, et des données socio-économiques et démographiques, telles que le revenu, la province/le territoire de résidence, le milieu de vie urbain/rural, l’âge des parents, le statut d’immigré, la structure familiale, le sexe de l’enfant et le nombre d’enfants.

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Nos résultats démontrent que les familles monoparentales, celles ayant au moins un garçon et celles vivant en milieu urbain étaient plus portées à demander le CiCpE et à demander des montants plus élevés. La probabilité de demander le CiCpE était entre 4 et 30 pour cent plus élevée dans les familles dont les niveaux de revenu annuel étaient supérieurs à 20 000 $ par rapport à celles gagnant moins de 20 000 $ annuellement. Dans la plupart des cas, le montant demandé augmentait également avec la hausse du revenu, de sorte que les familles gagnant de 100 000 à 200 000 $ et celles gagnant plus de 200 000 $ faisaient des demandes au titre du CiCpE qui étaient, en moyenne, de 125 $ et de 250 $ plus élevées, respectivement, que celles gagnant moins de 20 000 $.

Nous avons utilisé des méthodes statistiques semblables pour notre analyse des données d’enquête représentatives à l’échelle nationale, afin de calculer les fréquences et les estimations de la prévalence selon les caractéristiques des participants, et pour vérifier les associations entre la connaissance et la perception des parents à l’égard du CiCpE, et les principales variables sociodémographiques. Nos résultats démontrent que la connaissance du CiCpE était élevée, puisqu’environ 65 pour cent des répondants ont dit avoir entendu parler du crédit. Le sexe, l’âge, l’éducation et le revenu étaient tous des éléments importants liés à la connaissance du CiCpE : les femmes, les parents âgés de 40 à 49 ans, ceux ayant fait des études postsecondaires, et ceux gagnant plus de 40 000 $ annuellement étaient tous plus susceptibles de connaître le CiCpE. Parmi ceux qui connaissaient le CiCpE, moins d’un tiers estimait que le CiCpE les avait motivés ou encouragés, ou leur avait facilité la tâche, à inscrire leurs enfants à des programmes d’activité physique. Nos résultats offrent une information objective concernant l’utilisation du CiCpE et soulèvent des questions concernant l’équité et l’efficacité potentielle du programme. Avec l’instauration de crédits d’impôt semblables au CiCpE fédéral dans d’autres administrations fiscales provinciales, il est de plus en plus important d’évaluer de façon critique ces programmes et de mettre en œuvre les changements nécessaires pour combler leurs lacunes et ainsi maximiser le rendement de cet investissement public.

**ABSTRACT**

This study examines the awareness and use of Canada's children's fitness tax credit (CFTC), using taxfilers' income tax return data from 2007 through 2009 as well as national survey data that explore parents' perceptions of the CFTC. The income tax return data from Statistics Canada allow us to examine what taxfilers did, while the national survey data allow us to investigate the extent to which Canadians with children under the age of 18 were aware of the CFTC, their perceptions of its importance, and its relation to their decisions to enrol their children in organized physical activity programs. Collectively, these two data sources offer a more complete picture of who is using the CFTC and help in identifying possible reasons why others are not claiming the credit.

In the analysis of the income tax return data, multiple logistic regression procedures were used to examine statistical associations between the use of and the amounts claimed for the CFTC and socioeconomic and demographic data, such as income, province/territory of residence, urban/rural residence, parental age, immigration status, family structure, gender of the child, and number of children.

Our results show that families headed by a single parent, those with at least one male child, and those living in urban areas were all more likely to claim the CFTC and claimed greater amounts through the CFTC. The likelihood of claiming the CFTC was between 4 percent and 30 percent greater in families at annual income levels above $20,000.
comparing to those earning less than $20,000 annually. In most cases, the amount claimed also increased with increasing income such that families earning $100,000 to $200,000 and those earning more than $200,000 had CFTC claims that were, on average, $125 and $250 higher, respectively, than those making less than $20,000.

We employed similar statistical methods in our analysis of nationally representative survey data, in order to calculate frequencies and prevalence estimates by participant characteristic and to test for associations between parental awareness and perceptions of the CFTC and key sociodemographic variables. Our results show that awareness of the CFTC was high, with approximately 65 percent of respondents reporting that they had heard of the credit. Gender, age, education, and income were all significantly associated with CFTC awareness: women, parents between 40 and 49 years of age, those with post-secondary education, and those earning more than $40,000 annually were all more likely to be familiar with the CFTC. Among those familiar with the CFTC, fewer than one-third felt that the CFTC motivated them or encouraged them, or made it easier for them, to register their children in physical activity programs. Our results offer objective information regarding the use of the CFTC and raise questions regarding the equity and potential effectiveness of the program. With the spread of tax credits similar to the federal CFTC to other provincial jurisdictions, it is increasingly important to critically evaluate these programs and implement the changes necessary to address their limitations, and thereby maximize the return on this public investment.

**KEYWORDS:** Health ■ Policy ■ Tax Credits ■ Children ■ Youth ■ Tax Expenditures

**INTRODUCTION**

In most, if not all, industrialized nations, rates of physical activity among children and youth are alarmingly low. In Canada, recently released data suggest that fewer than 10 percent of Canadian children and youth meet current physical activity guidelines of 60 minutes of moderate- to vigorous-intensity physical activity daily. Given the health benefits of physical activity and current concerns about rising rates of childhood obesity and associated co-morbidities, increasing participation in

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physical activities among children and youth is now a public health priority in Canada. Researchers and public health decision makers have been exploring the use of economic incentives as a means of encouraging physical activity. An example of such a strategy is the children’s fitness tax credit (CFTC), which was introduced by the Canadian government in 2007. The CFTC allows parents to claim a non-refundable federal income tax credit for fees incurred (up to $500 per child) to register children under 16 years of age in eligible physical activity programs. To qualify, a program must meet several criteria: it must be ongoing (a minimum of eight consecutive weeks’ duration or, for children’s camps, five consecutive days); it must be supervised; and it must promote cardiorespiratory endurance plus at least one other component of physical fitness. There is limited evidence demonstrating the efficacy of such economic incentives in influencing greater physical activity. The effectiveness of fiscal policies in health promotion depends on the behaviour that a particular policy seeks to influence and the structure of the policy. Tax-based measures offer the advantage of administrative efficiency; however, they have inherent limitations owing


4 For a description of the operation of the credit, see Canada Revenue Agency, Line 365—Children’s Fitness Amount (www.cra-arc.gc.ca/fitness/). The age eligibility requirements state that the children must be under 16 years of age or under 18 years of age if eligible for the disability amount at the beginning of the year in which an eligible fitness expense was paid.

5 These criteria reflect recommendations for the design of the program set out in Canada, Report of the Expert Panel for the Children’s Fitness Tax Credit (Ottawa: Department of Finance, 2006). See also CRA, supra note 4.

to the structure of the tax system, including a delay between the time the expense is incurred and the time the tax benefit is received, and the small percentage (for the CFTC, typically 15 percent or less) of fees covered by the credit.7

With costs in forgone tax revenue somewhere between $90 million and $115 million per year, the CFTC represents a substantial investment of public funds.8 Periodic evaluation of this policy is necessary to ensure that

1. it effectively meets its stated objective of facilitating access to physical activity and recreation programs for children and youth;
2. its benefits reach all segments of society; and
3. its benefits exceed the costs

—that is, ensure that the investment is justified. In their recently published scoping review, Faulkner et al.9 assert that there is insufficient evidence to support recommendations for specific tax credits to promote physical activity. To date, there have been few published evaluations of the CFTC, and only one—by Spence et al.10—examined the uptake of the credit.11 In their early evaluation of the CFTC, Spence et al. found that income was a significant factor in whether Canadian parents were more likely to be aware of and make use of the CFTC, confirming early concerns regarding the equity of the program. However, their study is somewhat limited in that it was based only on self-reported data and therefore is subject to possible bias. Spence et al. focused primarily on the association between income and use of the CFTC, with a very limited examination of parental perceptions about the tax credit. In their discussion, they highlighted the need for access to objective claims data from the Canada Revenue Agency (CRA).

The objective of this study is to assess the awareness and use of the CFTC by examining rates of use by identifiable characteristics of taxfilers and exploring parental perceptions of the CFTC as they relate to parents’ decisions to enrol their children in organized physical activity programs. The impact of the CFTC ultimately depends on its effect on children’s rates of physical activity and health status. However, accurately measuring this effect presents significant challenges, particularly in

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8 Canada, Department of Finance, Tax Expenditures and Evaluations 2010 (Ottawa: Public Works and Government Services Canada, 2010), table 1, at 15.
9 Faulkner et al., supra note 3.
10 Spence et al. supra note 6.
11 In addition to the early study by Spence et al., published evaluations include reports by von Tigerstrom et al., supra note 3, and Larre, supra note 7.
the short term, when the health benefits of increased physical activity may not yet have manifested. Awareness and use of the credit are necessary, though not sufficient prerequisites, to the effectiveness of the program.

This study is, we believe, the first to use federal tax return data to examine the CFTC. In contrast to self-reported data collected via survey methods, the use of tax return data allows us to provide detailed and more accurate information on taxfilers, the credit, and the amounts claimed. Our study makes use of a large sample size, the ability to study multiple taxation years, and background taxfiler data (such as the size and profile of the family, urban/rural residence, province/territory of residence, immigration status, and household income) to provide a comprehensive examination of the CFTC. The use of tax return data is enriched with the addition of survey data pertaining to parental awareness, perceptions, and motivations related to the credit. Specifically, we identify the sociodemographic characteristics that influence perceptions of the CFTC, and compare the perceived importance or value of the CFTC with other factors (such as availability of organized programs) that may affect participation in physical activity. The combined presentation of the federal tax data and survey data provides unique and important insights into the public perception and use of the CFTC.

**METHODOLOGY**

Data from two sources were analyzed to examine the awareness and use of the CFTC in the years immediately following its implementation.\(^\text{12}\) Federal income tax return data compiled by Statistics Canada for the 2007 through 2009 taxation years\(^\text{13}\) were accessed in order to obtain information regarding rates and amounts of CFTC use and the demographic characteristics of the taxfilers claiming the credit. In addition, nationally representative survey data collected through the Canadian Fitness and Lifestyle Research Institute (CFLRI)\(^\text{14}\) were analyzed to assess the general awareness of the CFTC, along with the parents’ perceptions and motivations relating to their children’s participation in eligible programs. The income tax return data allow us to examine what taxfilers did, while the national survey data allow us to investigate the

\(^{12}\) Ethical approval for this study was granted by the University of Saskatchewan Behavioural Research Ethics Board.


\(^{14}\) Canadian Fitness and Lifestyle Research Institute, *2008 Physical Activity Monitor: Bulletin no. 1, “Methodology”* (Ottawa: CFLIR, 2009). The PAM is an ongoing nationwide telephone survey of physical activity conducted by the CFLRI and is subject to review by a departmental Research Ethics Board at York University.
extent to which Canadians with children under the age of 18 were aware of the CFTC and perceived it to be important. Collectively, these two data sources offer a more complete picture on who is using the CFTC and help in identifying possible reasons why others are not claiming the credit.

**Data Sources**

**Tax Data**

Federal income tax return data for the 2007 through 2009 tax years were accessed through Statistics Canada’s longitudinal administrative databank (LAD). The LAD is a random 20 percent sample of the tax-filing population constructed from the annual T1 family file (T1FF) and the longitudinal immigration database. Detailed information regarding the construction of the LAD is available elsewhere.15 Individuals are selected for inclusion in the LAD on the basis of their social insurance number (SIN) and, once selected, remain in the sample as long as they appear on the T1FF. Individual data across years are linked by a unique LAD identification number in order to create a longitudinal profile of each individual. The LAD is augmented each year so that it consists of approximately 20 percent of taxfilers for every year.

The LAD is based on the census family concept (one or more parents and children living at the same address) and is organized into four levels of aggregation: individual, spouse/parent, family, and child(ren) levels. Tax families are created from information in personal income tax returns. Both legal and common-law spouses are attached by the spousal SIN listed on the tax form, or by matching based on name, address, age, sex, and marital status. Children are identified through a similar algorithm and supplementary files.

The sample in our study was restricted to families with children under the age of 18 for which LAD tax data were available for the study period, resulting in a sample of approximately 3.4 million taxfilers. In instances where more than one member of a family was included in the database, the parent was chosen; if both were parents, the higher-income person was chosen.

**CFLRI Survey Data**

A set of questions specific to the CFTC was developed by the CFLRI, in collaboration with the research team, for inclusion in the 2009 and 2010 Physical Activity Monitor (PAM), in order to assess parents’ awareness and perceptions of the CFTC and its influence on their decisions to enrol their children in organized physical activity programs at a population level16 (table 1). The methodology used in the PAM is detailed elsewhere.17 Data were collected from June 1, 2009 until August 31, 2010

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15 See supra note 13.

16 The PAM, supra note 14, is based on a nationally representative sample such that, when the data are analyzed using sample weights (as was done in this study), the estimates produced represent results for the total population.

17 Ibid.


### TABLE 1  Questions About the Children’s Fitness Tax Credit Included in the 2009 and 2010 Physical Activity Monitor

<table>
<thead>
<tr>
<th>Questions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. In the past 12 months, has your child’s activity level increased, stayed the same, or decreased?</td>
<td></td>
</tr>
<tr>
<td>2. Have you ever heard of the child fitness tax credit?</td>
<td></td>
</tr>
<tr>
<td>3. (If yes to question 2) Would you tell me what is the child fitness tax credit?</td>
<td></td>
</tr>
<tr>
<td>4. Have you used this credit on your, or your spouse’s (2007, 2008) personal income taxes?</td>
<td></td>
</tr>
<tr>
<td>5. Do you plan on using this credit on your, or your spouse’s upcoming (2008, 2009) personal income taxes?</td>
<td></td>
</tr>
<tr>
<td>5a. In the past 12 months, how much did you spend on each of your children’s registration or membership fees for physical activity or sport?</td>
<td></td>
</tr>
<tr>
<td>5b. (If yes to question 4) How much did you claim per child as a child fitness tax credit on your (or your spouse’s) form last year (2007, 2008)?</td>
<td></td>
</tr>
<tr>
<td>5c. (If yes to question 5) How much do you intend to claim per child as a child fitness tax credit on your (or your spouse’s) upcoming (2008, 2009) tax form?</td>
<td></td>
</tr>
<tr>
<td>6a. On a scale from 1 to 5 where 1 represents not very important and 5 represents very important, how important do you think the child fitness tax credit is to increasing physical activity among Canadian children?</td>
<td></td>
</tr>
<tr>
<td>6b. Ranking on a scale from 1 to 5 where 1 represents the least important and 5 represents the most important, how would you rank the following for increasing participation in organized sport or physical activity for your child(ren)?</td>
<td></td>
</tr>
<tr>
<td>a) sport and recreation facilities</td>
<td></td>
</tr>
<tr>
<td>b) convenient and accessible programming</td>
<td></td>
</tr>
<tr>
<td>c) the child fitness tax credit</td>
<td></td>
</tr>
<tr>
<td>d) tax benefits to support your child’s participation</td>
<td></td>
</tr>
<tr>
<td>e) coaching or instruction</td>
<td></td>
</tr>
<tr>
<td>f) school or after-school programs</td>
<td></td>
</tr>
<tr>
<td>g) opportunities for free play</td>
<td></td>
</tr>
<tr>
<td>7a. Motivated or encouraged you to register your child(ren) in physical activity or sport?</td>
<td></td>
</tr>
<tr>
<td>7b. Made it easier to register your child(ren) in physical activity or sport?</td>
<td></td>
</tr>
<tr>
<td>7c. Allowed you to register your child(ren) when you wouldn’t have otherwise been able to?</td>
<td></td>
</tr>
</tbody>
</table>

*a The Physical Activity Monitor is a nationwide telephone survey conducted by the Canadian Fitness and Lifestyle Research Institute (CFLRI), based in Ottawa. These questions were designed by the study team in collaboration with the CFLRI.*

using a computer-assisted telephone interview system. The sample was selected using random-digit dialing from household-based telephone exchanges, and the sample selected was roughly proportional to the population in each province and territory. Respondents were selected at random from all individuals aged 15 years or older in the household. For the 2010 PAM, a two-stage selection process was used, where a parent or guardian was randomly selected on the basis of the accepted nearest-birth method. The overall survey response rate was approximately 41 percent. The sample size for the PAM was 8,000 over the two years (4,000 per year), of which 2,394 were parents of children under the age of 18 and therefore eligible for this study.
Data Analyses

All data tabulation and regression analyses of the LAD income tax data were carried out by Statistics Canada personnel using analytical programs provided by the research team. Descriptive statistics of CFTC claims across various socioeconomic and demographic variables were analyzed for 2007 through 2009. Multivariable logistic regression procedures were used to estimate the relative odds of CFTC use across the independent variables of interest (adjusted odds ratios \([OR_{adj}]\)). An \(OR_{adj}\) greater than 1 indicates a positive association between the use of the CFTC (the dependent variable) and the independent variable in question—that is, the odds of claiming the CFTC increase given a change in the independent variable—all other covariates being held constant. Conversely, an \(OR_{adj}\) less than 1 indicates a negative association between the use of the CFTC (the dependent variable) and the independent variable in question, all other covariates being held constant.18

The continuous dependent variable describing the amount claimed through the CFTC was modelled using multivariable linear regression procedures. In all analyses, the independent variables of interest were selected a priori on the basis of theoretical considerations and the data available within the LAD. These included

- family income (a seven-level categorical variable based on after-tax household income),
- province/territory of residence,
- urban/rural residence (a six-level categorical variable reflecting the size of the urban/rural area, based on the postal code and its associated area size rank (ASR) code),
- family structure (single/dual parent),
- male child in the family (yes/no),
- prior CFTC claim (yes/no, for 2008 and 2009 data), and
- time (indicating years since the CFTC came into effect).

The number of children in the family and parental age were also included in the regression models as control variables. Time was modelled as a continuous variable, with the 2007 taxation year taking a value of 0 and each subsequent year taking the corresponding value (2008:1; 2009:2).19

The CFLRI survey data were analyzed using IBM-SPSS Complex Samples® software and procedures20 to account for the multistage design of the survey and associated

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19 In the analysis of the LAD income tax data, stratification was not performed and no weights were applied, since the sampling weight is equal across all units.

sample weights, in order to properly determine the variance estimates for this complex sample. Post-stratification adjustments reflecting non-response and the latest census distributions for age, sex, and households with parents were applied to all sample weights in order to correct for disproportional inclusion of certain groups in the sample relative to the population. Cross-tabulation procedures were used to calculate frequencies and prevalence estimates by participant characteristic. Associations between parental awareness and perceptions of the CFTC and key socio-demographic variables were assessed using multiple logistic regression procedures. In all analyses, 95 percent confidence intervals surrounding the estimates were used to determine significant differences between estimates.

**RESULTS**

Federal income tax data pertaining to the use of the CFTC from 2007 through 2009 are presented in table 2. Overall, the proportion of families claiming the CFTC increased from 31 percent in 2007 to approximately 36 percent in 2009. The use of the CFTC varied across the provinces and territories, ranging from 3.5 percent of families in Nunavut to 38.6 percent of families in Prince Edward Island. Between 2007 and 2009, use of the CFTC increased in all provinces and territories except Nunavut, which saw a 3.1 percent decline in the proportion of families claiming the CFTC. During this period, growth in CFTC claims averaged 15 percent, with the greatest increase occurring among families in the Northwest Territories, at almost 29 percent.

Of the families that claimed the CFTC, approximately 13 percent were headed by a single parent and the majority (approximately 80 percent) had one or two children. The proportion of families claiming the CFTC was considerably higher in dual-parent households compared to single-parent households over the study period (39.5 percent versus 18.0 percent in 2007-2009). Use of the CFTC was highest among parents aged 35-45 years (38 percent to 46 percent per year) and in families with two or three children (41 percent to 47 percent). Fewer than 20 percent of parents under the age of 30 or families with a single child claimed the CFTC between 2007 and 2009. For the 2007-2009 period, the average annual household income of those claiming the CFTC was approximately $115,000 compared to the population average of approximately $80,000 (data not shown). Approximately 46 percent of families claiming the CFTC earned more than $100,000 annually.

The results of the multiple logistic regression analyses are presented in tables 3 through 5. Significant associations were found in the predicted directions between use of the CFTC and most independent variables included in the models.

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21 A more detailed explanation of these procedures can be found in documentation provided by the CFLRI, supra note 14.

22 See Tabachnick and Fidell, supra note 18.
TABLE 2  Use of the Children’s Fitness Tax Credit (CFTC) Among Families with Children Under 18 Years of Age in Canada, 2007-2009

<table>
<thead>
<tr>
<th>2007 $n = 3,455,390</th>
<th>2008 $n = 3,447,140</th>
<th>2009 $n = 3,437,270</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax families</td>
<td>Claimed CFTC</td>
<td>Tax families</td>
</tr>
<tr>
<td>$n$</td>
<td>$n$ (%)</td>
<td>$n$</td>
</tr>
<tr>
<td>Tax family/filers</td>
<td>3,455,390</td>
<td>1,080,890 (31.3)</td>
</tr>
<tr>
<td>Annual family income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&lt;$20,000</td>
<td>454,510</td>
<td>16,990 (3.7)</td>
</tr>
<tr>
<td>$20,000-$40,000</td>
<td>618,510</td>
<td>78,350 (12.7)</td>
</tr>
<tr>
<td>$40,000-$60,000</td>
<td>582,190</td>
<td>140,820 (24.2)</td>
</tr>
<tr>
<td>$60,000-$80,000</td>
<td>513,610</td>
<td>173,720 (33.8)</td>
</tr>
<tr>
<td>$80,000-$100,000</td>
<td>421,420</td>
<td>184,070 (43.7)</td>
</tr>
<tr>
<td>$100,000-$200,000</td>
<td>729,230</td>
<td>402,690 (55.2)</td>
</tr>
<tr>
<td>&gt;$200,000</td>
<td>132,010</td>
<td>83,460 (63.2)</td>
</tr>
<tr>
<td>Province/territory of residence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Newfoundland</td>
<td>51,320</td>
<td>13,970 (27.2)</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>14,490</td>
<td>5,330 (36.8)</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>91,750</td>
<td>26,280 (28.6)</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>76,430</td>
<td>21,530 (28.2)</td>
</tr>
<tr>
<td>Quebec</td>
<td>785,270</td>
<td>245,410 (31.3)</td>
</tr>
<tr>
<td>Ontario</td>
<td>1,386,260</td>
<td>435,490 (31.4)</td>
</tr>
<tr>
<td>Manitoba</td>
<td>123,440</td>
<td>38,920 (31.5)</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>102,640</td>
<td>34,660 (33.8)</td>
</tr>
<tr>
<td>Alberta</td>
<td>380,890</td>
<td>123,010 (32.3)</td>
</tr>
<tr>
<td>British Columbia</td>
<td>421,810</td>
<td>134,090 (31.8)</td>
</tr>
<tr>
<td>Northwest Territories</td>
<td>5,380</td>
<td>990 (18.4)</td>
</tr>
<tr>
<td>Yukon Territory</td>
<td>3,480</td>
<td>970 (27.9)</td>
</tr>
<tr>
<td>Nunavut</td>
<td>4,410</td>
<td>160 (3.6)</td>
</tr>
</tbody>
</table>

(Table 2 is continued on the next page.)
<table>
<thead>
<tr>
<th>Tax families</th>
<th>Claimed CFTC</th>
<th>Tax families</th>
<th>Claimed CFTC</th>
<th>Tax families</th>
<th>Claimed CFTC</th>
</tr>
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<tbody>
<tr>
<td>$n$</td>
<td>$n$ (%)</td>
<td>$n$</td>
<td>$n$ (%)</td>
<td>$n$</td>
<td>$n$ (%)</td>
</tr>
</tbody>
</table>

**Urban-rural residence—area size, by population**

<table>
<thead>
<tr>
<th>Area Size</th>
<th>2007 $n = 3,455,390$</th>
<th>2008 $n = 3,447,140$</th>
<th>2009 $n = 3,437,270$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\geq 500,000$</td>
<td>1,819,730</td>
<td>577,750 (31.7)</td>
<td>1,824,170</td>
</tr>
<tr>
<td>100,000-499,999</td>
<td>595,030</td>
<td>209,260 (35.2)</td>
<td>590,800</td>
</tr>
<tr>
<td>30,000-99,999</td>
<td>307,530</td>
<td>97,720 (31.8)</td>
<td>306,590</td>
</tr>
<tr>
<td>15,000-29,999</td>
<td>112,230</td>
<td>34,450 (30.7)</td>
<td>113,030</td>
</tr>
<tr>
<td>1,000-14,999</td>
<td>488,230</td>
<td>136,900 (28.0)</td>
<td>482,070</td>
</tr>
<tr>
<td>&lt;1,000</td>
<td>120,840</td>
<td>23,990 (19.9)</td>
<td>118,930</td>
</tr>
<tr>
<td>Missing</td>
<td>11,800</td>
<td>820 (6.9)</td>
<td>11,550</td>
</tr>
</tbody>
</table>

**Parental age (years)**

<table>
<thead>
<tr>
<th>Age Range</th>
<th>2007 $n = 3,455,390$</th>
<th>2008 $n = 3,447,140$</th>
<th>2009 $n = 3,437,270$</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;30</td>
<td>549,720</td>
<td>75,990 (13.8)</td>
<td>556,280</td>
</tr>
<tr>
<td>30-35</td>
<td>623,700</td>
<td>170,840 (27.4)</td>
<td>622,740</td>
</tr>
<tr>
<td>35-40</td>
<td>795,660</td>
<td>333,050 (42.2)</td>
<td>781,110</td>
</tr>
<tr>
<td>40-45</td>
<td>757,570</td>
<td>330,780 (44.9)</td>
<td>737,020</td>
</tr>
<tr>
<td>45-50</td>
<td>460,670</td>
<td>189,120 (40.4)</td>
<td>467,960</td>
</tr>
<tr>
<td>&gt;50</td>
<td>268,070</td>
<td>73,660 (28.0)</td>
<td>274,710</td>
</tr>
</tbody>
</table>

**Immigration status**

<table>
<thead>
<tr>
<th>Status</th>
<th>2007 $n = 3,455,390$</th>
<th>2008 $n = 3,447,140$</th>
<th>2009 $n = 3,437,270$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-immigrant</td>
<td>2,825,170</td>
<td>955,440 (33.8)</td>
<td>2,796,400</td>
</tr>
<tr>
<td>Immigrant</td>
<td>630,220</td>
<td>125,460 (19.9)</td>
<td>650,740</td>
</tr>
<tr>
<td>Recent immigrant</td>
<td>321,900</td>
<td>58,100 (18.0)</td>
<td>326,700</td>
</tr>
</tbody>
</table>

**Family structure**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Couple</td>
<td>2,603,830</td>
<td>943,520 (36.2)</td>
<td>2,602,420</td>
</tr>
<tr>
<td>Single parent</td>
<td>851,570</td>
<td>137,370 (16.1)</td>
<td>844,720</td>
</tr>
</tbody>
</table>

(Table 2 is concluded on the next page.)
TABLE 2 Concluded

<table>
<thead>
<tr>
<th>At least one male child</th>
<th>2007 n = 3,455,390</th>
<th>2008 n = 3,447,140</th>
<th>2009 n = 3,437,270</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax families</td>
<td>Claimed CFTC</td>
<td>Tax families</td>
<td>Claimed CFTC</td>
</tr>
<tr>
<td>n</td>
<td>n (%)</td>
<td>n</td>
<td>n (%)</td>
</tr>
<tr>
<td>At least one male child</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>2,343,120</td>
<td>790,350 (33.7)</td>
<td>2,339,350</td>
</tr>
<tr>
<td>No</td>
<td>1,112,270</td>
<td>290,540 (26.1)</td>
<td>1,107,790</td>
</tr>
<tr>
<td>No. of children</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One</td>
<td>1,487,450</td>
<td>287,210 (19.3)</td>
<td>1,480,440</td>
</tr>
<tr>
<td>Two</td>
<td>1,405,490</td>
<td>576,510 (41.0)</td>
<td>1,401,900</td>
</tr>
<tr>
<td>Three</td>
<td>425,580</td>
<td>175,940 (41.3)</td>
<td>426,110</td>
</tr>
<tr>
<td>≥Four</td>
<td>136,880</td>
<td>41,230 (30.1)</td>
<td>138,690</td>
</tr>
</tbody>
</table>

* Area sizes of <1,000 are classified as rural.

Source: Statistics Canada, longitudinal administrative databank (LAD), federal income tax return data for 2007 through 2009 (derived from the Canada Revenue Agency’s T1 family file [T1FF]). Sample counts were rounded to the nearest five. Totals and percentages are based on rounded counts.
The odds ratios reported in table 3 show that after controlling for household income, urban/rural residence, immigration status, parental age, and family composition, families living in Prince Edward Island, New Brunswick, Quebec, Manitoba, Saskatchewan, and British Columbia were all more likely to claim the CFTC than their counterparts in Ontario ($OR_{adj} = 1.04$ to $1.6$, $p < 0.01$). In contrast, families living in the Far North were significantly less likely to claim the CFTC. This was especially evident among families living in the Northwest Territories and Nunavut, where the odds of claiming the CFTC were approximately 60 percent and 90 percent lower, respectively, than the odds in Ontario.

The associations between family income, use of the CFTC, and the amount claimed through the CFTC are presented in table 4. After controlling for other covariates, household income was positively associated with the use of the CFTC, with the odds of claiming the CFTC being higher for each income group above $20,000 per annum ($OR_{adj} = 3.1$ to $23.1$, $p < 0.01$).

The amount claimed through the CFTC generally increased with increasing income levels. For families earning $100,000 to $200,000 annually and those earning more than $200,000, CFTC claims were, on average, $125 and $250 higher, respectively, than those for families with an annual income of $20,000 or less. The only exception was among those families earning between $20,000 and $40,000 annually; in this group, the CFTC claims were approximately $10 lower than those for families earning less than $20,000 annually.

Table 5 documents the associations between the remaining independent variables of interest and use of the CFTC. The odds of claiming the CFTC decreased with decreasing community size, such that families living in smaller urban centres (those with a population of less than 100,000) and in rural areas (those with a population of less than 1,000) were 2 percent to 32 percent less likely to claim the CFTC than families living in cities with a population greater than 500,000. The amounts claimed for the CFTC decreased with decreasing community size, such that families living in rural areas claimed approximately $90 less than those living in the largest urban centres.

After controlling for all other covariates, families headed by a single parent were approximately 8 percent more likely to use the CFTC than dual-parent families, and the amounts claimed by single-parent families was approximately $25 higher on average ($OR_{adj} = 1.083$, $p < 0.01$). The odds of claiming the CFTC increased by approximately 35 percent with each additional child, and the amount claimed increased by approximately $160. Having at least one male child in the family was also associated with higher odds of claiming the CFTC ($OR_{adj} = 1.126$, $p < 0.01$) and with a very small increase ($$3.50$) in the amount of the CFTC claimed ($p < 0.01$).

Immigrants were significantly less likely to claim the CFTC than non-immigrants ($OR_{adj} = 0.67$, $p < 0.01$), and recent immigrants were less likely than other immigrants to claim the CFTC ($OR_{adj} = 0.98$, $p < 0.01$). The amount claimed by immigrant families was approximately $20 less than that claimed by their non-immigrant counterparts, while the amount claimed by recent immigrants was approximately $30 less than that claimed by other immigrants ($p < 0.01$).
### TABLE 3  Use of the Children’s Fitness Tax Credit, by Claimant’s Province/Territory of Residence, Adjusted for Selected Sociodemographic Factors (n = 3,142 million)

<table>
<thead>
<tr>
<th>Province/territory</th>
<th>β</th>
<th>SE</th>
<th>OR_{adj}</th>
<th>95% CI</th>
<th>p</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newfoundland .........</td>
<td>−0.037</td>
<td>0.011</td>
<td>0.964</td>
<td>0.943-0.974</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Prince Edward Island.......</td>
<td>0.463</td>
<td>0.020</td>
<td>1.589</td>
<td>1.528-1.621</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Nova Scotia ...............</td>
<td>−0.025</td>
<td>0.009</td>
<td>0.975</td>
<td>0.958-0.984</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>New Brunswick ............</td>
<td>0.061</td>
<td>0.009</td>
<td>1.063</td>
<td>1.044-1.073</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Quebec ....................</td>
<td>0.036</td>
<td>0.004</td>
<td>1.037</td>
<td>1.029-1.041</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Manitoba ................</td>
<td>0.185</td>
<td>0.007</td>
<td>1.203</td>
<td>1.187-1.212</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Saskatchewan .............</td>
<td>0.206</td>
<td>0.008</td>
<td>1.229</td>
<td>1.210-1.239</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Alberta ..................</td>
<td>−0.148</td>
<td>0.004</td>
<td>0.862</td>
<td>0.856-0.866</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>British Columbia ..........</td>
<td>0.149</td>
<td>0.004</td>
<td>1.161</td>
<td>1.152-1.165</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Northwest Territories ....</td>
<td>−0.880</td>
<td>0.037</td>
<td>0.415</td>
<td>0.386-0.430</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Yukon Territory ..........</td>
<td>−0.239</td>
<td>0.042</td>
<td>0.787</td>
<td>0.725-0.821</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Nunavut ..................</td>
<td>−2.657</td>
<td>0.083</td>
<td>0.070</td>
<td>0.060-0.076</td>
<td>&lt;0.01</td>
</tr>
<tr>
<td>Ontario ..................</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Note: Reference category is indicated by italics. All analyses adjusted for annual family income (negative; < $20,000; $20,000-$40,000; $40,000-$60,000; $60,000-$80,000; $80,000-$100,000; $100-$200,000; > $200,000), urban/rural residence (area size by population), immigration status (immigrant—yes/no; recent immigrant—yes/no), parental age (< 30 years; 30-34 years; 35-39 years; 40-44 years; 45-49 years; ≥ 50 years), family composition (single parent—yes/no; male child in family—yes/no; number of children).

SE = standard error.
OR_{adj} = adjusted odds ratio.
CI = confidence interval.

Source: Statistics Canada, longitudinal administrative databank (LAD), federal income tax return data for 2007 through 2009 (derived from the Canada Revenue Agency’s T1 family file [T1FF]).

Finally, the odds of claiming the CFTC were significantly higher among families that had previously claimed the credit (OR_{adj} = 13.27), with the amount of the claim being approximately $160 higher relative to families with no previous claims (p < 0.01). However, the analysis also shows that after controlling for all other covariates, the likelihood of claiming the CFTC was approximately 7 percent lower and the amount claimed approximately $50 lower with each passing year (p < 0.01).

Information relating to parents’ awareness and perceptions of the CFTC was collected in the national survey conducted through the CFLRI. The survey data are presented in tables 6 through 10 and figures 1 and 2.

Descriptive statistics pertaining to the survey population are provided in table 6. Our analysis shows that approximately 65 percent of respondents reported that they had heard of the CFTC. Of those familiar with the CFTC, the majority were female (57.9 percent), were between 35 and 49 years of age (70.8 percent), and had at least some post-secondary education (83.0 percent). Over 40 percent of respondents familiar with the CFTC reported annual household incomes greater than $100,000.
### TABLE 4  Relationship Between Family Income and Children’s Fitness Tax Credit (CFTC) Use and CFTC Claim Amount, 2007-2009

<table>
<thead>
<tr>
<th>Annual family income</th>
<th>Use of CFTC(^a) ((n = 3.142 \text{ million}))</th>
<th>Amount of CFTC claim(^b) ((n = 1.241 \text{ million}))</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(\beta)</td>
<td>(SE)</td>
</tr>
<tr>
<td>≥ $200,000</td>
<td>3.141</td>
<td>0.012</td>
</tr>
<tr>
<td>$100,000-$199,999</td>
<td>2.866</td>
<td>0.010</td>
</tr>
<tr>
<td>$80,000-$99,999</td>
<td>2.507</td>
<td>0.010</td>
</tr>
<tr>
<td>$60,000-$79,999</td>
<td>2.195</td>
<td>0.010</td>
</tr>
<tr>
<td>$40,000-$59,999</td>
<td>1.802</td>
<td>0.010</td>
</tr>
<tr>
<td>$20,000-$39,999</td>
<td>1.125</td>
<td>0.010</td>
</tr>
<tr>
<td>&lt;$20,000</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Note: Reference category is indicated by italics. All analyses adjusted for urban/rural residence (population <1,000; 1,000-14,999; 15,000-29,999; 30,000-99,999; 100,000-499,999; >500,000), immigration status (immigrant—yes/no; recent immigrant—yes/no), parental age (<30 years; 30-34 years; 35-39 years; 40-44 years; 45-49 years; ≥50 years), family composition (single parent—yes/no; male child in family—yes/no; number of children), previous CFTC claims (yes/no) and time (years).

\(^a\) Analyzed using multiple logistic regression.

\(^b\) Analyzed using multiple linear regression.

SE = standard error.

\(OR_{adj}\) = adjusted odds ratio.

CI = confidence interval.

Source: Statistics Canada, longitudinal administrative databank (LAD), federal income tax return data for 2007 through 2009 (derived from the Canada Revenue Agency’s T1 family file [T1FF]).
TABLE 5  Relationship Between Children’s Fitness Tax Credit (CFTC) Claims and Selected Sociodemographic Characteristics, 2007-2009

<table>
<thead>
<tr>
<th>Area size, by population^c</th>
<th>Use of CFTC(a) ((n = 3.142) million)</th>
<th>Amount of CFTC claim(b) ((n = 1.241) million)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(\beta)</td>
<td>(SE)</td>
</tr>
<tr>
<td>&lt;1,000</td>
<td>-0.384</td>
<td>0.008</td>
</tr>
<tr>
<td>1,000-14,999</td>
<td>-0.132</td>
<td>0.004</td>
</tr>
<tr>
<td>15,000-29,999</td>
<td>-0.061</td>
<td>0.008</td>
</tr>
<tr>
<td>30,000-99,999</td>
<td>-0.022</td>
<td>0.005</td>
</tr>
<tr>
<td>100,000-499,999</td>
<td>0.086</td>
<td>0.004</td>
</tr>
<tr>
<td>(\geq 500,000)</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Parental age (years)</th>
<th>Use of CFTC(a)</th>
<th>Amount of CFTC claim(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\geq 50)</td>
<td>0.100</td>
<td>0.07</td>
</tr>
<tr>
<td>45-49</td>
<td>0.478</td>
<td>0.006</td>
</tr>
<tr>
<td>40-44</td>
<td>0.615</td>
<td>0.006</td>
</tr>
<tr>
<td>35-39</td>
<td>0.552</td>
<td>0.006</td>
</tr>
<tr>
<td>30-34</td>
<td>0.274</td>
<td>0.006</td>
</tr>
<tr>
<td>&lt;30</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Immigrant</th>
<th>Use of CFTC(a)</th>
<th>Amount of CFTC claim(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>-0.394</td>
<td>0.005</td>
</tr>
<tr>
<td>No</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recent immigrant</th>
<th>Use of CFTC(a)</th>
<th>Amount of CFTC claim(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>-0.017</td>
<td>0.007</td>
</tr>
<tr>
<td>No</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

(Table 5 is concluded on the next page.)
### TABLE 5  Concluded

<table>
<thead>
<tr>
<th>Use of CFTC(^a) ((n = 3.142) million)</th>
<th>Amount of CFTC claim(^b) ((n = 1.241) million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\beta)</td>
<td>(SE)</td>
</tr>
<tr>
<td><strong>Family structure</strong></td>
<td></td>
</tr>
<tr>
<td>Single parent</td>
<td>0.080</td>
</tr>
<tr>
<td>Couple</td>
<td>—</td>
</tr>
<tr>
<td><strong>Male child in family</strong></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>0.119</td>
</tr>
<tr>
<td>No</td>
<td>—</td>
</tr>
<tr>
<td><strong>No. of children</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.296</td>
</tr>
<tr>
<td><strong>Prior CFTC claim</strong></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>2.586</td>
</tr>
<tr>
<td>No</td>
<td>—</td>
</tr>
<tr>
<td><strong>Time</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>−0.511</td>
</tr>
</tbody>
</table>

Note: Reference category is indicated by italics. Analyses also adjusted for annual family income (negative; <$20,000; $20,000-$40,000; $40,000-$60,000; $60,000-$80,000; $80,000-$100,000; $100,000-$200,000; >$200,000).

\(^a\) Analyzed using multiple logistic regression.
\(^b\) Analyzed using multiple linear regression.
\(^c\) Area sizes of <1,000 are classified as rural.

SE = standard error.
\(OR_{adj}\) = adjusted odds ratio.
CI = confidence interval.

Source: Statistics Canada, longitudinal administrative databank (LAD), federal income tax return data for 2007 through 2009 (derived from the Canada Revenue Agency’s T1 family file [T1FF]).
Multivariable logistic regression analyses showed that gender, age, education, and income were all significantly associated with CFTC awareness (see table 7). Women, parents between 40 and 49 years of age, those with post-secondary education, and those earning more than $40,000 annually were all more likely to be familiar with the CFTC ($OR_{adj} = 1.791$ to $4.593$, $p < 0.01$).

Parental perceptions of the importance of the CFTC are highlighted in figure 1. Most survey respondents rated the CFTC as very important (58.8 percent) or important (17.3 percent) to increasing physical activity among Canadian children. As shown in table 8, regression analyses revealed that gender and parental education were both significantly associated with the perception that the CFTC is important to increasing children’s physical activity. Women were approximately 50 percent more likely than men to view the CFTC as at least somewhat important, and university-educated parents were approximately 35 percent less likely than those with no post-secondary
Table 7  Relationship Between Selected Sociodemographic Characteristics and Parental Awareness of the Children's Fitness Tax Credit (n = 2,394)

<table>
<thead>
<tr>
<th></th>
<th>β</th>
<th>SE</th>
<th>ORadj</th>
<th>95% CI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gender</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>0.583</td>
<td>0.098</td>
<td>1.791**</td>
<td>1.479–2.168</td>
</tr>
<tr>
<td>Male</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
<tr>
<td><strong>Age (years)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>≥50</td>
<td>0.193</td>
<td>0.224</td>
<td>1.213</td>
<td>0.783–1.880</td>
</tr>
<tr>
<td>45-49</td>
<td>0.625</td>
<td>0.220</td>
<td>1.868*</td>
<td>1.214–2.873</td>
</tr>
<tr>
<td>40-44</td>
<td>0.697</td>
<td>0.219</td>
<td>2.008*</td>
<td>1.309–3.082</td>
</tr>
<tr>
<td>35-39</td>
<td>0.420</td>
<td>0.221</td>
<td>1.522</td>
<td>0.987–2.349</td>
</tr>
<tr>
<td>30-34</td>
<td>0.111</td>
<td>0.230</td>
<td>1.118</td>
<td>0.712–1.754</td>
</tr>
<tr>
<td>&lt;30</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
<tr>
<td><strong>Annual household income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>≥$100,000</td>
<td>1.525</td>
<td>0.165</td>
<td>1.827*</td>
<td>1.229–2.717</td>
</tr>
<tr>
<td>$90,000–$99,999</td>
<td>1.003</td>
<td>0.229</td>
<td>2.151**</td>
<td>1.426–3.245</td>
</tr>
<tr>
<td>$80,000–$89,999</td>
<td>1.010</td>
<td>0.210</td>
<td>1.424</td>
<td>0.955–2.123</td>
</tr>
<tr>
<td>$70,000–$79,999</td>
<td>0.711</td>
<td>0.193</td>
<td>2.036**</td>
<td>1.395–2.972</td>
</tr>
<tr>
<td>$60,000–$69,999</td>
<td>0.353</td>
<td>0.204</td>
<td>2.746**</td>
<td>1.819–4.145</td>
</tr>
<tr>
<td>$50,000–$59,999</td>
<td>0.766</td>
<td>0.210</td>
<td>2.727**</td>
<td>1.742–4.269</td>
</tr>
<tr>
<td>$40,000–$49,999</td>
<td>0.603</td>
<td>0.202</td>
<td>4.593**</td>
<td>3.324–6.347</td>
</tr>
<tr>
<td>&lt;$40,000</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
<tr>
<td><strong>Parent's education</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>University</td>
<td>1.247</td>
<td>0.124</td>
<td>3.482**</td>
<td>2.73–4.435</td>
</tr>
<tr>
<td>College</td>
<td>0.808</td>
<td>0.115</td>
<td>2.244**</td>
<td>1.792–2.811</td>
</tr>
<tr>
<td>Secondary or less</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
</tbody>
</table>

Note: Reference group indicated with italics.
SE = standard error.
ORadj = adjusted odds ratio.
CI = confidence interval.
** p ≤ 0.001.
* p < 0.01.
Source: Canadian Fitness and Lifestyle Research Institute, Physical Activity Monitor, 2009 and 2010, responses to questions about the children’s fitness tax credit.

education to have this perception. With the exception of respondents at the $50,000–$59,999 income level (ORadj = 2.333, p < 0.05), perceived importance of the CFTC to increasing children’s physical activity was not significantly different for households earning more than $40,000 annually and those earning less (ORadj = 0.613 to 1.199, p < 0.05).

Figure 1 also includes descriptive information regarding parents’ perceptions of the influence of the CFTC on their decision making related to their children’s physical activity. When asked whether the CFTC provided motivation to register their child in a physical activity program, approximately 30 percent of parents answered affirmatively, and more than one-third (34.2 percent) perceived that the CFTC had made it financially easier for them to register their children in organized physical
FIGURE 1  Parental Perceptions of the Children's Fitness Tax Credit (CFTC)\(^a\) (n = 1,565)

Parental perceptions of the importance of the CFTC

Parental perceptions of the impact of the CFTC on their decision making regarding physical activity

Note: The cap on each box signifies the upper limit of the confidence interval (CI) for the estimate.

\(a\) Based on responses to question 7 of the CFTC survey.

Source: Canadian Fitness and Lifestyle Research Institute, Physical Activity Monitor, 2009 and 2010, responses to questions about the children’s fitness tax credit.

activity. Overall, fewer than 16 percent of parents agreed that the CFTC enabled them to register their children in a physical activity program when they otherwise would have been unable to do so. As shown in table 9, gender, age, and household income were all significantly associated with parental perceptions of the influence of the CFTC, while education was not. Women were significantly less likely than men to report that the CFTC had motivated them to register their children in physical activity programs (\(OR_{adj} = 0.792, p < 0.05\)). Parents over the age of 30 were more likely than younger parents to report that the CFTC provided motivation (\(OR_{adj} = 2.624\) to 7.449, \(p < 0.05\)), facilitated their decisions\(^{23}\) (\(OR_{adj} = 1.541\) to 3.333, \(p < 0.05\)) and made it possible to enrol their child in a physical activity program (\(OR_{adj} = 4.924\) to 9.566, \(p < 0.05\)). Parents with annual household incomes of

\(^{23}\) Except for parents aged 45-49.
### Table 8: Relationship Between Selected Sociodemographic Characteristics and Parental Perception of the Importance of the Children’s Fitness Tax Credit (CFTC)\(^a\) (n = 1,565)

<table>
<thead>
<tr>
<th></th>
<th>(\beta)</th>
<th>SE</th>
<th>OR(_{adj})</th>
<th>95% CI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gender</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>0.430</td>
<td>0.125</td>
<td>1.537**</td>
<td>1.203-1.965</td>
</tr>
<tr>
<td>Male</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
<tr>
<td><strong>Age (years)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(\geq 50)</td>
<td>-0.302</td>
<td>0.386</td>
<td>0.739</td>
<td>0.347-1.574</td>
</tr>
<tr>
<td>45-49</td>
<td>-0.293</td>
<td>0.375</td>
<td>0.746</td>
<td>0.358-1.555</td>
</tr>
<tr>
<td>40-44</td>
<td>0.030</td>
<td>0.375</td>
<td>1.030</td>
<td>0.494-2.150</td>
</tr>
<tr>
<td>35-39</td>
<td>-0.062</td>
<td>0.382</td>
<td>0.940</td>
<td>0.445-1.986</td>
</tr>
<tr>
<td>30-34</td>
<td>0.489</td>
<td>0.421</td>
<td>1.630</td>
<td>0.714-3.724</td>
</tr>
<tr>
<td>(&lt; 30)</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
<tr>
<td><strong>Annual household income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(\geq $100,000)</td>
<td>-0.306</td>
<td>0.250</td>
<td>0.736</td>
<td>0.451-1.203</td>
</tr>
<tr>
<td>($90,000-$99,999)</td>
<td>-0.205</td>
<td>0.324</td>
<td>0.815</td>
<td>0.432-1.537</td>
</tr>
<tr>
<td>($80,000-$89,999)</td>
<td>0.181</td>
<td>0.327</td>
<td>1.199</td>
<td>0.632-2.273</td>
</tr>
<tr>
<td>($70,000-$79,999)</td>
<td>0.098</td>
<td>0.318</td>
<td>1.103</td>
<td>0.592-2.056</td>
</tr>
<tr>
<td>($60,000-$69,999)</td>
<td>-0.043</td>
<td>0.351</td>
<td>0.958</td>
<td>0.481-1.906</td>
</tr>
<tr>
<td>($50,000-$59,999)</td>
<td>0.847</td>
<td>0.415</td>
<td>2.333*</td>
<td>1.035-5.261</td>
</tr>
<tr>
<td>($40,000-$49,999)</td>
<td>-0.489</td>
<td>0.318</td>
<td>0.613</td>
<td>0.329-1.143</td>
</tr>
<tr>
<td>(&lt; $40,000)</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
<tr>
<td><strong>Parent’s education</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>University</td>
<td>-0.428</td>
<td>0.183</td>
<td>0.652*</td>
<td>0.455-0.933</td>
</tr>
<tr>
<td>College</td>
<td>0.110</td>
<td>0.193</td>
<td>1.117</td>
<td>0.765-1.629</td>
</tr>
<tr>
<td>Secondary or less</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
<td>—</td>
</tr>
</tbody>
</table>

Note: Reference group indicated with italics.

\(^a\) As indicated by a ranking of “somewhat important” (3) or higher on the scale described in question 6a of the CFTC survey: “[H]ow important do you think the child fitness tax credit is to increasing physical activity among Canadian children?”

SE = standard error.

OR\(_{adj}\) = adjusted odds ratio.

CI = confidence interval.

** \(p \leq -0.001\).

* \(p < 0.05\).

Source: Canadian Fitness and Lifestyle Research Institute, Physical Activity Monitor, 2009 and 2010, responses to questions about the children’s fitness tax credit.
TABLE 9  Relationship Between Selected Sociodemographic Characteristics and Parental Perceptions of the Influence of the Children’s Fitness Tax Credit (CFTC) on Decision Making\(^a\) (\(n = 1,565\))

<table>
<thead>
<tr>
<th></th>
<th>Motivated or encouraged parents to register child in physical activity/sport program</th>
<th>Made it easier for parents to register child in physical activity/sport program</th>
<th>Allowed parents to register child in physical activity/sport program when they otherwise would not</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(OR_{adj})</td>
<td>95% CI</td>
<td>(OR_{adj})</td>
</tr>
<tr>
<td><strong>Gender</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>0.792*</td>
<td>0.629-0.996</td>
<td>0.960</td>
</tr>
<tr>
<td>Male</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
</tr>
<tr>
<td>Age (years)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>45-49</td>
<td>3.020*</td>
<td>1.292-7.063</td>
<td>1.541</td>
</tr>
<tr>
<td>40-44</td>
<td>3.664**</td>
<td>1.574-8.525</td>
<td>2.245*</td>
</tr>
<tr>
<td>30-34</td>
<td>7.449***</td>
<td>3.120-17.784</td>
<td>3.333***</td>
</tr>
<tr>
<td>(&lt; 30)</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
</tr>
<tr>
<td>Annual household income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(\geq $100,000)</td>
<td>0.565**</td>
<td>0.367-0.868</td>
<td>0.767</td>
</tr>
<tr>
<td>($90,000-$99,999)</td>
<td>0.897</td>
<td>0.515-1.562</td>
<td>1.109</td>
</tr>
<tr>
<td>($80,000-$89,999)</td>
<td>0.867</td>
<td>0.514-1.462</td>
<td>1.815*</td>
</tr>
<tr>
<td>($70,000-$79,999)</td>
<td>0.967</td>
<td>0.572-1.632</td>
<td>1.155</td>
</tr>
<tr>
<td>($60,000-$69,999)</td>
<td>1.037</td>
<td>0.582-1.848</td>
<td>1.845*</td>
</tr>
<tr>
<td>($50,000-$49,999)</td>
<td>1.121</td>
<td>0.642-1.956</td>
<td>1.473</td>
</tr>
<tr>
<td>($40,000-$49,999)</td>
<td>0.548*</td>
<td>0.304-0.986</td>
<td>0.936</td>
</tr>
<tr>
<td>(&lt; $40,000)</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
</tr>
</tbody>
</table>

\(^a\) Table 9 is concluded on the next page.
<table>
<thead>
<tr>
<th>Parent’s education</th>
<th>Motivated or encouraged parents to register child in physical activity/sport program</th>
<th>Made it easier for parents to register child in physical activity/sport program</th>
<th>Allowed parents to register child in physical activity/sport program when they otherwise would not</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OR&lt;sub&gt;adj&lt;/sub&gt;</td>
<td>95% CI</td>
<td>OR&lt;sub&gt;adj&lt;/sub&gt;</td>
</tr>
<tr>
<td>University</td>
<td>0.762</td>
<td>0.561-1.079</td>
<td>0.774</td>
</tr>
<tr>
<td>College</td>
<td>0.778</td>
<td>0.551-1.053</td>
<td>0.746</td>
</tr>
<tr>
<td>Secondary or less</td>
<td>ref</td>
<td>—</td>
<td>ref</td>
</tr>
</tbody>
</table>

Note: Reference group indicated with italics.

a Based on responses to question 7 of the CFTC survey.

OR<sub>adj</sub> = adjusted odds ratio.

CI = confidence interval.

*** p ≤ 0.001.

** p ≤ 0.01.

* p ≤ 0.05.

Source: Canadian Fitness and Lifestyle Research Institute, Physical Activity Monitor, 2009 and 2010, responses to questions about the children’s fitness tax credit.
$40,000-$49,999 or greater than $100,000 per annum were significantly less likely than those with annual household incomes below $40,000 to report that the CFTC provided incentives to register their children in physical activity programs \((OR_{adj} = 0.548, p < 0.05; \text{and} \ 0.565, p < 0.01, \text{respectively})\). Parents with annual household incomes between $60,000-$69,999 and $80,000-$89,999 were significantly more likely than parents with annual household incomes below $40,000 to feel that the CFTC facilitated registering their child in physical activity programs. Generally, parents with annual household incomes greater than $40,000 were less likely than those with annual household incomes below $40,000 to agree that the CFTC allowed them to register their child in a program when they would not have otherwise been able to do so \((OR_{adj} = 0.172 \text{ to } 0.538, p < 0.05)\).

Parental ratings of the importance of selected strategies for increasing their child’s participation in physical activity are presented in figure 2. Facilities and convenient and accessible programming were rated as very important by more than 70 percent of parents. Close to half (48.4 percent) perceived the CFTC as being very important, while 22.3 percent felt it was not at all important.

The results of regression analyses examining associations between gender, age, education, and income and parental perceptions of high importance of these strategies are provided in table 10. Women were significantly more likely than men to rate tax credits/benefits, coaching, programming, and opportunities for free play as very important to increasing children’s physical activity \((OR_{adj} = 1.422 \text{ to } 1.952, p < 0.001)\). Parents 30 years of age and older were more likely to rate tax credits/benefits, facilities, and coaching, and less likely to rate programming, school and after-school programs, and opportunities for free play as very important, compared to parents under the age of 30 \((OR_{adj} = 0.626 \text{ to } 0.709, p < 0.01)\). University-educated parents were less likely than those without post-secondary education to perceive tax credits/benefits, coaching, and school programs as being highly important, while college-educated parents were more likely than parents without post-secondary education to rate opportunities for free play as very important to increasing children’s physical activity \((OR_{adj} = 1.370, p < 0.05)\).

**DISCUSSION**

While, as noted earlier, there have been other evaluations of the CFTC, to our knowledge this study is the first to examine the use of the CFTC using federal tax claims data. The findings provide important information regarding the use of the CFTC and raise questions regarding the equity and potential effectiveness of the program in promoting physical activity for children and youth.

Our analysis reveals disparities in the use of the CFTC across family composition, urban/rural and provincial/territorial residence, immigration status, and household income, even after controlling for confounding variables. Contrary to what might be expected, families headed by a single parent were more likely than dual-parent families to make use of the CFTC, perhaps reflecting increased motivation to claim because single parents bear a relatively greater financial burden in enrolling their children in non-subsidized programs. The findings also show that families with at
TABLE 10  Relationship Between Selected Sociodemographic Characteristics and Parental Perceptions of the Importance of Selected Strategies for Increasing Physical Activity\(^a\) (\(n = 1,565\))

<table>
<thead>
<tr>
<th></th>
<th>Tax credits or benefits</th>
<th>Sport and recreation facilities</th>
<th>Coaching or instruction</th>
<th>Convenient and accessible programming</th>
<th>School or after-school programs</th>
<th>Opportunities for free play</th>
</tr>
</thead>
<tbody>
<tr>
<td>(OR_{adj}) (95% CI)</td>
<td>(OR_{adj}) (95% CI)</td>
<td>(OR_{adj}) (95% CI)</td>
<td>(OR_{adj}) (95% CI)</td>
<td>(OR_{adj}) (95% CI)</td>
<td>(OR_{adj}) (95% CI)</td>
<td>(OR_{adj}) (95% CI)</td>
</tr>
<tr>
<td><strong>Gender</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>1.550***</td>
<td>1.147</td>
<td>1.422***</td>
<td>1.952***</td>
<td>1.547</td>
<td>1.422***</td>
</tr>
<tr>
<td></td>
<td>(1.251-1.921)</td>
<td>(1.203-1.965)</td>
<td>(1.148-1.761)</td>
<td>(1.547-2.462)</td>
<td>(1.248-1.917)</td>
<td>(1.146-1.765)</td>
</tr>
<tr>
<td>Male</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
</tr>
<tr>
<td><strong>Age (years)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(\geq 50)</td>
<td>2.782**</td>
<td>1.286</td>
<td>2.543**</td>
<td>0.345**</td>
<td>0.186***</td>
<td>0.286**</td>
</tr>
<tr>
<td></td>
<td>(1.457-5.313)</td>
<td>(0.688-2.404)</td>
<td>(1.374-4.705)</td>
<td>(0.150-0.794)</td>
<td>(0.075-0.461)</td>
<td>(0.131-0.623)</td>
</tr>
<tr>
<td>45-49</td>
<td>2.049*</td>
<td>1.884*</td>
<td>2.138*</td>
<td>0.409*</td>
<td>0.164**</td>
<td>0.334**</td>
</tr>
<tr>
<td></td>
<td>(1.098-3.823)</td>
<td>(1.028-3.455)</td>
<td>(1.187-3.851)</td>
<td>(0.180-0.925)</td>
<td>(0.067-0.400)</td>
<td>(0.156-0.716)</td>
</tr>
<tr>
<td>40-44</td>
<td>2.449**</td>
<td>2.024*</td>
<td>1.982*</td>
<td>0.396*</td>
<td>0.208**</td>
<td>0.427</td>
</tr>
<tr>
<td></td>
<td>(1.314-4.564)</td>
<td>(1.104-3.712)</td>
<td>(1.103-3.563)</td>
<td>(0.176-0.893)</td>
<td>(0.085-0.505)</td>
<td>(0.199-0.916)</td>
</tr>
<tr>
<td>35-39</td>
<td>2.600**</td>
<td>1.817</td>
<td>1.699</td>
<td>0.478</td>
<td>0.146**</td>
<td>0.411*</td>
</tr>
<tr>
<td></td>
<td>(1.384-4.885)</td>
<td>(0.982-3.561)</td>
<td>(0.937-3.078)</td>
<td>(0.209-1.093)</td>
<td>(0.060-0.357)</td>
<td>(0.190-0.888)</td>
</tr>
<tr>
<td>30-34</td>
<td>3.262***</td>
<td>2.179*</td>
<td>2.054*</td>
<td>0.468</td>
<td>0.243**</td>
<td>0.584</td>
</tr>
<tr>
<td></td>
<td>(1.679-6.339)</td>
<td>(1.125-4.222)</td>
<td>(1.092-3.863)</td>
<td>(0.198-1.106)</td>
<td>(0.097-0.612)</td>
<td>(0.260-1.312)</td>
</tr>
<tr>
<td>&lt;30</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
<td>ref</td>
</tr>
</tbody>
</table>

(Table 10 is continued on the next page.)
Table 10

<table>
<thead>
<tr>
<th>Annual household income</th>
<th>Tax credits or benefits</th>
<th>Sport and recreation facilities</th>
<th>Coaching or instruction</th>
<th>Convenient and accessible programming</th>
<th>School or after-school programs</th>
<th>Opportunities for free play</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OR_{adj} (95% CI)</td>
<td>OR_{adj} (95% CI)</td>
<td>OR_{adj} (95% CI)</td>
<td>OR_{adj} (95% CI)</td>
<td>OR_{adj} (95% CI)</td>
<td>OR_{adj} (95% CI)</td>
</tr>
<tr>
<td>$\geq$100,000 ..........</td>
<td>0.492** (0.327-0.741)</td>
<td>0.867 (0.561-1.339)</td>
<td>0.886 (0.591-1.328)</td>
<td>1.023 (0.661-1.582)</td>
<td>0.892 (0.584-1.364)</td>
<td>0.471*** (0.301-0.738)</td>
</tr>
<tr>
<td>$90,000-$99,999 .......</td>
<td>0.626 (0.367-1.068)</td>
<td>0.777 (0.432-1.336)</td>
<td>0.717 (0.423-1.216)</td>
<td>0.771 (0.439-1.351)</td>
<td>0.791 (0.458-1.367)</td>
<td>0.429** (0.243-0.758)</td>
</tr>
<tr>
<td>$80,000-$89,999 .......</td>
<td>0.930 (0.559-1.546)</td>
<td>1.016 (0.588-1.757)</td>
<td>0.900 (0.544-1.487)</td>
<td>2.007* (1.105-3.646)</td>
<td>0.797 (0.474-1.341)</td>
<td>0.636</td>
</tr>
<tr>
<td>$70,000-$79,999 .......</td>
<td>0.749 (0.452-1.241)</td>
<td>2.255** (1.222-4.160)</td>
<td>1.189 (0.715-1.977)</td>
<td>2.182** (1.198-3.974)</td>
<td>0.896 (0.530-1.341)</td>
<td>0.624</td>
</tr>
<tr>
<td>$60,000-$69,999 .......</td>
<td>0.562* (0.321-0.984)</td>
<td>1.137 (0.615-2.100)</td>
<td>1.699 (0.948-3.044)</td>
<td>0.959 (0.525-1.752)</td>
<td>0.632 (0.354-1.127)</td>
<td>0.802</td>
</tr>
<tr>
<td>$50,000-$59,999 .......</td>
<td>1.465 (0.831-2.581)</td>
<td>0.956 (0.534-1.711)</td>
<td>1.576 (0.896-2.773)</td>
<td>2.138* (1.099-4.157)</td>
<td>1.037 (0.586-1.832)</td>
<td>0.650</td>
</tr>
<tr>
<td>$40,000-$49,999 .......</td>
<td>0.442** (0.2258-0.756)</td>
<td>0.461** (0.266-0.799)</td>
<td>0.641 (0.377-1.089)</td>
<td>0.586 (0.337-1.019)</td>
<td>0.391*** (0.226-0.677)</td>
<td>0.591</td>
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<td>&lt;$40,000 .............</td>
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(Table 10 is concluded on the next page.)
### TABLE 10 Concluded

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<thead>
<tr>
<th></th>
<th>Tax credits or benefits</th>
<th>Sport and recreation facilities</th>
<th>Coaching or instruction</th>
<th>Convenient and accessible programming</th>
<th>School or after-school programs</th>
<th>Opportunities for free play</th>
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<tr>
<td></td>
<td>$OR_{adj}$ (95% CI)</td>
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<td>Parent’s education</td>
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<td>University</td>
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<td>0.907 (0.645-1.276)</td>
<td>0.626** (0.460-0.851)</td>
<td>0.980 (0.705-1.363)</td>
<td>0.709* (0.518-0.969)</td>
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<td>College</td>
<td>0.977 (0.716-1.334)</td>
<td>0.729 (0.522-1.019)</td>
<td>0.977 (0.716-1.334)</td>
<td>1.263 (0.900-1.773)</td>
<td>0.832 (0.605-1.143)</td>
<td>1.370* (1.000-1.878)</td>
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*a Based on responses to question 6b of the children’s fitness tax credit survey.

$OR_{adj}$ = adjusted odds ratio.

CI = confidence interval.

*** $p \leq 0.001$.

** $p \leq 0.01$.

* $p \leq 0.05$.

Source: Canadian Fitness and Lifestyle Research Institute, Physical Activity Monitor, 2009 and 2010, responses to questions about the children’s fitness tax credit.
least one male child were more likely to claim the CFTC, providing support for concerns expressed shortly after the credit was introduced that it did not adequately take into account gender differences in children’s participation in physical activities, and consequently would benefit families with boys more than those with girls.24 The lower claim amounts by parents of a single child may be reflective of a child that was either very young or close to 18, who in both cases may be less likely to be enrolled in organized physical activity. In the case of very young children, it may also be that the costs of some physical activity programs designed for young children are lower than those geared toward older children.

Place of residence, in terms of both provincial/territorial jurisdiction and the urban/rural nature of the community, was also significantly associated with use of the CFTC. Of particular concern is the low uptake of the CFTC among those living in the Far North. Families in the Northwest Territories and Nunavut were much less likely to claim the CFTC than their counterparts in other jurisdictions, including

Yukon Territory. At the time the CFTC came into effect, Yukon Territory implemented a matching, territorial-level tax credit, which could partly explain the large disparity in CFTC claims between Yukon and the other two territories. However, there are other factors that may contribute to the low level of CFTC use in the Far North, including a lack of awareness of the CFTC, a lack of eligible physical activity and sports programs, a scarcity of qualified program leaders, and inadequate facilities.25 The same issues also affect families living in rural areas in other regions of Canada and may partly explain why rural families were less likely to make use of the CFTC than their urban counterparts. The lower claim amounts among smaller communities may indicate lower use of programs, as well as lower costs of programming. Targeted efforts to promote the CFTC to taxpayers in the Far North and rural Canada may encourage greater use of the credit in the future. However, this would likely address only one part of the problem. Efforts are also needed to increase the number and the diversity of physical activity and sports opportunities that are available to northern and rural children and youth. These may include building new or improving existing facilities; training parents, youth, and other community members to be coaches or physical activity leaders; and forging partnerships between community groups to improve community capacity related to physical activity and sports.26 It is not clear whether a greater uptake of the CFTC would require increasing the size of the credit, increasing awareness of the credit, increasing facilities and programming, or some combination of these.

Immigration status appears to affect CFTC claims, with recent immigrants being less likely than other immigrants to claim the CFTC. This could indicate limited financial resources or less awareness of the credit. Educational campaigns targeting recent immigrants could be useful in increasing takeup among members of this group.

Arguably, the strongest criticism of the CFTC to date has been that it favours families with higher household incomes.27 Our findings provide strong objective evidence that these concerns around equity are warranted. Differences in the probability of using the CFTC become more evident with variations in family income. Furthermore, our analyses show that the amount of CFTC claims tends to increase with family income; thus, those in higher income groups obtain greater benefit.


27 See Faulkner et al., supra note 3; von Tigerstrom et al., ibid.; Larre, supra note 7; Spence et al., supra note 6; and Block, supra note 14.
from the credit in two respects: they are more likely to claim the credit, and they receive a higher amount when they do make a claim (compared to lower-income claimants). Spence et al. have recommended (as have others) that alternative solutions, such as sponsorships or direct subsidies, may be preferable to tax credits to promote physical activity among low-income children.28

The multiyear analysis shows that the total number of families using the CFTC increased each year, and those families that had previously used the credit were more likely to use it in subsequent years, though the odds of claiming the CFTC and the amounts claimed decreased over time. The finding that families using the credit claimed lower amounts in subsequent years could indicate that awareness of the CFTC may not necessarily increase participation in organized physical activity programs beyond the initial year of use. Together, these findings also highlight the utility of going beyond describing rates of use in understanding the implications of the CFTC policy.

When assessing the CFTC, it is also important to consider the public perception of its influence. The findings in this regard are somewhat mixed, particularly if income is not taken into consideration. Overall, approximately one-third of the parents surveyed felt that the CFTC provided motivation or made it easier to register their children in physical activity or sports programs. At first glance, our findings seem to suggest that the CFTC provided little actual assistance in terms of facilitating access to programs, given that just 15 percent of respondents agreed that the CFTC allowed them to register their children in programs that they would not have otherwise been able to access. However, if we focus on the group most in need of assistance—families earning less than $40,000 annually—the CFTC was perceived to facilitate access to otherwise inaccessible physical activity programs for close to 30 percent of those parents, compared to 6.5 percent of parents with annual household incomes greater than $100,000. This suggests that the CFTC was an important or instrumental factor in decision making around physical activity for almost one-third of the families that it was intended to help. However, the LAD data indicate that rates of claiming and claim amounts are relatively low in the lower income groups, so it seems that individuals’ perceptions of the assistance that they are receiving may be higher than their actual rates of use. It is also important to note that the survey data provide important insights into the perceived importance of other factors that may affect physical activity participation, such as availability of facilities and programs. The results suggest that attention to these factors is also needed, both to increase the likelihood that the financial incentive of the CFTC can be effective in enabling participation, and independently as a means of ensuring access to physical activity opportunities for all Canadians.

Making the CFTC more useful to lower-income groups could reduce financial barriers to participation in organized physical activity programs and thereby increase

28 Spence et al., supra note 6, at 4-5. Also see Larre, supra note 7, at 12:10-11; and von Tigerstrom et al., supra note 3, at e13.
rates of physical activity among this group. It remains unclear whether the availability of the CFTC actually does increase participation in physical activity. If it does, at least to some extent, the credit will be more effective if it is used by those who are likely to face the greatest financial barriers to participation—that is, those in lower income groups. The distribution of claims across income groups is therefore one factor to consider in evaluating the potential impact of the CFTC. In addition, studies have recognized the importance of the equitable distribution of tax expenditures.29 Therefore, if the CFTC is to remain a part of the tax system, equity concerns should lead policy makers to consider steps to increase uptake among lower income earners.

One alternative would be to restructure the credit in a way that would allow lower-income parents to access it more readily or more immediately, so that they might then perceive it as a tangible benefit.30 Currently, the CFTC is a non-refundable credit; consequently, some families that might otherwise claim it may be unable to do so because they do not earn enough income. This would be the case for most families with annual household incomes under $20,000.31 Furthermore, the modest amount of the credit and/or the delay between incurring the expense and receiving the tax reduction may reduce its usefulness to those who are eligible.32 Saskatchewan’s active families benefit (for example) is a refundable credit where the benefit is equal to the full amount of fees paid up to a certain limit, rather than a percentage.33 Making the CFTC refundable would allow low income earners who do not owe tax to receive a direct benefit from the credit, and thus could be expected to increase uptake among low-income families. Furthermore, changing the credit to cover the cost of the program up to a specified limit, as opposed to a percentage (currently a maximum of 15 percent), would cover a larger proportion of the cost of programs—perhaps even the full cost of less expensive programs—and could thereby increase uptake by lower-income families.34 It would be possible to take a more revenue-neutral approach to this change by lowering the credit amount to $75. Finally, if the scope of programs eligible for the CFTC were expanded to include less structured, less costly, family-oriented activities (for example, using public swimming pools and

30 See von Tigerstrom et al., supra note 3, at e13; and Larre, supra note 7, at 12:8-11.
31 It is likely that families (single- or dual-parent) earning less than $20,000 a year would not pay tax and therefore could not use the CFTC. Even in situations where the distribution of income was not evenly split, the person with the higher income could use up the rest of the lower earner’s federal personal exemption. Single parents may claim a credit of close to $10,000 for their first child, so this reasoning will generally hold true for them as well.
32 See von Tigerstrom et al., supra note 3, at e12-13; and Larre, supra note 7, at 12:8-11.
34 See von Tigerstrom et al., supra note 3, at e13.
ice rinks), more families might take advantage of the tax benefit. However, the cost to the government would presumably be significantly higher.

We believe that this study is unique in that it is the first to examine the CFTC using both federal tax data and survey-based behavioural data. The comprehensiveness of the LAD data and the relatively large sample sizes of both data sets ensure that the estimates produced are reliable and representative of the Canadian population. Our findings are relevant to provinces and territories that have implemented a similar tax credit or are considering doing so. The study may also be useful in assessing other proposals that use economic incentives for obesity prevention or for other public health purposes, by highlighting factors that may influence awareness of these incentives or barriers to their use.

That said, this study is not without limitations. While it would have been ideal to be able to link the federal tax data with the survey data, the LAD tax data were de-identified prior to analysis, thus precluding this possibility. The cross-sectional nature of the CFLRI survey data limits the conclusions that can be drawn, and the possibility of bias owing to inaccurate recall or social desirability in self-reported behavioural data cannot be overlooked. However, these limitations are mitigated by the relatively large sample sizes of both data sets and the objective nature of the tax data. While the LAD is a comprehensive database, there remains the possibility of some loss of CFTC data owing to complex family situations that are not accounted for or clearly identified in the LAD. For example, the fact that the prior relationship of separated or divorced parents is not identified in the LAD may have implications for tracking CFTC claims. There are, however, checks in place to ensure that the data are as complete and accurate as possible. Finally, our analyses do not allow us to make any claims with respect to the effectiveness of the CFTC in increasing physical activity rates among children. Given the difficulty of collecting and tracking data on actual change in physical activity rates before the CFTC was introduced and subsequently, and of linking any change to the CFTC, direct measurement of the program’s effectiveness remains very challenging. However, the data presented and analyzed here provide the clearest indication yet of the patterns of use and influence on decisions that are necessary prerequisites in determining effectiveness.

CONCLUSION

Ultimately, the public health impact of the CFTC (and any similar future tax measures) depends on the extent to which the program increases physical activity among children and youth. As with other credits and deductions, this may be difficult, if not impossible, to ascertain. For example, it is not clear from the literature whether the tax deduction available for registered retirement savings plans increases total savings

35 These are discussed in the LAD documentation, supra note 13.
36 See von Tigerstrom et al., supra note 3, at e12.
by Canadians or simply replaces non-retirement savings with retirement savings.37 The CFTC represents a significant investment of public funds, and while it may be politically popular, it could be improved by addressing some of the limitations outlined above. Given that these programs continue to spread—British Columbia has now adopted a provincial children’s fitness tax credit, 38 the Alberta government announced its intention to implement a provincial credit, 39 and in 2011 the federal government announced its intention to double the amount of the CFTC and to introduce a similar tax credit for adults (to be implemented in 2015) 40—it is becoming all the more important to critically evaluate the CFTC (along with provincial tax credits) and implement the changes necessary to overcome the limitations of this policy, and thereby maximize the return on this public investment.

J.L. Ilsley and the Transformation of the Canadian Tax System: 1939-1943

Colin Campbell*

PRÉCIS
Entre 1939 et 1943, le régime fiscal canadien s’est transformé sous la direction et le leadership de J.L. Ilsley, ministre fédéral des Finances de 1940 à 1946. L’impôt sur le revenu des particuliers a été étendu à la plupart des travailleurs à des taux progressifs élevés, tandis que l’impôt sur le revenu des sociétés a été considérablement augmenté et appliqué aux profits excédentaires réalisés en temps de guerre. Grâce aux accords de location de domaine fiscal, la compétence en matière d’impôt sur le revenu est passée des provinces au gouvernement fédéral. Cela a fait en sorte que l’imposition du revenu est devenue la principale source de revenus du gouvernement fédéral, servant au financement de l’effort de guerre du Canada et jetant les bases du financement de l’État providence de l’après-guerre. La parfaite maîtrise des enjeux par Ilsley et son leadership, tant au Cabinet que devant la population, ont été des éléments essentiels de cette transformation.

ABSTRACT
Between 1939 and 1943, the Canadian tax system was transformed under the guidance and leadership of J.L. Ilsley, the federal minister of finance from 1940 to 1946. The personal income tax was extended to most of the working population at high, progressive rates, and the corporation income tax was raised drastically and applied to excess wartime profits. Through the tax rental agreements, income tax jurisdiction was transferred from the provinces to the federal government. The effect was to make income taxation the principal source of federal government revenue for financing Canada’s war effort and to lay the basis for financing the post-war welfare state. Ilsley’s mastery of the issues and his leadership both in Cabinet and before the public were essential elements of this transformation.

KEYWORDS: HISTORY ■ FEDERAL-PROVINCIAL ■ POLITICS ■ TAX-COLLECTION AGREEMENTS ■ TAX POLICY ■ INCOME WAR TAX ACT

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INTRODUCTION

When considering changes in a tax system, commentators tend to focus on detailed statutory provisions. These provisions are often complex, and tax professionals thrive on complexity. In addition, most tax professionals are practitioners with clients (many of whom are wealthy individuals and corporations) whose tax-planning strategies are often affected by statutory changes and whose interests are not those of the wider public or of society as a whole. In this article, I will describe the changes to the Canadian tax system between 1939 and 1943, a transformation that involved little statutory amendment by the standard of subsequent tax reforms (such as those of 1971 or 1987, for example) but that had far-reaching consequences for Canadian society as a whole and for most Canadians. These developments were for the most part effected through the 1941 and 1942 budgets; the budgets of 1939 and 1940 provide the background, while that of 1943 dealt with a number of loose ends and is considered for completeness.

The transformation was guided by James Lorimer Ilsley, the minister of finance from July 1940 to December 1946. Paul Martin Sr. (a member of Cabinet in the King, St. Laurent, Pearson, and Trudeau governments) noted in his memoirs that “James Ilsley, perhaps the ablest of my contemporaries . . . has passed completely from view.”¹ Martin’s comment was well taken. Ilsley was not responsible for drafting legislation or for analyzing the underlying tax policy objectives; that was properly the task of the civil servants in the Department of Finance, notably the deputy minister, William Clifford Clark. Ilsley’s job was to master and understand the issues, make decisions as to the policy direction to follow, take those decisions to the Cabinet, and then explain and justify them to the Canadian people. In short, he exercised, and to a high degree, political leadership. The focus of this article is primarily on Ilsley’s role with respect to the Cabinet, the parliamentary opposition, and the provinces; his relationship with the voting public is closely connected with his role in

promoting the massive wartime borrowing program of the federal government, a detailed discussion of which is beyond the scope of the article.

The transformation of the Canadian tax system was driven by the need of the Canadian government to raise unprecedented amounts to finance the unlimited war effort to which Canada committed in 1940. This in turn required the minister of finance and his officials to address a number of critical policy issues:

- **Whether to rely primarily on borrowing or to raise taxes.** The decision to rely on taxation as far as possible was strongly influenced by the desire to minimize the socially disruptive and fundamentally inequitable effects of inflation, viewed as bearing largely on those with lower incomes.
- **What type of tax to use.** The commitment to equity dictated unprecedented reliance on, and expansion of, income taxation and the imposition of extremely high rates of tax, on both individuals and corporations.
- **How to deal with the provinces.** The provinces already occupied the income tax field, and the variegated array and levels of provincial tax made it difficult to impose a consistent and equitable national policy.

These choices in turn led Ilsley and the federal government to extend the income tax to lower- and middle-income Canadians who had not previously borne income taxation. The pursuit of the war effort on a basis of equitably shared financial sacrifice could be done no other way.

**THE WAR AND THE TAX SYSTEM**

While academics and civil servants like Clifford Clark, Oscar Skelton, and W.A. Mackintosh had given thought to the question of how changes to the tax system might be made (and the Rowell-Sirois commission was directing a significant part of its deliberations to the tax system), there was no apparent political pressure or political will in 1939 to undertake any significant reforms. The catalyst for the transformation was Canada’s entry into the Second World War. War and money go hand in hand, and when Canada declared war on Germany in September 1939, financing the war effort was a priority for the Mackenzie King government. Fortuitously, the capacity of the federal government to deal with fiscal and monetary policy had been significantly enhanced in the 1930s by the establishment and staffing of the Bank of Canada in 1934 under Graham Towers, the bank’s first governor, and the hiring of Clifford Clark as deputy minister of finance in 1932. Clark, Skelton (Clark’s former colleague in the Department of Economics and Political Science at Queen’s

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2 The Royal Commission on Dominion-Provincial Relations was appointed in 1937 with a broad mandate to review and make recommendations on, among other things, the allocation of financial powers and obligations between the federal government and the provinces. The commission delivered its report in 1940. See the discussion below at note 69 and the related text.
University—the “kindergarten” of the Department of Finance—and in 1939 under-secretary of state for external affairs, Canada’s senior civil servant), and Towers had given considerable thought to war finance in light of Canada’s experience in the First World War, and were of one mind on the issue.

The cost of Canada’s effort in the First World War had been financed entirely by borrowing, rationalized on the basis that the cost of the war was a sort of capital investment, made to preserve the freedom of Canadians. While the resulting increase in the money supply was initially absorbed by slack in the economy, inflation inevitably ensued. The money supply increased by 40 percent between 1917 and 1918, and the cost of living increased by 34 percent between 1916 and 1918, and by 74 percent between 1914 and 1918. Inflation in turn cast a disproportionate burden on lower-income Canadians and fostered social unrest, culminating in the Winnipeg general strike of 1919. The mandarins in Ottawa were adamant that, to avoid inflation, the next war should be financed by taxation, as far as practicable, together with borrowing from the real savings of the Canadian public. Bank borrowing was to be only employed to cover short-term cash needs or to provide immediate stimulus where the productive capacity of the economy was underutilized. Clark reiterated this position in a memorandum to Ilsley (at the time acting minister of finance) in early September 1939, and the Cabinet appears to have approved this course with little discussion.

Clark anticipated a deficit of “staggering proportions,” which would require the government to show “that it is making the most serious effort to reorient its tax structure to the new burdens” in order to maintain confidence in the capital markets and enable borrowing at reasonable rates—“not anything like the rates which prevailed during the last war.” “Real sacrifices” by the Canadian public were required to reassure the markets. Clark also recommended that tax policy should “secure equality of sacrifice on a basis of ability to pay” and be designed so as to “eliminate profiteering or undue and unreasonable profit” on the part of businesses that would benefit from wartime activity. The Canadian public would not accept profits that

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3 See the budget speech of W.T. White in 1915: “[W]e need have no reluctance in borrowing to meet the expense of this war, because such borrowing is for the purpose of accomplishing for future generations that which is infinitely more precious than material undertakings, namely, the preservation of our national and individual liberty.” Canada, House of Commons, Debates, February 11, 1915, at 84.

4 See, for example, O.D. Skelton, Canadian Federal Finance—II, Bulletin of the Departments of History and Political and Economic Science in Queen’s University no. 29 (Kingston, ON: Jackson Press, October 1918), at 8-9 and 18-19.

5 See memorandum of September 5, 1939 from W.C. Clark to Ilsley, Public Archives and Library Canada (herein referred to as “LAC”), Department of Finance records (RG19), volume 3427.

6 Ibid., at 4.

7 Ibid.

8 Ibid., at 5.
could not “be justified in comparison with the human sacrifice that will have to be asked from individuals.” There is no indication of Ilsley’s immediate response (or indeed of any discussion that preceded Clark’s memorandum). However, his agreement with Clark’s position was clearly reflected in the budget he presented on September 12, 1939.

In that first wartime budget speech, Ilsley stated that inflation was

> easily the most unfair and inequitable of all the methods of diverting labour and materials to war-time purposes. It represents merely a thinly disguised scheme of taxation of a most unjust type. . . . It represents a complete violation of the principle of taxation in accordance with ability to pay.

Therefore, he announced, the government would pursue “as far as may be practicable a pay-as-you-go policy.” Taxes would be imposed in accordance with

> the principle of equality of sacrifice on the basis of ability to pay. . . . What we cannot meet by taxation we shall finance by means of borrowings from the Canadian public at rates as low as possible.

Ilsley reiterated this policy two years later, in his budget speech delivered on April 29, 1941, in which he emphasized that the basis for taxation was

> derived not from any dogma of financial orthodoxy . . . but from the known and proved inequities and the disorganizing and shattering effects of inflationary rises in prices and incomes.

This position was reinforced by the assumption in 1939 that war expenditure would be limited and manageable. Canadian support for the war, though widespread in English Canada, was lukewarm in Quebec and, in any event, devoid of the enthusiasm of 1914. Prime Minister Mackenzie King, above all, was determined to avoid

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9 Ibid.

10 Canada, House of Commons, Debates, September 12, 1939, at 139. Ilsley also addressed White’s argument that borrowing to finance the war was a sort of capital investment to benefit future generations, stating that some “feel that borrowing at home may enable us to shift part of the burden to the next generation. Ill-considered and excessive domestic borrowing, of course, may add unnecessarily to the burdens of certain members of the present and post-war generations who will find it necessary to pay interest to those of their fellows who may be bondholders. But the war generation does not thereby shift its own real burden on to posterity because borrowing at home does not enable us to borrow from future production the physical goods and services that are used up during a war. Borrowing at home is merely one means of diverting our production into war requirements.” Ibid., at 138.

11 Ibid., at 139.

12 Ibid., at 139-40.

13 Canada, House of Commons, Debates, April 29, 1941, at 2335.
conscription, which had divided the country and, perhaps as importantly, the Liberal Party in 1917. This entailed a war effort that minimized casualties, and Andrew MacNaughton was appointed to command the Canadian army in October 1939 largely because of his belief that modern equipment and training would reduce casualties and his consistent opposition to conscription. In September 1939, the Cabinet authorized raising a single infantry division to be sent to Britain, a second infantry division for service in Canada, and continued expansion of the navy and air force. Canada’s principal contribution was envisaged to be the provision of war matériel and other raw goods, most of which Britain and France would take and pay for. When, after the outbreak of war, the British government raised again its earlier proposal for a British Commonwealth Air Training Plan (BCATP), the King government eagerly embraced it, anticipating no overseas involvement and no casualties—and carried out protracted negotiations with Britain in December 1939 regarding the allocation of costs.14 The service chiefs proposed spending $491 million in the first full year of the war, but when this figure was put before the War Committee of the Cabinet, Clark and Towers were brought into the meeting to explain to the generals why Canada could afford only half that amount, a spending limit that was duly approved.15

**THE SEPTEMBER 1939 BUDGET**

The September 1939 budget was brought down by Ilsley, then minister of national revenue, on behalf of newly appointed Finance Minister J.L. Ralston, who had no seat in the Commons at the time.16 Clark and C. Fraser Elliott, the commissioner of income tax, had placed various alternatives before Ilsley and Ralston for income tax increases, including reductions in the basic exemptions and increases in the graduated tax rates. Flat-rate percentage increases were rejected on the basis that they would

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14 King admitted in his diary that, had the BCATP been in place before September 1939, Canada might have confined its contribution to that initiative “instead of having to head so strongly into expeditionary forces at the start.” *The Diaries of William Lyon Mackenzie King*, September 28, 1939 (www.collectionscanada.gc.ca/databases/king/index-e.html) (herein referred to as “Mackenzie King diaries”).

15 Meeting of September 18, 1939, LAC, microfilm C-4783. The figure suggested by Clark and Towers was consistent with the initial war appropriation of $100 million, approved earlier in September, for the remaining 6½ months of the 1939-40 fiscal year, when added to the projected peacetime spending for 1939-40 of about $64 million.

16 When war broke out, Ilsley was acting minister of finance in the absence of Charles Dunning, who had ongoing medical problems. Ilsley had previously acted in Dunning’s place on a number of occasions. On September 6, Layton Ralston, who had retired from public life in 1935, was appointed minister of finance. Because Ralston did not have a seat in the Commons until November 1939, the first war budget speech was delivered by Ilsley. Ilsley had worked with Clark and other officials in the Department of Finance prior to Ralston’s appointment and worked with Ralston in preparing the budget.
disproportionately fall on lower-income taxpayers. The final proposals simply imposed a neutral, 20 percent surtax on all income tax payable by persons other than corporations. The general corporation income tax rate was raised from 15 percent to 18 percent, providing a minimum corporate tax to accompany a proposed excess profits tax. As proposed, that tax would have weighed less heavily, if at all, on some larger corporations with both substantial profits and high capital levels (such as the chartered banks). The increase of 3 percentage points in the corporate income tax rate guaranteed a minimum 20 percent tax increase for such corporations.

The proposed excess profits tax on business income was critical to the “equality-of-sacrifice” policy that Ilsley set out in the budget speech. Allegations, often well founded, of substantial corporate profit making from war-related contracts (usually described with the pejorative term “profiteering”) during the First World War had dogged the Borden government, which eventually imposed an excess profits tax in 1916. The 1939 excess profits tax, which was retroactively repealed and replaced in 1940, is discussed in more detail below. Finally, the budget proposed a number of immediate increases in commodity taxes, primarily on alcohol and tobacco products.

For the remaining portion of the 1939-40 fiscal year, it was estimated that these measures would raise an additional $21 million. In fact, as table 1 indicates, tax revenue in 1939-40 was about $30 million greater than in 1938-39, and military expenditures were about $80 million greater (rising to $118.3 million). The deficit, coincidentally, was $118.4 million. The increase of $60 million in the deficit from the April 25, 1939 budget estimate reflected higher war expenditures less increased sales and excise taxes and duties. Income tax revenues, calculated on 1938 incomes at pre-war rates, actually declined. Personal and corporation income taxes combined accounted for less than 24 percent of total revenue.

The relatively small contribution of income taxes in 1939-40 (notwithstanding the September 1939 rate increases) was a function of three factors. The first was the timing of tax payments. Under the existing provisions of the Income War Tax Act (IWTA), individuals were required to file returns for a taxation year (the calendar year) by April 30 of the following year, and corporations were required to file within four months of the end of their fiscal year. One-third of the tax owing was payable with the return and the balance within four months (with interest). Consequently, any increased taxes imposed in respect of the 1939 taxation year would not be payable until after the end of the government’s 1939-40 fiscal year (March 31, 1940).

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17 See memorandum of September 9, 1939 from C. Fraser Elliot to Ilsley, LAC, RG 19, vol. 3427, and Clark’s memorandum of September 5, 1939, supra note 5, at 9: “I had first thought of avoiding any elaborate attempt to reorganize the existing scale [of personal income tax rates] by merely applying a flat increase of 2% to all rates. This, however, would result in an unduly heavy increase in the lower income brackets.”

18 Enacted by An Act To Amend the Income War Tax Act, SC 1939-40, c. 6.

19 Enacted by the Excess Profits Tax Act, SC 1939-40, c. 4.

20 RSC 1927, c. 97, as amended, sections 33, 35(2), and 48.
The proposed excess profits tax applied only to 1940 income and would similarly not be payable until after the end of a corporation’s 1940 fiscal period. There were at that point no source deductions and no provision for instalment payments.

The second factor was the willingness of the government to rely on borrowing to a greater extent in the early stages of the war to stimulate the economy and war production. Such stimulus was considered necessary to address the excess capacity in the economy which was a lingering effect of the Great Depression. In a memorandum to Ilsley in early September 1939, Clark offered the following advice:

We should try to avoid imposing at the start tax increases that would tend to retard the recovery of our economy to full activity and employment. . . . [O]ur first borrowing operation is intended, as you know, to be a short term banking operation which will have the effect of expanding the cash basis of the banking system and of stimulating the economy generally.21

The third and most important factor was the secondary place of income tax in Canadian public finance at the time. Since its inception in 1917, the federal income tax had been limited to a fairly small, high-income group. In 1939, of a total Canadian population of nearly 12 million, there were fewer than 300,000 income taxpayers, paying tax at marginal rates ranging from 3 percent to 66 percent. A married taxpayer with two dependent children and a spouse who did not work (and no other deductions) would become liable to tax only when his or her annual income reached $2,800,22 more than twice the average industrial wage. The war budget of 1939 did not increase the number of taxpayers, but only the burden on those already liable to tax. As indicated in table 2, in 1938-39, the manufacturer’s-level sales tax (of 8 percent) and the various excise duties and taxes (principally on tobacco and alcohol)

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21 Memorandum of September 5, 1939, supra note 5, at 4-5. The government in fact borrowed $2.09 billion from the Canadian banks in November 1939, $92 million of which was used to repatriate Canadian securities held in the United Kingdom, so as to address the UK balance-of-payments problem discussed below (see the text following note 63).

22 The IWTA provided exemptions of up to $2,000 for a married taxpayer and $400 for each dependent child. Since average weekly wages and salaries for all industries in 1939 were $23.44 or $1,219 annually, the $2,800 tax threshold for a married taxpayer with two dependent children was approximately 2 1/3 times the average industrial wage. On the basis of the average weekly
accounted for almost 40 percent of tax revenue, while customs duties accounted for about 18 percent and direct taxes on income about 30 percent. Approximately two-thirds of total income tax receipts came from the corporate income tax. Immediately before the war, the personal income tax produced no more than about 10 percent of total tax revenue. In the 1939-40 fiscal year, personal income tax accounted for just under 10 percent of all tax revenue and corporate income tax for almost 17 percent. By contrast, customs duties provided 22 percent of tax revenue, and excise duties and taxes 42 percent.

Even before the crisis of 1940 (discussed below), it was recognized that the budget proposals of September 1939 were only an interim measure. War expenditures were bound to increase (particularly because of the cost of the vastly more sophisticated equipment and armaments used in the Second World War), and while an expanding economy was producing increased tax revenues ($50 million more than in 1938-39), further tax increases were inevitable. There were no real estimates of the likely cost of Canada’s limited war commitment—perhaps the estimate of $491 million suggested by the chiefs of staff in September 1939 is as close an approximation as possible. In late January 1940, estimated war expense for 1940-41 was $500 million, which is consistent with that conclusion. That would have required

![Table 2](image)

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales and excise duties</th>
<th>Customs duties</th>
<th>Personal income tax</th>
<th>Corporation income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1938-39</td>
<td>173.4</td>
<td>78.8</td>
<td>46.9</td>
<td>85.2</td>
</tr>
<tr>
<td>1939-40</td>
<td>198.4</td>
<td>104.3</td>
<td>45.4</td>
<td>77.9</td>
</tr>
</tbody>
</table>


Income tax revenues in 1938-39 were made up of $85.2 million in corporation income tax payments, $46.9 million in personal income tax payments, and $9.9 million from the 5 percent non-resident withholding tax on interest and dividends. See J. Harvey Perry, *Taxes, Tariffs, & Subsidies: A History of Canadian Fiscal Development*, vol. 2 (Toronto: University Toronto Press, 1955), table 6, at 624ff.

in excess of $300 million in increased revenue over the actual 1939-40 results, a
level of war-related expenditure that would have represented nearly 10 percent of
Canada’s gross national product (GNP) in 1939 ($5.69 billion—see table 4 below).
Had war spending in 1939-40 been $491 million rather than $118 million, the defi-
cit would have been $370 million.

THE CRISIS OF 1940
Canada’s limited war commitment and the accompanying fiscal measures came to
an abrupt end in May 1940. By mid-June, Hitler was in Paris, the German army had
advanced to the English Channel, and Canada was Britain’s principal (and nearly
only) ally. Faced with the supreme crisis of the 20th century, the King government,
to its credit abandoned its initial limited war policy and committed Canada to total
war and the mobilization of all available human, material, and financial resources.
In the midst of this crisis, on June 10, 1940, a Royal Canadian Air Force plane flying
from Ottawa to Toronto crashed just outside Newtonville, killing all on board,
including Norman Rogers, the minister of national defence. The resulting recon-
struction and strengthening of the Cabinet took about a month as King pondered
and consulted the usual sources. In the result, Layton Ralston was moved from
Finance to Defence and Ilsley from National Revenue to Finance, tasked now with
financing a vastly expanded war effort. Ilsley had been passed over for Finance in
1939, and his appointment in 1940 was one “most reluctantly taken by King.”25

Ilsley was 46 years old, a lawyer from the Annapolis Valley in Nova Scotia. As an
undergraduate at Acadia University, he had been a brilliant and precocious student,
the gold medallist in his graduating class, and the leading debater on campus.26 He
studied law at Dalhousie University and, after articling in Halifax, practised law in
Kentville. He was elected to Parliament in 1926, and in October 1935 became min-
ister of national revenue. As noted above, during the late 1930s, he was acting
minister of finance on a number of occasions; however, in the Cabinet reorganization
of September 1939, it was Ralston, not Ilsley, who was given the Finance portfolio.

The civil servants in Finance welcomed Ilsley’s appointment. “We already knew
and liked him,” Robert Bryce recalled, describing Ilsley as intelligent, industrious,
and well-read.27 J.L. Granatstein has described him as “a minister of great ability,
integrity and first-class intelligence.” Both Bryce and Granatstein noted that Ilsley would not accept advice from his deputy minister or other senior staff that he himself did not understand, and he would often debate both sides of an issue with Finance officials, sometimes late into the night:

He understood problems and arguments very quickly—so well that he saw both sides of most of the issues that came before him, finding it difficult to reach decisions. He used to debate both sides with us in his office. Ilsley was a fitting minister to match wits with Clark, Towers and Donald Gordon.

This was also Ilsley’s great weakness; having thoroughly canvassed both sides of an issue, he worried constantly about the consequences of his decision, to the point of endangering his health. As Bryce remarked, “[a]t several critical times in the late years of the war, Ilsley worried himself sick and had to get away to relax.”

Observers described Ilsley as a man of “austere habits,” “dour,” and either “rugged” or “granitic” (the latter term clearly referring to a facet of his personality and not his personal appearance). A contemporary reporter wrote of Ilsley, a staunch Baptist, that he was reminded of “those earnest and unsmiling young men you might meet at the neighbourhood tabernacle, who will give you a grip of the hand and ask you if you are saved.” It is perhaps not surprising, then, that a journalist wrote in Ilsley’s hometown newspaper that

Mr. Ilsley is by no stretch of the imagination the typical politician. Even several campaigns have not taught him to slap a back. He kisses no babies.

The journalist’s description of Ilsley’s campaigning style is revealing:

Coldly, calmly, rationally he lays before his people his reasoned convictions and the course of action which he believes to be in their best interest and in the interest of the country. And offers them himself and all that he has in unselfish and unswerving public service.

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29 See ibid., at 160: “Ilsley worried incessantly about everything, but he would accept no advice from the Deputy Minister, Clifford Clark, that he did not understand well enough to put before the Cabinet.”

30 Bryce, supra note 27, at 4.

31 Ibid.


33 See Austin F. Cross, *The People’s Mouths* (Toronto: Macmillan, 1943), at 68.

34 See the *King’s Courier*, November 23, 1940.

35 Ibid.
Donald Fleming wrote in his memoirs of Ilsley’s “homespun honesty of purpose.” This reputation for honesty and integrity was to stand him in good stead.

**THE 1940 BUDGET**

Ralston delivered the 1940 budget on June 24, 1940, two weeks before Ilsley replaced him. This was necessarily to some extent a stop-gap measure, with insufficient time to develop a longer-term approach to war financing. By this time, estimated war expenditures for 1940-41 had increased to $700 million, about six times those of the previous year.

The 1939 excess profits tax was retroactively repealed and replaced. Because the tax as enacted in 1939 applied to 1940 income and used the same filing and payment arrangements as set out in the IWTA, it had never had effect. The 1939 statute had technical shortcomings, centring on the same issue encountered by Canada and the United Kingdom in the First World War, namely, how to define what constituted “excess” profits. Ralston noted in his budget speech that

> one main feature which appeared to be undesirable was the right of the taxpayer to choose between the two options. In the light of actual conditions it was found that many established firms would pay little or no tax, while others [which were new or expanding] would be subject to what appeared to be unwarranted discrimination.

In the debate on the budget resolutions, Ilsley (by then minister of finance) pointed out that some corporations were not earning more during the war than before but could still enjoy a high return on capital and “get off without any taxation” beyond the 18 percent minimum tax.

The 1939 version of the excess profits tax had provided two alternative bases for taxation, at the taxpayer’s option. The corporation could pay tax at a sliding scale from 10 percent to 60 percent on profits in excess of specified percentages of “capital employed” in the business. The latter consisted of share capital and accumulated profits, less half of dividends paid or deemed to be paid. Share capital representing the value of goodwill, other intangible assets, or unrealized appreciation of assets was excluded. In the alternative, a corporation could pay tax of 50 percent of actual profit in excess of the average annual profit for the 1936 through 1939 years. In determining profits, income tax paid, intercorporate dividends, and depreciation of assets acquired to fill war orders were excluded.

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36 Donald Fleming, *So Very Near: The Political Memoir of the Honourable Donald Fleming*, vol. 1, *The Rising Years* (Toronto: McClelland and Stewart, 1985), at 133. Donald Fleming was elected as a member of Parliament in 1945 and later served as the minister of finance in the Diefenbaker government.

37 See Canada, House of Commons, *Debates*, June 24, 1940, at 1011-76.

38 Ibid., at 1022-23.

39 Canada, House of Commons, *Debates*, July 11, 1940, at 1537.
The Excess Profits Tax Act, 1940\textsuperscript{40} abandoned any attempt to measure returns on capital and, following the British model, imposed tax on “excess profits,” defined as profits in excess of “standard profits” (the average yearly profits in the 1936-1939 period from carrying on the “same general class of business”). Various adjustments to standard profits were allowed to reflect changes in capital employed (measured, in general, as the net equity value of the enterprise) and certain other factors. A board of referees was established to determine standard profits where there were no prior profits\textsuperscript{41} (for example, because the business was new). The tax imposed was the greater of 12 percent of profits determined for the purposes of the IWTA and 75 percent of excess profits.

These provisions effectively imposed a minimum 30 percent corporate tax rate\textsuperscript{42} to ensure that “no profitable business [would] escape taxation.”\textsuperscript{43} Both the 1939 and the 1940 statutes adopted the reporting and payment provisions of the IWTA, so that tax arising in respect of 1940 profits, for example, would not generally be payable until 1941 (for fiscal periods ending after August 31, 1940). The tax applied to all income earned after January 1, 1940 and was expected to yield $100 million in a full year and $25 million in the 1939-40 fiscal year.

Ralston reiterated the policy set out by Ilsley the year before, that increased reliance would be placed on personal income taxation, which “in principle most nearly approximates ability to pay.”\textsuperscript{44} The “stubborn fact” was that there was insufficient income in the higher brackets to produce enough revenue.\textsuperscript{45} The aggregate income of all persons liable to tax in 1938-39 was only $739 million, and taxing 100 percent of incomes in excess of $2,000 per year would yield only about $115 million in additional revenue. Further, the provinces were also imposing steeply graduated rates, a problem Ilsley was soon to address.\textsuperscript{46}

Ralston’s budget replaced the 20 percent surtax on personal income tax with a new rate structure ranging from 6 percent to 78 percent. The amount of income exempt from tax was reduced from $2,000 to $1,500 for married persons and from $1,000 to $750 for single persons.\textsuperscript{47} The 5 percent surtax on income in excess of

\textsuperscript{40} SC 1939-40, c. 32.

\textsuperscript{41} Or losses, which were disregarded, the loss year still being counted in determining the average profits.

\textsuperscript{42} When added to the 18 percent rate under the IWTA.

\textsuperscript{43} Canada, House of Commons, Debates, June 24, 1940, at 1023.

\textsuperscript{44} Ibid., at 1024.

\textsuperscript{45} Ibid.

\textsuperscript{46} Prior to the 1941 tax rental arrangements, provincial income taxes were not integrated with the federal income tax. See the discussion of the “tax jungle” below under the heading “Dealing with the Provinces: The 1941 Dominion-Provincial Conference.”

\textsuperscript{47} The $400 exemption for dependent children remained unchanged. Thus, the threshold for the application of income tax for a married taxpayer with two children was lowered to $2,300 (compared to $2,800 under the prior law).
$5,000 was eliminated. Ralston estimated that the personal income tax increases would produce an additional $58 million in a full year (but no additional revenue in the current year). In addition, a national defence tax (NDT) was imposed under part XV of the IWTA on all incomes over $600, at a rate of either 2 percent or 3 percent, deducted at source by employers and payers of interest and dividends. The NDT was in some respects the most important part of the budget because it taxed lower income earners (albeit at low rates), who had not previously been subject to tax under the IWTA. Since the tax would be collected through source deductions, taxpayers who were not otherwise subject to income tax would be required to file a return only if the NDT had not been fully paid at source. The NDT applied to only half of 1940 income and was expected to produce $20 million, or about $35 million in a full year. While there were also further increases in various excise taxes, of about $21 million in a full year, and a war exchange tax of 10 percent on all non-sterling imports (estimated to raise $65 million in a full year), nearly 70 percent of new revenue was projected to come from income taxation and, of that, nearly half from individuals. As table 3 indicates, total tax revenue in 1940-41 in fact increased to $778 million, 89 percent of total revenue of $872 million. Of this, personal income tax (including the NDT) accounted for $103.5 million and corporate income tax $131.6 million. Expenditures reached $1,254 million, including actual war expenditures of $791 million, resulting in a staggering deficit of $355 million.

1940-41: THE FISCAL CHALLENGES

The issue facing Ilsley in the summer and fall of 1940 was as much political as technical. The government was committed to devoting as much manpower and matériel to the war effort as was physically possible. Ilsley’s challenge and his commitment was to finance this, to realize revenue equal to a corresponding portion of the total national income. At a Cabinet War Committee meeting in late September, he

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48 Canada, House of Commons, Debates, June 24, 1940, at 1029.
49 Approximately 50 percent of the average industrial wage. The 2012 equivalent amount is approximately $23,500, using the increase in average wages, or $9,300, using consumer price inflation (see supra note 22).
50 The tax rate for married persons with an annual income over $1,200 and single persons with an annual income of $600 to $1,200 was 2 percent; for single persons with an annual income over $1,200, the rate was 3 percent. A tax credit of $8 for each dependent child was allowed, and tax was not payable to the extent that it would reduce income below the $600 or $1,200 threshold.
51 A married taxpayer with two dependent children and an income of $1,500 would pay $14 in NDT, an effective rate of less than 1 percent.
52 In all, it was estimated that the new taxes would raise about $280 million in a full year. In the circumstances of 1939, this would have been more than ample; however, in fiscal 1940-41, defence expenditures were projected to increase from $118 million to $752 million, and projected future increases were in multiples of this.
warned that the second war loan campaign then under way might not be fully subscribed, and “if the people of Canada would not lend the money, it would have to be raised by increased taxation.”

In the throne speech debate in November 1940, Ilsley set out at length the principles of war finance that the government had adopted, repeating the now-familiar propositions made in the 1939 and 1940 budgets. In real terms, the cost of the war was immediate. With lost production being diverted to war purposes, the fiscal challenge was to finance the cost of that production in a way that would restrict civilian demand for economic resources that were no longer available. Taxation was the preferred method because it was “fairer and final” as compared with borrowing. Taxes should be imposed “on a basis of equality of sacrifice, having regard to ability to pay.” Because there were practical limits to levels of taxation, borrowing was unavoidable but should be made “as far as possible out of voluntary public savings,” so as to avoid inflation, “the most unfair, the most uneconomical and the most dangerous of all methods” of war finance. Ilsley warned that, although in the early stages of the war “some expansion of credit is often possible without inflation,” as the productive capacity of the economy became fully employed, the expansion of credit as a result of war spending would necessarily produce inflation. “Strict counter-measures” were required to combat inflation, including “severe taxation” and large-scale borrowing from the wider public from funds that would otherwise be used for consumption expenditures. In this respect, Ilsley stated that the reliance that had been placed principally on financial intermediaries—banks, investment

## Table 3: Federal Budget, Canada, 1939-40 and 1940-41, Tax Revenues and Expenditures

<table>
<thead>
<tr>
<th></th>
<th>Total tax revenues</th>
<th>Personal income tax</th>
<th>Corporation income tax</th>
<th>All expenditures</th>
<th>Defence expenditures</th>
</tr>
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<tbody>
<tr>
<td>1939-40</td>
<td>468.2</td>
<td>45.4</td>
<td>77.9</td>
<td>660.2</td>
<td>118.3</td>
</tr>
<tr>
<td>1940-41</td>
<td>778.2</td>
<td>103.5</td>
<td>131.6</td>
<td>1,254.0</td>
<td>791.0</td>
</tr>
</tbody>
</table>


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53 War Committee minutes of September 27, 1940, LAC, microfilm C-4873.
54 Canada, House of Commons, *Debates*, November 21, 1940, at 280ff.
55 Ibid., at 281.
56 Ibid.
57 Ibid.
58 Ibid.
59 Ibid.
dealers, and brokers—for the initial war loans made in 1939 and 1940 would be replaced by a “broad national organization” of the “cooperative type.” It would be, he said, “[t]he most comprehensive organization of the whole community with a vast army of amateur volunteer workers assisting the professionals . . . and a tremendous amount of advertising and publicity.”

King noted in his diary that he had

"listened to Ilsley who made a splendid speech on finances. . . . Ilsley’s address was really a treatise on war finance; principles and policies referring thereto. A year ago, we would not have dreamt that it was possible for the country to even attempt what today it is achieving."  

By late January 1941, the Department of Finance had calculated that $1.3 billion could be spent on direct war expenditures in 1941-42, noting that actual war expenditures at the time were running at an annualized rate of $1 billion. This represented almost a quarter of the national income at the time and, as Ilsley told the War Committee on January 27, could be raised only “by great strain and widespread sacrifice, for which the people of Canada were apparently not yet prepared.”

The following day,

Mr. Ilsley impressed upon the Committee his view of the extreme gravity of attempting to raise and expend the large proportion of national income represented by $1,300 million dollars. It would mean a budget which would make people gasp.

Funds were also required to finance the growing British balance-of-payments deficit. After British gold and dollar balances were exhausted, Canada had provided foreign exchange to Britain by purchasing Canadian securities (Canadian government bonds and Canadian National Railway bonds and debentures guaranteed by the Canadian government) held in the United Kingdom. For this, an additional $350-$375 million was required in 1941-42 (which effectively exhausted the supply of those securities). This left Canadians holding unconvertible sterling balances with a value of about $700 million. In early 1942, the Cabinet decided that Canada would finance this balance by converting the existing balance to a loan. The Foreign Exchange Control Board acquired the sterling, which was then sold to Britain in

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60 Ibid., at 283.
61 Mackenzie King diaries, supra note 14, November 21, 1940. King noted with respect to Ilsley’s speech, “All carefully prepared by the men in his Department. I felt as I listened how important [the] study of economics has become in these times, and what it means to have scientifically trained minds in the public service. Queen’s University has made a great contribution to government in Canada.” Ibid.
62 War Committee minutes of January 27, 1941, LAC, microfilm C-4873.
63 War Committee minutes of January 28, 1941, LAC, microfilm C-4873.
consideration of Britain’s agreement to repay the amount after the war.\textsuperscript{64} Adding these war-related expenditures to ordinary federal civil expenditure of about $450 million and provincial and municipal expenditures of about $575 million resulted in total government expenditure at all levels of about $3.4 billion, more than half of the estimated national income. By comparison, in 1938–39, total government expenditures at all levels were about $943 million, representing about 16 percent of GNP.\textsuperscript{65}

The 1941 budget contemplated ordinary civil expenditures of $433.1 million, $35 million for wheat acreage reduction payments, and $1.3 billion in war expenditures, for a total of $1.768 billion. However, adding nearly $1 billion to finance the British deficit and assuming $1.15 billion in revenue from existing taxes at 1940 rates, a gap of about $1.5 billion remained to be filled by increased taxes and borrowing. Ilsley told the War Committee that

if the government so decided, he was prepared to undertake a war budget of $1,300 million and take the consequences. However, if he did so, he wished his colleagues to understand how great would be the strain and how severe the criticism and agitation to which the government would be subjected.\textsuperscript{66}

While noting King’s warning that “if people felt the burden was too heavy now national unity would suffer,” the War Committee gave Ilsley the green light.\textsuperscript{67}

It was clear that, to raise the money, personal income taxes would have to be substantially extended. In particular, the personal income tax could yield significant additional revenue only if it was extended to a much greater portion of the population, to working class and low-to-middle-income taxpayers, and at higher rates. For people who had never filed income tax returns or paid income tax, this would potentially be a rude shock. In order to achieve public acceptance, it was essential that the tax be viewed as fairly and equitably imposed—that the financial sacrifices were seen as being borne fairly, just as personal wartime sacrifices were borne fairly. In theory, this was easily solved—by 1940, income tax rates were highly progressive and could be made more so. Likewise, the excess profits tax on corporations made unlikely the accusations of profiteering that had dogged the Borden government in the First World War and could be raised further. Taxing corporations, however, did not involve the same political considerations as taxing individuals.

\textsuperscript{64} The UK loan was made pursuant to the War Appropriation (United Kingdom Financing) Act, 1942, SC 1942–43, c. 8.

\textsuperscript{65} See Perry, supra note 23, at 621, table 3, and table 4 below.

\textsuperscript{66} War Committee minutes of January 28, 1941, LAC, microfilm C-4873.

\textsuperscript{67} Ibid.
DEALING WITH THE PROVINCES: THE 1941 DOMINION-PROVINCIAL CONFERENCE

In practice, the waters were muddied by longstanding provincial and municipal occupation of the income tax fields. The first provincial personal income tax (in British Columbia) dated from 1876; by 1940, personal income tax was imposed by all provinces except Nova Scotia and New Brunswick, and by a number of municipalities, including Montreal and Saint John. All provinces imposed income taxes on corporations as well as a wide variety of other corporate taxes, including on capital, insurance premiums, loans and deposits, bank branches, and places of business. The burden of these taxes had been increased sharply, in particular in the poorer provinces, in the 1930s to deal with the consequences of the Depression.

In peacetime, when federal tax rates were relatively low, the inequality of the aggregate tax burden was annoying but not critical. The new wartime rates contemplated by the federal government, however, could produce combined federal and provincial tax rates in excess of 100 percent, and it was thought that the public would not accept this “most inequitable double taxation.” For corporations, such levels of tax could threaten their financial stability and thus indirectly the production of war matériel. While the federal government could invoke the principle of dominion paramountcy and ensure that, in any event, its taxes would be collected, this did not avoid the political problem of persuading Canadians to bear financial sacrifices that were not imposed equitably. Furthermore, a threat to provincial revenue from a federal-provincial tax dispute potentially threatened the credit of some of the more indebted provinces and their ability to service, and avoid default on, their bonds.

Coincidentally, and fortuitously, the Rowell-Sirois commission had delivered its report in early 1940 and had addressed this issue of the so-called tax jungle, albeit in the context of the Depression, not war. It had recommended that the provinces withdraw entirely from imposing personal and corporation income taxes (and related business taxes) and succession duties. In return, the federal government would assume the cost of relief for the employable unemployed and their dependants; assume the provinces’ net debt service charges; and introduce a system of equalization payments (“national adjustment grants”) to provide financial assistance to the poorer provinces.

The Department of Finance strongly supported the report’s recommendations, stating that provincial taxes were a problem in preparing the June 24, 1940 federal budget and that adoption of the report would make a “vital contribution to the financing of the war.” In the longer term, management of government expenditure to support employment “will be clearly beyond the power of the Dominion government if the present chaotic system of competition in taxation and disorderly grants

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68 See memorandum of February 21, 1941 from W.L. Gordon, LAC, RG 19, volume 751.

69 Canada, Report of the Royal Commission on Dominion-Provincial Relations (Ottawa: King’s Printer, 1940).

70 Unsigned memorandum of September 11, 1940, LAC, RG 19, volume 2701.
to the provinces is still in operation.”71 The department believed that the commission’s proposals had the potential for wide public support, stating that they should “have a very wide appeal to the many Canadians who are eager to see Canada as a nation brush aside petty sectional differences and selfish local interest which weaken her in the present emergency.”72

Ilsley shared this view. In a letter to a Liberal backbencher from Nova Scotia, he said:

[The Report, as you correctly indicate, is based on the principle that no part of the country can be allowed to lag far behind another part in standards of living, education, social services and so on. There is, as you may well understand, considerable resistance to this theory in the more favoured parts of Canada.73

Grant Dexter, Ottawa correspondent of the *Winnipeg Free Press* and probably the best-connected journalist in Ottawa at the time, commented in a memorandum to J.W. Dafoe (the editor of the *Winnipeg Free Press* and one of the members of the Rowell-Sirois commission):

Ilsley, under the constant prodding of Clark, Towers and the other experts, is beginning to see that if sound financial measures are to be taken, the Dominion must greatly enlarge its field of taxation and impose new taxation upon a scale which might well embarrass the provincial governments.74

Ilsley was named chair of a Cabinet committee to consider the Rowell-Sirois report and toured the provincial capitals in October 1940, finding support in most provinces but strong opposition in Ontario and British Columbia (and, to a lesser extent, Alberta). This was not entirely surprising: the Rowell-Sirois recommendations would have eliminated provincial income tax revenue in those provinces that exceeded the net debt service costs that the federal government assumed. On the basis of a conversation with Alex Skelton,75 Dexter reported that

Ilsley . . . has worked out a kind of temporary way of adopting the report. If the Dominion, to do its job, must invade fields of taxation presently occupied by the provinces . . . [the] Dominion should shoulder the full burden of provincial debt, leaving the actual taking of it over until after the war.76

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71 Ibid.
72 Unsigned memorandum of July 24, 1940, LAC, RG 19, volume 2701.
73 Ilsley to I.J. Kinley, January 7, 1941, LAC, RG 19, volume 2701.
74 Frederick W. Gibson and Barbara Robertson, eds., *Ottawa at War: The Grant Dexter Memoranda, 1939-1945* (Winnipeg: Manitoba Record Society, 1994), at 78, quoting from Dexter’s memorandum of October 17, 1940.
75 Son of O.D. Skelton and then head of the research department of the Bank of Canada. Alex Skelton had served as the secretary of the Rowell-Sirois commission.
76 See supra note 74.
It was on these terms that Ilsley approached the provinces in mid-October 1940. At that point, the federal government's proposal was partial adoption of the Rowell-Sirois recommendations but with full implementation delayed until after the war. The committee reported to Cabinet on November 1, 1940 recommending that the Rowell-Sirois proposals be implemented and that a federal-provincial conference be convened to consider the matter. After considerable discussion, the Cabinet approved calling the conference, not so much in the hope of obtaining provincial unanimity but to demonstrate the federal government's good faith and to direct public opinion against provincial holdouts by forcing them to reject the proposals in public.

The conference convened on January 14, 1941. Mackenzie King pointed out in his opening statement that unlimited exercise of the federal government's spending power to finance the war, without agreement of the provinces, “would involve grave inequalities and injustices,” would produce “serious discontent and a weakening of morale,” and would hurt the war effort. Restructuring the fiscal relationship with the provinces, on the other hand—the crux of the Rowell-Sirois report—would strengthen Canadian credit, reduce borrowing costs, and “make possible a scientific reform of the whole Canadian tax system.” King also tied reform of the tax system to enabling post-war social and economic adjustments.

Mitchell Hepburn, the premier of Ontario, replied immediately, describing the report as the product of the “minds of three professors and a Winnipeg newspaper man, none of whom had any governmental administrative experience, and whose opinions all of us cannot share.” It was, in his view, a “well-cooked, nefarious deal” designed to boost the market price of provincial bonds. While Hepburn’s primary criticism was that the report and the conference itself were unnecessary distractions from the war effort, T.B. McQuesten, Ontario’s minister of highways and municipal affairs, in a less impassioned speech the following day, pointed out that Ontario would lose $17 million in net revenue if the report was adopted.

The conference effectively collapsed on the second day when Ontario, British Columbia, and Alberta refused to participate in any of the committees proposed to consider detailed implementation of the Rowell-Sirois report. King then asked Ilsley to make a statement. Ilsley began by observing that

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77 Canada, *Dominion-Provincial Conference: Tuesday, January 14, 1941 and Wednesday January 15, 1941* (Ottawa: King’s Printer, 1941), at 6.
78 Ibid., at 8.
79 Ibid., at 11.
80 Ibid., at 14.
81 Ibid., at 77-78.
82 The conference organizing committee, chaired by Ernest Lapointe, the justice minister, reported that the finance minister should make a statement on the “financial position” of Canada, and King commented that “that appears to have been generally agreed on” (ibid., at 70). Hepburn immediately objected, stating “I do not recall that it was agreed on by myself,” and reserved the right to reply to any statement of a “controversial nature” (ibid.). Ilsley’s statement appears to
much of the discussion yesterday revealed little understanding of the full financial implications of the war programme to Canada and to the provinces and to the people of Canada. Our war effort is planned . . . on the basis of the maximum war effort of which Canada is capable. . . . But it means violent changes in our economy and our daily lives if we are to put forward our maximum effort. . . . It means expenditures of simply colossal proportions, and those expenditures cannot be taken care of by any financial magic; they must be borne by the taxpayers of all the provinces of Canada.83

Ilsley pointed out that the divisions in Canadian society were no longer the “racial divisions and religious divisions” of the past but

are economic divisions . . . ; they are due to trouble between various classes of society, between various occupations and various industries; . . . and it is to try to eliminate the danger of those cleavages and that kind of sectionalism that we give our support to the adoption of the recommendations in this report.84

The war burden could not be fairly distributed

so long as the provinces occupy the progressive fields of taxation and use them in such a way as to produce a tax system with varying rates of burden and of incidence in different provinces, and with inevitable conflicts, overlapping, duplication and needless expense and waste.85

If the federal government had to impose its own tax rates on top of the widely varying rates imposed by the provinces, inequities would inevitably result. Ilsley also reiterated several points made by Mackenzie King in his opening address, arguing that adoption of the Rowell-Sirois recommendations would facilitate war finance by strengthening Canadian credit, provide “minimum standards of decency and justice in all parts of Canada,”86 and provide the basis for post-war reconstruction.

Ilsley then issued what amounted to an ultimatum to the provinces, outlining actions that the federal government “may be compelled” to take87 should the conference fail. It would invade provincial tax fields, increase income tax rates, and curtail provincial revenues. Federal assistance in providing unemployment relief would end, and the federal government would not assist provinces in meeting financing

have been carefully stage-managed by King to put the government’s response before the public and force the dissenting premiers onto the defensive. Ilsley prefaced his remarks by stating, “I am not just sure whether it is understood that I am to keep off any controversial ground?” King replied, “Oh no; go ahead” (ibid., at 71).

83 Ibid., at 71.
84 Ibid., at 73.
85 Ibid.
86 Ibid., at 74.
87 Ibid.
difficulties. Gasoline might be rationed, eroding a significant source of provincial revenue. Ilsley concluded by reminding the premiers that the dominion had unlimited constitutional taxing authority and, in any event, under the War Measures Act, “we may do what is necessary as a war measure.”

McQuesten’s formal reply for Ontario for the most part dealt with the calculation of the revenue losses that would result for Ontario if the report were adopted. Hepburn jumped in, insisting that Ontario would cooperate in the war effort, but ranting again about the report as the “product of the minds of a few college professors and a Winnipeg newspaper man who has had his knife into Ontario ever since he was able to write editorial articles.” He then announced that Ontario was withdrawing from the conference. Premiers Aberhart of Alberta and Pattullo of British Columbia supported him, though in more temperate language.

King then terminated the conference, satisfied that he had won the battle for public opinion. Shortly after the conference, the mercurial Hepburn issued a statement proposing that the war be financed by expansion of the money supply, to avoid taxation and borrowing. Ilsley rejected this summarily:

We shall not abuse the right to issue money by creating more than the country needs and thereby bring about inflation merely to avoid taking the unpleasant action that is necessary to spread the cost of the war honestly in accordance with ability to pay.

He accused Hepburn of joining “Bible Bill” Aberhart in raising the “rubber money” issue.

THE 1941 BUDGET

The federal government’s response to the financial challenges of the war, and its offer to the provinces in response to the positions taken at the conference, were contained in the April 29, 1941 budget. The fundamental decision, to rely principally on income taxation, was taken at a Cabinet meeting on March 26, 1941. In his diary, King set out the options as follows:

The choice lay between one kind of budget which means going into provinces and taking the bulk of our taxation from income tax, corporation taxes and succession duties—a field which B.C., Ontario and Quebec have invaded, going pretty far in this direction, practically monopolizing that field, and offering to give the provinces back

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88 Ibid., at 75.
89 Ibid., at 80.
91 Statement of JLI, January 20, 1941, LAC, RG 19, vol. 3450.
92 Ibid.
the equivalent of what they had raised this year so as not to rob them of revenue but to make the burden upon the provinces impossible should they seek to continue to use those sources themselves [and give the poorer provinces the alternative of payments equal to the interest on their debt]. . . .

The other kind of budget would be one that would increase the sales tax, increase the defence tax but slightly increase the other taxes. . . .

[In respect of the proposal that there be another federal-provincial conference, the Cabinet agreed] we should do what we were going to do in the budget without a word in advance, as at our last conference we had been told that we had the power to do this and should do it. . . . The Cabinet became one in that view. There was final agreement on adopting the first plan proposed, the only difference of view being whether it might not be better to impose new taxes on income, succession duties and corporation taxes, leaving [it] to provinces themselves to work out their own salvation. . . .

 Ilsley pointed out, however, that it would mean we could not, next year, get the benefit of the enormously larger taxes there would be growing out of the war profits. We all felt it would be better to do the thing that would be the most satisfactory in the long run. What is now being done will last until the year after the war which may mean that, at that time, the provinces will have come to see that the Sirois report [sic] is, after all, what is best for them as well as for us. It is a bold and far-reaching policy.93

In delivering the budget, Ilsley began by reiterating the pay-as-you-go policy and stressing once again the commitment to equity:

[There will be no disappointment [in the Budget] for those who believe that the financial burden of war should be distributed on a basis of equality of sacrifice, having regard to ability to pay.94

He then summarized the cash requirements of the government for 1941-42, pointing to the gap of about $1.5 billion between cash needs of about $2.7 billion95 and the estimated yield from existing taxes of about $1.07 billion, describing it as “the staggering task which this places upon the Canadian people.”96 Of the new tax increases proposed, the bulk (75 percent) came from direct taxes:

We still believe that if there must be increased taxes, then it is better to increase the direct taxes as much as we possibly can. And in this most critical year of our history when the future existence of all the important things that matter to us is at stake, I do not think it unreasonable to ask our people to accept further drastic increases in both personal and corporate income taxes.97

93 Mackenzie King diaries, supra note 14, March 26, 1941.
94 Canada, House of Commons, Debates, April 29, 1941, at 2334.
95 War appropriations of $1.3 billion, ordinary expenditures of $468 million, and $800-$900 million to finance the British balance of payments deficit.
96 Canada, House of Commons, Debates, April 29, 1941, at 2343.
97 Ibid., at 2343-44.
Ilsley then turned to the question of the provinces, asking whether the dominion could ignore existing high provincial tax rates and create combined tax burdens that varied substantially from province to province and would result in particularly high rates on higher incomes in the western provinces:

However, if the dominion rates on higher incomes are not increased then the combined taxes on such higher incomes in eastern Canada will be unfairly low as compared with the proposed increased taxes on lower incomes. Since the taxes on lower incomes must be increased substantially in order to produce the revenues required, it is only proper that we should also increase the taxes on the higher incomes if we are to preserve the principle of spreading the burden in proportion to ability to pay.

We have reached the conclusion that the rates of personal and corporation income taxes should be raised by the dominion to the maximum levels which would be reasonable at this time, if the provinces were not in those fields.\textsuperscript{98}

Ilsley then proposed to the provinces, as a “temporary expedient,” that they (and their municipalities) vacate the personal and corporation income tax fields.\textsuperscript{99} In compensation, he made a proposal that reflected portions of the Rowell-Sirois recommendations.\textsuperscript{100} For any province that agreed to suspend its personal and corporation income tax and other corporate taxes for the duration of the war, the federal government would pay either the amount that it had collected from those taxes in 1940 or the province’s annual debt service costs, whichever was more advantageous to the province. This differed from Ilsley’s original plan by giving the wealthier provinces the actual 1940 revenue for the taxes given up, which would exceed their debt service costs. In any event, federal taxes would be imposed at high levels. Reflecting the failure to achieve agreement on the permanent implementation of the Rowell-Sirois recommendations, Ilsley agreed that these arrangements would terminate one year after the end of the war. Eight provinces accepted the federal offer. Ontario initially refused until Ottawa agreed to drop the proposed non-resident withholding tax on interest paid to foreign holders of provincial bonds, which it was thought would destroy the US market for provincial bonds. The new arrangements were eventually embodied in the tax rental agreements entered into in 1942. A number of smaller subsidies were, more or less inevitably, added for the poorer provinces.

Ilsley acknowledged that the 1941 budget “endeavoured to raise the rates of direct taxation to the highest level which I think the Canadian people can be asked to bear in this historic year.”\textsuperscript{101} The budget measures\textsuperscript{102} more than doubled the minimum rate of income tax from 6 percent to 15 percent and raised the maximum rate from 78 percent to 85 percent. The 2 percent and 3 percent NDT rates were raised

\textsuperscript{98} Ibid., at 2345.
\textsuperscript{99} Also included were other corporation taxes, such as those on capital; ibid.
\textsuperscript{100} The principal authors of the proposal were Walter Gordon and Alex Skelton.
\textsuperscript{101} Canada, House of Commons, Debates, April 29, 1941, at 2346.
\textsuperscript{102} Enacted by An Act To Amend the Income War Tax Act, SC 1940-41, c. 18.
to 5 percent and 7 percent respectively,\textsuperscript{103} although the threshold for the tax was raised from $600 to $660, an increase in excess of the rate of inflation. The tax credit under the NDT for dependent children was increased retroactively to $12 per child in 1940, $14 in 1941, and $20 thereafter. As a result, maximum marginal tax rates for individuals (income tax and NDT combined) could reach 92 percent. The sliding scale surtax on investment income (defined in the 1940 budget to include any income in excess of $14,000) was replaced by a 4 percent surtax on “true” investment income over $1,500.\textsuperscript{104} As a result, the maximum marginal rate on investment income could reach 96 percent.\textsuperscript{105} Ilsley stated that rates less than these would result in the “unfair distribution of the burden by imposing less equitable forms of tax to restrict consumption.”\textsuperscript{106}

The budget also addressed, to some extent, the cash flow issue for the government raised by delayed payment of taxes.\textsuperscript{107} The filing date for returns (which was also the first payment date) was advanced from April 30 to March 31, and a voluntary instalment arrangement was adopted. Under this, an individual or corporation could pay one-twelfth of the estimated tax in each of the last four months of the taxation year and one-eighth of the balance in each of the first eight months of the succeeding year. If these instalments were made, no interest was payable on the portion of the tax paid after the filing date.\textsuperscript{108}

The excess profits tax on corporations was increased\textsuperscript{109} to raise the minimum level of corporate income tax from 30 percent to 40 percent.\textsuperscript{110} The non-resident withholding tax on interest, dividends, trust distributions, and certain royalty payments was increased from 5 percent to 15 percent.\textsuperscript{111} As agreed with Ontario in connection with the negotiation of the tax rental agreements, the increase did not apply to interest paid on provincial government obligations or obligations guaranteed by a province or interest payable by a province pursuant to a statute.\textsuperscript{112}

\begin{itemize}
\item\textsuperscript{103} The increased NDT rates applied from July 1, 1941, so that the rates for 1941 were 3.5 percent and 5 percent, respectively.
\item\textsuperscript{104} Or the aggregate of the exemptions for spouses, children, and certain other dependants.
\item\textsuperscript{105} For a single taxpayer with income in excess of $500,000.
\item\textsuperscript{106} Canada, House of Commons, Debates, April 29, 1941, at 2349.
\item\textsuperscript{107} The delay meant that increased tax rates did not immediately produce increased tax revenue. This problem had been partially mitigated by higher voluntary prepayments of income tax between January and March 1941, amounting to about $45 million.
\item\textsuperscript{108} Where the taxpayer was an individual or a corporation with a calendar year-end, this would result in about 70 percent of tax for a taxation year being paid in the government’s fiscal year beginning in that year.
\item\textsuperscript{109} Enacted by An Act To Amend the Excess Profits Tax Act, 1940, SC 1940-41, c. 15.
\item\textsuperscript{110} A rate of 18 percent under the IWTA plus the greater of 22 percent of total profits and 75 percent of excess profits.
\item\textsuperscript{111} A 10 percent rate applied for the use of motion pictures.
\item\textsuperscript{112} An Act To Amend the Excess Profits Tax Act, 1940, supra note 109, section 18.
\end{itemize}
The IWTA had imposed a tax on gifts in 1935, applicable to aggregate annual gifts exceeding $4,000 at rates ranging from 5 percent to 15 percent (on gifts in excess of $1 million). The rates were increased to range from 7 percent to 25 percent (on the same range of amounts). The gift tax was payable on the filing date for the year.

Many commodity taxes were increased or instituted, including a tax on gasoline. Although Ilsley did not propose that the provinces withdraw from the succession tax field, he announced that dominion death duties would be imposed, on the basis that the provinces had not fully occupied the field. Ilsley stated his view that “[d]eath duties . . . are a very good type of tax, second only to income tax in their essential fairness and the possibilities of adjusting them progressively to ability to pay.”

After Ilsley had presented his budget, King wrote in his diary:

[Ilsley’s] address took over two hours. A very difficult task. He has really done extraordinarily well in its preparation. It is the largest single transaction ever introduced in the Parliament of Canada. It places a burden that would have been beyond belief on the shoulders of the Canadian people, a year and a half ago. There seemed to be an immediate acceptance of the situation, people realizing that the choice is between present sacrifice or loss of freedom.

Faced on the one hand with force majeure by the federal government and on the other with popular support for the war effort (which was bolstered by Ilsley’s powerful arguments about fairness and equity), the provinces agreed, with varying degrees of grace, to the tax rental proposals. However, it took a year to draft and negotiate the final agreements. Walter Gordon spent the summer of 1941 gathering information and preparing draft agreements, which were circulated on November 1, 1941. A federal-provincial meeting between Ilsley and the provincial treasurers was convened on December 18, 1941 and final draft agreements circulated on January 15, 1942. At the December conference, Ilsley said of the negotiations, “I have never attempted anything half so difficult in my life.”

In part, this was because the provinces had particular interests, and several wanted special treatment, but Ilsley insisted on keeping the discussions open and transparent. In his opening remarks, he emphasized that

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113 Canada, House of Commons, Debates, April 29, 1941, at 2349.
114 Mackenzie King diaries, supra note 14, April 29, 1941.
115 The agreements were signed between February 20, 1942 and May 27, 1942.
116 Transcript of meeting, December 18, 1941, LAC, RG 19, vol. 2702, at 8.
117 Premier Hart of British Columbia, for example, made a long and impassioned plea for continuance of the “special interim” annual payment of $750,000 granted in 1934 on a permanent and even enhanced basis. Ibid., at 91ff.
I wished to avoid the slightest suggestion that there was any hole and corner work going on, or that some delegations were seeing me or the government privately, securing some advantage, and going away satisfied while other provinces were not being accorded similar satisfaction.118

In this respect, he appears to have been successful: Thane Campbell, the premier of Prince Edward Island, while complaining that the federal proposals were inadequate, conceded:

[T]he fact that these offers have been made in open conference, in full view of the representatives of all the provinces, indicates clearly and emphatically that the Dominion has studied the whole matter from the standpoint of fairness and equity to all.119

THE 1942 BUDGET

The 1942 budget largely completed the transformation of federal finances begun in 1941.120 In the budget speech delivered on June 23, 1942,121 Ilsley reported that direct or income taxes had become the largest single component of revenue. Of the total tax revenue of $1.361 billion in 1941-42, the personal and corporate income taxes, the NDT, and the excess profits tax yielded $646 million, and succession duties $7 million, together accounting for 48 percent of the total. Once again, Ilsley repeated the government’s commitment to the policy of “pay as you go as far as it may be practicable” and setting “its face against distributing the cost of war through the medium of inflation.”122 Faced with expenditures expected to increase from $1.895 billion in 1941-42 to $3.9 billion (including up to $1 billion as a gift to Britain for war supplies)123 in 1942-43, Ilsley looked first to the personal income tax, identifying three objectives—equity, incentive, and savings.

The personal income tax was, he noted,

the fairest method of taxation. By and large, a person’s income is the best single measure of his taxable capacity, particularly when we take into account the number of persons dependent on him.124

118 Ibid., at 14.
119 Ibid., at 201.
120 The budget measures were enacted by An Act To Amend the Income War Tax Act, SC 1942-43, c. 28.
121 Canada, House of Commons, Debates, June 23, 1942, at 3570-3642.
122 Ibid., at 3576.
123 The Cabinet had decided that there was little economic sense in forcing Britain to borrow further from Canada to finance war supplies. It was doubtful that Britain could repay such loans, and the burden would prevent Britain from resuming the purchase of Canadian exports after the war. Accordingly, Canada paid for and supplied the goods and material to Britain as “material aid.”
124 Canada, House of Commons, Debates, June 23, 1942, at 3578.
Referring to the possible disincentive to work resulting from higher taxes, Ilsley stressed that the new tax measures were designed “to preserve as much as possible of the earnings incentive for the great majority of the working population.” At the same time, it was essential that increased taxes operate to reduce consumption and not savings.

In pursuit of these objectives, the NDT was incorporated into the income tax as a flat-rate “normal” tax at rates of 7 percent on income exceeding $660 for a single person or $1,200 for a married person, 8 percent for a single person with income over $1,800, and 9 percent for a single person with income over $3,000. The NDT credit for children against normal tax was again increased, to $28. The minimum rate of “graduated” tax on income was doubled, from 15 percent to 30 percent, and applied to all income in excess of $660 (the threshold for normal tax). The deductions from income for married taxpayers and for dependent children were replaced by tax credits of $150 in respect of the spouse of a married taxpayer and $80 for each dependent child. The effect of the credit was to shield lower- and middle-income taxpayers to some extent from the effect of the increased rates. Ilsley explained that “we are ‘freezing’ the value of these present exemptions at about the amount they have been worth to a taxpayer having an income of around $2,500 or $3,000.” Furthermore, normal tax could not reduce income below the $660 and $1,200 thresholds. This meant that persons not liable to income tax before the budget would not become liable as a result of the budget proposals.

In order to soften the blow of sharply increased taxes on lower-income individuals, a portion of the income tax was made refundable, a form of compulsory

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125 Ibid., at 3579.

126 A married taxpayer with two dependent children and an income of $1,400 (below the $1,500 income threshold for the “graduated” portion of the income tax) would pay $42 in NDT, compared to $12 at 1940 rates and $42 at 1941 rates.

127 A married taxpayer with two dependent children would pay no graduated tax, as before, and $49 in normal tax. A single taxpayer with an income of $750 would pay $27 in graduated tax, compared to no such tax previously, and $52.50 in normal tax.

128 Canada, House of Commons, Debates, June 23, 1942, at 3579. An annual income of $2,500-$3,000 was about twice the average industrial wage, corresponding to approximately $90,000-$100,000 in the 2012 equivalent, using the increase in average wages, or approximately $35,000-$42,000, using the increase in consumer prices. See supra note 20.

129 These amounts corresponded to approximately 50 percent and the full amount, respectively, of annual income at the average industrial wage.

130 These provisions created an anomalous “notch” in the marginal tax rate. A married taxpayer with income of $1,200 would pay no tax, but one with an income of $1,300 would pay tax of $100 (of which $50 was refundable)—a marginal rate of 100 percent. This was corrected in the 1943 budget by providing that, in the income ranges affected, tax could not exceed two-thirds of the difference between income and the relevant ($660 or $1,200) threshold.

131 Under new section 93 of the IWTA.
savings. For lower-income taxpayers, the refundable portion was generally at least equal to the amount by which tax had been increased by the increased rates imposed in the budget.

The refundable tax was payable after the war with interest at the rate of 2 percent.

Ilsley explained that the refundable tax satisfied the need for new revenue without eroding the incentive to work and that, for those in the lower income brackets, the refundable tax exceeded the increases in tax rates imposed in the budget, so that net tax on lower earners was somewhat lower. Certain types of savings—life insurance premiums, home mortgage payments, and pension contributions—were treated as alternatives that satisfied the compulsory savings requirement. These payments reduced consumption and were often reinvested by financial intermediaries in federal government debt issues.

The refundable tax concept had been developed and promoted extensively in the United Kingdom by J.M. Keynes and had been implemented by this time in Britain. It received considerable attention in academic circles in Canada from late 1939 and had been promoted internally in the Department of Finance by followers of Keynes (such as Robert Bryce and Alex Skelton) as a method of increasing revenues in a counterinflationary manner and providing post-war countercyclical stimulus when the tax was refunded after the war. Keynes also contemplated using the refundable tax for redistributive purposes: low-income taxpayers would amass savings, which would not be eroded by inflation, while the well-to-do would not receive interest on the loans that the government would otherwise have to make from them. This element of Keynes's plan, however, seems to have received little or no attention or support in Canada.

The refundable tax was not well understood by labour groups and workers generally and was widely blamed for absenteeism as a disincentive to work. There were also difficulties in defining the alternative investments allowed, and the refundable tax was removed in the 1944 budget, effective July 1, 1944. During the two years in which the tax was in effect, it raised $269 million, all of which was returned to taxpayers with interest in 1948 and 1949.

The emphasis on equity was also reflected in illustrations that Ilsley gave of the effect of the new measures. A married taxpayer with two dependent children and income of $1,500 would suffer an increase in tax liability of $35-$45, half of which was

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132 The amount refundable was the lesser of, generally
1. half of the tax payable and
2. the aggregate of:
   a. the lesser of $800 and 8 percent of the taxable income for a single taxpayer, or $1,000 and 10 percent of taxable income for a married taxpayer with income over $1,200; and
   b. the lesser of 1 percent of taxable income and $100 for each dependant other than a child.


134 See the discussion in Perry, supra note 23, at 362-64.
refundable. A married taxpayer with two dependent children and income of $4,000 would see tax liability rise from $450 to $1,148, of which $480 was refundable.\textsuperscript{135}

The gift tax was again increased, by 3 percentage points on each rate, so that the tax began at 10 percent and reached a maximum of 28 percent. The non-resident withholding tax was extended to salaries, wages, and other periodic payments made to a non-resident who was either employed, carrying on business, or providing services in Canada. It applied only to residents of countries that treated Canadian residents in a similar manner and was directed to persons commuting across the Canada-US border.

Finally, the government’s cash flow problem was addressed directly. New part XVI of the IWTA provided a comprehensive source deduction and instalment regime, which came into effect on September 1, 1942. Payers of employment income and payers of interest or dividends were required to withhold and remit within one week 7 percent in the case of interest and dividends and prescribed amounts (intended to represent 90 percent of tax payable during that period, taking into account NDT already deducted at source) in respect of employment income. An individual whose salary or wages amounted to more than 75 percent of income was required to file a tax return and pay any tax not satisfied by source deduction by September 30 of the following year. Any other individual was required to make quarterly instalment payments by October 15 of the taxation year and by January 15, April 15, and July 15 of the following year. Each of the first two instalments was to equal 25 percent of total estimated tax, while the latter two instalments were together equal to 50 percent of the remaining tax, after taking source deductions into account. The filing date for individual returns was restored to April 30 of the year following the taxation year. Corporations were required to make 12 instalment payments commencing six months before the end of the taxation year, the first 8 each equal to one-twelfth of estimated tax for the year and the last 4 each equal to 25 percent of the remaining tax.

Excise duties and taxes, particularly on alcohol and tobacco products, were raised, and new taxes were imposed on candy, cinema admission, cameras, soft drinks, and a range of luxury goods including jewellery, china, and watches.

Of the total full-year additional revenue projected from all tax increases of $246 million, $115 million, or 46 percent, came from the personal income tax alone. Ilsley concluded by pointing out that, notwithstanding the tax increases, the budgetary deficit was estimated at $1.85 billion, of which more than $1 billion was required to be borrowed from individuals, the bulk of whom were lower income earners. He therefore asked

\begin{quote}
that there should be by every individual the most rigorous economy. . . . Let us compete with our neighbours in saving, not spending; in making shift with what clothing and house furnishings we have, not in buying more; in hard work and plain and thrifty living.\textsuperscript{136}
\end{quote}

\textsuperscript{135} Canada, House of Commons, Debates, June 23, 1942, at 3583.

\textsuperscript{136} Ibid., at 3593.
King was unhappy with the increases in taxes but did not attempt to block them in Cabinet. Following a Cabinet discussion of tax matters in July 1942, he complained in his diary:

I feel that Ilsley has gone much too far in his budget—that his taxes are unnecessarily heavy. They are putting a burden on the people greater than they can bear, and only helping to force the whole country into the hands of the C.C.F. [the Commonwealth Co-operative Federation] Also, they are going to help the Social Credit group. Already, last night, Slaght [a Toronto Tory backbencher] made a long speech advocating paper money. McGeer [a BC Liberal backbencher and a loose cannon] has done the same today, and Ilsley is terribly upset, as the whole thing means inflation, against which our price ceiling policy is directed. . . .

We sat until 2.20 p.m. I felt sorry for Ilsley with his load.  

THE 1943 BUDGET

The March 2, 1943 budget completed the transition to the pay-as-you-earn system. The source deduction regime was amended to fully apply to current (1943) income, and quarterly instalments were moved to March, June, September, and December of each year, in the amounts of 20 percent, 25 percent, 25 percent, and 30 percent respectively of estimated tax on income for that year. Farmers were required to pay two-thirds of estimated tax for the year by December 31 of that year. The effect of these changes was to accelerate the payment of tax in respect of calendar year 1943 income fully into 1943 (which had been only partially accelerated in 1942, because source deductions only commenced in September 1942). To alleviate the cash flow problems arising, tax on half of 1942 earned income (and the first $3,000 of investment income) was forgiven. Taxation of excess 1942 investment income was deferred until the death of the taxpayer.

For corporations, instalments were varied to one-twelfth of estimated tax for each of the first 11 instalments and the balance on the last instalment. Interest was imposed on understated instalments.

In the 1943 budget speech, Ilsley hinted at the growing influence of Keynesian ideas in the Department of Finance, stating that the revised collection arrangements made it easier to adjust rates quickly when economic conditions changed and thus made “the income tax a better instrument of fiscal policy in helping to maintain full employment.”

The excess profits tax was amended to restructure the minimum 40 percent corporation tax rate and increase the rate on excess profits from 75 percent to

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137 Mackenzie King diaries, supra note 14, July 16, 1942.
139 Ibid., at 848.
140 Enacted by An Act To Amend the Excess Profits Tax Act, 1940, SC 1943-44, c. 13.
100 percent. The increase was softened somewhat by provision for refunding of a portion of the tax. For the tax on 1941 profits, the refund would be made in the second fiscal year commencing after the cessation of hostilities; for the 1942 profits, in the third fiscal year and so on (the same refund schedule as for individuals).

Ilseley’s personal reputation for integrity and austerity stood him in good stead when dealing with the public reaction to these draconian tax measures. While Canadians were generally committed to the war effort and therefore disposed to accept high taxation, there was the potential for opposition. Ilsley defused this in part by insisting on equality of financial sacrifice in the measures themselves, in part by his ability to clearly explain to the public the rationale for the measures, and in part by his own reputation for “absolute personal integrity” (as his hometown newspaper put it). Immediately after the 1941 budget, one R.M. Bennett from Winnipeg wrote to Ilsley:

The taxes are very fair, everyone will do their share, in accordance with their ability to pay. You have done the impossible, the tax collector is the most popular man in the country.

C.P. Stacey wrote that Ilsley would be remembered “as the man who taxed Canadians as they had never been taxed before, and almost made them like it.”

**FORGING POLITICAL CONSENSUS**

Ilsley also received significant support for the 1941 and 1942 budget proposals from the opposition in the House of Commons, and criticism levelled was directed largely at other aspects of government policy rather than the fiscal measures in issue. Immediately following the budget speech in 1941, in a thinly veiled attack, not on the budget measures, but on the King government’s conscription policy, R.B. Hanson, Leader of the Opposition and of the Conservative Party, stated that

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141 A rate of 18 percent under the IWTA plus 12 percent of profits under part 3 of the second schedule and the greater of 10 percent of profits under part 1 of the second schedule and 100 percent of excess profits (after deduction of the 18 percent and 12 percent taxes) under part 3 of the second schedule. This had the effect of substantially increasing the tax liability of a corporation whose profits had increased by more than one-sixth of its “standard” profits.

142 The amount by which excess profits exceeded 10 percent of all profits.

143 King’s Courier, November 23, 1940.

144 Letter to Ilsley of May 1, 1941, LAC, RG 19, vol. 2697.

145 C.P. Stacey, *Arms, Men and Governments: The War Policies of Canada, 1939-1945* (Ottawa: Queen’s Printer, 1970), at 37. Ilsley’s defence of the government’s tax policies was closely connected with his participation in the various victory loan campaigns. He crossed the country several times, promoting the sale of victory bonds and defending the fiscal policy of which the bond campaigns were a part. Discussion of the victory bond campaign is beyond the scope of this article.
Turning to the proposals for the tax rental arrangements, Hanson conceded that “[i]n certain respects, I think it [the tax rental arrangement] has become inevitable” and criticized the provinces for not restricting their expenditures in wartime.\(^{147}\)

In opening the main debate on the budget on May 5, 1941, Hanson stated that Ilsley had “acquitted himself with credit. . . . He told us lucidly and in plain language what the position is and what the proposals are.”\(^{148}\) Hanson thought that there would not be “much, if any, disposition to oppose the minister’s proposals.”\(^{149}\) Ilsley’s proposal to the provinces, however, was “generous—perhaps too generous.”\(^{150}\) Hanson’s principal criticism was that non-war expenditures, particularly on the Canadian National Railway, were too high and that the new taxes on low-income persons might increase pressure for higher wages. Hanson also made it clear that he agreed with the excess profits tax, though he questioned some details.\(^{151}\)

The CCF leader, M.J. Coldwell, was more critical (perhaps predictably), suggesting higher exemptions and graduated rates beginning at 2 percent for the NDT measure, advocating compulsory interest-free loans to the government by the wealthy, and criticizing increases in indirect taxation on equity grounds. Nevertheless, he concluded:

> In spite, however, of all these . . . criticisms, I realize that the Minister of Finance has tried to be fair within the limits of the economic environment which must determine his financial policy.\(^{152}\)

Much of Coldwell’s attention was focused on the CCF’s advocacy of “economic democracy” in a “cooperative, planned society” and on the King government’s failure to provide a blueprint for post-war economic reconstruction and social policy.\(^{153}\) The Social Credit finance critic, Victor Quelch, while devoting a large part of his remarks to criticism of the banking system and to Social Credit proposals for increasing the money supply, still conceded that the principle of equality of sacrifice had been reflected in the tax system.\(^{154}\)

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146 Canada, House of Commons, Debates, April 29, 1941, at 2394.
147 Ibid.
148 Canada, House of Commons, Debates, May 5, 1941, at 2536.
149 Ibid.
150 Ibid., at 2540.
151 Ibid., at 2540-42.
152 Ibid., at 2553.
153 Ibid., at 3821.
154 Ibid., at 2546.
Reaction to the 1942 budget followed the same pattern. Hanson described the increased tax rates as “expected” and said that they would “make for equality of sacrifice.” In proposing the system of refundable taxes, “the minister has adopted in large measure the principles and theories of the great English economist, John Maynard Keynes” which, Hanson stated, the Conservatives fully supported. Ilsley’s proposal for source deduction of tax provided the “easiest and surest” method of collection. Hanson’s principal criticism of the government in the budget debate did not relate to the budget proposals but to the alleged failure of the government to restrain non-war expenditures and to impose conscription. In fact, Hanson’s sharpest words were reserved for the “socialist party” and its criticism of Ilsley, and for the CCF argument for “conscription of wealth.” He concluded by calling for approval of the budget.

The CCF was similarly supportive of Ilsley and in stronger terms than in the previous year. Coldwell congratulated the Minister of Finance upon his able presentation of the financial position of the country. It was, I think admirably done and he deserves every credit for doing such a splendid job. . . . [H]is proposals move in the right direction.

Although noting the heavy impact of the measures on middle income earners, Coldwell suggested that

[f]ew will object to the higher income tax, because after all the income tax is probably the fairest way of assessing taxation in a modern country.

The CCF approved the refundable tax as a move toward its policy of compulsory loans but continued to advocate conscription of wealth and nationalization of the “great trusts and great monopolies.” Coldwell concluded by repeating his call of the previous year for a comprehensive post-war reconstruction policy. J.H. Blackmore, the Social Credit leader, predictably decried the high levels of wartime government

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155 Canada, House of Commons, Debates, June 30, 1942, at 3792.
156 Ibid., at 3791.
157 Ibid., at 3789.
158 Ibid., at 3799. Hanson’s quibble that the excess profits tax did not leave enough to corporations to fund post-war reconstruction investment foreshadowed the later debate within the King government on the respective roles of free market policy and government intervention in the post-war period. In the course of discussing the excess profits tax, Hanson suggested that Ilsley should put the question to “those master minds, who behind the scenes are formulating our war-time financial policies.” Ilsley interjected that he could and would answer the question himself (ibid., at 3795).
159 Ibid., at 3817.
160 Ibid., at 3818.
161 Ibid.
debts (the interest payments on which would, he predicted, cause post-war depression) caused by the government’s failure to expand the money supply. After criticizing the level of tax on lower incomes, he veered off into criticism of agricultural policy.  

Discounting the references to the conscription issue, alleged excess non-war expenditures, and the absence of plans for post-war reconstruction, the reaction of the opposition parties disclosed little or no substantive criticism of Ilsley’s budget proposals. To the contrary, their remarks were generally supportive, if not congratulatory.

CONCLUSION

The changes to the system, by 1942, based on a rigorous application of the principle of vertical equity, were having a predictable levelling effect on income distribution. In the 1943 budget speech, Ilsley addressed this issue, pointing out that after-tax business profits were now only 75 percent of the pre-war standard and that upper and middle income groups had suffered “very definite reductions in [their] customary standard of living.” Farmers, on the other hand, were better remunerated “than in any but the record years,” and average weekly earnings in other sectors were higher than they had been even under inflation following the First World War. These “far-reaching and important change[s] in the distribution of income in the country” had been “desirable and the government has welcomed and facilitated it,” though worrying that further demands from farmers and labour groups could not be satisfied without creating inflationary pressures.

Ilsley also noted in 1943 that attempts to make the tax system more equitable, by tailoring taxable income more closely to the real ability to pay (giving as an example the expanded medical expense deduction allowed in 1942) made the law more complex. He warned that “[w]e cannot make our tax so complicated that the ordinary man cannot understand it.” Complexity not only put a greater administrative burden on the Department of National Revenue but also raised the possibility of arbitrariness in administration.

The measures taken between 1939 and 1942, which were for the most part introduced and defended by Ilsley, transformed the Canadian tax system. For individual working Canadians, the income tax had become nearly universal. In 1940, about 300,000 persons filed income tax returns. For the 1941 taxation year, the number was nearly 900,000, and for 1942, approximately 1.8 million. By 1945, the number would reach 2.25 million. The $45 million of personal income tax revenue realized in 1939-40 became $296 million in 1941 and $768 million by 1945. Between 1939 and 1945,

162 Ibid., at 3800ff.
164 Ibid., at 845.
165 Ibid.
166 Ibid.
167 Ibid., at 847.
corporation income tax (including the excess profits tax) increased from $78 million to $740 million. The growth of federal tax revenue and the increased importance of income taxation as a source of revenue are illustrated in table 4.

The impact of income tax on public finance was permanently transformed. While indirect tax revenue (principally from customs and excise duties and sales tax) slightly more than doubled between 1939 and 1945, personal direct tax revenue increased by approximately 1,700 percent and corporate tax revenue by approximately 950 percent. From being a secondary source of federal revenue imposed on a high-income minority, the personal income tax was “democratized,” becoming nearly universal and well on the way to becoming the principal single source of government revenue. In the post-war period, the revenue stream that financed the war effort was used to fund the rapidly developing welfare state, and federal dominance in the direct tax field underlay the post-war application of Keynesian countercyclical fiscal policy.

It is tempting to connect the tax policies proposed and defended by Ilsley with the increase in public support during the war for greater government involvement in directing the economy and providing a more comprehensive social welfare system, and for political parties (particularly the CCF) that advocated such policies. It is similarly tempting to view those tax policies as manifestations of Keynesian economic theory. However, in the period reviewed in this article (1939 to 1942), there is no evidence that Ilsley was influenced by anything other than the overriding need for war funding and the general principles enunciated by him in 1939. As a Nova Scotian, Ilsley was clearly attracted by the interprovincial equalization promised by the Rowell-Sirois report, and he therefore supported adoption of the report’s recommendations. The use of new revenue sources to fund the welfare state (and to fend off the rise of the CCF) was a later development, however consistent it might have been with Ilsley’s underlying commitment to equity in the tax system. There is also no evidence that Ilsley viewed the fiscal policies adopted in 1939-1942 as the forerunner of Keynesian countercyclical budgeting. Government spending as economic stimulus was practised in Canada during the late 1930s (and, as noted above, in the early stages of the war, by government borrowing), before Robert Bryce and others introduced Keynesian theory into the Department of Finance. The compulsory savings scheme of 1942 was consistent with that pre-Keynesian thinking. It is important not to project the full-fledged Keynesian proposals put to the provinces in the 1945-46 dominion-provincial conference back on to the 1939-1942 period.

Federal government expenditures (on all matters) during the war peaked at $5.3 billion in 1943-44 and declined slightly to $5.2 billion in 1944-45 and $5.1 billion in 1945-46 as war expenditures stabilized.\(^\text{168}\) The budgetary deficit also peaked

\(^{168}\) The revenue and expenditure amounts in this paragraph are derived from the House of Commons debates on the budget papers released with the 1944 through 1948 budgets: see Canada, House of Commons, Debates, June 26, 1944, at 4206-45; October 12, 1945, at 1023-60; June 27, 1946, at 2939-77; April 29, 1947, at 2564-72; and May 18, 1948, at 4147-57.
in 1943-44 at $2.56 billion, declining to $2.12 billion in 1945-46 as revenues increased. By 1946-47, this had turned into a surplus of $374 million, and in 1947-48, a surplus of $676 million. This masked unprecedented increases in domestic non-defence expenditures—during those years, revenue remained virtually unchanged, but defence expenditures declined substantially. Non-defence expenditures, held by Ilsley to between $400 and $600 million between 1939-40 and 1944-45, increased to $1.062 billion in 1945-46, $1.236 billion in 1946-47, and $1.383 billion in 1947-48. Income taxes and succession duties accounted for about 60 percent of all tax revenue, about half (30 percent) from personal income taxes.

The tax jungle that disappeared with the tax rental scheme of 1941 never returned. Although Ilsley’s attempt at provincial agreement on a comprehensive reordering of federal-provincial finance in 1945-46 was unsuccessful, the tax rental agreements were maintained with all of the provinces except Quebec (and for Ontario corporation income tax) until 1962. While the provinces were required to reimpose income taxes after 1962, the taxes imposed by the provinces have been structured on a tax base substantially identical to the federal tax base, and most have been administered by the federal tax authority. Although variations in tax rates gradually reappeared, they did not replicate the situation of the 1930s and have not had the negative consequences feared in the 1940s.

<table>
<thead>
<tr>
<th>Year</th>
<th>GNP</th>
<th>Total tax revenue</th>
<th>% of GNP</th>
<th>Personal income tax</th>
<th>% of tax revenue</th>
<th>Corporate income tax</th>
<th>% of tax revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939</td>
<td>$5,690</td>
<td>$436.3</td>
<td>7.7</td>
<td>$46.9</td>
<td>10.7</td>
<td>$85.2</td>
<td>19.5</td>
</tr>
<tr>
<td>1945</td>
<td>$12,112</td>
<td>$2,154.6</td>
<td>17.8</td>
<td>$672.8</td>
<td>31.2</td>
<td>$617.0</td>
<td>28.7</td>
</tr>
</tbody>
</table>

Note: Dollar amounts are in millions.


Table 4 Changes in Gross National Product (GNP) and Federal Tax Revenues, Canada, 1939-1945


170 $1.315 billion in 1946-47 and $634 million in 1947-48, of which a significant portion were demobilization expenditures more akin to welfare payments than to conventional defence expenditures.

171 $398 million in 1939-40, $391 million in 1940-41, $445 million in 1941-42, $566 million in 1942-43, and $610 million in 1943-44. Beginning in 1941, this included payments to the provinces under the tax rental agreements, amounting to about $85 million in a full year.

172 Family allowances, the keystone of the King government’s reconstruction program, amounted to $245 million in 1946-47 (the first full year of payments), equal to about 50 percent of all pre-war federal government expenditures.
The transformation was consistently effected on a principled basis—current, pay-as-you-go financing; avoidance of inflation; vertical equity in reliance on progressive income taxation; and revamped administrative and collection mechanisms, which produced a cash flow matching the federal government’s expenditure needs. All of this was tirelessly and consistently propounded, explained, and defended by Ilsley, both in words and in actions.173

173 Shirley Tillotson, Contributing Citizens: Modern Charitable Fundraising and the Making of the Welfare State 1920–66 (Vancouver: UBC Press, 2008) agrees that the large-scale “community chest” fundraising campaigns that developed in several Canadian cities in the 1920s paved the way for changes in the tax system by pressing, with considerable success, the idea that community needs should be met by contributions from large numbers of citizens, based on ability to pay. I have found no evidence or reference to this in the records of the Department of Finance. Progressivity was a feature of the income tax from 1917, and the principle applies to predate the community client movement. The decision to extend the progressive tax to the under population appears to have been based entirely on the pressing need for money to finance the war, and there is no evidence that the Canadian public felt otherwise.
A Few Thoughts on Treaty Shopping

Robert Couzin*

PRÉCIS
L’auteur fournit quelques brèves réactions immédiates au document de consultation sur le chalandage fiscal du ministère des Finances. Elles portent sur certaines questions de politique fiscale : la quantification d’une perte de revenu, qui suppose certaines hypothèses normatives; la pertinence de la résidence du propriétaire pour les demandes relatives aux avantages découlant d’une convention par une société; le rôle de la « substance » d’entreprise; et la distinction entre les structures de conduit adossées et d’autres formes possibles d’abus d’une convention. L’auteur conclut que les décideurs devraient prêter une attention plus particulière aux principes de base relatifs aux questions de ce type avant de se pencher sur les mécanismes d’une solution.

ABSTRACT
The author provides some brief and immediate reactions to the Department of Finance’s consultation paper on treaty shopping. These concern certain tax policy issues: the quantification of revenue loss, which implies some normative assumptions; the relevance of the residence of the owner to claims of treaty benefits by a corporation; the role of corporate “substance”; and the distinction between back-to-back conduit arrangements and other possible forms of treaty abuse. The author concludes that policy makers should pay closer attention to the basic principles relating to issues such as these before they focus on the mechanics of a solution.

KEYWORDS: TREATY SHOPPING ■ POLICY ■ TAX LAW

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INTRODUCTION

Canada’s Department of Finance has released a consultation paper (herein referred to as “the paper”) posing seven questions about a possible response to treaty shopping.1 Those questions raise many interesting structural issues. Should an anti-treaty-shopping rule be general or specific, put into domestic law or into treaties? How does such a rule avoid being underinclusive or overinclusive? How can it be integrated with existing treaty provisions? In order to examine the remedy, however, one must first identify the mischief. The paper therefore begins with a discussion on the “problem” of treaty shopping.

To my aging eyes, the policy discussion is not as sharp as it should be. Fuzziness is endemic in treaty-shopping rhetoric. Commentators do not always mean the same thing and may have different agendas. I am not heartened by the repeated appeals to an international consensus; consensus-driven decisions often sacrifice clarity on the altar of mutual agreement.2

In this brief note, I would like to step farther back than the starting point of the paper and raise a few basic policy questions in the hope of stimulating some useful conversation. My comments are selective; there are many more questions to ask. For simplicity I will use the expression “treaty shopping” as if we had a common understanding of what it meant.

DATA

How important is treaty shopping? The Organisation for Economic Co-operation and Development (OECD) conceded in its initial publication on base erosion and profit shifting (BEPS)3 that data demonstrating the extent of these phenomena in general are unavailable, and the same is true for treaty shopping in particular. The paper remarks that the tax at issue in two beneficial ownership cases, Canada v. Prévost Car Inc.4 and Velcro Canada Inc. v. The Queen,5 was “significant.”6 Citing, in addition, the “experience of CRA [Canada Revenue Agency] auditors” and foreign

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2 This is apparent in many documents issued by the Organisation for Economic Co-operation and Development (OECD), and perhaps explains their length.
4 2009 FCA 57; aff ’g. 2008 TCC 231.
5 2012 TCC 57.
6 In Prévost Car, the dividends paid over 4 years (1996-1999) totalled $67 million. The withholding tax at stake (resulting from the difference between the applicable rates under the Canada-Sweden and the Canada-UK treaties and the rate in the Canada-Netherlands treaty) was highest in 1997, at about $2 million, and dropped thereafter when the treaty rate with Sweden was reduced to 5 percent. The figure in Velcro was $8.6 million, covering 10 years.
direct investment (FDI) statistics, the paper concludes that “treaty shopping has a significant role in inbound direct investment in Canada.”

FDI statistics do suggest, unsurprisingly, that many apparent direct investors are probably acting as intermediaries, although not necessarily (or likely) for the purpose of treaty shopping. The Netherlands, Switzerland, and Luxembourg are singled out for suspicion on the basis of a discrepancy between their rankings as FDI investors into Canada and as trading partners (set out in table 2 of the paper). The missing fact is where the funding originates. Some undoubtedly comes from local residents, and most of the rest probably represents capital invested by residents of other treaty countries, since the only significant pools of investor capital outside Canada’s treaty network are in the Middle East. I would hazard that the lion’s share of these intermediaries serve to support tax-efficient financing and repatriation strategies, sometimes avoidance or deferral of residence-country taxation, and perhaps non-tax purposes, but not treaty shopping.

As a footnote to the rankings in table 2, it should be noted that Switzerland makes the blacklist because it is 4th in FDI but only 15th in trade—yet no one suggests that Brazil (5th in FDI and 13th in trade) is used for treaty shopping. This might suggest some caution about the methodology.

The paper fails to clarify what should be the normative assumption concerning the “right” amount of tax. In Vêlero, for example, the CRA assessed on the basis that royalties paid to a Netherlands company were beneficially owned by its Netherlands Antilles parent, the owner of the intellectual property. I have no personal knowledge of the group, but I suspect that this “parent” was itself part of a global tax plan; if the elimination of treaty shopping means looking through the intermediaries to the owners of the capital, or to the highest legal entity in the chain with an active and substantial business operation (the derivative benefits concept), then there may well have been no treaty shopping in Vêlero. From this perspective, and taking into account the breadth of Canada’s treaty network and the high degree of consistency in its stipulated withholding rates, one wonders how large the leakage could possibly be. Many arrangements labelled as treaty shopping are more correctly regarded as financing or holding structures primarily benefiting group companies in other jurisdictions. Anti-treaty-shopping provisions would make such planning more difficult or more expensive. This may be a desirable international goal, and Canada may even collect more tax if the structures are still efficient enough to be retained, but the issues should be made explicit.

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7 Thinking back to Prévost Car, almost all of Canada’s treaties with likely investor countries (including Sweden and the United Kingdom) now have a 5 percent rate on dividends paid to a company holding a prescribed percentage of the shares. During the years under litigation, the majority of the shares of Velcro Industries NV were owned by a BVI company the ownership of which is not public. Based on what one can find on the Web, it probably traces back to the United Kingdom. Most of the remaining, publicly traded, shares were held in the United States. The Antilles company was not owned by Antilles residents who were “treaty shopping” through the Netherlands.
RESIDENCE OF THE OWNER

The “lookthrough” approach described in the paper (whether stand-alone or incorporated into the four-step proposal outlined in section 7.2 of the paper) presupposes that a company should not be entitled to treaty benefits if its owners reside in a different jurisdiction, or at least not unless those owners would themselves be entitled to equivalent benefits. Three reasons are listed (although they really amount to three versions of one reason): benefits should be denied in such circumstances to prevent the one-way flow of treaty benefits, support the negotiation of reciprocal benefits, and preserve the bilateral character of tax conventions. I am not unalterably opposed to governments’ using either tax treaties or domestic law for international fiscal extortion in a good cause. Canada’s exempt surplus system proved quite successful in convincing countries in the 1970s and 1980s to enter into bilateral tax treaties, and now it serves well as a carrot to promote tax information exchange agreements. It does not, however, follow that international tax rules should always demand reciprocity. The main reason for lower withholding rates and exemptions in bilateral treaties is not to obtain a quid pro quo but to promote trade and investment and facilitate commerce. The reduction in Canadian withholding tax benefits Canada. This is why there is no tax on arm’s-length interest payments, wherever the payee may reside.

Not only is the relevance of absentee ownership to the granting of treaty benefits far from self-evident, it is also contrary to the practice in other spheres. The North American Free Trade Agreement (NAFTA), for example, provides protection to “investors of a Party,” defined to include corporations incorporated under the laws of a party and carrying out business activities there, with no reference to share ownership. Nor do domestic corporate income tax systems generally pay attention to shareholder residence. In Canada, it is relevant in only a few limited contexts, each with its own peculiar policy rationale, like the Canadian-controlled private corporation provisions designed to aid local entrepreneurship, and section 19 of the Income Tax Act meant to protect Canadian print media. These provisions would not survive the “national treatment” non-discrimination provision in article 24(5) of the OECD model, and that is why our treaties replace it with a “most-favoured nation” rule. The domestic provisions meet that test for all non-residents, whether or not resident in a treaty country.

8 Definitions for the investment chapter of NAFTA are in article 1139; see www.nafta-sec-alena.org/Default.aspx?tabid=97&language=en-US.
9 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.
The limitation-on-benefits (LOB) juggernaut loosed by the United States in 1981 will be difficult to stop, but if treaty shopping is to receive serious consideration, the relevance of shareholder residence should be opened for discussion.

**ECONOMIC SUBSTANCE**

“Economic substance,” or at least some kind of substance, seems intuitively relevant to a claim for treaty benefits, and without regard to the location of ownership. Indeed, one might think that substance should be a requirement for any tax rule, not just treaties, but this is not the case. The thinnest nexus is generally sufficient to support the imposition of tax. Canada happily taxes the world income of every corporation incorporated in Canada, exempts qualifying (exempt surplus) dividends that those corporations receive, and collects part XIII tax on non-residents to whom they make prescribed payments. Substance has nothing to do with it. The general practice of imposing tax without any substance requirement is important in considering treaty shopping. The OECD raised the problem of international coordination in its BEPS report. Serious distortions will arise if all countries adopt a substance rule that applies only to non-resident companies.

Defining “substance” is very difficult; Canadian judicial conceptions of sham and agency presumably set too high a standard for these purposes. One basic question is: What does a substance requirement apply to? The paper, like most treaty-shopping discussions, focuses on substance of the entity, and this is reflected in a common exemption within LOB provisions. But why should a corporation escape an anti-treaty-shopping rule just because it has substance? One might have thought substance should be required for the investment or transaction, not just the entity. One is reminded of the “more closely connected business activities” rule in subsection 212.3(16) of the foreign affiliate dumping provisions.

I am not advocating this position, just pointing out the logical problem. The practical consequences appear to be daunting.

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11 Suppose that companies A and B are article 4 residents in country X and each has a Canadian subsidiary. A is owned by an individual resident in country X; B is owned by an individual resident in country Y. The Canadian treaties with countries X and Y provide 5 percent withholding tax on dividends from a Canadian company to a parent in the respective country, and 15 percent to anyone else. If companies A and B both lack substance, the perceived abuse should be the same: substitution of 5 percent for 15 percent withholding tax. However, the LOB approach only reaches the dividends paid to company B because only it is owned by a third-country resident.

12 Discussions of treaty shopping often imply that a few nasty countries allow companies to sneak into their article 4 “liable to tax” definition without a substantial nexus with the jurisdiction. In Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998), at 22-23, the OECD identified the lack of a requirement that activity be substantial as one of the secondary hallmarks of a tax haven.

13 Supra note 3, at 7-8.
CONDUITS

Targeted anti-conduit measures are described in the paper as the “channel” approach, but in most cases they are really a subset of the “subject-to-tax” approach, which effectively adds to the entity-level “liable to tax” rule in treaty article 4 an analogous requirement attaching to specific items of income. This would not be acceptable as a general rule because it is far too restrictive of fiscal sovereignty. A country that retains jurisdiction to tax may decide not to exercise it for domestic policy reasons.

In the usual conduit case, the income received by the intermediary company would have been subject to tax but for an offsetting deductible payment. Applying the undifferentiated notion of “treaty shopping” to these arrangements along with problems involving lack of substance and claims about the importance of the location of ownership is unhelpful. Contrary to what seems to be the usual view (as reflected, for example, in the paper), it should be irrelevant in such conduit arrangements who owns the entity or even whether it has substance. A company that has significant business activity and is owned entirely by local residents can still make back-to-back deductible payments to a related company in another jurisdiction, raising the same tax policy issue.

The obvious solution would be to replace the ineffective (and poorly labelled) “beneficial ownership” rule with something more explicit. One is reminded of subsection 18(6) of the Act. In practice, such a rule can raise thorny problems of tracing, purpose, and so on. In addition, the same issue raised above regarding normative assumptions applies. Many or even most conduit arrangements are not meant primarily to save Canadian withholding tax but rather to avoid increasing that tax as a result of the interposition of an intermediary company that serves some other tax, or non-tax, purpose.

CONCLUSION

In the case of treaty shopping, the devil lies not only in the details but also in basic principles of international taxation, in the role of tax treaties in promoting trade, investment, and commerce, and in a proper scrutiny of the extent and character of the activity in question. Finance’s seven questions presuppose that there is a “problem” and that it is fiscally “significant.” They could be right, but I for one would like to see a more thorough and open consideration of the issues.

14 An exception concerns dividends, the subject of the Prévost Car case and not usually considered in this context.

15 Elements of this approach already exist in some treaties. For example, a trust is resident in a contracting state under article IV(1) of the Canada-US treaty “only to the extent that income derived by the estate or trust is liable to tax in that State”: The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

16 Or even an unrelated company, in an arrangement whereby the intermediary “rents” its treaty status.
Policy Forum: Editor’s Introduction—Income Splitting

In 1966, the Royal Commission on Taxation (the Carter commission) advocated the use of the family as the basic unit of taxation. Three justifications for this choice were offered. First, the commission spoke for the fair treatment of families with earnings split in different ways across the spouses. Second, the commission cited tax administration and efficiency concerns related to the prevention of tax arbitrage between family members. Using the family as the unit of taxation would close off opportunities for such arbitrage by eliminating the difference in tax rates applicable to individual family members under the existing system. Third, the commission argued that the tax unit ought to reflect the reality that economic decisions were made at the family level. According to the commission, “the family, as we find it in our modern society, continues to be the basic economic and financial entity.” Although Canada’s tax system never embraced the tax unit envisioned by the Carter commission, the arguments set out in the commission’s report have provided a sturdy and lasting foundation for those interested in understanding family-based taxation.

The “modern society” to which Carter referred has, of course, continued to evolve over the subsequent 47 years. Some elements of our social evolution have important implications for the choice of the tax unit and should inform a contemporary discussion. For example, Statistics Canada has tracked year-to-year changes in the respective shares of household income earned by the male and female members of opposite-sex couples. The proportion of couples in which the female earns more has almost quadrupled from 8.5 percent in 1976 to 31.4 percent in 2010 (see table 1). While these data make it clear that family taxation still has an important gender dimension, it no longer seems empirically appropriate to analyze family taxation as though “secondary earners” generally meant the female member of a couple.

This policy forum addresses family taxation—specifically, proposals put forward by the Conservative Party of Canada during the 2011 federal election campaign, to

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1 Canada, Report of the Royal Commission on Taxation (Ottawa: Queen’s Printer, 1966). See, in particular, the commission’s discussion of this proposal in volume 3 of the report, at 124.

2 Ibid., vol. 3, at 124.

3 Statistics Canada, CANSIM database, table 202-0105, “Distribution of Total Income, by Husband-Wife Families, 2010 Constant Dollars.” The sample includes only those couples in which at least one of the two individuals reported earned income in the particular year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Wife</th>
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Source: Statistics Canada CANSIM database, table 202-0105.
introduce a form of income splitting between spouses in reporting earned income. The insights of the three articles that follow reflect concerns that are viewed quite differently today than they would have been in the 1960s.

Single-earner families were much more common in the 1960s than they are today. The rise of dual-earner families has amplified concerns about the tax incentives facing employment decisions by secondary earners within families. The first article in the forum, by Matthew Krzepkowski, develops a proposal to alter the transfer of the spousal tax credit in the case of single-earner families, with the explicit aim of limiting the tax hit faced by secondary earners. While the proposal does not eliminate a jump in the tax rate for all secondary earners, it does go some way to alleviate the labour incentive criticism of a move toward greater use of family taxation.

The thinking of economists about internal decision making within families has also developed in new directions over the last 40 years. The second article, by Elisabeth Gugl, explores how proposals for income splitting change the bargaining power within households. In particular, Gugl examines a model in which present and future earnings are weighed by both household members when deciding on a division of labour within and outside the household. Tax considerations may lead to more time out of the workforce by the lower-earning spouse. This can potentially hurt that spouse’s bargaining power, not just at that time but also through reduced earnings power in the future.

Finally, views on the family as a financial unit have changed since the 1960s, with the heightened prominence of feminist perspectives. In the third article, Lisa Philipps draws an important distinction between income splitting and taxation based on individual income: income splitting shifts nominal liability for tax on income without shifting control over the labour or assets that produced the income. In practice, this has a strong gender dimension since women may then become liable for tax on assets that are out of their control. In the United States, so-called innocent spouse problems have led to women being left with large tax liabilities for activities of former spouses about which those women had no knowledge. Using this example, Philipps points out the problems raised by nominal tax sharing that advocates of income-splitting proposals should consider.

Kevin Milligan
Editor
Policy Forum: Tax Consequences of Income Splitting for Canadian Households

Matt Krzepkowski*

**KEYWORDS:** INCOME SPLITTING • FAMILIES • TAX BURDEN

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**INTRODUCTION**

Personal income tax systems have become an increasingly complex tool for adjusting the distributional impact of taxes of a widely diverse set of individuals. A recurring topic for policy debate has been the extent to which the income of a spouse should be included in determining an individual’s tax burden. While the tax system is focused primarily on the welfare of individuals, structuring the tax system solely around the individual as the tax unit would ignore the fact that the welfare of an individual depends on whether he or she lives alone, with a spouse, or with children. An individual may be able to pool income with a spouse in order to save on necessary household expenses and allow for increased consumption spending, while raising children incurs substantial additional costs. These issues have led tax commissions in Canada¹ and the United Kingdom² to recommend that the family, rather than the individual, be considered the appropriate unit of taxation.

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Including household income to some degree when determining tax burdens has become the norm across most developed countries, though the extent varies considerably. The United States maintains a full joint-filing system, with tax-bracket thresholds that are simply doubled for couples. France has a more elaborate measure to determine the size of the household for tax purposes, which includes the number of children. Some other countries allow for limited splitting of income between spouses. A more common approach, and the one currently employed in Canada, is to continue to maintain the individual as the tax base for the progressive income tax scale, while having a transfer system that is means-tested on total household income. Currently, only seven countries in the Organisation for Economic Co-operation and Development (OECD) require joint filing by couples, with six additional countries offering couples the option to file jointly.

There are a number of arguments against moving toward taxing the income of the household instead of the individual. Comparing families solely on the basis of their joint household income may ignore key differences in family structure that may favour some households over others. In the case of couples, if a single-earner couple has the same total income as a dual-earner couple, the two couples will have an equivalent tax burden. However, the single-earner family is able to provide additional unpaid household production as compared with the dual-earner family. Individuals living alone and single parents also have different expenses than households with two adults. The second argument against taxation based on the combined income of both spouses is that this raises the marginal tax rate of the secondary (lower) earner to the rate of the higher-earning spouse, distorting and discouraging his or her labour force participation.

These concerns have led to a shift away from joint tax systems back to a system in which the individual is the primary tax unit. Over the last 40 years, seven OECD countries have switched from joint taxation to individual taxation, namely, Austria, Denmark, Finland, Italy, the Netherlands, Sweden, and the United Kingdom (despite the issuance of the Meade report\(^3\) promoting joint taxation). The prevalence of tax brackets based on the individual but with transfer systems based on the household reflects an attempt to alleviate problems in individual incentives faced by joint tax schemes while acknowledging the importance of household income in individual welfare.

Recent exceptions to this trend include France and Canada. France has one of the most complex personal income tax structures aimed at ensuring equality between families. The French tax code weights the number of adults and children within a household as part of the measurement of the household’s tax burden. In 2012, the French government attempted to impose a 75 percent marginal tax rate on individuals making more than €1 million per year. This proposal was eventually struck down by France’s Constitutional Council because it “violated the principle of equality,” in that two households with identical income may or may not have been

\(^3\) Ibid.
subject to the tax “depending upon the division of income between the taxpayers comprising the household.” Though France’s ruling simply maintained the status quo, Canada is potentially moving toward the introduction of measures that move the tax structure closer to joint taxation. During the 2011 federal election, the Conservative Party of Canada proposed a variation of joint taxation in the form of income splitting, allowing couples with a child under the age of 18 to shift up to $50,000 of income between spouses for tax purposes, and thereby potentially lower the family’s total tax burden.

The purpose of this article is to consider how income splitting would affect different subsets of the Canadian population. The next section shows how the tax burden of couples most affected by income splitting would change under different proposals, and why these changes may be preferable to an increased reliance on means-tested transfers. The discussion then continues with a look at how these proposals may affect tax equity between households of different sizes. The article concludes with a short comment on issues of implementation and intra-family inequality.

THE CANADIAN TAX SYSTEM AND INCOME SPLITTING

The current Canadian personal income tax system is similar to the systems in many OECD countries. Individuals file separate tax returns with tax brackets based on their own income, while the size of transfers and credits is largely based on the total income of the household. For example, the value of the goods and services tax/harmonized sales tax refundable credit depends on total family income, and specific tax credits for families with children can only be claimed by one spouse. Any unused portion of the basic personal exemption can also be transferred to a spouse.

With this type of tax system, the tax burden of an individual who is married or in a common-law relationship depends not only on the individual’s income but also, to a lesser degree, on the income of his or her spouse. When one member of the couple is in a higher income tax bracket than the other, the two individuals will have a greater joint tax burden than will be the case for couples where both spouses are in the same tax bracket. This difference in the tax burden hinges on the progressive nature of tax brackets. Low-income couples will have similar tax burdens whether or not there is an income disparity between the spouses, since the higher income earner will still be in a low income-tax bracket. High-income couples with a large income disparity will pay more taxes than high-income couples with evenly split earnings, since in the former case one earner will be in a higher marginal tax bracket, whereas in the latter case both individuals will be in a lower tax bracket.

4 Le Conseil Constitutionnel Decision no. 2012-662 DC, at paragraph 73, 29 December 2012.
Consider the tax burden of two hypothetical families, each consisting of a couple with no children: one family has a single wage earner who provides all of family’s employment income; the other has two earners, each of whom earns half of the family’s total employment income. The joint taxes paid by these two couples as their income increases are illustrated in figure 1. These calculations include not just the progressive income tax scale but all other credits and deductions available to the couple, and exclude payroll taxes. Both payroll taxes—employment insurance (EI) and Canada Pension Plan (CPP)—are premiums paid by working individuals that have specified maximum contributions. The contribution is capped to limit the amount of insured earnings (under EI) and the amount of forced retirement savings (CPP). The effect of these caps is that a single earner who earns more than the cap pays less into these programs than is the case for dual-earner families. However, both of these programs have expected benefits that would also need to be factored into any analysis. Dual-earner families would receive higher benefits from EI if both spouses became simultaneously unemployed, and would receive a higher public pension owing to employer contribution matching. Rather than attempting to account for the benefits for each family type throughout the income distribution, these taxes have been omitted from the calculations.

At low incomes, the total tax burden between the two couples is almost identical. Much of their tax burden is reduced by tax credits based on total income, and neither family has an earner in a high income-tax bracket. As soon as the single-earner couple reaches a higher tax bracket, the tax burdens diverge. At a total household income of $75,000, a family with a single earner will pay almost $2,500 more in taxes, or 31 percent more, than the dual-earner family. The absolute difference in tax burden grows with income, though the percentage gap begins to narrow when both dual earners enter the highest tax bracket.

However, the joint income of these couples may not be an appropriate measure of their total welfare. The most obvious difference in the two hypothetical families in this simple example is the time allocation of one of the spouses. The family with a single earner has a stay-at-home spouse who is able to provide additional unpaid, and untaxed, production at home that adds to the total implicit household income of the family. This household income is important and should be accounted for in the tax system. Currently, the only mechanism for taxing this additional household production is through the progressive nature of the tax system. Since lower-income couples already have similar tax burdens, it is only when a single earner moves into a higher

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6 All calculations of tax burdens are done using Kevin Milligan’s Canadian Tax and Credit Simulator (CTaCS) for the 2012 tax year: Kevin Milligan, “Canadian Tax and Credit Simulator,” database, software, and documentation, version 2012-1 (2012) (faculty.arts.ubc.ca/kmilligan/ctacs/). The Conservative Party’s most recent proposal for income splitting restricted its use to families with children under the age of 18. For a comparison of the tax burdens for families with children, see Matt Krzepkowski and Jack Mintz, “No More Second-Class Taxpayers: How Income Splitting Can Bring Fairness to Canada’s Single-Income Families” (2013) 6:15 SPP Research Papers 1-17 (University of Calgary, School of Public Policy).
income bracket that the tax system implicitly accounts for differences in home production. This would be justified if the additional home production were correlated in some manner to the income of the wage earner, but this does not seem to be the case. In a survey of household time use, Frazis and Stewart from the US Bureau of Labor Statistics\(^7\) show that the value of household production is relatively flat across the income distribution and acts similarly to a lump-sum transfer of income.

A Statistics Canada study\(^8\) attempted to quantify the value of household work provided by an individual on the basis of gender and whether the individual was married, employed, or had children. The calculation was done using a replacement-cost approach, taking the hours spent on each household tasks and matching these


with the hourly wage of employees in a corresponding service industry. Updating these values for inflation, a single-earner household provides approximately $35,400 in unpaid household income, compared to $24,300 for a dual-earner family. These values are comparable to those calculated for the United States by Frazis and Stewart. By ignoring differences in household production, the current tax system imposes a lower tax burden on single-earner couples at the low end of the income scale and on dual earners at higher incomes. Income splitting equalizes the tax burden between the types of couples on the basis of total market income, not the total implicit household income. In this sense, income splitting on its own may shift the tax burden for high-income single-earner couples below that for dual-earner couples by not accounting for their additional household production.

The tax burden of the two hypothetical families under an income-splitting proposal is shown in figure 2 as a function of their total implicit household income. Since the tax burden of the two families is almost equal but the single-earner family is able to provide more household production from the at-home spouse, the tax system provides a tax benefit to single-earner households. Since the additional household production is likely constant throughout the income distribution, the difference in tax burdens between the two families is relatively stable at just under $1,500 for couples making less than $85,000 and increases to $2,250 for couples making over $100,000 as earners shift between tax brackets. Instead of being used to provide a tax break to some families, income splitting may be used to allow for alternative mechanisms to adjust for differences in the earning structure of couples. One potential change is to adjust the use of the basic personal tax exemption alongside an income-splitting proposal to account for differences in time allocation.

Currently (in 2012), the basic personal exemption is $10,822, which is multiplied by the tax rate for the lowest tax bracket (15 percent) to yield a tax credit of $1,623.30.

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9 The other approach used by Statistics Canada and others is the opportunity-cost approach, which attempts to predict the employment possibilities of individuals. This method is considered to be less accurate than the replacement-cost approach.

10 This includes the estimated value of an employed husband and wife for the dual-earner couple and an employed husband and unemployed wife for the single-earner couple. The secondary earner is usually classified in the literature simply as the lower income earner or the stay-at-home spouse. The primary earner is usually characterized as male and the secondary earner as female (though, as Milligan notes in the introduction to this Policy Forum, more recent data suggest that this characterization is no longer appropriate). Changes in gender roles and composition in couples will affect the amount of household work done. This analysis also assumes the same amount of work done by the male whether the spouse works or not. It is likely that an individual with an unemployed spouse may do less household work than one with an employed spouse, so this underestimates the differences in total household production.

11 With income splitting, the only difference between a single-earner couple and a dual-earner couple would be the value of the employment income tax credit on the first $1,095 of income.
Each spouse is eligible to claim this exemption, but any unused amount can be transferred to the other spouse. The rationale for the transferability of this deduction is to allow households a higher threshold of tax-free income in order to fund additional necessary expenses of a low-income spouse. With income splitting, the tax structure could be changed so that, rather than allowing transferability and income splitting jointly, individuals choosing to split income would be permitted to use the basic personal exemption only against their own employment income. This would prevent single-earner couples from receiving two tax benefits (the transferred amount and the savings from income splitting), and the value of the credit would be approximately equal to the additional tax burden faced by a dual-earner couple if income splitting were in place after including household production. Dual-earner couples with a large amount of income disparity would therefore be the primary recipients of a tax break, instead of single-earner couples. These dual-earner couples would

12 A similar adjustment was first proposed in Douglas Hartle, Taxation and Married Women in Canada, report prepared for the Royal Commission on the Status of Women (Ottawa: Information Canada, 1971).
not benefit from additional household production, as a single-earner couple would, yet they would face a similar tax burden since the higher-income spouse would still be in a higher marginal tax bracket.

Sacrificing transferability would also limit the effect of some disadvantages of income splitting. A key argument against income splitting is that it would negatively affect the secondary earner’s labour force participation. Increasing the impact that an individual’s income has on the tax burden of his or her spouse results in their labour decisions becoming more interdependent. As the benefit of income splitting is simply to shift income from a high income tax bracket onto a lower one, this shift increases the marginal tax rate of a secondary earner. Rather than being subject to the same progressive income scale, the secondary earner is immediately subject to the high marginal tax rate of his or her spouse. Recent literature has argued that the marginal tax rate for the secondary earner should be decreasing in relation to the earnings of the primary earner, not increasing as in the case of joint taxation. Kleven, Kreiner, and Saez13 develop a model wherein the secondary earner makes a discrete choice to enter the labour force. They then look at how the tax rate of the secondary earner should be correlated with the earnings of the primary earner. When the secondary earner makes a discrete choice to work, it is the average, not the marginal, tax rate that influences the labour decision. The decision to enter the labour market signals that an individual has low costs of work; therefore, a positive tax rate for dual-earner couples would lead to optimal redistribution. However, the secondary earner’s relative contribution to the total welfare of the household decreases as the primary earner’s income increases, and this lowers the value of the redistribution. Accordingly, the optimal tax system should exhibit “negative jointness,” such that the average tax rate applicable to the secondary earner as a result of entering the labour force should decrease as the income of his or her spouse increases.

Income splitting would result in a move toward “positive jointness,” since the marginal tax rate of the secondary earner would be equal to the tax rate of the primary earner, and that rate would rise as their income increased and they moved into higher tax brackets. Immervoll, Kleven, Kreiner, and Verdelin14 find that moving toward negative jointness rather than positive jointness may result in significant efficiency gains. They show that a revenue-neutral decrease in the tax rate applicable to secondary earners in 15 European countries could increase the welfare of a dual-earner couple by $1, by taking away less than $0.50 from single-earner households. Several studies of European tax changes have shown that moving toward a system of joint taxation has negative effects on the female labour supply (since secondary

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earners are predominantly women), though these effects are relatively small compared to other factors of female labour force participation over the last few decades.

Restricting the transfer of the basic personal exemption would counteract this effect of positive jointness and would lower the tax rate of many secondary earners. Currently, because the basic exemption is transferable, it is used whether the secondary earner enters the labour force or not, provided that the primary earner’s net income is greater than twice the amount of the exemption, or $21,644. This means that a secondary earner effectively begins to pay tax on any employment income above the existing $1,095 employment tax credit, even though this would fall into the lowest tax bracket. Under the modified income-splitting proposal above, secondary earners would claim the exemption on their own income, lowering their tax burden, even though they will face a higher marginal tax rate once they become tax-paying. If $50,000 of income (the maximum under the Conservative Party proposal) is shifted to the lower-income spouse, the average tax rate for a secondary earner making less than $32,000 under the adjusted system proposed here would be lower than under the current tax system. Past that threshold, since the secondary earner would then be in a higher income tax bracket, the tax burden on that individual would increase, though the total tax burden of the family would clearly still be lower. Nevertheless, this is a relatively high threshold since it approximates the median individual Canadian income, and is higher than the estimates of the value of household production. Crossley and Jeon show that labour force participation of lower-income individuals may be quite sensitive to these types of tax changes. They use a 1988 tax reform that modified the basic exemption from a tax deduction to a tax credit, and thereby lowered the marginal tax rate for secondary earners with high-income husbands by up to 17 percent. Crossley and Jeon argue that this reform translated to a 10 percent increase in the labour force participation of lower-educated women married to high-income husbands.

15 This continues to be the case in Canada. Of all married, opposite-sex couples in 2010, 42.6 percent were dual-earner couples where the husband earned more than the wife, and an additional 15.6 percent were single-earner couples with the husband being the sole earner. See Statistics Canada, CANSIM database, table 202-0105. However, as noted by Milligan (citing data from the same source), in recent years the proportion of higher-earning women among couples with at least one working spouse is increasing: see the Editor’s Introduction to this Policy Forum and table 1 therein.


The adjustment to the basic exemption described above would also introduce some negative jointness further into the income distribution than would be the case for most other tax systems. The negative jointness feature of European tax systems is primarily attributable to the clawback of means-tested transfers as household income increases. As the primary earner’s income increases, the secondary earner’s income will have a smaller effect on reducing the value of the transfers, thus lowering the effective tax rate that results from entry into the labour force. This effect holds only where the primary earner has low income and the tax rate applicable to the secondary earner is quite flat or increasing through the remainder of the primary earner’s income distribution. Limiting transferability of the basic amount with income splitting would add a further reduction in the average tax rate past the point where means-tested transfers would otherwise be clawed back for low-income secondary earners.

OTHER EQUITY ISSUES

The previous section showed how adjustments to the personal tax system could equalize the joint tax burden of couples regardless of how the income is earned between spouses. Reforming the tax system with this focus would also cause distortions in the relative tax burden between different subsets of the population. Adding income splitting into the Canadian tax system, either in its standard form or alongside changes as proposed in the previous section, effectively results in a tax break for relatively high-income couples that have a disparity in their earnings, and will not affect the taxes paid by others. This will result in high-income couples contributing a smaller proportion of total personal tax revenue to the federal government, altering the proportion of taxes paid across the income distribution and between family types. Laurin and Kesselman analyzed the original income-splitting proposal put forward by the Conservative Party, without the additional changes proposed here. They estimate that the proposal, which was restricted to couples with children under the age of 18, would cost $2.7 billion per year, and would swell to $5.6 billion if extended to all couples. There would also be an additional cost of $3.5 billion for the provinces if they followed along with the proposal. Laurin and Kesselman show that 41 percent of these benefits would go to couples with market income greater than $125,000. Single individuals would receive no benefit, and many of the other beneficiaries would receive less than $1,000 in tax relief, resulting in a decrease in the overall progressivity of the tax system.

Comparing the appropriate tax burden between couples and single individuals requires some weighting of the individuals within a household to control for differences in costs of living. While a couple requires more resources to achieve the same

18 Immervoll et al., supra note 14.
standard of living as an individual, this is partially offset by returns of scale in household costs; consequently, a couple requires less than twice the income to have the same standard of living as an individual making the same amount of money. Attempting to compare welfare across family types has led to equivalence scales to allow for determination of the amount of income that a family of a given size should have to be comparable to the income of an individual. The OECD, and recently Statistics Canada, have taken to using the so-called square-root rule to calculate household equivalence scales. This is a simple approach that takes the square root of the number of individuals within a household to determine its individual-income equivalent. This means that a couple’s income can be divided by approximately 1.414 in order to be directly comparable to the income of a single person. This scaling can then be used to compare the respective tax burdens of single- and dual-earner couples against that of an individual taxpayer. Both before-tax and after-tax incomes of these households should correspond to the same equivalent-income scale, so that a couple should have the same average tax rate as an individual with an equivalent-adjusted income.

This equivalency in tax burden holds under a flat income tax, since the average tax rate and the marginal tax rate will always be equal. Means-tested transfers based on household income lower the average tax burden for equivalent individuals, and fixed deductions and a progressive income tax structure lower the average tax burden for dual-earner couples (though this depends on the spacing of tax brackets). The average tax rates for the two hypothetical couples introduced earlier, and for an individual with an equivalent-adjusted income, are shown in figure 3 for varying levels of market income, where all three have positive tax burdens. Under the current tax system, dual-earner couples making more than $20,000 in joint income will have a lower average tax burden than an individual throughout the remainder of the income distribution. This percentage point difference varies between 1.5 percent and 3 percent. The disparity results from a combination of the couple’s ability to claim two basic personal exemptions, in addition to gaps in the income tax brackets where the single-earner will move to a higher income tax bracket before the dual-earner couple. A single-earner couple has a lower average tax burden than the equivalent-income individual until an income of around $55,000, at which point the couple will reach higher tax brackets sooner (since they need a larger income to be comparable). Because this equivalence scale is based on total market income, the income-splitting proposal here puts the single-earner couple above the dual-earner couple and below the individual throughout most of the income distribution. Thus, an income-splitting proposal will result in a shift in the proportion of tax payments from couples onto single individuals, although the tax share will be similar regardless of how the couple’s income is earned. Without including an equivalence weighting in the calculation of the tax burden, this will be a by-product of any income-splitting proposal, and one that should be carefully considered.  

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20 Increasing the average tax rate for couples would lead to an increase in the cohabitation or marriage penalty described previously.
Still other important differences exist between couples. The preceding analysis assumed that the welfare of a couple could be determined simply by aggregating their total market incomes and any household production. A dollar earned by one spouse provided the same effect as a dollar earned by the other. There is evidence that this may not be the case. Many couples do share incomes, particularly in paying for household expenses, but their expenditures may differ depending on who earns income within the family.\(^{21}\) The key issue for policy makers is the extent to which the tax system should take these differences into account. The less the government’s perception that individuals share income with each other, the less preferable any policies toward joint taxation will be.

This does lead to a final point on implementation of any income-splitting proposal. Since couples may not fully share their earnings, any income-splitting proposal should recognize its potential effect on intra-family equity. From a tax-filing perspective, an income-splitting proposal would notionally shift income to give a higher-income spouse some tax relief while leaving the lower-income spouse with

a tax bill for income over which he or she may not have physical control. If couples paid taxes out of their own earnings, this would result in a decrease in intra-family equity. The lower-income spouse would incur a larger tax bill and see his or her personal disposable income decline, while the higher-income spouse would receive the windfall. Instead, provisions in the tax legislation could adjust for the tax difference from income splitting by providing for a transfer to the lower-income spouse. This would result in the higher-income spouse having an identical tax burden as he or she would bear without income splitting, but would lower the total tax burden on the family by providing a transfer to the lower-earning spouse as a tax benefit. This solution would increase the complexity of tax filing to a certain degree, but it would not be overly difficult to implement as a way of ensuring that the tax system does not have adverse effects on intra-family equity.

CONCLUSION

Introducing income splitting in its simplest form would likely have a number of undesirable consequences for the economy. That said, there may be potential gains if this increased connection between the taxes of spouses included a partial substitution of the transferability of the basic personal exemption. The reduction in transferability would effectively adjust the tax system to recognize the tax benefit of work done by stay-at-home spouses, while simultaneously providing an additional tax credit to encourage them to enter the labour force, at least partially offsetting negative effects of income splitting on a secondary earner’s labour force participation. This adjustment would nonetheless require some tradeoffs in other equity comparisons. It would lower the average tax rate for higher-income couples with a high earning disparity to a tax rate closer to the rate of couples with similar spousal incomes, but provide no benefits to single individuals or single-parent households if income splitting were not extended to them.

Elisabeth Gugl*

**KEYWORDS:** Income splitting • Decision making • Labour supply • Welfare • Spouse

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**INTRODUCTION**

In this article, I consider the income-splitting proposal put forward by the Conservative Party of Canada in 2011\(^1\) and assess its impact on the distribution of welfare within a household. I assume that spouses make joint decisions governed by a bargaining process in the family based on various types of bargaining models as discussed in one of my previous articles.\(^2\)

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2 Elisabeth Gugl, “Income Splitting, Specialization, and Intrafamily Distribution” (2009) 42:3 Canadian Journal of Economics 1050-71. I use the terms “family” and “household” interchangeably.
Since the seminal work of Manser and Brown\(^3\) and McElroy and Horney,\(^4\) economists have moved away from the assumption that a couple behaves as if it were one economic agent. Instead, many family economists now treat household decision making as the result of bargaining between the partners.

Bargaining models characterize family decision making as a cooperative conflict; they capture the tension of each family member between self-interest and concern for the family as whole. That actions of family members are governed by both a willingness to cooperate and self-interest is best illustrated by the following anecdote.\(^5\)

When I recently picked up my daughter from the house of one of her friends, I complimented the friend’s mother—let’s call her “\(A\)”—on her attractive garden, and she said, “It’s so hard to keep up with the work! We already have so many expenses: daycare for the kids, the nanny; we can’t afford to hire somebody to take care of the garden! I have a good-paying job, but sometimes I wonder if it wouldn’t be easier just to stay home and take care of the kids and the garden myself.” These comments speak to a desire shared by many couples: to produce the greatest benefit to the family as a whole with the financial and time resources that the family has at its disposal. Simply put, household members pool their resources to achieve a common goal.

However, \(A\) also mentioned, with a sigh of regret, “My husband used to take care of our garden but then he discovered marathon running.” This speaks to another important feature of family decision making: while couples make decisions trying to do what is best for the family, they also balance their own interests with their concerns for the family as a whole. Clearly, \(A\) would have liked her husband to spend more time gardening and less running, while her husband preferred running to doing more gardening. Bargaining models explain how \(A\) and her husband divide their time between activities that benefit the family as a whole and activities that mostly benefit one spouse individually. They also explain how the family allocates goods, not just time; if \(A\)’s bargaining power increases, the expenditure pattern of the household reflects her preferences to a higher degree than her husband’s.

In this article, I use numerical examples to illustrate the findings in my earlier study.\(^6\) I consider a couple’s labour supply decision in the current year and its implications for their earning potential\(^7\) five years from now under the current system of family taxation and under the income-splitting proposal. The proposal creates incentives for the secondary earner in the family to reduce his or her labour supply and instead work more in household production. I discuss the bargaining rules

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\(^5\) Details of this story have been changed to preserve the anonymity of the individuals concerned.

\(^6\) Supra note 2.

\(^7\) By earning potential, I mean the amount of pre-tax income that an individual could earn if he or she worked full-time.
under which a decrease in the earning potential of the wife in the future can have such a high negative impact on her bargaining power relative to her husband’s that she is worse off under the proposal than under the current tax system.

I first introduce the particular policy and then show the different effects of the proposal on different household types. In my analysis, I abstract from other taxes and focus on the federal income tax schedule only. I also assume that the change in the tax schedule for families does not alter who enters into a relationship with whom. Holding partner characteristics constant, the question I answer in this article is, “How does the welfare of each partner change as couples are allowed to split their income according to the Conservative Party’s plan?”

Throughout the analysis I assume that there is no change in the service level of the government as revenues decrease from the tax change. In the conclusion, I discuss how changes in the expenditure level or increases in tax rates to make the tax change revenue-neutral could further change the distribution of welfare within a family.

The Income-Splitting Proposal

The Conservative Party of Canada went into the federal election in May 2011 with a promise to change how Canadian families are taxed. In particular, the proposed change would allow couples with at least one child under the age of 18 to transfer up to $50,000 from the spouse with the higher taxable income to the spouse with the lower taxable income.8 Since marginal federal tax rates increase with taxable income, such a transfer would reduce a couple’s joint tax liability whenever the marginal tax rate of one spouse was different from the marginal tax rate of the other under the current system of individual taxation.

All the calculations of a couple’s tax liability in this article are based on the tax schedule presented in table 1. The table follows closely the format of schedule 1 of the federal T1 general tax form for 2012. I ignore any deductions that lower the taxable income of an individual and any tax credits that cannot be claimed by all taxpayers. However, I take into account the basic personal amount of $10,822. In addition, the current tax system allows an individual to lower the tax liability if his or her spouse or common-law partner has a net income that is below the personal amount.9 If the spouse does not have any net income, the spousal or common-law partner amount is $10,822. Any net income of the spouse or partner reduces this amount dollar for dollar.

To calculate the tax liability of a couple, first each spouse’s taxable income is determined and entered in table 1. The last row yields a person’s tax liability. In order to calculate the couple’s tax liability the two amounts from the last row have to be added. This method works, even if one spouse earns less than $10,822. For example, if the

8 See supra note 1.

9 In my examples, total income, net income, and taxable income are all the same. They differ in reality owing to various deductions (for example, for union dues and registered retirement savings plan contributions).
### Table 1 Calculation of Federal Tax on Taxable Income

<table>
<thead>
<tr>
<th>If taxable income is</th>
<th>If taxable income is more than $42,707 but not more than $85,414</th>
<th>If taxable income is more than $85,414 but not more than $132,406</th>
<th>If taxable income is more than $132,406</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enter taxable income here</td>
<td>− 0.00</td>
<td>− $42,707.00</td>
<td>− $85,414.00</td>
</tr>
<tr>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td>×</td>
<td>$42,707.00</td>
<td>$85,414.00</td>
<td>$132,406.00</td>
</tr>
<tr>
<td>=</td>
<td>$6,406.00</td>
<td>$15,802.00</td>
<td>$28,020.00</td>
</tr>
<tr>
<td>Basic personal amount</td>
<td>$10,822.00</td>
<td>$10,822.00</td>
<td>$10,822.00</td>
</tr>
<tr>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td>Net federal tax</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
</tbody>
</table>

Source: Canada Revenue Agency, form T1 General 2012, schedule 1, Federal Tax (modified and simplified).

The net income of a spouse is zero, according to table 1 this translates into a negative tax liability (hence a refund) of $10,822 × 15% = $1,623. Combining this amount with the other spouse's tax liability results in a tax liability for the couple as if the spousal or common-law partner amount had been considered explicitly. Immediately below, I present an example of how a couple's tax liability is computed using table 1 when the current law is applied or when the income-splitting proposal is implemented to transfer up to $50,000 from the higher earner to the lower earner.

**Example: Calculation of a couple's tax liability under the current and the proposed tax regimes**

Consider a couple consisting of a higher earner with an income of $170,000 before taxes and a lower earner with an income of $30,000 before taxes.

**Current taxation**

Higher earner:

- Taxable income: $170,000
- − 132,406
- $37,594
- × 29%
- $10,902
- + 28,020
- − 1,623

- Tax liability: $37,299
Lower earner:

Taxable income................................. $ 30,000
− 0
30,000 × 15%
4,500 + 0 − 1,623
Tax liability................................. $ 2,877

Tax liability for the family: $37,299 + $2,877 = $40,176.

Income-splitting proposal

Higher earner:

Taxable income ($170,000 − $50,000) ................... $120,000
− 85,414
34,586 × 26%
8,992 + 15,802 − 1,623
Tax liability................................. $ 23,171

Lower earner: $30,000 + 50,000 = 80,000

Taxable income ($30,000 + $50,000). ..................... $ 80,000
− 42,707
37,293 × 22%
8,204 + 6,406 − 1,623
Tax liability................................. $ 12,987

Tax liability for the family: $23,171 + $12,987 = $36,158.

In table 2, I show the tax savings for families at various income levels where the income-splitting proposal is applied according to the 2012 tax schedule. Three levels of taxable family income are included, ranging from $75,000 to $200,000. For each level of taxable income, I consider five different earnings distributions.

As can be seen in table 2, the proposal generates greater tax savings for higher-income families (holding within-family income inequality constant) and for families
with greater income inequality (holding family income constant). Among the examples in table 2, the proposal generates the greatest tax savings for the single-earner couple with taxable income of $200,000.

A pure income-splitting proposal (without a cap on the amount of income that can be transferred from the high earner to the low earner) always leads to a family being taxed as if each earner made half of the family income. In such a case, each earner faces the same marginal tax rate. The $50,000 cap under the proposal limits the ability of some households to fully split their income. Specifically, the cap prevents full income splitting for some high-income, high-inequality households (in table 2, for the two most unequal households at the $200,000 family-income level).

Given the marginal tax rates applicable in 2012, the most that a family can save under the proposal is $6,490. Such savings are achieved when the high earner in a household earns enough so that all of the last $50,000 of his or her income is taxed at the highest marginal rate of 29 percent and the low earner earns nothing. In such a case, transferring $50,000 of income away from the high earner lowers his or her tax liability by $14,500, and increases the tax liability of the low earner by $8,010.
The increase in tax liability for the low earner comes from the fact that, under the 2012 tax schedule, the low earner would pay 15 percent tax on the first $42,707 of the transferred income, and 22 percent tax on the remaining $7,293 of the transferred income.

**IS IT WORTH CHANGING THE LABOUR SUPPLY AS THE TAX SYSTEM CHANGES?**

In this section, I investigate the labour supply of the couple under the two tax regimes. Table 2 shows how family income of the same amount but with different composition is taxed differently under the current tax law, and it illustrates the tax savings that may be achieved under the income-splitting proposal. It is important to note that, because after-tax income under the proposal is already higher, in most cases, than it is under the current system, where labour supply stays constant across the two tax regimes, the family has more financial resources and hence is better off under the proposal. Any change in labour supply resulting from the change in the tax system, if decisions are efficient, must make the family as a whole better off under the proposal.

Table 2 is not very useful in determining how a couple changes labour supply as the tax system changes, because typically the family cannot alter the composition of earnings while holding total income constant. Rather, the spouses’ decisions will most likely lead to different earnings composition and family income, as the two scenarios described below demonstrate.

**Scenario 1: Impact of Labour Supply Decision in the Year of Choice**

Consider the situation of a couple with two young children over a period of one year. I focus on a family in which the earning potential of the spouses is fairly unequal. As noted in the previous section, the income-splitting proposal would produce the greatest tax savings for high-income, high-inequality couples. These are also the households in which the incentive for the secondary worker to drop out of the labour force as the tax system changes is greatest.

Consider the family in table 2 in which the low-income spouse earns $30,000 in taxable income and the high-income spouse earns $170,000 if both work full-time. While a growing number of women are becoming primary earners, on average, it is still more common for women to be the secondary earners in Canadian families.  

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10 Recall that earning potential is the amount of income before taxes that an individual could earn if he or she worked full-time.

For that reason, I will assume that the spouse earning $30,000 is the wife and the spouse earning $170,000 is the husband.

Assume that the couple has two children under the age of six, and annual child-care costs are $20,000. Let’s consider the financial resources that the family has at its disposal to buy goods (referred to here as the “disposable income” of the family). Child-care costs diminish those financial resources and hence should be subtracted from total income, in addition to the tax liability, in order to determine disposable family income. Clearly there are also other costs associated with both spouses working full-time, but I will ignore them for the sake of exposition.

Under the current tax system, the family income after taxes minus child-care expenses is $180,000 – $40,176 = $139,824. Under the income-splitting proposal, the family would keep an income of $180,000 – $36,158 = $143,842.

Now assume that the wife considers staying at home. This frees up time for her to contribute more home-produced goods in form of a clean house, a well-kept garden, clean laundry, home-cooked meals, and, most importantly, child care. I assume that child-care expenses are zero when the wife stays at home.

Under the current system of individual taxation, this would leave the family with a disposable income of $170,000 – $37,299 – ($1,623) = $134,324. The change in disposable income is –$5,500, as compared with the amount available when the wife worked full-time.

Under the income-splitting proposal, the wife’s decision to stay at home yields a disposable income of $170,000 – $23,171 – $6,387 = $140,442. The change in disposable income is –$3,400, as compared with the amount available when the wife worked full-time.

Looking at the annual change in family income under the two tax regimes, we see that when a spouse stays at home, the reduction in disposable income is less under the proposal. At the same time, the household still has a higher disposable income with the stay-at-home wife than it had under the current tax regime when the wife worked full-time.

The example illustrates the benefits to the household of the income-splitting proposal compared to the current system, within the period in which a change in labour supply could be made. If the family chose labour supply based on within-period benefits only, the optimal scenario might be for the wife, with an earning potential of $30,000 before taxes, to reduce her earnings to zero when the income-splitting proposal is implemented, but to work full-time under the current system of taxation.

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12 The 2012 federal income tax schedule allows for a child-care deduction against the lower earner’s income. With the income-splitting proposal, often there is no lower earner, and it is unclear how this deduction would be applied. I therefore ignore this provision in my calculations. Child-care costs could differ under the two tax regimes if, owing to the lower government revenues under the proposal, public expenditure on child-care centres and/or public education were reduced.
Such a change in labour supply has an impact on government revenues. Not only does the couple save (and the government lose) $4,107, as would be the case if earnings of each spouse stayed the same under both tax regimes, but also the drop in the wife’s labour supply further decreases tax revenues. The additional loss is $30,000 \times 0.22 = $6,600.

**Scenario 2: Effects of Labour Market Experience on Future Earnings**

Next I consider what happens when there are two periods of labour market choice, not just one. The labour supply in the first period as described above has an impact on the wage rate that spouses can earn in a later period, because a key determinant of wages is experience. For the high earner, the extra time at work afforded by having a stay-at-home spouse enhances earnings. For a lower-earning spouse, staying out of the labour force results in the loss of potential work experience and possibly future as well as current wages. A forward-looking couple would not make a labour-supply choice in any given year on the basis of within-period benefits alone, but would look also at the consequences for the years ahead. I continue with the previous example to illustrate this point.

Consider the family in scenario 1 five years from now, when the children do not require full-time day care because they have entered school. Suppose that instead of staying at home, the wife spent those five years working full-time, earned a promotion, and is now making $40,000 a year instead of $30,000. Her husband has also made career progress and now earns $200,000. Child-care costs are down to $10,000 a year. So the family’s disposable income under the current tax system is $230,000 \quad - \quad ($200,000 \quad - \quad $132,406) \times 0.29 \quad - \quad $28,020 \quad - \quad $40,000 \times 0.15 \quad + \quad (2 \times $1,623) \quad = \quad $179,624.

Under the income-splitting proposal, it would be $230,000 \quad - \quad ($150,000 \quad - \quad $132,406) \times 0.29 \quad - \quad $28,020 \quad - \quad ($90,000 \quad - \quad $85,414) \times 0.26 \quad - \quad $15,802 \quad + \quad (2 \times $1,623) \quad = \quad $183,129.

Even if the wife stayed at home during the last five years, she can enter the labour force now. In this case, assume that her starting wage is $27,000, owing to her lack of recent labour market experience. The husband, having had more time to network and keep up with his profession in his leisure time with the support of his stay-at-home wife, is making $210,000. So the family’s disposable income under the current tax system is $227,000 \quad - \quad ($210,000 \quad - \quad $132,406) \times 0.29 \quad - \quad $28,020 \quad - \quad $27,000 \times 0.15 \quad + \quad (2 \times $1,623) \quad = \quad $175,674. The change in disposable income is $-3,950, as compared with having the wife work full-time five years earlier. Disposable income under the income-splitting proposal is $227,000 \quad - \quad ($177,000 \quad - \quad $132,406) \times 0.29 \quad - \quad $28,020 \quad - \quad ($50,000 \quad - \quad $42,707) \times 0.22 \quad - \quad $6,406 \quad + \quad (2 \times $1,623) \quad = \quad $181,101. So the difference is $-2,028.

The example illustrates the intertemporal benefits to the household under the income-splitting proposal as compared with the current system. Although a lower first period labour supply of the wife lowers family income five years from now, it lowers it by less under the proposal than under the current system. Given the benefits of increased household production in the first period, it might still be optimal
for the wife to stay at home in the earlier period when the proposal is implemented, but to work full-time under the current system of taxation.

This example illustrates two very important points. First, the family has more disposable income and a higher level of household production under the income-splitting proposal in the first period. Even in the second period, the husband’s higher earnings and the more favourable tax treatment under the proposal make up for the wife’s diminished earnings compared to the disposable family income under the current system. Overall, the household has more financial resources in each of the two time periods under the proposal than under the current tax system.

Note that this is just one example of how labour supply decisions in an earlier period could affect the family’s earning potential in five years. The example delivers higher earnings for the husband in the second period, which make up for the lower earnings of the wife. This may not always be the case. It could be possible that the wife’s lack of experience decreases her earning potential in the future by so much that the higher earnings of the husband and the more favourable treatment under the proposal cannot make up for them.

Second, we can also see that choosing a lower labour supply for the wife in one period changes her earning potential over the long run, leading to a bigger gender gap in the earnings of the couple. In the first period, the earning potential ratio—that is, how much each spouse could earn if he or she chose to work full-time—is $170,000/$30,000 = 5.67. Given that both spouses work full-time in the first period, the earning potential ratio in the second period is $200,000/$40,000 = 5. If the wife stays at home in the first period, the ratio in the second period is $210,000/$27,000 = 7.78.

The above ratios do not take taxes into account. I will return to the impact of taxes on the ratio of disposable incomes in the next section. Here I emphasize that the labour supply decision in an earlier period has an impact on the earning potential of a spouse in subsequent periods, and that more specialization of spouses in earlier periods leads to a higher earning potential ratio in subsequent periods. Why this might be of concern is addressed in the next section.

**BARGAINING AND DISTRIBUTION OF WELFARE WITHIN THE FAMILY**

The previous section focused on an example in which cooperation under the two tax regimes leads to more disposable income and household production under the income-splitting proposal than under the current tax system. I now turn to the question of how this relatively higher wealth might be distributed between the spouses.

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13 Another important result from the example is that tax revenues are lower under the proposal than under the current system because the family as a whole has lower earnings before taxes and is taxed less than under the current system. The loss in revenue should be taken into account in an overall assessment of whether the proposal should be implemented. This issue is not, however, the focus of this article.
Manser and Brown\textsuperscript{14} and Horney and McElroy\textsuperscript{15} were the first to apply bargaining models to household decision making. One can think of this approach as describing principles that govern the process of how family members make decisions. If spouses cooperate, each spouse will consume shared goods and private goods that will lead to increased well-being by comparison with the consumption of goods that the spouse can afford in a state of disagreement. The question then becomes, “How should the gains from cooperation be distributed, and what constitutes a state of non-cooperation or disagreement?”

In the context of bargaining among spouses, the state of non-cooperation is interpreted as either a situation in which the spouses do not live together (remain single or get a divorce) or a situation in which the spouses still live under the same roof and remain in the relationship, but refuse to coordinate their actions. In either of these states of non-cooperation, a person’s well-being is much more closely linked to his or her own earning potential than is the case in a state of cooperation.

The well-being of a spouse in a state of non-cooperation depends on the quantity of goods and leisure that the spouse can consume in such a state. Household production plays a lesser role in non-cooperation, and so a person’s well-being is closely related to his or her disposable income from working full-time. The taxes that apply to total income have an impact on disposable income, and hence the tax schedule has an impact on a spouse’s bargaining power. For example, if the state of disagreement is taken to be the utility of a spouse when single, then the level of utility depends on the tax rates that are applied to the person’s total income. Given that each person works full-time, a proportional tax on earnings yields the same ratio of disposable income as of earning potential. A more progressive tax schedule changes the ratio of disposable income in favour of the person with the lower earning potential as compared with the ratio of earning potential.

Sorting out the disagreement point is just one part of describing the bargaining approach. The other part consists of discussing which rules should lead the spouses from their minimal claims to their actual utility in marriage. With regard to this question, I assume that if the potential gains from cooperation change without a change in minimal claims, both spouses should be either better off or worse off than before (that is, they share the gain or pain of this change).\textsuperscript{16}

The proposed change in family taxation increases the gains from cooperation whenever the couple can lower their tax liability, given taxable incomes before the tax change as illustrated in table 2. Whatever the actual choices of the spouses—even if they lead to a lower disposable income in the second period—family wealth as a whole

\textsuperscript{14} Manser and Brown, supra note 3.
\textsuperscript{15} Horney and McElroy, supra note 4.
\textsuperscript{16} For further discussion of this issue, see Elisabeth Gugl and Justin Leroux, “Share the Gain, Share the Pain?—Almost Transferable Utility, Changes in Production Possibilities, and Bargaining Solutions” (2011) 62:3 Mathematical Social Sciences 133-43.
will be increased when both periods are considered together. Hence, the source of any adverse effect of the proposed tax change arises from a change in the minimal claims of spouses. This change is due to the effect of the tax change on spouses’ earning potential.

Looking at the choices discussed above, we can see that the earning potential for the husband, while the same under the current tax system and under the proposal in the first period, is higher under the proposal in the second period owing to the different first-period labour supply decision. Similarly, the earning potential for the wife is the same under the current tax system and under the proposal in the first period, but it is lower under the proposal in the second period owing to the different first-period labour supply decision.

The earning potential of the wife is the same before making a decision in the first period with respect to how much to work, no matter whether the proposal is implemented or not, and hence her minimal claim to gains from cooperation in the first period stays the same under both tax regimes. The same is true for the husband. Hence, the bargaining power of each spouse in the first period is independent of the tax regime in marriage. Gains from cooperation in the first period are higher under the proposal than under the current system, so both spouses benefit from the proposal in the first period.

It is important to note that the wife is not punished for her low earnings in the first period. In this period, she has a minimal claim based on her earning potential (of $30,000), not her actual earnings in the first period. If there were no other period, staying at home would come at no loss of bargaining power to her.

In the second period, however, under the income-splitting proposal, the wife’s earning potential is lower while the husband’s is higher than they are under the current system. If bargaining in the second period is based on the earning potential of each spouse in the same period, we conclude that the wife’s bargaining power has decreased. This decrease could lower the wife’s second-period utility so much that her overall utility (that is, taking her well-being into account in all periods) is lower under the proposal than under the current system of taxation. Such a change would manifest itself in less time for leisure activities (and more for household chores) than under the current system, and in an expenditure pattern of the household that reflected the husband’s preferences to a higher degree over time.

So far, I have ignored any strategic interaction. I have assumed that labour supply is based on producing the highest wealth in household production and financial resources possible. However, we could think of a scenario in which both spouses have autonomy in deciding how much they will work. Once they have made this choice, and family income and household goods are generated, that income and those goods are distributed as before, on the basis of the bargaining power of spouses. Now the spouses take into account how their first-period labour supply affects their own welfare in the two periods, and each of them will choose how much to work on the basis of what is best for himself or herself alone, given the other person’s decisions. Note that there are still elements of cooperation: both spouses agree on what is a fair division of family income in each of the two periods.
In my earlier study, I point out that it is the husband’s actions that can have a negative impact on the wife’s welfare when spouses choose their labour supply strategically. However, if the husband does exactly the same under both tax regimes—that is, he contributes the same amount of time to household production and works the same number of hours—the wife will change her labour supply only when it is in her best interest to do so. She is aware of the implications of her actions for her earning potential in the second period, and the possibility of a lower share of gains from cooperation owing to her diminished bargaining power. In such a situation, the wife is under full control and will choose to stay at home in the first period only if doing so is in her best interest. Hence, even if she reduces her working hours and her future earning potential under the income-splitting proposal, she does so because she is better off.

In the scenario discussed above, I assumed that a husband with a stay-at-home spouse would have an advantage in making career progress as compared with a husband whose wife worked full-time. When the husband, through his own actions, increases his earning potential under the income-splitting proposal beyond his earning potential under the current system, the wife suffers a loss of bargaining power, which may have a negative impact on her welfare under the proposal, even if the spouses make their labour supply decisions strategically.

**CONCLUSION**

This article illustrates with simple examples the theoretical results derived in my earlier study. Conventional wisdom predicts that the Conservative Party’s income-splitting proposal would lower the labour force participation of women, since they are still, on average, more often the secondary earner in Canadian families. Whether lower earnings translate into lower bargaining power and lower welfare for the wife depends on the bargaining process in the family. If the ratio of within-period earning potential determines the bargaining power of spouses to a large extent, then lower labour supply in an earlier period leads to lower bargaining power in subsequent periods. The reduction in welfare of the spouse with decreasing bargaining power in later periods may not be offset by the higher welfare in the first period.

Implementing the income-splitting proposal will result in lower revenues for the government. Lower expenditure on public services or increases in other taxes to offset the revenue loss may have regressive impacts. If that is the case, the bargaining power of spouses could be further changed in favour of the spouse with the higher earning potential. Hence, it becomes more likely that wives (owing to their role as secondary earners) will be hurt by the proposal.

17 Gugl, supra note 2.
18 Ibid.
The results presented in this article also show that the proposal cannot hurt wives if both husbands and wives do not change their labour supply as the tax system changes. In this case, spouses will just share the higher disposable income resulting from the tax savings that income splitting provides to families with children. The article by Matt Krzepkowski in this issue discusses how the proposal could be tweaked to reduce the incentives for wives to drop out of the labour force.
Policy Forum: Real Versus Notional Income Splitting—What Canada Should Learn from the US “Innocent Spouse” Problem

Lisa Philipps*

KEYWORDS: Equality ■ Income Splitting ■ Men ■ Tax Administration ■ Tax Policy ■ Women

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Introduction

Any evaluation of tax policy choices in the area of spousal income splitting must include consideration of its effects on gender equality. Applying the classic tax policy criteria of equity, efficiency, and administrative simplicity in a way that avoids gender is particularly unsatisfying in this context, because income splitting has such obviously gendered dynamics. It is incumbent on income-splitting advocates to consider how the rules can best be designed to enhance rather than detract from women’s economic equality, autonomy, and security. In order to do so, I argue, income splitting must be conditioned on a transfer of legal control over income or property between spouses. I refer to this as “real” income splitting in order to contrast it with the purely notional assignment of income to the tax return of a lower-earning spouse.

Notional income splitting was introduced for the first time in Canada in 2007, through the pension income-splitting rules.¹ This comment discusses why notional

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¹ Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”), paragraphs 60(c) and 56(1)(a.2) and section 60.03. Unless otherwise stated, statutory references in this article are to the Act.
income splitting is damaging to gender equality, and why real income splitting is a superior model. It highlights the egregious risk that under notional income splitting some individuals, overwhelmingly women, will be targeted for enforcement actions to collect unpaid taxes on income that they have never received or controlled. This is because the legislation imposes joint and several liability of the spouses for any tax owing on pension income that is shifted between tax returns, regardless of who owns or has influence over the expenditure of that income.\(^2\) Joint and several liability continues indefinitely, and given the time lag from filing to assessment, audit, and enforcement, an individual may be pursued by tax authorities even after a relationship has ended to cover unpaid taxes of a former partner who has since become judgment-proof.\(^3\) Known in the United States as the “innocent spouse” problem, this is the most acute, but by no means the only, way in which women are systematically disadvantaged by such rules. Indeed, it is likely that many more women will be negatively affected by the economic incentives under notional income splitting for second earners to be financial dependants rather than income earners or property holders in their own right. Far from eliminating “second-class taxpayers,” as claimed by Krzepkowski and Mintz, this comment explains why notional income splitting reinforces women’s second-class economic status, by erecting new tax barriers to their financial autonomy.\(^4\)

Statistics on the takeup of pension income splitting confirm that men are the primary beneficiaries by a significant margin. In 2010, 82 percent of the over 1 million individuals claiming the deduction for split pension income were men, and they accounted for 89 percent of the total dollar amount of claims.\(^5\) The revenue cost of these provisions to the federal government is projected to rise to over $1 billion per year in 2012. Thus, pension income splitting has provided a substantial tax reduction for a select, male-dominated group of taxpayers who have had a portion of their income reported on the tax returns of their lower-earning spouses, almost always women. Interestingly, household income data for the same year indicate that men were the sole or higher earners in only about 69 percent of couples with some earnings, yet they captured an even higher proportion of the benefits of pension income splitting.\(^6\) These data drive home the need to consider intra-household economic

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\(^2\) Subsection 160(1.3).

\(^3\) Subsection 160(2).


\(^6\) Statistics Canada, CANSIM database, table 202-0105. By way of speculation, the reasons may relate to men’s higher average incomes increasing their potential benefit from income splitting, or to intra-household income distribution among the specific demographic that receives private pension income.
disparities between men and women in any policy analysis of income splitting. Proponents of income splitting tend to gloss over these intra-household effects, preferring instead to focus on comparing the aggregate tax burdens of single- and dual-earner households.7 It was this logic that framed the Conservative Party’s 2011 election promise to introduce “income sharing” for all couples with dependent children under 18, allowing “spouses the choice to share up to $50,000 of their household income, for federal income-tax purposes,” once the federal budget is balanced.8 Before moving ahead, the government should undertake a full evaluation of the effects of pension income splitting.9 In considering different ways to deliver on its election promise, it should pay especially close attention to the distinction between real and notional income splitting.

**DISTINGUISHING REAL AND NOTIONAL MODELS OF INCOME SPLITTING**

A critical variable in assessing the gender equality effects of income splitting is whether the higher-income spouse must cede legal control over the split income (or the underlying asset that generates the split income) in order to achieve a reduction of tax liability. Until 2007, this was always the case in Canada. That is, a transfer of income or assets in favour of the lower-income spouse was required in order to split income for tax purposes. The pension income-splitting rules departed from this norm. For the first time in the history of Canadian income tax law, a tax reduction can be obtained for individuals through a purely notional transfer of income on paper, from the tax return of the spouse who legally owns the income to the return of the non-owning spouse. In other words, pension income splitting allows for a shifting of tax liability to the lower-earning spouse without any corresponding shift of legal control over economic resources.10 Rather than “income sharing,” “tax sharing” would be a more accurate term to describe these provisions.

The tax policy arguments against spousal income splitting are linked to the well-known arguments in favour of maintaining an individual, versus joint marital or

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7 See, for example, Krzepkowski and Mintz, supra note 4.
9 See John Lester’s proposal for regular benefit-cost evaluation of all tax expenditures that are close substitutes for program spending, in which he includes the pension income-splitting rules: John Lester, “Managing Tax Expenditures and Government Program Spending: Proposals for Reform” (2012) 5:35 *SPP Research Papers* 1-42, at 13 (University of Calgary, School of Public Policy).
familial, taxation unit. The case for joint taxation of couples is based on the view that “the income and expenditure of two individuals are not independent when they live together.” However, empirical studies have shown that it is far too simplistic to assume that all income is pooled and shared equally within all households. Rather, couples are highly diverse in the degree to which they share decision making about the use of household income, who manages the finances, and who benefits from consumption. The studies indicate that even where funds are pooled in a joint account, the legal earner or owner still enjoys more control over how money is spent.

From a gender equality perspective, the objections to spousal income splitting (or any other shift toward joint taxation of couples) typically include the following:

- It mainly benefits higher-income married men.
- It privileges couples with a sharply gendered division of labour over all other household forms.
- It discourages wives’ participation in paid work by raising the tax rate on “secondary” earned income.
- It reduces government revenues that could be used to fund transfers or services aimed at reducing labour force barriers and promoting gender equality.


12 Krzepkowski and Mintz, supra note 4, at 2.


While agreeing with this critique overall, I also suggest that it is insufficiently nuanced in tarring all income splitting with the same brush. I have argued elsewhere that a feminist case can be made for permitting real income splitting, conditioned on shifting legal control of income or property to the lower-income spouse.\textsuperscript{15}

If properly designed, real-income-splitting rules could provide an incentive for higher-income earners to transfer title over income or assets to their lower-earning spouses, potentially enhancing the latter’s economic autonomy and security both during the marriage and in the event of relationship breakdown. Such transfers would also serve materially to recognize and compensate, at least in part, the unpaid caregiving and other household labour performed by a much lower-earning spouse, usually a woman. These incentive effects have been documented in the United Kingdom, which moved from joint marital taxation to an individual unit in 1990, but allowed outright transfers of property between spouses without attribution of income.\textsuperscript{16} Likewise, Schuetze\textsuperscript{17} found that self-employed men in Canada are more likely to allocate salary, wages, or profits to their wives for tax purposes, compared to their counterparts in the United States, who need only file a joint return with a lower earning spouse to reduce their personal tax rate. Even if the sole motive for such transfers is tax minimization, they must be legally enforceable to have the desired effect.

A possible objection to real income splitting is the difficulty of ensuring that interspousal transfers actually take place and are legally effective rather than sham transactions. One simple way to encourage compliance would be to require a declaration in prescribed form by the transferor spouse that legal ownership of the split income has been gifted or otherwise transferred absolutely to the other spouse. The existing pension income-splitting rules already require a joint election and certification that both spouses agree to the designated amount being deducted on the pensioner’s return and included in the other spouse’s income, and that they understand that they are jointly and severally liable for any resulting tax, interest, and penalties.\textsuperscript{18} Undoubtedly the transferor spouse would in many cases retain some informal influence or would benefit from the expenditure of the funds, but this does not take away the value of giving lower-earning spouses legal title to a greater share of the household income. Studies of family economic behaviour indicate that legal

\textsuperscript{15} Philipps, supra note 14.


\textsuperscript{18} Canada Revenue Agency, Form T1032, “Joint Election To Split Pension Income.”
ownership comes with a greater sense of entitlement to participate in decision making.19 As Zelenak suggests, property owners often make consumption decisions cooperatively with a spouse, but ultimately “they still have control over the source of the income (as well as control over whether to remain married).”20 On divorce, family-law rights to claim a share of assets can be difficult and expensive to enforce against an unwilling ex-spouse. Gaining documented title to assets is therefore an important source of future economic security for a low-earning spouse, providing a more meaningful option to exit from a relationship, which should also translate into greater bargaining power within the relationship.21 For all these reasons, tax rules that allow for real income splitting could have some gender-equality-enhancing effects.22

By contrast, notional income splitting of the kind introduced in Canada in 2007 reinforces gender inequalities, because it involves the transfer of tax liability without any legal requirement to share control over the income that gives rise to it. The drafters of this policy presume that income is pooled within the household, and this is precisely the problem. As Lahey has pointed out, “[g]iving people who do not share incomes or property the benefit of presumed sharing eliminates any incentive they might otherwise have to share.”23 If the law is amended to allow notional income splitting of up to $50,000 per annum, many couples who would otherwise engage in real income splitting through existing legal means such as spousal registered retirement savings plans or payment of wages or dividends to a spouse, will likely opt instead simply to shift income on paper. Doing so would often be simpler, and would allow the wealthier spouse to avoid transferring title to any assets or income. Notional income splitting would push couples away from existing tax-planning mechanisms by which a non-earning or low-earning spouse currently can acquire some independent financial resources.

A further challenge is that any income earned independently by the transferee spouse will be stacked on top of the split income, raising fiscal barriers to women’s equal participation in paid labour. This is the primary reason why most tax policy analysts reject joint taxation.24 The proposal by Krzepkowski and Mintz to eliminate the spousal credit for couples who split income, replacing it with an employment income credit for the lower-earning spouse, is an unsatisfying response.25 While alleviating the stacking effect on the first $10,822 (in 2012) of employment income received by a second earner, any dollars above that modest amount would still be

19 See Burton et al., supra note 13.
20 Zelenak, supra note 14, at 357.
21 For a more detailed elaboration of these arguments in favour of real income splitting, see Philipps, supra note 14, at 240-50.
22 For a similar analysis, see Laurin and Kesselman, supra note 14, at 17-18.
23 Lahey, supra note 14, at 26. See also Woolley, supra note 10, at 613.
24 See the articles and reports cited supra at notes 17 and 20.
25 Krzepkowski and Mintz, supra note 4, at 10-11.
exposed to steeper tax rates because the second earner is also reporting a share of the primary breadwinner’s income. Moreover, it is unclear why the second earner should not be able to claim the credit on investment, business, or other independent sources of income. Contrary to its claim, the proposal would create “second-class taxpayers” who would lose access to a comprehensive basic personal credit that is available to every other Canadian resident, and would be exposed to relatively high marginal tax rates on any income beyond $10,822 of wages.

Notional income splitting therefore tends to exacerbate economic inequality between spouses, because it acts as a disincentive to both intra-household transfers and independent earning by the partner who is reporting split income. In theory, wives should be able to bargain for a redistribution of income or property in return for signing a joint election to split income. In practice, many economically dependent wives lack the information, the sense of entitlement, or the bargaining power to demand greater control over household resources. It is common simply to trust that the higher-earning spouse will do the right thing in covering taxes and providing for family expenses. The potential for this to go badly wrong for some people is illustrated vividly in the “innocent spouse” cases that have plagued the US income tax system. I elaborate on the innocent spouse problem below in order to demonstrate the challenges raised by notional income splitting.

THE US INNOCENT SPOUSE PROBLEM

The nature of the problem is best illustrated through a story. One of many well-publicized innocent spouse cases in the United States involved Carol Ross Joynt, whose husband, Howard Joynt, died after evading payroll and business income taxes for years. In her memoir,26 Carol described suffering occasional physical abuse by Howard but also enjoying a privileged lifestyle funded (she believed) through her husband’s inherited wealth and the popular bar and restaurant he owned in Washington, DC. Though a successful journalist who earned a salary of her own, Carol wrote that she knew little of Howard’s business affairs and deferred to his insistence on managing the household finances exclusively. Her occasional questions were met with reassurances that she need not worry, and she signed joint returns trusting that the accountants who prepared them had done so correctly. All seemed well until Howard’s death, when Carol learned that he had been audited by the Internal Revenue Service (IRS), and she was now the defendant in a claim for over $3 million in unpaid taxes, penalties, and interest, an amount that exceeded the value of his entire estate.27 Following a protracted appeal and with the help of legal advice, she eventually reached

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a settlement with the IRS, which accepted at least in part her claim for relief under the “innocent spouse” provisions of the Internal Revenue Code.28

The US legislated joint liability for spouses who file a joint marital return in 1938.29 Importantly, this liability is not limited to the taxes shown on the face of the return, but applies to all taxes subsequently assessed on unreported or misreported income.30 The liability is not limited in time or affected by the terms of a divorce decree or separation agreement.31 Thus, the US system poses an especially grave risk to those who are unaware that their spouses are engaging in aggressive avoidance or evasion of tax. The only defence available to an unwitting spouse under the 1938 legislation was to invoke a common-law doctrine such as duress or fraud to invalidate the signature on the joint return. The harsh effects of the law were revealed in a series of cases involving wives who were made to pay taxes and penalties on the ill-gotten gains of their judgment-proof ex-husbands, even if, for example, the unreported income had been embezzled from the wife’s own business.

Judicial calls for legislative relief were answered with the enactment of the first generation of innocent spouse provisions in 1971. These rules protected spouses from liability in limited circumstances involving an omission of income from the return and only in cases of serious financial hardship.32 Experience showed that the law did not provide relief in all deserving cases, and public and judicial outcries led to successive waves of reform in 1980, 1984, and 1998 to expand the grounds for relief. Not surprisingly, the reforms have also made the rules more complicated. It is now possible to apply for innocent spouse relief under three separate heads, with overlapping but distinct criteria that require the claimant to show, for example, that she (usually) did not know (and in some cases did not have reason to know) of the understatement of tax, and that it would be inequitable to hold her liable for the unpaid tax.33

28 Internal Revenue Code of 1986, as amended, IRC section 6015, discussed infra.
30 Beck, supra note 29, at 930.
31 United States, Department of the Treasury, supra note 29, at 9, note 8.
32 McMahon, supra note 29, at 638-39.
33 IRC sections 6015(b), (c), and (f).
These ambiguous provisions have generated extensive interpretive debates, and their application must often be based on limited evidence such as the inconsistent testimony of spouses, with the IRS delving into allegations of abuse, mental illness, and other intimate details of a former marriage. The cost to the government of administering these provisions is substantial. The IRS maintains a centralized, dedicated office for processing innocent spouse claims, which were listed by the National Taxpayer Advocate as one of the IRS’s top 10 litigated issues in all but one year in the last decade. From a taxpayer perspective, Drumbl has underlined the access-to-justice and fairness issues created when separated or divorced spouses, often single parents far less privileged than Carol Ross Joynt, must hire professional advisers and prosecute multiple levels of appeal to win the right to innocent spouse relief. While most critiques have focused on the deserving cases that still fall through the cracks, McMahon has also argued that the current rules are at the same time too liberal, opening opportunities for spouses to collude in abusing the provisions in order to evade taxes.

While there is a range of opinions about how best to fix the innocent spouse rules, US commentators seem to agree that they remain costly and unfair despite several rounds of legislative and administrative reform. Moreover, it is overwhelmingly women who bear the brunt of this problem. Tax policy makers ought to consider whether Canada risks importing this problem as they contemplate the implementation of notional income-splitting rules akin to US joint filing.

**Lessons for Canadian Tax Policy Makers**

Notional income splitting carries a real risk that taxes owing on income earned by a wealthier spouse will be unjustly recovered from the other. Admittedly, Canada’s existing pension income-splitting rules do not create the same degree of risk as the US joint-filing system. First, the joint liability of spouses is limited to taxes owing on the split income, unlike the US rules which extend to all unreported income of the other spouse, from any source. In addition, private pension income is subject to withholding at source under subsection 153(1) of the Act, and subsection 153(2) provides that

\[(2) \text{if a pensioner and a pension transferee (as those terms are defined in section 60.03) make a joint election under section 60.03 in respect of a split-pension amount}\]


35 McMahon, supra note 34, at 4.

36 Drumbl, supra note 29.

37 McMahon, supra note 34.
(as defined in that section) for a taxation year, the portion of the amount deducted or withheld under subsection (1) that may be reasonably considered to be in respect of the split-pension amount is deemed to have been deducted or withheld on account of the pension transferee’s tax for the taxation year under this Part and not on account of the pensioner’s tax for the taxation year under this Part.

In most cases, this deeming rule will protect the spouse who reports the income from unexpected tax liabilities after the fact. But it is not a foolproof system. A payer may fail to withhold or remit taxes as required under subsection 153(1), or the amount withheld may turn out to be inadequate to cover tax liability as assessed (particularly if the transferee spouse has other sources of income).

Nor does the law require pension payers or recipients, or the Canada Revenue Agency (CRA), to share information slips so that a spouse can see for herself how much tax has been paid in advance in respect of pension income being reported on her return. The CRA’s Q&A Release on pension income splitting states:

2. Is it necessary to contact the payer of the pension?
Splitting eligible pension income does not have any effect on how or to whom the pension income is paid, so it does not involve the payer of the pension. Information slips will be prepared and sent to the recipient of the pension income in the same manner as previous years.

6. Who will claim the tax withheld at source from the eligible pension income?
The income tax that is withheld at source from the eligible pension income will have to be allocated from the pensioner to the spouse or common-law partner in the same proportion as the pension income is allocated.38

The Q&A responses suggest that spouses have no right to demand copies of information slips provided to pension recipients. The release is silent as to who bears the responsibility for ensuring an appropriate allocation of withheld amounts to the spouse.

These concerns are mitigated to some degree by the CRA’s prescribed form for making the joint election, which does require the parties to provide information about the amount of tax deducted at source in respect of the split income.39 Further, subsection 60.03(4) provides that “[a] joint election is invalid if the Minister establishes that a pensioner or a pension transferee has knowingly or under circumstances amounting to gross negligence made a false declaration in the joint election.” Thus,

an unscrupulous spouse who purposely understates source deductions may remain solely responsible for tax on the pension income, if the form is challenged and the minister can prove the requisite state of mind. However, these measures may not assist in cases where the pension recipient is abusive or domineering, or simply makes an error, and the reporting spouse trusts the information provided, or is not willing or able to challenge or verify information about withholding. As in the United States, not all Canadian marriages are open and cooperative, and both the relationship and the financial circumstances of a taxpayer can change in unpredictable ways between the time when a joint election is signed and the time when tax is finally assessed and must be paid. Realistically, though, the scale of this risk under the current pension income-splitting rules should not be exaggerated. While we should not overlook individual cases of injustice or hardship that may arise, these should be relatively rare instances because source deductions on pension income will usually ensure that the reporting spouse has no additional tax to pay.

A far more significant risk of innocent spouse liability will arise if notional income splitting is opened up to a wider range of income sources and taxpayers, as suggested in the 2011 election campaign. Presumably the income qualified for splitting would include business and investment income that is not subject to withholding of tax at source, and that accordingly creates greater opportunities for aggressive tax avoidance or evasion by the recipient. Cases decided under existing joint-and-several-liability provisions of section 160 of the Act substantiate this concern and offer a glimpse into the potential for an unwitting spouse to be assessed for unpaid taxes, penalties, and interest accruing over multiple years.

In essence, section 160 provides for joint and several liability where an individual transfers property to a spouse for less than fair market value consideration, at a time when the individual owes income tax. As with any tax debt, the normal reassessment period of three years may be indefinite if the primary earner has fraudulently misrepresented his (or her) income. Moreover, the courts have held that the limitation period for assessing the joint debtor starts to run only 90 days after the first spouse is assessed for the unpaid tax, not on the earlier date when the property was transferred.40 In addition, section 160 has been held to impose absolute liability that does not require any knowledge of the primary debtor’s unpaid tax.41 The joint debt can be enforced against the spouse even after the primary debtor has gone bankrupt.42 Further, where the primary debtor owes tax for some years that are subject to joint spousal liability and some that are not (for example, because they postdate the transfer of assets to the spouse), the CRA is under no obligation to apply any amounts that it recovers from the bankruptcy against the joint spousal liability. Rather, the CRA

40 See Madsen v. The Queen, 2004 TCC 511.
41 See Wannan v. Canada, 2003 FCA 423; No. 605 v. MNR, 59 DTC 159 (TAB).
42 See Clause v. The Queen, 2010 TCC 410; Wannan, supra note 41; Bergeron et al. v. The Queen, 2003 TCC 286; and The Queen v. Heavyside, 97 DTC 5026 (FCA).
can apply recoveries to the amounts for which the primary debtor is solely liable, preserving its ability to assess the spouse for joint debts.\textsuperscript{43}

The risk for spouses inherent in joint liability is nicely captured by Sharlow JA’s comments in the court’s decision against the spouse (the wife) in \textit{Wannan}:\textsuperscript{44}

While not every use of section 160 is unwarranted or unfair, there is always some potential for an unjust result. There is no due diligence defence to the application of section 160. It may apply to a transferee of property who has no intention to assist the primary debtor to avoid the payment of tax. Indeed, it may apply to a transferee who has no knowledge of the tax affairs of the primary debtor. However section 160 has been validly enacted as part of the law of Canada. If the Crown seeks to rely on section 160 in a particular case, it must be permitted to do so if the statutory conditions are met.\textsuperscript{44}

It should be remembered that in section 160 cases the joint debtor has actually received a transfer of property that may be available to satisfy the tax debt, or that has in some way enriched the joint debtor. The spouse’s situation may be much worse with notional income splitting since joint liability is imposed without any requirement for an actual transfer of income or property.

The US experience shows that it is not a simple matter to design relieving provisions for innocent spouses that will effectively prevent injustice without imposing burdensome costs on taxpayers and tax authorities, and without opening up opportunities for not-so-innocent spouses to collude to defeat the tax authorities. At the very least, this issue needs to be thought through from the standpoint of gender equality, as well as administrative feasibility, before income-splitting rules are broadened. The preferred approach would be to make tax advantages conditional upon a legal transfer of income or assets—that is, to enact real income splitting rather than notional income splitting.

\textbf{CONCLUSION}

The so-called innocent spouse problem refers to unjust imposition of joint return liability on a lower-income spouse, where the higher earner has become judgment-proof or is harder to pursue for unpaid taxes. In relatively egalitarian relationships characterized by strong transparency and communication, spouses may well structure their affairs to ensure that taxes are covered by the higher-income spouse and that there is shared benefit from the tax savings on split income, if not from the full amount of the underlying income. However, studies of household economic behaviour suggest that this best-case scenario does not apply in all cases. Rather, some spouses will sign a joint election form without full or accurate information about the implications for their own tax liability, and without gaining control over any additional household resources. The lower-earning spouse (almost always a woman in

\textsuperscript{43} See supra note 42.

\textsuperscript{44} \textit{Wannan}, supra note 41, at paragraph 3.
the innocent spouse cases) may then become the target of enforcement actions to collect unpaid tax, perhaps after the relationship has ended, and whether or not she has access to the underlying income. The US experience is that this happens with alarming frequency, and the chosen remedy in that country of granting special relief to spouses deemed “innocent” has created its own set of inequities and administrative burdens.

I highlight the innocent spouse problem in this comment as just the tip of an iceberg. It is one of the more visible, measurable ways in which notional income-splitting regimes undermine gender equality, and one that should dissuade governments from extending notional income splitting any further. But there is a larger and less visible part of the iceberg that should be at least as concerning to policy makers. Notional models of income splitting actually remove incentives for a wealthier spouse to place legal title to assets or income in the hands of a partner who does not have equal earning power, or who forgoes opportunities in the paid labour market in order to focus on parenting or other unpaid care roles. Notional income splitting also raises the marginal effective tax rate on any income earned independently by that partner, raising the fiscal barriers to women’s equal participation in the labour market. These effects may attract less immediate attention but will be far more pervasive than the innocent spouse problem. Wrongheaded from the standpoint of economic efficiency, such a policy also would be a step back in the process of securing Canadian women’s economic and social equality. Real-income-splitting models should be considered as an alternative that could be appropriately designed to have some gender-equality-promoting effects.
International Tax Planning
Co-Editors: Pierre Bourgeois* and Michael Maikawa**

Are You Ready for the Upstream Loan Rules?
Ken J. Buttenham***

For many years, “upstream loans” have been a popular repatriation technique used by Canadian taxpayers to defer foreign withholding taxes and expedite corporate distributions. However, recently enacted amendments to the Income Tax Act have introduced new restrictions on the use of upstream loans as a repatriation technique, specifically in respect of loans from or indebtedness owing to a foreign affiliate from a related entity other than another foreign affiliate that is controlled by the Canadian taxpayer. The new rules represent a significant change in policy that will affect both Canadian multinational corporations and foreign multinationals with Canadian subsidiaries and foreign affiliates.

This article provides an overview of the new upstream loan provisions and a framework for determining when they will apply. It also highlights some of the uncertainties inherent in the legislation and offers suggestions for adapting to, and managing the consequences of, the new rules.

Keywords: Loans ■ Foreign Affiliates ■ Series ■ Repatriation ■ Multinationals ■ Surplus

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INTRODUCTION

On August 19, 2011, the Department of Finance released long-awaited proposals relating to the taxation of Canadian multinational corporations with foreign affiliates. As well as setting out many expected revisions to the foreign affiliate rules, the proposals included new provisions governing arrangements referred to as “upstream loans.” The upstream loan rules have since been enacted with the passage of Bill C-48.

The upstream loan rules can result in income to a Canadian-resident taxpayer when a certain person or partnership (a “specified debtor,” discussed below) receives a loan from or becomes indebted to a foreign affiliate of the taxpayer.

The explanatory notes to the 2011 proposals describe this new rule as being necessary to protect the integrity of both the taxable surplus regime and the new hybrid surplus regime. The introduction of the upstream loan rules represents a significant change in policy. Previously, taxpayers and advisers relied on pronouncements from

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1 Canada, Department of Finance, Legislative Proposals in Respect of Foreign Affiliates (Ottawa: Department of Finance, August 2011) (herein referred to as “the 2011 proposals”) and accompanying Explanatory Notes—Foreign Affiliate Amendments (Ottawa: Department of Finance, August 2011) (herein referred to as “the 2011 explanatory notes”).

2 In this article, the term “upstream loan” generally refers to both a loan from or indebtedness owing to a foreign affiliate of a Canadian-resident taxpayer where such loan or indebtedness is made to or owed by a “specified debtor.”


4 2011 explanatory notes, supra note 1, at 1.

5 Although these rules represent a significant change in policy as it relates to the use of upstream loans, one could argue that the introduction of the new provisions is consistent with a broader policy trend over the last number of years toward ensuring that profits earned either in Canada or by a foreign affiliate are repatriated back through Canada and not redeployed using Canada’s
the Canada Revenue Agency (CRA) confirming that certain lending arrangements between foreign affiliates and Canadian residents would not attract unwanted tax consequences. As a result, Canadian corporations routinely repatriated earnings from foreign affiliates using upstream loans to defer taxes and minimize administrative costs. The new rules are relevant not only to Canadian multinational corporations but also to any multinational group that includes a Canadian corporation that owns shares of a foreign affiliate.

With the enactment of the upstream loan provisions, companies are focused on assessing the effect on their current structures and the need to unwind certain loans by the relevant dates. Therefore, this article focuses on certain interpretive and practical issues that taxpayers may encounter when evaluating the risks associated with their current treasury arrangements.

OVERVIEW OF THE NEW RULES

The essential features of the new rules are described below. (A more detailed analysis of the rules is beyond the scope of this article.)

INCOME INCLUSION—SUBSECTION 90(6)

Subsection 90(6) of the Income Tax Act requires a Canadian-resident taxpayer to include in income a “specified amount” in respect of an upstream loan made by a foreign affiliate of the taxpayer to a “specified debtor.” Both terms are defined in subsection 90(15).

“Specified debtor” identifies the borrower that would be subject to the upstream loan rules. A specified debtor includes the taxpayer, a person with which the taxpayer does not deal at arm’s length (other than a controlled foreign affiliate as defined in section 17), and a partnership the members of which include the taxpayer or such non-arm’s-length person.

If the specified debtor is a foreign affiliate, the “specified amount” (the amount to be included in income under subsection 90(6)) is determined by multiplying the amount of the upstream loan by the excess of the taxpayer’s surplus entitlement

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6 Such loans were often non-interest-bearing and denominated in Canadian dollars in order to eliminate foreign accrual property income (FAPI) and avoid the recognition of foreign exchange gains or losses by the Canadian corporation.

7 For discussion of the various transitional dates, see below under the heading “Applicable Dates.”

8 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.

9 If a foreign affiliate is a controlled foreign affiliate (CFA) solely because it is controlled by a related non-resident, for the purposes of section 17 it is not considered a CFA.
percentage\textsuperscript{10} (SEP) in the creditor affiliate (the lender) over its SEP in the specified debtor. Otherwise, the specified amount is the amount of the upstream loan multiplied by the taxpayer’s SEP in the creditor affiliate.

**Exceptions—Subsection 90(8)**

By virtue of subsection 90(8), there is no income inclusion under subsection 90(6) if the upstream loan is repaid within two years of the day on which the loan was made (other than as part of a series of loans or other transactions and repayments) or if the loan arose in the ordinary course of business of the creditor and bona fide arrangements were made for repayment within a reasonable time.\textsuperscript{11} These two exceptions are similar to those in the shareholder loan rules in subsection 15(2).

**Deductions—Subsection 90(9)**

To provide relief from the upstream loan rules, subsection 90(9) allows a deduction equal to the total of certain deductions that could have been claimed had the specified amount in respect of an upstream loan been instead distributed as a dividend (or a series of dividends) to the taxpayer. Conceptually, this provision allows a taxpayer to continue to repatriate funds via an upstream loan without Canadian tax implications if, solely because of foreign tax or legal considerations, a loan is made instead of payment of an actual dividend.

Any deduction taken under subsection 90(9) must be included in income in the following taxation year under subsection 90(12), but the income inclusion could be offset by a new deduction under subsection 90(9) if all the conditions continue to be met. A deduction under subsection 90(9) is available in respect of a specified amount that is included in income under subsection 90(6) or (12) if all of the following conditions are met:

- **Paragraph 90(9)(a).** If, at the time the loan is made, the taxpayer can demonstrate that if the specified amount had instead been received by the taxpayer as a dividend (a “notional dividend distribution”), the taxpayer would be entitled to deductions under subsection 113(1) or 91(5) in respect of exempt surplus,\textsuperscript{12} hybrid surplus where there is sufficient underlying foreign tax (UFT),\textsuperscript{13} taxable surplus where there is UFT,\textsuperscript{14} preacquisition surplus to the

\textsuperscript{10}See the definition of “surplus entitlement percentage” in regulation 5905(13).

\textsuperscript{11}See paragraphs 90(8)(a) and (b), respectively. There is a third exception, in paragraph 90(8)(c), that may apply to upstream loans made in the ordinary course of carrying on a life insurance business outside Canada; however, that exception is not addressed in this article.

\textsuperscript{12}Clause 90(9)(a)(i)(A) refers to the deduction available under paragraph 113(1)(a).

\textsuperscript{13}Clause 90(9)(a)(i)(B) refers to the deduction available under paragraph 113(1)(a.1) to the extent that the entire hybrid surplus is fully covered by the grossed-up balance of hybrid underlying taxes.

\textsuperscript{14}Clause 90(9)(a)(i)(C) refers to the deduction available under paragraph 113(1)(b) to the extent of the grossed-up UFT balance.
extent of the adjusted cost base (ACB), and amounts previously taxed as foreign accrual property income (FAPI).

Paragraph 90(9)(b). The same amount of surplus or ACB may not be used during the period in which the loan is outstanding to support a claim for a subsection 90(9) deduction in relation to any other upstream loan, or any deduction under subsection 91(5) or 113(1) in respect of an actual dividend. This condition prevents double-counting of the surplus and/or ACB.

Paragraph 90(9)(c). The same amount of ACB cannot be used to determine the taxability of any other distribution, again to prevent double-counting—in this instance, in respect of other distributions, such as a qualifying return of capital under subsection 90(3).

No deduction is available under subsection 90(9) in respect of the portion of a notional dividend distribution that would be deductible under paragraph 113(1)(d) if the specified debtor is a non-arm’s-length non-resident.

Downstream Surplus—Subsection 90(11)

Similar to the situation for an election under subsection 93(1), in determining the amount of surplus available to a taxpayer as a deduction under subsection 90(9), surplus balances downstream of the creditor foreign affiliate are taken into account on the basis of the operation of regulation 5902(1)(a). Under regulation 5902(1)(a), the amount of surplus is equal to the surplus that would be included had dividends been paid starting from the lowest-tier affiliate up to the creditor foreign affiliate. Therefore, in computing this amount, deficits of any foreign affiliate above the lowest-tier affiliate may reduce or eliminate the amount of surplus available.

Repayment of Loan—Subsection 90(14)

A deduction is available in the year in which the loan is repaid (other than as part of a series of loans or other transactions and repayments) to the extent of the amount that was included in income under subsection 90(6). This is similar to the deduction available under paragraph 20(1)(j) for a repayment of a shareholder loan. In the year of repayment, by virtue of subsection 90(13), the deduction under subsection 90(9) is not available to prevent a double deduction.

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15 Clause 90(9)(a)(i)(D) refers to the deduction available under paragraph 113(1)(d) to the extent of the ACB in the shares of the top-tier foreign affiliate in the chain.

16 Subparagraph 90(9)(a)(ii) refers to the deduction available under subsection 91(5). This deduction is available only if the specified debtor is a non-arm’s-length non-resident.

17 While any double-counting of surplus or ACB results in a loss of the ability to claim a subsection 90(9) deduction, it appears that this condition can be satisfied if surplus is moved up the foreign affiliate chain but is not used to support another subsection 90(9) deduction, and no dividends are paid to the Canadian taxpayer such that any deductions are claimed under subsection 91(5) or 113(1).
Back-to-Back Loans—Subsection 90(7)

Pursuant to subsection 90(7), certain back-to-back loans are collapsed into one loan for the purposes of the application of the upstream loan rules, to the extent of the lesser of the amount of the loans. This provision is modelled on subsection 17(11.2).

Applicable Dates

The upstream loan rules generally apply to loans or indebtedness incurred after August 19, 2011. Loans or indebtedness incurred on or before August 19, 2011 are grandfathered, whereby any amount that remains outstanding on August 19, 2014 is deemed to be a separate loan or indebtedness issued on August 20, 2014. Therefore, upstream loans in existence on or before August 19, 2011 are entitled to a minimum five-year grace period instead of the regular two-year repayment period provided by subsection 90(8).

Working with the Upstream Loan Rules

As mentioned above, the focus of this article is on certain of the interpretive and practical considerations that may be encountered by taxpayers attempting to operate within the upstream loan rules. To help taxpayers approach the application of these rules to their own situations, a four-step general framework is presented and a flow chart is included as an appendix.

Step 1: Identify All Loans to and Indebtedness from a “Specified Debtor”

The upstream loan rules apply each time a specified debtor receives a loan from, or becomes indebted to, a creditor that is a foreign affiliate of a taxpayer resident in Canada. Because these rules apply loan by loan, or indebtedness by indebtedness, the first step is to identify all upstream loans.

This may be a straightforward exercise if a Canadian multinational corporation owns relatively few creditor foreign affiliates. In such cases, all upstream loans will be centralized in the Canadian multinational group, and the Canadian multinational corporation should have ready access to the necessary information regarding all relevant amounts. However, in certain structures this initial step may be more of a challenge. Consider a large foreign multinational corporation with many global subsidiaries, including a group of Canadian companies that in turn own a large group of foreign affiliates. In this instance, the quantity of potential upstream loans can be multiplied significantly, and the Canadian taxpayer may not have ready access to the necessary information to fully assess the application of the upstream loan rules.

When identifying upstream loans, it is important not to overlook day-to-day intercompany transactions, such as trade receivables. If the parties transact on an

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18 Subsection 90(6). Assuming that subsections 15(2) and 90(8) do not apply.
arm’s-length basis, it is expected that the ordinary course of business exception would be met for trade receivables or, at the very least, that these amounts would be repaid within two years of the date of the original loan and would therefore meet the repayment exception in subsection 90(8). However, if intercompany accounts are not settled on a fairly regular basis, trade or other intercompany receivables could be subject to the upstream loan rules.

In determining whether a specific amount has been repaid within two years (other than as part of a series of loans or other transactions and repayments), the CRA has indicated that it is willing to accept, in certain circumstances, a first-in, first-out (FIFO) approach to track the origination and settlement of multiple debts that may arise from intercompany transactions.¹⁹ This position will be helpful in situations where lump-sum repayments against upstream loans are made on a fairly regular basis; however, companies will have to ensure that the necessary tracking processes and policies are put in place to settle intercompany accounts regularly.

In some cases, specific intercompany amounts may not be settled on a regular basis because receivables from and payables to foreign affiliates are managed on a net basis. For financial statement reporting purposes, receivables from and payables to a particular specified debtor may be offset—effectively treating payables to a particular specified debtor as a repayment of all or a portion of the receivable from that specified debtor. However, for the purposes of identifying upstream loans, receivables from specified debtors should not be automatically netted against payables to the same specified debtors without ensuring the legal right to offset.²⁰

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¹⁹ See CRA document no. 2013-0483751C6, May 23, 2013. In comments made during the CRA round table presentation at the 2013 International Tax Seminar of the International Fiscal Association (IFA) (Canadian branch), held in Montreal on May 23, 2013, the CRA confirmed that it would accept this FIFO approach with respect to receivables that have identical terms. In situations where there are substantial differences in the terms of the receivables, the CRA believes that it would be necessary for the debtor to specify which specific receivable balance was being paid. The CRA’s comments were made in the context of the foreign affiliate dumping rules in section 212.3; however, there is no reason to believe that those comments would not have equal application in the context of the upstream loan rules. Further support for this approach can be found in the examples in Interpretation Bulletin IT-119R4, “Debts of Shareholders and Certain Persons Connected with Shareholders,” August 7, 1998. The examples in IT-119R4 clearly illustrate that repayments can be considered to apply first to the oldest loans outstanding (citing the FIFO basis) unless the facts clearly indicate otherwise.

²⁰ See CRA document no. 2003-0033915, February 17, 2004, which sets out the CRA’s view for the purposes of subsection 15(2), that debts between a shareholder and a particular person do not generally offset in determining whether a shareholder has “become indebted to” or “received a loan from” a particular person in the first instance or whether that indebtedness or loan was repaid. Also see, for example, Johnston’s Estate v. MNR, 64 DTC 204 (TAB), which supports the position that for a debt or loan to have been repaid for the purposes of subsection 15(2), there must have been a repayment of the loan or indebtedness in the form of money or money’s worth. For the reasons discussed later in this article, the CRA’s view on these matters in relation to the upstream loan rules is expected to be consistent with its views on subsection 15(2).
Taxpayers must be aware of these situations. They may want to take the necessary steps to legally offset receivables and payables, so as to eliminate or reduce amounts subject to the upstream loan rules to the extent possible.

Cash Pooling

Cash pool arrangements create numerous interpretive issues related to the upstream loan rules. They are used by multinational companies to efficiently manage global cash resources and foreign exchange risks. Applying the upstream loan rules to a cash pool arrangement requires an understanding of the following:

- the type of cash pool mechanism employed and the legal relationships created;
- the members of the cash pool (for example, whether they include the Canadian taxpayer, other non-arm’s-length Canadian companies, foreign affiliates, and/or any other non-arm’s-length non-resident entities that are not foreign affiliates); and
- the specific participation of each member in the cash pool (for example, each member’s debit or credit position at various points in time).

This analysis becomes more difficult where the members of the cash pool may change over time and where any one member’s participation in the cash pool arrangement may change often—perhaps even daily. If no specified debtors are members of the cash pool or the foreign affiliate members of a cash pool are all consistently net borrowers from the cash pool, one would expect that there should be no upstream loans. Otherwise, upstream loans could exist, depending on the legal relationships created by the cash pool agreement.

There are numerous types of cash pool arrangements. At one end of the spectrum is a “notional” cash pool. In a notional cash pool, the members of the pool maintain separate bank accounts with a financial institution. However, the calculation of interest received or paid is usually based on the consolidated balance of all members, including both positive and overdraft positions. The interest is then allocated to the separate bank accounts according to a formula.

If the terms of a specific notional cash pool do not create loans or indebtedness between the members of the cash pool because the pooling is only from the perspective of the financial institution with respect to the calculation of interest, a foreign affiliate that is a member of the notional pool and that has a positive cash balance should not be considered to have made an upstream loan where one or more specified debtors are also members of the cash pool. Further, depending on the relevant facts, including in part the business reasons for the foreign affiliate’s participation in the notional pool, it may be difficult for the CRA to apply the general anti-avoidance rule to such arrangements on the basis of a back-to-back recharacterization of the actual legal relationships.

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21 Section 245.
At the other end of the spectrum, “zero balance” or “cash concentration” cash pool arrangements usually require the physical transfer of funds to or from each member of the pool to the account of a member that is designated as the “pool head” or “concentrator.” It is generally recognized that these types of arrangements create intercompany payables and receivables between each pool member and the pool head. If the pool head is a specified debtor, a foreign affiliate’s positive balance in such a pool likely would constitute an upstream loan.

The generic types of cash pooling briefly touched on above are only two of numerous possibilities. Many taxpayers will have arrangements somewhat different from the examples above, because each arrangement is designed to address taxpayers’ specific structures, currency risks, and liquidity requirements. In practice, it may be challenging for taxpayers and the CRA to determine the correct application of the upstream loan rules when cash-positive foreign affiliates are members of a cash pool that also includes specified debtors. Owing to the nature of cash pool arrangements, not only is it difficult to determine whether an upstream loan exists, but it can also be difficult to track repayments (and maintain that they are not part of a series of loans or other transactions and repayments), as well as to determine when a “new” upstream loan is made.

It seems unreasonable that foreign affiliates with working capital funds on deposit in a cash pool should be subject to these rules. Nevertheless, no general carve-out is available for these cases. It is hoped that the CRA will agree that the two-year repayment exception should generally apply in the case of a foreign affiliate with a continuous positive balance in a cash pool where the balances represent funds required for working capital.

Identifying the Relevant Creditor Affiliate

In most cases, it will be relatively straightforward to identify the relevant creditor foreign affiliate associated with a specific upstream loan; however, care should be taken when back-to-back loans exist. Subsection 90(7) applies to collapse back-to-back loans and deem an upstream loan made by an “intermediate lender” to the “intended borrower” to have been made by the “initial lender” to the intended

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22 See Arthur Andersen Inc. v. Toronto-Dominion Bank (1994), 17 OR (3d) 363 (CA), which held that end-of-day transfers of amounts between related corporations in a mirror concentration arrangement were legally effective as between the corporations.

23 There may not be any ultimate income inclusion under these rules if one of the exceptions in subsection 90(8) applies or if a full deduction can be claimed under subsection 90(9); however, where an upstream loan exists, the potential application of these relieving provisions will have to be considered.

24 It also may be difficult to assess whether an upstream loan resulting from the participation in a cash pool can be grandfathered.

25 Although the balance would be consistently positive, this positive balance could arguably be viewed as the cumulative result of many deposits and withdrawals over any given period. This position is supported by the FIFO approach discussed above (supra note 19 and the related text).
borrower.\textsuperscript{26} For subsection 90(7) to apply, there must be a causal link between the back-to-back loans (that is, the loan from the intermediate lender to the intended borrower must have been made \textit{because} the intermediate lender received a loan from the initial lender). Identifying the correct creditor affiliate is important because the availability of certain exceptions and deductions under the upstream loan rules is based on the actions and attributes of the creditor affiliate.

\textbf{Step 2: Determine When the Upstream Loan Rules Apply}

Once all upstream loans have been identified, it is necessary to determine how the coming-into-force rules may apply to each specific loan. The upstream loan rules apply to loans received and indebtedness incurred after August 19, 2011 and to any portion of a particular loan received or a particular indebtedness incurred on or before August 19, 2011 (a “grandfathered loan”) that remains outstanding on August 19, 2014. Furthermore, a grandfathered loan is treated as if it were a separate loan or indebtedness that was received or incurred on August 20, 2014 (in the same manner and on the same terms as the grandfathered loan) for the purposes of the upstream loan rules.\textsuperscript{27}

While grandfathered loans receive a much more generous grace period than an upstream loan arising after August 19, 2011, grandfathering applies only if the original loan remains outstanding (that is, it is not replaced by a “new” loan). In this context, no “series of loans or other transactions and repayments” language can be relied on (in the taxpayer’s favour) to ensure that a repayment of a grandfathered loan followed by the making of a new upstream loan (as part of a series) is ignored. If transactions undertaken after August 19, 2011 give rise to a new loan (or new indebtedness) under common-law principles, the upstream loan rules will apply to the new upstream loan and grandfathering will be lost.\textsuperscript{28} Therefore, care should be taken to identify any grandfathered loans and to ensure that they are not inadvertently replaced by new upstream loans.\textsuperscript{29}

\textsuperscript{26} The terms “intermediate lender,” “intended borrower,” and “initial lender” are defined in subsection 90(7). The amount of such deemed loan is the lesser of (1) the amount of the loan made by the initial lender to the intermediate lender, and (2) the amount of the loan made by the intermediate lender to the intended borrower. If the taxpayer so elects, the back-to-back loan provisions in subsection 90(7) do not apply in respect of all loans received and indebtedness incurred on or before October 24, 2012.

\textsuperscript{27} This addition to the coming-into-force rules for grandfathered loans is a welcome change from the original upstream loan proposals, which deemed an upstream loan existing on August 19, 2011 to have been advanced on that day, thereby effectively providing the same two-year grace period as is provided for all loans made after August 19, 2011.

\textsuperscript{28} Although the upstream loan rules will not apply to the grandfathered loan that ceases to exist (assuming that the “new” upstream loan is created prior to August 19, 2014).

\textsuperscript{29} Changes to the terms of an existing loan or indebtedness may result in the termination of that loan or indebtedness and the creation of a new loan or indebtedness. In General Electric Capital
The ability to claim a reserve against an income inclusion pursuant to the upstream loan rules depends on, among other things, the amount of exempt surplus available in the foreign affiliate chain that includes the foreign affiliate that has the upstream loan. This is discussed below. In the case of a grandfathered loan that is deemed to arise on August 20, 2014 for the purposes of the upstream loan rules, a taxpayer has the benefit of three additional years of earnings available to support a reserve against any income inclusion.\(^{30}\)

**Step 3: Decide Whether the Upstream Loan Is To Be Repaid Within Two Years**

As noted above, one of the exceptions to the application of the upstream loan rules is for an upstream loan that is repaid within two years of the day it was made, other than as part of a series of loans or other transactions and repayments (“a series”).\(^{31}\) If a taxpayer plans to rely on this exception, it will be critical to ensure that any repayment is not considered to be part of a series so that the repayment will be respected for the purposes of the upstream loan rules.\(^{32}\)

In this regard, the upstream loan rules have clearly and deliberately been modelled on the provisions in subsection 15(2.6) and paragraph 20(1)(j) in respect of the shareholder loan rule in subsection 15(2). The revised explanatory notes issued in October 2012 specifically state that the upstream loan rules are modelled on

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\(^{30}\) Of course, the foreign affiliate could also sustain losses in the intervening period unless planning is undertaken to mitigate.\(^{30}\)

\(^{31}\) Paragraph 90(8)(a).

\(^{32}\) It is also important to ensure that a repayment is not part of a series in order to claim a deduction under subsection 90(14) where the repayment occurs more than two years after the day on which the upstream loan arose.
subsection 15(2) in the domestic context (modified as required). Therefore, it seems appropriate to refer to the relevant jurisprudence and the CRA commentary relating to subsection 15(2.6) (and its predecessor in former paragraph 15(2)(b)) to determine the meaning of the term “series of loans or other transactions and repayments” as used in subsections 90(8) and (14).

**Meaning of “Series”**

The courts have interpreted “series,” on the basis of accepted dictionary definitions, to mean succession, sequence, or continued course (of action or conduct, of time, life, etc.). The determination of whether or not a series existed in the context of the shareholder loan rules was considered in *Meeuse v. The Queen*. This case involved a taxpayer who had borrowed various sums from her husband’s company. Each of the loans had been entered into for a separate and distinct purpose. The CRA assessed the taxpayer on the basis that the loan entered into to finance the construction of a storage building should be included in her income pursuant to subsection 15(2) and the subsequent repayment of that loan should be ignored. Bowman J held that the amount fell within the exception set out in paragraph 15(2)(b) (as it then read) for loans repaid within one year and did not form part of a “series of loans or other transactions and repayments.” In the course of his analysis of whether or not the various loans that had been entered into by the taxpayer formed


34 This approach has judicial support. In *Canada Trustco Mortgage Co. v. MNR*, 91 DTC 1312 (TCC), the court, in interpreting the words “active business” in section 95, applied jurisprudence that had developed concerning the meaning of this term in the context of section 125, thereby employing the established principle of interpretation that words should be given the same interpretation or meaning wherever they appear in a statute. (Also see *Thomson v. Canada* (1992), 89 DLR (4th) 218, at 243 (SCC): “Unless the contrary is clearly indicated by the context, a word should be given the same interpretation or meaning whenever it appears in an Act.”) The CRA confirmed in its comments during the round table presentation at the 2013 IFA seminar, supra note 19, that it will generally look to the administrative policies for the application of subsection 15(2) for guidance on the application of the upstream loan rules.

35 See, for example, *Kates v. MNR*, 84 DTC 1605 (TCC).

36 94 DTC 1397 (TCC).

37 For example, one loan was used to finance the acquisition by the taxpayer of a new automobile, another for the purpose of erecting a storage building on a parcel of land that the taxpayer owned, and a third to allow the taxpayer to acquire a coffee shop franchise.

38 The minister contended that the repayment was not a bona fide repayment, or alternatively that it was part of a series of loans and repayments. Presumably this is based on the fact the taxpayer obtained a new loan (for the coffee shop franchise) just weeks after the repayment in question.
part of a series, Bowman J emphasized that each loan had been entered into “for a wholly different purpose.”

Bowman J sensibly interpreted the term “series” contextually, in light of the purpose underlying the particular provision before him. This is particularly appropriate given the Supreme Court of Canada’s endorsement in *Canada Trustco* of a “textual, contextual and purposive” approach to statutory interpretation. In *Meeuse*, Bowman J was careful to avoid adopting an overly broad interpretation of “series.” On balance, the case law suggests that for transactions to constitute a series, they require a common purpose.

The CRA seems to be in agreement with this view. It has stated that

[i]t is acceptable to have a repayment of an older loan and to make a new loan in the same year around the same time if the facts support the transactions. Given a situation where an earlier loan is made for a specific purpose, say to purchase equipment, and is to be repaid on or before a given date and subsequently another loan is made for a specific purpose, say to purchase land, around the date the earlier loan is repaid, we would accept this as being a repayment of an earlier loan and a new loan having been made, rather than insisting that it is part of a series of loans and repayments. On the other hand, if there are numerous non-specific loans and non-specific payments, it would be considered as part of a series of loans and repayments, in which case the increases in a particular year-end balance would be treated as a loan in that year and a decrease in a year-end balance would be treated as a repayment.

Thus, the CRA seems to agree that a repayment of a loan made for a specific identifiable purpose followed shortly by another loan made for a different specific identifiable purpose should not be considered to be part of a series. Conversely, the CRA seems to be of the view that repayments made in the course of a series of upstream loans for non-specific reasons and repayments that are clearly of a temporary nature should be treated as being part of a series.

Furthermore, in the case of successive loans, there is support for the argument that an intervening taxable event (such as payment of a dividend or a return of capital) should delink the loans such that they are not considered part of a series. In

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39 Supra note 36, at 1400. In his decision, Bowman J stated, ibid., “Where we have a bona fide borrowing for a genuine business purpose[,] a repayment of the funds from an independent source[,] and an unrelated subsequent borrowing for a wholly different purpose[,] I do not think that this is the type of abuse at which the concluding words of [paragraph] 15(2)(b) are aimed.”


41 CRA document no. 9219115, October 5, 1992.

Attis v. MNR and Hill v. MNR, the Tax Court of Canada dealt with the situation where shareholders received loans from their respective corporations during a year, which were later repaid in whole or in part by the declaration of dividends or bonuses. In Attis, the taxpayer's indebtedness to his corporation as at August 31, 1985 (the year-end of the corporation) was repaid in full by the payment of bonuses and dividends in early 1986. His indebtedness to the corporation as at August 31, 1986 was likewise repaid in full by the payment of bonuses and dividends in January 1987. The taxpayer asserted that subsection 15(2) had no application because any loan made by the corporation in a particular year had been completely repaid within one year from the end of the corporation’s fiscal year in which the loan was advanced. The minister argued that the taxpayer could not rely on the exception because the new advances in the following year made any repayment part of a series of loans or other transactions and repayments. The court concluded that Parliament could not have intended subsection 15(2) to operate in circumstances where the repayments involved a series of payments that were required to be included in the taxpayer’s income under specific provisions of the Act. A similar conclusion was reached in the Hill case.

In Income Tax Technical News (ITTN) no. 3, the CRA confirmed that, consistent with these cases, bona fide repayments of shareholder loans that are the result of the declaration of dividends, salaries, or bonuses should not be considered to be part of a series of loans or other transactions and repayments. Therefore, when determining whether a specific repayment should be respected (as not being part of a series), it is important to consider the tax treatment of all transactions undertaken to fund the repayment, as well as the tax treatment of any new upstream loans that may come into existence.

It is a question of fact whether a repayment of a loan is part of a series of loans or other transactions and repayments. Because the taxpayer must establish that a repayment is not part of such a series, the facts and circumstances of each loan or indebtedness should be reviewed. In summary, on the basis of the discussion above, the following questions should be considered to determine whether a specific repayment to a creditor affiliate should be respected under subsections 90(8) and (14):

- What did the creditor foreign affiliate use the repayment funds for? Was another upstream loan (a “new” upstream loan) made to that or another specified debtor?
- How much time passed between the repayment and the making of the new upstream loan, and what did the creditor foreign affiliate do with the funds in the intervening period?

43 92 DTC 1128 (TCC).
44 93 DTC 148 (TCC).
If a new upstream loan was made, to what extent have the following changed when comparing the upstream loan that was repaid with the new upstream loan: debtor, creditor, principal amount, and, most importantly, the use by the specified debtor of the funds advanced under the new upstream loan?

If the creditor foreign affiliate has changed, what was the nature of the transactions undertaken to transfer the funds for the new upstream loan to the new creditor? If an upstream loan has been settled, what was the nature of the transactions undertaken between the creditor foreign affiliate and the specified debtor on settlement?

Is any new upstream loan that arises as part of the repayment specifically acknowledged and treated differently under the provisions of the Act?

Failure To Repay the Loan

If an upstream loan is not repaid within two years of the day on which the upstream loan was made (or deemed to have been made), the exception in subsection 90(8) will not apply, and an amount in respect of the upstream loan (equal to the specified amount) will be required to be included in the income of the Canadian taxpayer. The income inclusion pursuant to subsection 90(6) occurs in the taxation year that includes the time the upstream loan was made. Therefore, upstream loans repaid (other than as part of a series) after the two-year period will be subject to an income inclusion in the earlier year, with no offsetting deduction available until the subsequent taxation year in which the repayment is made. In this case, interest and penalties will be owing in respect of the specified amount. Therefore, if a taxpayer plans to rely on the two-year repayment exception to avoid the application of the upstream loan rules, it will be imperative to ensure that the repayment is made on time and that it is respected (that is, it is not considered to be part of a series) in order to avoid interest and, potentially, penalties.

Transactions Subsequent to Upstream Loan

The application of subsection 90(6) and other upstream loan rules is based on the relationships and tax attributes that exist at the time an upstream loan arises, with no reference to, or relief provided for, any subsequent changes in relationships. This becomes an issue if, for example, foreign affiliates of a Canadian taxpayer are

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46 Assuming that neither the “ordinary course of business” exception nor the “ordinary course of an insurance business” exception (in paragraphs 90(8)(b) and (c), respectively) is met.

47 See CRA comments made during the roundtable presentation at the 2013 IFA seminar, supra note 19. The CRA was asked whether it would apply its administrative positions in respect of the shareholder loan rules to the upstream loan rules. As noted above, the CRA stated that it generally will look to the administrative policies for the application of subsection 15(2) for guidance on the application of the upstream loan rules; however, it specifically indicated that it would not be applying its administrative position set out in paragraph 38 of IT-119R4, supra note 19. The CRA’s intent is to enforce interest and penalties if there is a subsection 90(6) inclusion in a past taxation year and a repayment in a subsequent year.
disposed of to a foreign parent company during the first two years after an upstream loan arises (and before its repayment), or if a specified debtor ceases to be a specified debtor (in situations where the specified debtor is not the Canadian taxpayer or a non-arm’s-length Canadian entity) prior to a repayment.48

If a foreign affiliate that has made an upstream loan is disposed of for proceeds equal to fair market value, it does not seem equitable for the rules to continue to apply after the disposition. In this scenario, the upstream loan has been indirectly repaid in the form of proceeds (and if the sale is at the Canadian taxpayer level, the funds have also effectively been repatriated to Canada). As well, it is unclear how the Canadian taxpayer will be able to enforce or have any knowledge of the ultimate repayment of the upstream loan once the upstream loan is between two related non-residents.

The CRA is aware of this inequitable result;49 however, for the time being, planning will be required to ensure that transactions subsequent to the initiation of an upstream loan will not create adverse results pursuant to the upstream loan rules.

**Step 4: Decide If a Subsection 90(9) Deduction Can Be Claimed**

Once all upstream loans have been identified and it is clear that subsection 90(6) (or (12)) will require an income inclusion in respect of a specific upstream loan, taxpayers will want to determine whether a deduction can be claimed under subsection 90(9). According to the October 2012 explanatory notes, the purpose of this provision is to allow taxpayers to make loans rather than pay dividends when there is no tax benefit in doing so.50 To determine the amount deductible under subsection 90(9), a notional dividend (or dividends, if the creditor affiliate is lower-tier) is presumed to have been paid at the lending time by the lending affiliate up the chain to the taxpayer, and the deductions that would be available under paragraphs 113(1)(a), (a.1), (b), and (d) and subsection 91(5) are assessed. Paragraphs 90(9)(b) and (c) contain rules to ensure that tax attributes “used” in this manner to shelter an income inclusion relating to an upstream loan cannot also be used to shelter a different loan or an actual distribution.

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48 The latter situation may be less likely to arise, because upstream loans are likely to be repaid prior to a third-party sale of the specified debtor or the upstream loan may be purchased by the acquiror. The sale of an upstream loan to a third party does not seem to meet the repayment requirement under the upstream loan rules.

49 See CRA comments made during the round table presentation at the 2013 IFA seminar, supra note 19. The CRA indicated that it agrees that this appears to be an inequitable result and is in consultations with the Department of Finance to determine the best way to proceed. See also CRA document no. 2013-049106, where upstream loans were required to be repaid immediately prior to the fair market value sale of all creditor affiliates to avoid the application of the upstream loan rules.

50 Supra note 33, at 153.
To quantify the amount of a subsection 90(9) deduction that may be claimed in respect of an upstream loan, it is necessary to have calculated certain tax attributes, including surplus balances for all foreign affiliates in the creditor affiliate chain, and, potentially, previously taxed FAPI amounts and the Canadian taxpayer’s cost base in the shares of its first-tier foreign affiliate. Furthermore, this information is required as at the date on which the applicable upstream loan arose (or was deemed to arise), since the subsection 90(9) deduction amount is calculated as if the notional dividend were paid on that date. This means that surplus earned or other attributes arising subsequent to making an upstream loan will not allow for an additional deduction under subsection 90(9), even though the deduction may be claimed on an annual basis. As discussed below, where a creditor affiliate makes multiple upstream loans at different times, each notional dividend under subsection 90(9) will have to take into account each such dividend that came before it.

Uncertainties Associated with Reserve Calculations

The operation of subsection 90(9) raises a host of unanswered questions and is probably what will create the most uncertainty as taxpayers apply the rules. This uncertainty stems from a lack of clarity concerning the relationship between the rules applicable to a notional dividend and the basic distribution rules that apply to actual dividends.

The two sets of rules will often give different results. For example, subsection 90(11) considers the net surplus of the creditor affiliate for the purposes of the notional dividend to include the net surplus of all lower-tier affiliates. That is not the case for actual dividends. On the other hand, a deduction is available under paragraph 113(1)(a.1) in respect of the hybrid surplus component of an actual dividend whether there is any associated hybrid UFT or not. With respect to the notional dividend, a deduction is permitted only if there is sufficient hybrid UFT to result in the hybrid surplus dividend being fully sheltered.51 Yet another difference relates to the deduction under subsection 91(5) for previously taxed FAPI. This is available in respect of a notional dividend only if the specified debtor is a non-resident.52

There are many other situations that the upstream loan rules do not address. The question for taxpayers in these cases is whether the normal distribution provisions can be relied on or not. The following paragraphs touch briefly on four of the more pressing questions.

51 See clause 90(9)(a)(i)(B).

52 See subparagraph 90(9)(a)(ii). At the 2013 IFA seminar, supra note 19, the CRA was asked to comment on whether a reserve would be available under subsection 90(9) in respect of previously taxed FAPI if Canco were the specified debtor; the CRA said that it may be prepared to develop an administrative position that an election can be made to change the ordering so that the notional dividend is considered to be a distribution coming out of preacquisition surplus.
The 90-Day Rule
Assume that a foreign affiliate (FA) makes an upstream loan of $1,000 when it has no net surplus. Further assume that the loan was advanced more than 90 days from the beginning of FA’s taxation year and that FA earns net exempt earnings of $1,000 in that taxation year. The 90-day rule in regulation 5901(2) will apply to characterize an actual dividend as being paid from FA’s exempt surplus, making a full deduction available under paragraph 113(1)(a). However, it is not clear that a similar result arises under subsection 90(9). Clause 90(9)(a)(i)(A) refers to the exempt surplus of the affiliate in respect of the taxpayer at the lending time. As noted above, the premise behind subsection 90(9) appears to be to put a taxpayer in a similar position as if a dividend were paid rather than a loan made. From that perspective, it is consistent with the policy rationale of the upstream loan rules to allow taxpayers to take the 90-day rule into account when calculating the amount of a subsection 90(9) deduction.

Distribution Elections
The Act includes a number of elections that provide taxpayers with considerable flexibility in managing the consequences of actual dividends, including the following:

- the election in regulation 5900(2) that deems a dividend to be paid from taxable surplus ahead of exempt surplus;
- the election in regulation 5901(1.1) that deems a dividend to be paid from taxable surplus ahead of hybrid surplus;
- the preacquisition surplus election in regulation 5901(2)(b) that deems a dividend to be paid from preacquisition surplus; and
- the disproportionate election in respect of UFT under paragraph (b) of the definition of “underlying foreign tax applicable” in regulation 5907(1).

The question for taxpayers is whether these elections are available to them as notional elections when assessing the deductions available under subsection 90(9) in respect of notional dividends. Subsection 90(9) does not address this question. However, the October 2012 explanatory notes make it clear that the Department of Finance intended that the disproportionate election be taken into consideration when determining the hypothetical deduction under paragraph 113(1)(b).

53 Comparable language in respect of hybrid, taxable, and preacquisition surpluses is contained in clauses 90(9)(a)(i)(B), (C), and (D), respectively.
54 Supra note 33, at 153.
Similar to the application of the 90-day rule, it seems consistent with the policy rationale of the upstream loan rules to allow taxpayers to take these elections into account, unless the specific rules in subsection 90(9) provide otherwise.\textsuperscript{55}

Unlike the other elections listed above, the preacquisition surplus election must be filed jointly by all related Canadian corporate taxpayers that have a surplus entitlement in the lender foreign affiliate. Thus, it may also be appropriate to require all such related Canadian taxpayers to take a consistent position in their tax filings related to the upstream loan rules.

**Capital Gains Pursuant to Subsection 40(3)**

Assume that Canco owns 100 percent of the shares of FA 1, and FA 1 owns 100 percent of the shares of FA 2. FA 2 makes a loan to Canco of $1,000 when FA 1 has a net exempt surplus balance of $750 and FA 2 has nil net surplus. Also assume that the ACB of FA 1 in the shares of FA 2 is nil.

If FA 2 were to pay an actual dividend of $1,000 up the chain to Canco, FA 1 would experience a gain of the same amount pursuant to subsection 40(3). This gain would have surplus consequences for FA 1 that would depend on whether the shares of FA 2 were excluded property or not. Those surplus consequences could also affect the character of future dividends received by Canco.

This example raises two questions:

1. Is surplus upstream of the lending affiliate available for the purposes of subsection 90(9)?
2. Are downstream subsection 40(3) gains ignored for the purposes of subsection 90(9)?

On the basis of the examples in the October 2012 explanatory notes, the answer to both questions appears to be yes.

From the explanatory notes, it appears that the intention is for the surplus balances (or deficits) in the entire foreign affiliate chain of investment, extending from the taxpayer down to the lender affiliate, to be taken into account in determining the amount deductible under subsection 90(9). There is no mention of other tax attributes that would be relevant if an actual dividend were paid. In example 1 in the explanatory notes,\textsuperscript{56} FA 2 does not have sufficient surplus to support a hypothetical dividend of $800. A portion of the dividend hypothetically paid to FA 1 in that example would be from preacquisition surplus. The example also states that there is no ACB in the shares of FA 2. Consequently, an application of the entire foreign affiliate regime when assessing the implications of this hypothetical dividend would result

\textsuperscript{55} On the basis of comments made at the 2013 IFA seminar, supra note 19, the CRA may be open to this suggestion, at least as it relates to a regulation 5901(2)(b) election.

\textsuperscript{56} Supra note 33, at 156-58.
in a subsection 40(3) gain to FA 1. The example does not address that possibility, but concerns itself only with the movement of surplus from affiliate to affiliate. On the basis of this example, ACB appears to be relevant only when the notional dividend is paid from a top-tier affiliate to a taxpayer, at which point a notional deduction under paragraph 113(1)(d) becomes a consideration.

Reorganizations

The upstream loan provisions lack rules to deal with situations where loans are transferred within a foreign affiliate group as a result of certain reorganization transactions. For example, assume that Canco owns 100 percent of the shares of FA 1, and FA 1 owns 100 percent of the shares of FA 2. FA 2 makes a loan to a specified debtor in year 1. In year 2, FA 2 liquidates into FA 1.

As a consequence of the liquidation, the specified debtor becomes indebted to FA 1 in year 2. Thus, it appears that both subsections 90(6) and (12) apply with respect to the same loan, resulting in a double income inclusion. A deduction under subsection 90(9) should be available in year 2, but there does not seem to be a way to eliminate the second income inclusion. In particular, the loan owing to FA 2 has not been repaid to FA 2, and in fact can no longer be repaid to FA 2.

The issue described above could arise through any form of assignment of the loan that results in a new creditor. Similar issues may occur when there has been an assumption resulting in a new debtor. It is suspected that these situations will be common.

It is hoped that the CRA will agree to provide administrative relief in situations, such as those described above, where subsection 90(6) could apply more than once to the same loan or debt.57

Surplus Accounting Implications

It is fair to say that most taxpayers prepare surplus calculations only to the extent necessary to justify deductions claimed under subsection 91(5) or 113(1). They will now also have to prepare surplus calculations to support deductions claimed under subsection 90(9). These calculations must also address the rather severe requirements imposed by paragraphs 90(9)(c) and (d), under which surplus and cross-border ACB earmarked for a particular upstream loan must not be used to support any other loan or any actual (or deemed) dividend. The October 2012 explanatory notes confirm that this is an all-or-nothing condition—any amount used twice, no matter

57 The CRA does currently provide administrative relief in similar situations involving the shareholder loan rules. In CRA document no. 2005-0129551E5, June 21, 2005, the CRA concluded that the assignment of a loan from Lendco to a related corporation would not result in a new loan or indebtedness under subsection 15(2), provided that there was no novation of the loan and the terms and conditions of the loan remained unchanged.
how small, will result in a loss of the subsection 90(9) deduction in all future years in respect of that particular upstream loan.\textsuperscript{58}

In straightforward situations, where there are few upstream loans with stable balances, it may be sufficient to merely add a note or addendum to the existing surplus calculations. In more complex situations, parallel calculations will be required, especially if there are actual dividends to track as well. For example, if certain of the distribution elections are claimed for the purposes of subsection 90(9), the remaining tax attributes for this purpose may differ markedly from the actual surplus balances. Transactions subsequent to the lending time that result in changes in the SEP in the lending affiliate will also cause differences between actual and notional surplus, since the notional surplus will continue to be based on the tax attributes available at the time of the loan.

Fluctuating upstream loan balances will also present a difficult challenge. Incremental increases typically would be treated as new loans requiring a determination of surplus balances at the time of each increase.

CONCLUSION

The introduction of the upstream loan rules is a significant change in policy. Even though the upstream loan provisions are modelled on the shareholder loan rules, many interpretive and practical questions remain. Taxpayers should expect a long process consisting of technical amendments, ruling requests, technical interpretations, and perhaps jurisprudence before any certainty is gained with respect to the application of the new rules. In the meantime, decisions need to be made regarding existing upstream loans as well as the effect of the new rules on future planning and cash flow requirements.

This article has provided a framework for approaching the application of the upstream loan provisions to specific situations, together with a discussion of some of the uncertainties inherent in the rules. With respect to existing upstream loans, taxpayers will want to ensure that a comprehensive review is undertaken to identify and act on problem loans. Taxpayers will also need to develop policies and procedures (often working internally with their treasury groups) for identifying and monitoring upstream loans. From a planning perspective, some taxpayers may look at options such as restructuring their foreign affiliate group to minimize the effect of the rules.

\textsuperscript{58} Supra note 33, at 154.
APPENDIX  DETERMINING WHETHER THE UPSTREAM LOAN RULES APPLY

Did a “specified debtor” receive a loan from a foreign affiliate (FA) of the Canadian-resident taxpayer?

Yes  No

A grandfathered loan is a loan received or indebtedness incurred on or before August 19, 2011.

Is an FA of the taxpayer a member of a cash pool arrangement?

Yes  No

Are the upstream loan rules applied?

Yes

No

Was the grandfathered loan repaid (other than as part of a series of loans or other transactions and repayments) on or before August 19, 2016?

Yes

No

Did a specified debtor incur any other type of indebtedness owing to an FA (such as trade accounts payable, other intercompany payables?)

Yes  No

Did the nature of the cash pool arrangement create an intercompany receivable from a specified debtor to an FA?

Yes  No

Was the loan received or indebtedness incurred repaid (other than as part of a series of loans or other transactions and repayments) within two years of the day the amount arose?

Yes

No

Did the indebtedness arise in the ordinary course of the business of the creditor or was the loan made in the ordinary course of the creditor’s money-lending business?

Yes  No

Were bona fide arrangements made for repayment within a reasonable time?

Yes  No

Upstream loan rules apply

Note: The exception in paragraph 90(8)(c), relating to amounts arising in the ordinary course of carrying on a life insurance business outside Canada, is not included in this decision tree.
This article provides an update on the types of investments permitted for registered savings plans, taking into account the recent introduction of tougher anti-avoidance rules and penalties for registered retirement savings plans, registered retirement income funds, and tax-free savings accounts. Registered disability savings plans also are discussed.

**KEYWORDS:** REGISTERED RETIREMENT SAVINGS PLAN ■ REGISTERED RETIREMENT INCOME FUND ■ TAX-FREE SAVINGS ACCOUNT ■ REGISTERED DISABILITY SAVINGS PLAN ■ ANTI-AVOIDANCE ■ PENALTIES

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INTRODUCTION
Over the years, Canada has introduced a range of registered savings plans, to encourage individuals to save for retirement, education, the long-term financial security of a disabled family member, and other personal financial goals. These plans include registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), registered education savings plans (RESPs), registered disability savings plans (RDSPs), and tax-free savings accounts (TFSAs).

From time to time, in order to promote the use of registered savings plans and make them more attractive, the government has expanded the types of qualified investments permitted under the Income Tax Act\(^1\) and has enhanced the tax attributes

\(^1\) 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.
of particular plans.\textsuperscript{2} Other measures have been introduced to combat a growing concern over the perceived abuse of such plans to obtain unintended tax benefits. For example, the government announced tighter anti-avoidance rules for TFSAs in October 2009 and for RRSPs and RRIFs in March 2011.

This article provides an update on qualified investments for registered savings plans, and discusses how the rules differ among the various plans. In addition, the article reviews the various penalty taxes that may apply to discourage inappropriate investments and transactions—the non-qualified investment rules, prohibited investment rules, and advantage tax rules. The impact of these rules on certain commonly held investments is also discussed. Finally, the article reviews various transitional and other relieving measures available to individuals who find themselves offside the rules.

The discussion of the penalty rules for TFSAs, RRSPs, and RRIFs under part XI.01 of the Act takes into account, as if it were law, the draft legislation of December 2012.\textsuperscript{3} The impact of these proposed amendments is highlighted where applicable.

**QUALIFIED INVESTMENTS**

The starting point for determining whether an investment may be held in a registered savings plan is the definition of “qualified investment” for the particular type of plan.\textsuperscript{4} There are subtle differences among the definitions, but they all share the same three basic components: specific inclusions by reference to qualified investments for deferred profit-sharing plans (DPSPs), the specific inclusion of certain annuity contracts, and the listing of prescribed investments. The types of investments included in each category are briefly described below.

**Qualified Investments for DPSPs**

The following types of investments are qualified for all plans by virtue of being qualified for DPSPs:\textsuperscript{5}

\textsuperscript{2} Examples include the introduction of the RRSP home buyers’ plan and lifelong learning plan; elimination of the seven-year limit on the carryforward of unused RRSP deduction room; an increase in the contribution limits for RESPs and RRSPs; the introduction of rollovers between various plans; the introduction of Canada savings grants and bonds for RESPs and similar grants and bonds for RDSPs; and the introduction of various improvements to RDSPs in the 2011 and 2012 federal budgets.

\textsuperscript{3} Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, December 21, 2012) (herein referred to as “the December 2012 draft legislation”). References in this article to “proposed” sections or regulations are to provisions contained in this draft legislation.

\textsuperscript{4} Definitions of “qualified investment” are found in subsections 146(1), 146.1(1), 146.3(1), 205(1), and 207.01(1), applicable to the respective plans covered by those provisions.

\textsuperscript{5} Section 204, the definition of “qualified investment.”
money, deposits, and guaranteed investment certificates;
- government bonds and investment-grade debt;
- debt obligations of certain entities listed on a “designated stock exchange”\(^6\) in Canada or a foreign country;
- debt obligations issued by an authorized foreign bank and payable at a branch in Canada of the bank; and
- securities (other than futures contracts or other derivative instruments in respect of which the holder’s risk of loss may exceed the holder’s cost) that are listed on a designated stock exchange.

**Annuity Contracts**

All plans may generally hold various accumulation annuities and segregated fund policies. In addition, RRSPs, RRIFs, and RDSPs may invest in certain other annuities that meet specified conditions.\(^7\)

**Prescribed Investments**

The following types of investments are prescribed for all plans:\(^8\)

- an interest in a trust or a share of the capital stock of a corporation that was a registered investment for the plan trust;\(^9\)
- a share of the capital stock of a public corporation, including certain mortgage investment corporations;
- a bond, debenture, note, or similar obligation of various types of corporations;
- a unit of a mutual fund trust;
- an option, warrant, or similar right issued by a person or partnership that gives the holder the right to acquire property that is a qualified investment, or to receive a cash settlement in lieu of that property, where that property is a share of the capital stock of, unit of, or debt issued by, the issuer and the issuer is not a connected person;
- a debt obligation that is fully secured by a mortgage or similar instrument in respect of real property situated in Canada where the debtor is not a connected person;

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\(^6\) As defined in subsection 248(1).
\(^7\) See supra note 4.
\(^8\) Regulation 4900.
\(^9\) A “registered investment” as defined in subsection 204.4(1) generally includes various pooled investment vehicles marketed as investments for tax-deferred plans and specifically approved by the minister of finance. A list is published in the *Canada Gazette* and may be found at www.gazette.gc.ca. See also regulation 4900(5).
- a debt obligation secured by a mortgage where the debt obligation is administered by an approved lender under the National Housing Act and insured under the National Housing Act;
- a gold or silver legal tender bullion coin or bullion bar; and
- a share of the capital stock of certain eligible or small business corporations, a limited partner interest in a small business investment limited partnership, and an interest in a small business investment trust.\(^\text{10}\)

This list has evolved over time and now includes various forms of foreign investment that were previously restricted. More recently, the introduction of the prohibited investment rules makes it significantly more difficult for private company shares to be considered qualified investments. (See “Private Company Shares” below for further discussion.)

**ANTI-AVOIDANCE PENALTIES**

The Act includes a number of penalty taxes and other anti-avoidance rules aimed at preventing possible abuses involving registered plans, such as inappropriate investments and transactions.\(^\text{11}\) The following discussion focuses on the non-qualified investment rules, the prohibited investment rules, and the advantage tax rules.

**TFSA*s, RRSP*s, and RRIF*s**

Shortly after the original TFSA provisions came into effect, the government introduced tighter penalties and anti-avoidance rules.\(^\text{12}\) The enhanced anti-avoidance rules, applicable after October 16, 2009, target deliberate overcontributions and asset transfer transactions ("swaps") intended to shift value from one registered account to another, and prevent the tax-sheltered growth of investment income attributable to deliberate overcontributions, prohibited investments, and non-qualified investments.\(^\text{13}\)

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10 The rules applicable to small business investments vary among the particular plans: see regulations 4900(6) through (14) and proposed regulation 4900(15).

11 For example, part X.1 tax for overcontributions to an RRSP, part X.4 tax for overpayments to an RESP, and section 207.02 tax for excess TFSA amounts; section 207.03 tax for non-resident contributions to a TFSA; penalties for using registered property as security under section 206.3 and subsections 146(10) and 146.3(7); and part X.5 tax on accumulated income payments from an RESP.


13 As defined in subsection 207.01(1).
The government was also concerned about a growing number of aggressive tax-planning schemes involving RRSPs and RRIFs, including, for example, RRSP strips (arrangements designed to access RRSP funds on a tax-free basis).\(^{14}\) As a result, the 2011 federal budget extended the enhanced TFSA anti-avoidance rules to RRSPs and RRIFs (with some modifications as appropriate).\(^{15}\)

**RESPs and RDSPs**

There is less opportunity for abusive tax planning involving RESPs and RDSPs. These plans are designed for very specific purposes, and the conditions for registration ensure that the holders (or subscribers) and issuers adhere to those purposes. For example, an RDSP can only be opened for the benefit of an individual who is eligible for the disability tax credit (DTC).\(^{16}\) In the case of RESPs, an additional 20 percent tax on amounts withdrawn as accumulated income payments discourages the use of these plans for unintended purposes.\(^{17}\)

For these reasons, the anti-avoidance rules for RESPs and RDSPs are not as extensive as those introduced for RRSPs, RRIFs, and TFSA. Nonetheless, RESPs and RDSPs are subject to penalties for holding non-qualified investments, and RDSPs are also subject to penalty taxes on certain advantages and transactions involving inadequate consideration.

**NON-QUALIFIED INVESTMENTS**

Adverse tax consequences arise when a registered plan acquires or holds an investment that is a non-qualified investment.

**RESPs**

An RESP trust is liable for a 1 percent penalty tax in respect of any month in which the trust holds property that is a non-qualified investment at the end of the month. The 1 percent tax is based on the fair market value (FMV) of the non-qualified investment at the time it was acquired.\(^{18}\) In addition, if an RESP trust acquires a non-qualified investment, or holds a property that ceases to be a qualified investment and is not

\(^{14}\) See Canada Revenue Agency (CRA), *Compliance Bulletin no. 6r1*, December 2012 and *Compliance Bulletin no. 4*, June 2007, as well as the CRA’s *Tax Alert* notices released on November 29, 2007 and March 17, 2009.

\(^{15}\) Canada, Department of Finance, 2011 Budget, March 22, 2011.

\(^{16}\) Subsection 146.4(1), the definition of “DTC-eligible individual,” and paragraph 146.4(4)(f).

\(^{17}\) Subsection 204.94(2). Accumulated income payments are generally amounts not used as education assistance payments and not eligible for rollover to another registered plan.

\(^{18}\) Subsection 207.1(3).
disposed of within 60 days of becoming a non-qualified investment, the plan may be revoked by the minister of national revenue. The plan registration is revoked, the trust becomes taxable as an inter vivos trust.

**RDSPs, RRSPs, RRIFs, and TFSAs**

The holder of a TFSA or the annuitant of an RRSP or RRIF must pay a penalty tax for each calendar year in which the trust has acquired a non-qualified investment, or in which a property held by the trust becomes a non-qualified investment. The tax is equal to 50 percent of the FMV of the non-qualified investment at the time the property was acquired or became a non-qualified investment. A similar penalty tax applies to an RDSP trust when a non-qualified investment is acquired or a property held by the trust becomes a non-qualified investment. This tax may be refunded or waived in certain circumstances. (See the discussion below under “Transitional and Other Relieving Measures.”)

In addition, a TFSA, RRSP, RRIF, or RDSP must pay Part I income tax (at rates applicable to an inter vivos trust) on any income earned from a non-qualified investment held in the year. Income from a non-qualified investment includes capital dividends and the full amount of capital gains in excess of capital losses. Unlike RESPs, these plans are not required to dispose of the investment within 60 days.

For RRSPs and RRIFs, the 50 percent tax on non-qualified investments replaces the former income inclusion and deduction for the annuitant, as well as a 1 percent per month penalty tax for the trust. The current rules apply to non-qualified investments acquired by an RRSP or RRIF after March 22, 2011, and to investments acquired before March 23, 2011 that first became non-qualified investments after March 22, 2011. In the case of TFSAs, the rules apply after 2008.

**PROHIBITED INVESTMENTS**

The prohibited investment rules apply only to RRSPs, RRIFs, and TFSAs, and are intended to

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19 Subsections 146.1(2.1) and (12.1). See regulation 4900(13) for circumstances in which a qualified investment may become non-qualified.

20 Subsection 146.1(11).

21 Subsections 207.04(1) and (2).

22 Section 206.1.

23 Subsections 146(10.1), 146.2(6), 146.3(9), and 146.4(5), applicable, respectively, to RRSPs, TFSAs, RRIFs, and RDSPs.

24 An annuitant of an RRSP or RRIF was required to include in income the FMV of a non-qualified investment acquired by the RRSP or RRIF under former subsections 146(10) and 146.3(7), and was allowed an offsetting deduction when the investment was disposed of under former subsections 146(6) and 146.3(8). The 1 percent per month penalty tax was imposed on the trust under former subsections 207.1(1) and (4).
prevent the acquisition by an individual’s registered plan of closely-held investments . . . , or investments that carry a significant risk of being designed with a view to streaming disproportionate returns into a registered plan (effectively circumventing contribution limits) or that facilitate an intentional de-valueation of the investment (in order to avoid a later income inclusion).25

It is important to recognize that even if an investment is a qualified investment, it may nonetheless be considered a prohibited investment.

**Penalty Tax on Prohibited Investments**

The penalty tax is the same as the tax for non-qualified investments. For TFAs, RRSPs, and RRIFs, the annual tax is equal to 50 percent of the FMV of the prohibited investment at the time the property was acquired by the trust or became a prohibited investment for the trust.26 This tax may be refunded or waived in certain circumstances. (See the discussion below under “Transitional and Other Relieving Measures.”)

For RRSPs and RRIFs, the penalty tax applies to prohibited investments acquired after March 22, 2011 and to investments acquired before March 23, 2011 that first became prohibited investments after October 4, 2011.27 An exception is provided for transfers between RRSPs or RRIFs of the same annuitant if the investment was a prohibited investment of the transferring RRSP or RRIF on March 23, 2011.28 In the case of TFAs, the rules apply after 2008.

The holder or annuitant may also be subject to a 100 percent advantage tax on any income and realized capital gains reasonably attributable to a prohibited investment in the plan. (See the discussion below under “Advantage Tax Rules.”)

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25 Canada, Department of Finance, “Part XI.01 Registered Retirement Savings Plan and Registered Retirement Income Fund Measures,” comfort letter issued to the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, June 12, 2012.

26 Subsections 207.04(1) and (2).

27 In Canada, Department of Finance, “Part XI.01 Taxes—Expansion of the Transitional Relief for Certain Prohibited Investments Held by an Individual’s RRIF or RRSP,” comfort letter issued February 12, 2013, the Department of Finance indicated that it will recommend that grandfathered property status be preserved for the purposes of the prohibited investment and advantage tax rules where an RRSP or RRIF acquires new shares on a share-for-share exchange involving grandfathered property in the course of certain corporate reorganizations (such as butterflies), provided that no non-share consideration is included in the transaction and the exchange occurs on an FMV basis.

28 Coming-into-force provision of subsection 207.04(1).
**WHAT IS A PROHIBITED INVESTMENT?**

A prohibited investment may generally be described as an investment to which the holder of a TFSA or the annuitant of an RRSP or RRIF is closely connected, including the following:29

- a debt of the holder or annuitant;
- a debt or equity investment in a corporation, trust, or partnership in which the holder or annuitant has a significant interest;30
- a debt or equity investment in a corporation, trust, or partnership with which the holder or annuitant does not deal at arm’s length;
- an interest in, or right to acquire, any of the investments described above; and
- a share that ceased to be a qualifying share of a specified small business corporation, a venture capital corporation, or a specified cooperative corporation, at any time after the share was acquired.

The following are specifically excluded from prohibited investments (beginning after March 22, 2011):31

- certain insured mortgages (and similar instruments);
- certain equity investments in regulated mutual funds, or registered investments that follow an investment diversification policy, if the mutual fund or registered investment entity is in its 24-month startup phase or 24-month windup phase; and
- certain equity investments that satisfy a seven-part test and as a result can be viewed as arm’s-length portfolio investments.

For the purposes of the third exclusion, the seven-part test examines the closeness of the relationship between the holder or annuitant of the registered plan and the issuer of the investment to determine whether the holder or annuitant is in a position to manipulate the value of the investment or the distribution of income. The seven-part test requires that all of the following conditions be met:32

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29 See the definition of “prohibited investment” in proposed subsection 207.01(1), and proposed regulation 4900(15), replacing existing regulation 5001.

30 Subsection 207.01(4) and subsection 248(1), the definition of “specified shareholder.” An individual holds a significant interest in a corporation if that individual owns, alone or together with non-arm’s-length persons, 10 percent or more of the issued shares of any class of the capital stock of the corporation.

31 The definition of “excluded property” in proposed subsection 207.01(1), replacing existing regulation 5000. Prior to March 23, 2011, the only exclusions provided in regulation 5000 included certain insured mortgages (and similar instruments) and certain investments in regulated mutual funds during the 24-month startup phase of the fund.

32 Paragraph (c) of the definition of “excluded property” in proposed subsection 207.01(1).
Arm’s-length individuals hold at least 90 percent of the FMV of all equity of the issuer.

Arm’s-length individuals hold at least 90 percent of the total FMV of all equity and debt of the issuer.

Arm’s-length individuals hold at least 90 percent of the votes that can be cast at an annual meeting of the issuer.

The terms and conditions of each share or unit held by the registered plan are the same as, or similar to, the terms and conditions of the equity held by arm’s-length individuals (arm’s-length equity).

The FMV of the arm’s-length equity with the same (or similar) terms and conditions is equal to at least 10 percent of the total FMV of all equity of the issuer with the same (or similar) terms and conditions.

The holder or annuitant deals at arm’s length with the issuer.

None of the main purposes of the structure of the issuer, or the terms or conditions of the equity, is to accommodate transactions or events that could affect the FMV of the investment held by the registered plan in a manner that would not occur in a normal commercial or investment context in which parties deal with each other at arm’s length and act prudently, knowledgeably, and willingly.

This exclusion may apply, for example, where an individual and his or her close family members own more than 10 percent of a single class of shares of a large arm’s-length mutual fund corporation with multiple classes of shares representing different funds, and the equity interest is very small relative to the capitalization of the corporation as a whole.

The implications of the prohibited investment rules for certain commonly held investments are discussed further below under “Impact of Tighter Penalty Rules on Specific Investments.”

**ADVANTAGE TAX RULES**

A penalty tax also applies to certain “advantages” obtained from transactions intended to exploit the tax attributes of TFSAs, RRSPs, RRIFs, or RDSPs. The advantage tax rules do not apply to RESPs.

**Penalty Tax on Advantages**

The advantage tax is equal to 100 percent of the FMV of the benefit obtained, or in the case of a loan or indebtedness, the amount of the loan or indebtedness. Similarly,

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33 As defined in proposed subsection 207.01(1) in respect of TFSAs, RRSPs, and RRIFs, and in subsection 205(1) in respect of RDSPs.

34 Section 206.2 for RDSPs and section 207.05 for TFSAs, RRSPs, and RRIFs.
in the case of an RRSP strip\textsuperscript{35} (discussed below), the amount of the tax is equal to the amount of the RRSP strip.\textsuperscript{36}

The tax is payable by the annuitant or holder of the registered plan, except that if the advantage is extended by the issuer of the registered plan or by a person not dealing at arm’s length with the issuer, the issuer is liable for the tax. In certain circumstances, this tax may be waived. (See the discussion below under “Transitional and Other Relieving Measures.”)

For RRSPs, the new advantage tax rules replace the former penalty on the issuer equal to the greater of $100 and the value of the advantage.\textsuperscript{37} The advantage tax applies to both RRSPs and RRIFs in respect of transactions occurring, income earned, capital gains accruing, and investments acquired after March 22, 2011.\textsuperscript{38}

In the case of RDSPs and TFSAs, the 100 percent advantage tax generally applies from the time those plans became effective (that is, for taxation years after 2007 in the case of RDSPs and for taxation years after 2008 in the case of TFSAs). However, the expanded TFSA advantage tax rules that target deliberate overcontributions, swap transactions, and second-generation income attributable to deliberate overcontributions, prohibited investments, and non-qualified investments apply after October 16, 2009.

**What Is an Advantage?**

An advantage is broadly defined to include any benefit, loan, or indebtedness that depends on the existence of the registered plan, subject to certain specified exceptions and inclusions. Owing to variations in the rules, it is necessary to review the specific exceptions and inclusions for TFSAs, RRSPs, and RRIFs separately from those applicable to RDSPs.

**RDSPs**

An advantage in relation to an RDSP\textsuperscript{39} means any benefit or loan that is conditional on the existence of an RDSP, other than

- a disability assistance payment;
- a contribution made or authorized by the holder of the RDSP;
- an eligible transfer from one RDSP to another for the same beneficiary;
- a Canada disability savings grant or bond, or a payment under a designated provincial program;

\textsuperscript{35} As defined in proposed subsection 207.01(1).
\textsuperscript{36} Paragraph 207.05(2)(c).
\textsuperscript{37} Repealed subsection 146(13.1).
\textsuperscript{38} Proposed subsection 207.01(7), and CRA document no. 2011-0418161E5, February 3, 2012.
\textsuperscript{39} Defined in subsection 205(1).
a benefit derived from the provision of administrative or investment services for the plan; or

an RDSP contribution loan made in the ordinary course of the lender’s business (with reasonable repayment terms).

For the purposes of determining whether there is an advantage, a benefit includes any payment or allocation of an amount to an RDSP that is represented to be a return on investment in respect of property held within the plan, but that cannot reasonably be considered to be on open market (arm’s-length) terms and conditions.40

**TFSAs, RRSPs, and RRIFs**

An advantage in relation to a TFSA, RRSP, or RRIF41 generally means any benefit, loan, or indebtedness that depends on the existence of the plan, other than

- a benefit derived from the provision of administrative or investment services for the plan;
- an arm’s-length loan;
- a plan distribution to the holder or annuitant;
- a payment or allocation made directly to the plan by the issuer or carrier; and
- a benefit provided under a widely offered incentive program by the plan issuer (or a person related to the plan issuer), provided that none of the main purposes is to allow the holder or annuitant to benefit from a part I tax exemption.

The last exclusion noted above, added by the December 2012 draft legislation, permits financial institutions to use promotional incentives (such as fee rebates and cash bonuses) to sell their products.

An advantage also specifically includes a benefit that is an increase in the FMV of property held in connection with a registered plan where the increase is attributable to42

- a transaction or event that would not have occurred in a normal commercial or investment context between arm’s-length parties, where one of the main purposes of the transaction or event was to provide an exemption from part I tax on an amount in respect of the registered plan—for example, the issuance of common shares for nominal consideration to a TFSA or RRSP of a key employee as part of an estate freeze transaction;43

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40 Subsection 205(1), the definition of “benefit.”
41 Paragraph (a) of the definition of “advantage” in proposed subsection 207.01(1).
42 Paragraph (b) of the definition of “advantage” in proposed subsection 207.01(1).
- a payment for services (or a payment received on account or in lieu of, or in satisfaction of, such a payment) provided by the holder or annuitant of the plan, or by a person who does not deal at arm’s length with the holder or annuitant (for example, a discretionary dividend paid in lieu of salary to key employees of a private company where the private company shares are held within a registered plan);
- a payment of a return on investment (including interest, dividends, rent, or royalties), or proceeds of disposition, for property held outside the plan by the holder or annuitant, or by a non-arm’s-length person (for example, a return on an investment held within a registered plan that is tied to a second type of investment held outside the plan, where the return on each component of the investment is designed to shift income into the plan);\(^{44}\)
- a swap transaction (discussed below); and
- specified non-qualified investment income (essentially second-generation income) that has not been paid out of the plan within 90 days of receiving a notice from the Canada Revenue Agency (CRA) requiring that the amount be withdrawn.\(^{45}\)

An advantage also includes income, or a capital gain, attributable to\(^ {46}\)

- a prohibited investment;
- in the case of a TFSA, a deliberate overcontribution to the plan;\(^ {47}\) or
- in the case of an RRSP or RRIF, certain amounts received by the annuitant (or a non-arm’s-length person) that would not have been paid if it were not for property held in the plan, where the amount was a payment for services provided by the annuitant (or a non-arm’s-length person), a return on investment (including interest, dividends, rent, or royalties), or proceeds of disposition (for example, a return on an investment or proceeds of disposition for an investment held outside a registered plan that is tied to a second type of investment held inside the plan, where the return on each component of the investment is designed to shift income out of the plan in order to benefit from preferential tax treatment that is not available within the plan, such as that applicable to dividends and capital gains).\(^ {48}\)

\(^{44}\) For an example involving real estate transactions, see Amanjit Lidder, “Current Issues Forum,” in 2011 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2011), 1A:1-25, at 1A:i.

\(^{45}\) The definition of “specified non-qualified investment income” in proposed subsection 207.01(1), and subsection 207.06(4).

\(^{46}\) Paragraph (c) of the definition of “advantage” in proposed subsection 207.01(1).

\(^{47}\) As defined in subsection 207.01(1).

\(^{48}\) See supra note 44.
Finally, an advantage includes an RRSP strip in respect of the plan (as discussed below), and a “prescribed benefit.”49 There are currently no prescribed benefits under the regulations.

Given the broad list of advantages, individuals will need to closely monitor the administration of their registered plans to ensure that they do not inadvertently become subject to the advantage tax rules.

Transactions Subject to the Advantage Tax Rules

Certain transactions undertaken in connection with a TFSA, RRSP, or RRIF will result in the application of the advantage tax rules. A penalty tax may also apply to transactions undertaken in connection with an RDSP for inadequate consideration. The following discussion examines the types of transactions that the penalty rules are aimed at preventing.

Swap Transactions

Swap transactions (generally, purchase and sale transactions between accounts) can shift value out of or into a registered plan while avoiding the income inclusions on withdrawal or the limits on contributions (see example 1 below). The rules applicable to such transactions are intended to prevent the exploitation of fluctuations in the market price of securities as a means of shifting value to or from a registered plan, and avoiding tax on any increase in such value.

Generally, a swap transaction refers to a transfer of property between an RRSP, RRIF, or TFSA and the holder or annuitant of the plan (or a non-arm’s-length person). However, the definition of “swap transaction” specifically excludes the following transactions:50

- a distribution in satisfaction of the holder’s or annuitant’s interest (which may occur on a change from one plan issuer to another);
- a payment into the plan that is a contribution, premium, or permitted transfer to a RRIF (such as a transfer of funds from a registered pension plan to a RRIF);51
- a transfer of a prohibited investment or a non-qualified investment out of the plan for consideration in circumstances where the annuitant or holder is entitled to a refund of the penalty tax (see the discussion below under “Refund of Penalty Tax”);52 and

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49 Paragraphs (d) and (e) of the definition of “advantage” in subsection 207.01(1).
50 The definition of “swap transaction” in proposed subsection 207.01(1).
51 The permitted transfers are provided for in paragraph 146.3(2)(f).
52 The December 2012 draft legislation clarifies that the consideration paid to the registered plan on the swapout of a non-qualified or prohibited investment is also exempt from the advantage tax rules.
a transfer of property between an annuitant’s registered plans that are both RRSPs or RRIFs, or a transfer of property between two TFsAs of the same holder.

With respect to the last item, transfers between a TFSA and an RRSP or RRIF of the same individual do not fall within the exception and are considered swap transactions.

Increases in the FMV of a registered plan that are in any way attributable (directly or indirectly) to a swap transaction are considered an advantage. This includes all future increases in the FMV of the registered plan that are reasonably attributable to the initial swap transaction. The CRA has indicated that this includes any dividends, interest, or other amounts paid on the swapped security, any appreciation in the value of the swapped security or a substituted property, and any second-generation income.53

The advantage tax applies to swap transactions involving a TFSA after October 16, 2009; in the case of RRSPs and RRIFs, swap transactions occurring after June 2011 are generally subject to the advantage tax rules. However, a transitional rule permits a swap transaction to be undertaken before 2022 to remove any property from a RRIF or RRSP that would, if retained in the plan, result in part XI.01 tax. (See the discussion below under “Transitional and Other Relieving Measures.”)

**RRSP Strips**

The rules related to RRSP strips are intended to target transactions, such as certain swap transactions, that extract amounts from an RRSP or RRIF on a tax-free basis. However, the definition in the Act as originally drafted included any amount obtained by the annuitant as a result of a transaction or series of transactions one of the main purposes of which was to enable the annuitant (or a non-arm’s-length person) to obtain a benefit in respect of property held by the RRSP or RRIF (subject to certain specified exceptions). The definition was not restricted to decreases in the FMV of RRSP or RRIF property.

In response to concerns raised over the broad meaning, the December 2012 draft legislation clarifies that an RRSP strip occurs only where there is a reduction in the FMV of property held by an RRSP or RRIF as a result of a transaction or series of transactions one of the main purposes of which was to enable the annuitant (or a non-arm’s-length person) to obtain a benefit as a result of the reduction. Under the amended definition,54 an RRSP strip does not include the following:

- an amount included in the income of the annuitant or the annuitant's spouse or common-law partner;

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54 Proposed subsection 207.01(1), the definition of “RRSP strip.”
an amount withdrawn under the home buyers’ plan or the lifelong learning plan; 
• certain permitted transfers between RRSPs and RRIFs; or 
• the principal amount of a debt obligation that is “excluded property” (generally defined to mean insured mortgages and similar instruments).55

If property is removed from an RRSP or RRIF by way of a sale to the annuitant of the RRSP or RRIF for consideration that is less than the FMV of the property, the transaction will be considered to be an RRSP strip,56 and the difference between the FMV of the property and the consideration will be considered to be an advantage, unless the amount is otherwise included in the annuitant’s income.57

The following example illustrates a swap transaction and an RRSP strip that these rules are intended to prevent.

Example 1
Sarah is close to retirement and has $150,000 in her RRSP and $10,000 in her TFSA at the end of the prior year. In the current year, she contributes $5,000 to her TFSA and uses the funds to acquire 500 common shares of Pubco for $10 a share. A few months later, the price of one Pubco share increases to $13, and Sarah transfers the 500 shares in her TFSA for $6,500 cash from her RRSP. There is nothing offensive about this transaction since there is no change in the FMV of either the TFSA or the RRSP.

Now assume that a few weeks later, the price of the shares goes back down to $10, and Sarah transfers the shares back to her TFSA for $5,000 cash. Her TFSA now has an FMV of $16,500 ($10,000 + $5,000 contribution + $6,500 - $5,000) and her RRSP now has an FMV of $148,500 ($150,000 - $6,500 + $5,000). Sarah has shifted $1,500 in value from her RRSP to her TFSA, which she can receive tax-free when she withdraws the funds from her TFSA. Had Sarah withdrawn the same amount directly from her RRSP, she would have been subject to part I income tax.

If such a transfer were repeated over and over again, Sarah could take advantage of the volatility of the stock market to shift value from her RRSP to her TFSA, and withdraw the extra value in her TFSA on a tax-free basis. However, under the advantage tax rules, the increase in the FMV of the TFSA resulting from the swap and the decrease in the value of the RRSP (resulting in an RRSP strip) would both be subject to the 100 percent advantage tax. The double imposition of the tax penalizes Sarah for violating the contribution limit rules in respect of the amount shifted to her TFSA, and for avoiding part I tax on the value shifted out of her RRSP.

As indicated in the example, there is nothing offensive about simply swapping property in a TFSA for cash or other consideration of equal value in the holder’s RRSP. It is the subsequent transaction that makes the first one offensive. Rather than simply

55 See the definition of “excluded property” in proposed subsection 207.01(1).
57 Subsections 146(9) and 146.3(4).
targeting the second abusive transaction, the advantage tax will apply to any transfer of property from a TFSA to an RRSP or RRIF, or from an RRSP or RRIF to a TFSA. There is an expectation by the CRA that many RRSP issuers and RRIF carriers will simply stop processing swap transactions prohibited under the new rules. In this event, individuals wishing to move investments between registered and non-registered accounts to improve the tax efficiency of their investment holdings (such as swapping interest-earning investments outside a registered plan for dividend-yielding investments inside a plan) will be required to liquidate and repurchase, and as a result may incur increased transaction fees or realize accrued losses within the plan.

In-Kind Contributions and Distributions

In-kind contributions to registered plans are still permitted, provided that the investment is a qualified investment. A plan issuer that accepts an in-kind contribution of a non-qualified investment could be liable for a penalty. The contribution of a qualified investment is considered to be made at the FMV of the property at the time of the transfer. Any capital gain is included in the individual's income, and any capital loss is denied. Similarly, in-kind distributions may also be made from a TFSA, RRSP, or RRIF. The plan issuer is responsible for determining the FMV of the property. If the value is not properly reported, the individual may obtain an advantage and the plan issuer may be subject to the advantage tax.

RDSPs—Inadequate Consideration Transactions

Although the RDSP advantage tax rules do not specifically apply to swap transactions or RDSP strips, the RDSP rules do impose a separate penalty tax on dispositions and acquisitions of RDSP property for inadequate consideration.

Similar to the advantage tax on RRSP strips, if RDSP property is disposed of for consideration that is less than FMV, or RDSP property is acquired for consideration greater than FMV, the holder of the RDSP is liable for a penalty tax equal to the difference between the FMV of the property and the consideration. In certain circumstances, this tax may be waived. (See the discussion below under “Waiver of Tax.”)

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59 Subsections 207.01(5) and 162(7).
61 Subsection 207.05(3).
62 Subsections 206(1) and (2).
IMPACT OF TIGHTER PENALTY RULES ON SPECIFIC INVESTMENTS

Using recent CRA technical interpretations as a guide, the following discussion reviews the impact of the tighter penalty rules on specific types of investments that have commonly been owned in tax-deferred plans.

PRIVATE COMPANY SHARES

Restrictions on private company share investments within registered plans prevent taxpayers from getting around the contribution limit rules and using registered plans to shelter excessive income in non-arm’s-length situations. There are exceptions that allow RRSPs, RRIFs, TFSAs, and RESPs to hold arm’s-length investments in certain private companies. Recently, the exceptions for RRSPs and RRIFs have been tightened to prevent private company share investments that are prohibited investments.

Previously, shares of a private corporation were qualified investments for an RRSP or RRIF if the corporation was either an eligible corporation of which the annuitant was not a designated shareholder63 or a specified small business corporation (“specified SBC”) of which the annuitant was not a connected shareholder.64 The tests are similar except that the eligible corporation test must be met throughout the entire period during which the shares are owned by the registered plan, while the SBC test only needs to be met at the time the shares are acquired by the plan. As a result, most pre-March 23, 2011 private company share investments likely qualified under the specified SBC test.

CURRENT RULES FOR SMALL BUSINESS CORPORATION SHARES

The rules for post-March 22, 2011 RRSP and RRIF investments in specified SBC shares65 mirror the rules for TFSAs that have existed since 2009 and that essentially narrow the eligibility criteria for private company shares acquired after March 22, 2011, by replacing the connected shareholder test with a prohibited investment test.66

For the purposes of the former rules, an individual is a “connected shareholder” if he or she owns (directly or indirectly) 10 percent or more of the issued shares of any class of the corporation or a related corporation.67 For this purpose, the taxpayer is deemed to own shares owned by non-arm’s-length persons. Specifically

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63 Regulation 4900(6).
64 Former regulation 4900(12).
65 Regulation 4900(14).
66 The eligible corporation test in regulation 4900(6) also continues to apply with the added requirement that the shares are not prohibited investments.
67 Regulation 4901(2), the definition of “connected shareholder.” These rules continue to apply for the purposes of the specified SBC test in regulation 4900(12) for RESPs.
excluded from the definition of a connected shareholder is an individual who deals at arm’s length with the corporation and whose investment cost is less than $25,000. The prohibited investment test maintains the 10 percent threshold. However, shares will also be prohibited if the company does not maintain its SBC status at all times. The $25,000 low-cost exception has been removed. The following examples illustrate these changes.

Example 2
Facts and assumptions:
- SBCCo is a Canadian corporation operating an active business in Canada.
- Individual A purchased 15 percent of the common shares of SBCCo for $15,000.
- At the time the shares were acquired, SBCCo was a specified SBC.
- Individual A is not related to any of the other shareholders of SBCCo.
- All of the shareholders are Canadian.

Tax consequences:
- **Pre-2011 budget changes:** Individual A has a greater than 10 percent interest but is not a connected shareholder because of the low-cost exemption. Therefore, these shares are a qualified investment and may be transferred to individual A’s RRSP.
- **Post-2011 budget changes:** Individual A has a greater than 10 percent interest in SBCCo, which represents a significant interest. Therefore, the shares are a prohibited investment and a non-qualified investment and cannot be transferred to individual A’s RRSP.

Example 3 illustrates the impact of the 2011 budget amendments in regulation 4900(14) and proposed regulation 4900(15).

Example 3
Facts and assumptions:
- On April 1, 2011, Aco qualified as an SBC.
- On April 1, 2011, individual A purchased 5 percent of the shares of Aco directly and acquired an additional 4 percent of Aco through an RRSP.
- The shares of Aco were not prohibited on April 1, 2011.
- Throughout the remainder of 2011 and in 2012, Aco built up significant earnings.
- In 2012, Aco used those earnings to make a significant investment in a US operating company, such that Aco no longer qualified as an SBC.

Tax consequences:
- The shares were purchased after March 22, 2011 and became prohibited in 2012 when Aco ceased to be an SBC. Accordingly, they are no longer qualified investments.

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68 Proposed regulation 4900(15), replacing existing regulation 5001.
Without the arm’s-length and low-cost exception, it is now more difficult for private company shares to be considered qualified investments. More significantly, they will have to be closely monitored to ensure that they do not become prohibited and subject to the 50 percent tax on their value and the 100 percent advantage tax on income (including capital gains). For a shareholder with significant equity in the business, it may be difficult to swap funds or assets of equivalent value in exchange for the private company shares.

Example 4 illustrates the grandfathering relief available for pre-March 23, 2011 qualified investments. This example is based on a CRA document issued in February 2013.

Example 4

Facts and assumptions:
- Individual B owned 5 percent of the shares of Bco through an RRSP and was not related to any other shareholders.
- Bco was an SBC at the time its shares were acquired by individual B’s RRSP, before March 23, 2011.
- The shares of Bco were a qualified investment at the time they were acquired.
- In 2012, Bco began the process of winding up and selling its business assets, such that it no longer qualified as an SBC.

Tax consequences:
- Since the conditions in regulation 4900(12) only had to be met at the time of acquisition of the shares by the RRSP, the windup and loss of SBC status did not have any impact on the qualified investment status in 2012.
- An investment acquired before March 23, 2011 by an RRSP or RRIF that was a qualified investment because of regulation 4900(12) will continue to retain its qualified investment status under that provision after March 22, 2011, even though that provision has since been restricted to RESPs.

The CRA noted that investments that are qualified because of regulation 4900(14) will no longer qualify if at any time the company ceases to meet the SBC criteria. However, as long as an investment acquired by an RRSP or RRIF before March 23, 2011 qualified under former regulation 4900(12), it will not become prohibited under these new rules. The prohibited investment penalty and advantage tax will, however, apply if shares acquired before March 23, 2011 otherwise become prohibited after October 4, 2011 (for example, where more than 10 percent of the shares are held by the annuitant and non-arm’s-length persons). (For further discussion

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69 However, the 50 percent tax will not apply to shares held on March 22, 2011 that first became a prohibited investment before October 4, 2011 under the grandfathering rule in subsection 207.04(1) (coming-into-force provision).

of the relief available in respect of prohibited investments held on March 23, 2011, see below under “Transitional and Other Relieving Measures.”)

**Mortgages**

Mortgages in respect of real property situated in Canada are qualified investments for all registered plans as long as the debtor is not a connected person.\(^{71}\) If the debtor is a connected person, the mortgage may still qualify if it is administered by an approved lender under the National Housing Act, and insured under the National Housing Act or by an approved private insurer of mortgages.\(^{72}\)

The CRA’s position is that the registration of the plan may be jeopardized and/or certain benefit and penalty provisions may apply where the interest rate and other terms do not reflect normal commercial practice and the mortgage is not administered by the approved lender in the same manner as a mortgage on property owned by a stranger.\(^{73}\)

The CRA has confirmed that an insured mortgage does not constitute a prohibited investment and therefore continues to qualify for investment in a tax-deferred plan.\(^{74}\) This position is consistent with the December 2012 draft legislation, which includes an insured mortgage described in regulation 4900(1)(j.1) as “excluded property” in the context of prohibited investments.\(^{75}\)

**Warrants, Options, and Convertible Securities**

Generally, an option, warrant, or similar security giving the holder the right to acquire property that is a qualified investment (or to receive a cash settlement in lieu of that property) may itself be a qualified investment.\(^{76}\)

In several recent technical interpretations, the CRA was asked whether the 50 percent tax on prohibited investments would apply if an RRSP or RRIF were to exchange a pre-March 23, 2011 prohibited investment for a new prohibited investment after March 22, 2011.

In one technical interpretation,\(^{77}\) the CRA stated that where an RRSP or RRIF trust owns shares and related warrants acquired before March 23, 2011 that are a prohibited investment and the exercise of the warrants results in the acquisition of

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71 Regulation 4900(1)(j), and regulation 4901(2), the definition of “connected person.”

72 Regulation 4900(1)(j.1).


75 Paragraph (a) of the definition of “excluded property” in proposed subsection 207.01(1).

76 Regulation 4900(1)(e). Specific guidance on put and call options is provided in IT-320R3, supra note 73, at paragraphs 22 and 23.

shares after March 22, 2011, the 50 percent tax will apply and will be based on the FMV of the shares at the time of acquisition. The fact that the tax did not apply to the warrants because they were acquired before March 23, 2011 is not relevant to the determination. The CRA further stated that the same would be true in the context of options, convertible securities and other exchanges of securities.

A similar technical interpretation78 commented on convertible debt. Essentially, if a new security is a prohibited investment and it was acquired after March 22, 2011, the 50 percent tax on prohibited investments will apply, regardless of the fact that the tax would not otherwise apply to the original convertible security because it was acquired before March 23, 2011.

**Shares of Cooperative Corporations**

In a recent technical interpretation,79 the CRA stated that a share of a cooperative corporation may be a prohibited investment if a plan holder or annuitant has a significant interest in the cooperative corporation. The CRA went on to say that a share of a cooperative corporation that initially qualified may be prohibited where, subsequent to the acquisition, the cooperative ceased to be a “specified cooperative corporation.”80

**Escrowed Property**

Property held in escrow is held in trust for someone until certain agreed-upon conditions are met. In general, securities subject to an escrow agreement may not be transferred or sold, but may entitle the beneficial owner to votes or dividends while in escrow.

A share of a corporation subject to an escrow agreement may be a qualified investment if all of the following conditions are met:81

- the share has been issued to a plan trust;
- the shareholder has all the rights of ownership; and
- identical non-escrowed shares are qualified investments.

In a recent technical interpretation,82 the CRA was asked whether a property subject to an escrow agreement, being a unit consisting of one common share and one-half of a warrant, can be held by a TFSA. The CRA confirmed its longstanding

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80 Proposed regulation 4900(15), replacing existing regulation 5001, and regulation 4901(2), the definition of “specified cooperative corporation.”
81 IT-320R3, supra note 73, at paragraph 5.
position described above, and stated that as long as the escrowed property met the criteria, and the underlying share and warrant were qualified investments, the escrowed property would also be a qualified investment. The CRA also indicated that an appropriate valuation method must be used to determine the value of the warrant.

**Mortgage Investment Corporation**

In general, shares of a mortgage investment corporation (MIC) may be a qualified investment provided that the MIC does not hold any indebtedness of a connected person. Further, as long as the holder of the plan does not have a significant interest in the MIC, the share will not be a prohibited investment. This position is confirmed in two technical interpretations addressing the question of whether a TFSA may hold shares of a MIC.

**Foreign Exchange Trading**

As discussed previously, foreign currency is generally a qualified investment for registered plans. Foreign-currency options that are listed on a designated stock exchange are also qualified.

Foreign exchange contracts that trade over the counter are not qualified because the over-the-counter market is not a designated stock exchange. In addition, where a futures contract is listed on a designated stock exchange but the risk of loss exceeds the cost of the contract, the contract is specifically excluded as a qualified investment. Further, where a plan trust engages in speculative foreign-currency trades, it may be considered to be carrying on a business and therefore be taxable under Part I. Contracts should reflect commercial arm’s-length terms; otherwise, they may be found to artificially shift value into the plan, causing the advantage tax rules to apply.

**Mutual Fund Investments**

Mutual fund investments are generally qualified investments, but may be prohibited if the plan holder has a significant interest and the investment is not excluded property. As described above under “Prohibited Investments,” certain mutual fund investments held during the 24-month startup or windup period of the issuer will be considered to be excluded property and not subject to the prohibited investment rules. Certain arm’s-length, portfolio-type investments will also be excluded property.

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83 Regulation 4900(1)(c).
85 Subparagraph (b)(i) of the definition of “advantage” in proposed subsection 207.01(1), and CRA document no. 2010-0356811E5, January 5, 2011.
TRANSITIONAL AND OTHER RELIEVING MEASURES

A number of specific measures provide relief from the penalty rules.

TRANSITIONAL RULES APPLICABLE TO RRSPs AND RRIFs

Transitional Prohibited Investment Benefit Election

Recall that the 100 percent advantage tax applies to income earned from prohibited investments held after March 22, 2011, and to capital gains accruing after that time and attributed to such investments. However, an election is available not to have the 100 percent advantage tax apply provided that the qualifying income or gains are withdrawn (annually) from the RRSP or RRIF.87 The qualifying income and gains for a taxation year are reduced by any capital losses realized in the year that are attributable to an investment that was a prohibited investment on March 23, 2011, and that accrued after March 22, 2011.88 The net amount is referred to as a “transitional prohibited investment benefit.”89

This relief was originally available only for income earned and capital gains realized before 2022, but the termination date has since been removed. This change is welcome news for individuals who hold illiquid private company investments that became prohibited investments on March 23, 2011, and who do not have the necessary funds available to swap the investment out of the RRSP or RRIF.

To take advantage of the transitional relief, the annuitant was required to file an election before March 2, 2013.90 In addition, the transitional prohibited investment benefit for a calendar year must be withdrawn within 90 days after the end of the year, and the withdrawal cannot be paid by way of a transfer to another registered plan of the annuitant.

The withdrawn amount is included in income for the year and is subject to the annuitant’s marginal tax rate (just like any regular RRSP or RRIF withdrawal).

Swapping Out Non-Qualified and Prohibited Investments

A transitional rule permits a swap transaction to be undertaken before 2022 to remove any property from an RRSP or RRIF that would, if retained in the plan, result in the 50 percent penalty tax. Individuals should identify any investments that could potentially become prohibited or non-qualified investments and should plan to remove such investments before 2022 or restructure their holdings so that they do not fall offside.

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87 Proposed subsection 207.05(4).
88 See supra note 27.
89 Defined in proposed subsection 207.01(1).
90 CRA form RC341, “Election on Transitional Prohibited Investment Benefit for RRSPs or RRIFs.” The election was originally required to be filed before July 2012; however, the deadline was extended to allow more time for individuals to determine whether they needed to apply for transitional relief.
When swapping out a non-qualified or prohibited investment, it is important to ensure that the RRSP or RRIF receives FMV consideration for the property; otherwise, the swap may be considered to be an RRSP strip. In this respect, caution should be exercised where the value of the investment is not easily determined (as in the case of private company shares).91

**Refund of Penalty Tax**

In the case of TFSAs, RRSPs, and RRIFs, the 50 percent penalty tax may be refunded if the investment is disposed of by the end of the calendar year following the year in which the tax applied (or such later time as the CRA considers reasonable). No refund will be allowed if the holder or annuitant knew (or should have known) at the time the investment was acquired that it was, or would become, a non-qualified or prohibited investment.92

Further, if a part XI.01 return is not filed within three years after the end of the relevant year, the individual may be precluded from receiving the allowable refund (subject to the taxpayer relief provisions).93

Similar refund provisions (with similar conditions) apply for the RDSP penalty tax on non-qualified investments.94

There is no refund provision for the 1 percent monthly tax on RESPs holding non-qualified investments.

**Double Taxation Relief**

If at any time an investment is both a prohibited and a non-qualified investment, the investment is deemed not to be a non-qualified investment for the purposes of the 50 percent penalty tax and the part I tax applicable to income earned by the trust on the investment.95 This relieving rule ensures that the holder or annuitant is subject to only one penalty tax regime in respect of the investment and any income earned on the investment.

For RRSPs and RRIFs, this relieving rule applies to prohibited investments that were acquired after March 22, 2011, or that were acquired before March 23, 2011 and first became prohibited after October 4, 2011. It also applies to non-qualified investments that were acquired, or that first became non-qualified, after March 22, 2011.

It is the CRA’s view that this relieving rule does not apply in circumstances where non-qualified private company shares acquired before March 23, 2011 continue to be held after March 22, 2011 and are considered to be a prohibited investment on

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92 Subsection 207.04(4).
93 Section 207.07 and subsection 164(1.5).
94 Subsections 206.1(4) and 207(2) and (4).
95 Subsection 207.04(3).
March 23, 2011 (for example, where a person related to the annuitant owns more than 10 percent of the shares of the company). In this situation, the investment will continue to be considered both a prohibited and a non-qualified investment, and income earned, and capital gains accruing, on the investment (after March 22, 2011) may be subject to both the advantage tax imposed on the annuitant and regular part I tax imposed on the trust. The transitional prohibited investment benefit election would provide relief from the advantage tax in such a situation; however, if the election was not filed by the due date, the annuitant should apply to the CRA for a waiver of the part XI.01 tax.96

**Deemed Disposition and Reacquisition**

When a property held within a TFSA, RRSP, RRIF, or RDSP ceases to be a non-qualified or a prohibited investment, the plan trust is deemed to have disposed of the investment at that time for proceeds equal to its FMV at that time and to have reacquired it at a cost equal to that FMV.97 This ensures that regular part I tax applicable to the trust or the advantage tax applicable to the annuitant or holder ceases to apply to any income earned, and gains accrued, on the investment after that time.98

This rule may accommodate circumstances where an individual does not wish to dispose of a particular investment within a registered plan that is a non-qualified or a prohibited investment. This may be the case where securities are a prohibited investment because the individual’s holdings inside and outside a registered plan represent a significant interest, and it would be more desirable to dispose of the same securities held outside a registered plan to reduce the individual’s interest in the entity (for example, to trigger capital losses that can be used to offset taxable capital gains, or to continue to shelter dividend income on the securities held within the registered plan).

The deemed disposition of a non-qualified or prohibited investment is considered to be a disposition for the purposes of the refund rules. Therefore, it is not necessary for the plan to actually dispose of the investment for the holder or annuitant to qualify for a refund of the penalty tax.

A similar deemed disposition and reacquisition rule applies when property held by a TFSA, RRSP, or RRIF becomes a non-qualified or prohibited investment. This rule ensures that any gains that accrued prior to the time when the investment became non-qualified or prohibited are not subject to the advantage tax.

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97 Subsection 206.1(6), and existing subsection 207.04(5), which is to be replaced by proposed subsection 207.01(6).

98 Under subsections 146(10.1), 146.2(6), 146.3(9), 146.4(5), and 207.05(1).
Waiver of Tax

The CRA has the authority to waive certain penalty taxes.

RRSPs, RRIFs, and TFSA

The CRA may, at its discretion, waive all or a portion of the 50 percent penalty tax or the 100 percent advantage tax if it considers it just and equitable to do so, taking into account the particular circumstances, including specifically the following:

- whether the tax arose as a consequence of a reasonable error;
- the extent to which the transaction or series of transactions that gave rise to the tax also gave rise to another tax under the Act; and
- the extent to which payments have been made from the person’s registered plan.

The additional requirement that amounts giving rise to the advantage must be withdrawn without delay is repealed in the December 2012 draft legislation. The CRA has published guidance and examples of circumstances in which a waiver may be granted. The CRA has stated that it will administer the waiver provisions in a fair and flexible manner in order to promote voluntary compliance with these new rules and to encourage taxpayers to come forward and correct situations that are offside of the new rules, particularly those that involve pre-March 23, 2011 investments.

RDSPs

The CRA also has the discretion to waive all or a portion of the tax payable in respect of the various penalty provisions for RDSPs (including tax payable for inadequate consideration, tax payable on non-qualified investments, and advantage tax). A waiver will be granted in circumstances similar to those described above. The CRA has not issued specific guidance on waiver requests for RDSPs, but given the similarity in the wording of the provision, it is likely that the form of the request and the conditions for favourable consideration would be similar to those discussed above.

RESPs

There is no waiver provision in the context of the 1 percent per month tax on RESPs holding non-qualified property.

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99 Proposed subsection 207.06(2).
101 Ibid.
102 Section 206.4.
DEPARTMENT OF JUSTICE

WITHDRAWALS FROM LOCKED-IN RETIREMENT ACCOUNTS AND RETIREMENT INCOME FUNDS

Because of restrictions on withdrawals from locked-in retirement accounts and locked-in retirement income funds, it may not be possible for the annuitant to withdraw amounts giving rise to the penalty taxes. However, the CRA has recommended the following to mitigate any adverse tax consequences under the penalty rules:\(^{103}\)

- The amount may be withdrawn from the annuitant’s unlocked RRSP or RRIF instead of the locked-in plan. (There is no requirement for the withdrawal to be made from the particular plan.)
- A prohibited investment could be swapped out of the locked-in plan for FMV consideration to stop the advantage tax from applying to future investment earnings.
- The applicable provincial pension laws should be reviewed to determine whether there are any other options, such as transfers between plans or the capability for some unlocking.

The CRA has also indicated that the withdrawal of a transitional prohibited investment benefit from a RRIF may be taken into consideration in satisfying the RRIF carrier’s obligation to pay the minimum amount from the RRIF.\(^{104}\)

CONCLUSION

With registered savings plans being an important component of Canadian investment portfolios and financial plans, it is important for tax advisers and their clients to understand the types of investments that can be held within the various plans. The tighter anti-avoidance rules for RRSPs, RRIFs, and TFSAs have added new complexities that require closer monitoring of investments held within, and transactions undertaken in connection with, registered savings plans. The new penalty rules may also create an increased compliance burden.

The penalty taxes must be remitted and reported annually, and failure to remit and file on time may result in additional penalties. It will therefore be important to review changes in the FMV of registered plans annually in order to determine the amount of any advantage, and to review investment holdings on a more frequent basis in order to determine whether any investments have become non-qualified or prohibited. It may also be difficult to determine whether an investment is offside without understanding what investments are held by family members and other non-arm’s-length persons. In many cases, it will be important to remove offside investments as soon as possible. In the case of private company investments, this may require a proper valuation of the shares.

\(^{103}\) CRA document no. 2012-0456601I7, February 18, 2013.

\(^{104}\) CRA document no. 2012-0453161C6, October 5, 2012.
Planification fiscale personnelle

Directrices de chronique : Pearl E. Schusheim* et Gena Katz**

Régimes enregistrés d’épargne : investir sans pénalité

Maureen De Lisser et Janna Krieger**

Le présent article fait le point sur les types de placements permis pour les régimes enregistrés d’épargne, compte tenu de l’adoption récente de règles anti-évitement et du resserrement des pénalités pour les régimes enregistrés d’épargne-retraite, les fonds enregistrés de revenu de retraite et les comptes d’épargne libre d’impôt. On traite également des régimes enregistrés d’épargne-invalidité.

Mots clés : Régime enregistré d’épargne-retraite • fonds enregistré de revenu de retraite • compte d’épargne libre d’impôt • régime enregistré d’épargne-invalidité • anti-évitement • pénalité

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INTRODUCTION

Avec les années, le Canada a mis en place une gamme de régimes enregistrés d’épargne pour encourager les particuliers à épargner pour la retraite, les études, la sécurité financière d’un membre de la famille handicapé et d’autres objectifs financiers à long terme. Ces régimes comprennent le régime enregistré d’épargne-retraite (REER), le fonds enregistré de revenu de retraite (FERR), le régime enregistré d’épargne-études (REEE), le régime enregistré d’épargne-invalidité (REEI) et le compte d’épargne libre d’impôt (CELI).

De temps à autre, pour promouvoir l’usage des régimes enregistrés d’épargne et les rendre plus intéressants, le gouvernement a élargi les types de placements.

Le présent article fait le point sur les placements admissibles pour les régimes enregistrés d’épargne, et montre comment les règles diffèrent parmi les divers régimes. L'article passe aussi en revue les divers impôts de pénalité qui peuvent s’appliquer pour décourager les placements et opérations inappropriées, à savoir les règles sur les placements non admissibles et les placements interdits, et les règles de l’impôt sur les avantages. On traite aussi de l’incidence de ces règles sur certains placements courants. Finalement, l’article examine diverses mesures transitoires et autres mesures d’allégement disponibles pour les particuliers qui se trouvent à l’écart des règles.

La discussion sur les règles de pénalité applicables aux CELI, aux REER et aux FERR en vertu de la partie XI.01 de la Loi tient compte des propositions législatives de décembre 2012, comme si elles avaient été adoptées. L’incidence des modifications proposées est soulignée, s’il y a lieu.

**PLACEMENTS ADMISSIBLES**

Le point de départ pour déterminer si un placement peut être détenu par un régime enregistré d’épargne réside dans la définition de « placement admissible » pour le type de régime particulier. Les définitions comportent des différences subtiles, mais elles partagent toutes les trois éléments de base suivants : inclusions précises relativement aux placements admissibles pour les régimes de participation différée aux bénéfices (RPPDB), inclusion précise de certains contrats de rente et liste des placements prévus par règlement. Voici une brève description des types de placement inclus dans chaque catégorie.

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1 LRC 1985, c. 1 (5e suppl.), telle que modifiée (ci-après « la Loi »). À moins d’indication contraire, les renvois législatifs dans cet article sont à la Loi.

2 Notons, à titre d’exemple, l’introduction du régime d’accession à la propriété et du régime d’encouragement à l’éducation permanente pour le REER; l’élimination de la limite de sept ans pour le report des droits de cotisation à un REER inutilisé; une augmentation des plafonds de cotisation au REE et au REER; l’introduction du transfert par roulement entre divers régimes; l’introduction de la subvention canadienne pour l’épargne-études et du bon d’études canadien pour le REE et de la subvention canadienne pour l’épargne-invalidité et le bon canadien pour l’épargne-invalidité pour le REEI ainsi que diverses bonifications du REEI annoncées dans les budgets fédéraux de 2011 et 2012.

3 Canada, ministère des Finances, Propositions législatives à la Loi et au Règlement de l’impôt sur le revenu (Ottawa : ministère des Finances, 21 décembre 2012) (ci-après les « propositions législatives de décembre 2012 »). Dans cet article, les mentions d’article ou de règlement « proposé » renvoient aux dispositions contenues dans ces propositions législatives.

4 Les définitions de « placement interdit » se trouvent aux paragraphes 146(1), 146.1(1), 146.3(1), 205(1) et 207.01(1), applicables aux régimes respectivement couverts par ces dispositions.
Placements admissibles pour les RPDB

Les types de placement suivants sont admissibles pour tous les régimes du fait qu’ils sont des placements admissibles pour le RPDB\(^5\) :

- espèces, dépôts et certificats de placement garantis;
- obligations du gouvernement et titres de créance ayant une cote d’évaluation supérieure;
- titres de créance émis par certaines entités inscrites à la cote d’une « bourse de valeurs désignée »\(^6\) au Canada ou dans un pays étranger;
- titres de créance émis par une banque étrangère autorisée pourvu que le titre soit payable à une succursale de la banque située au Canada;
- titres (sauf des contrats à terme ou d’autres instruments dérivés dont le risque de perte pour le détenteur peut excéder le coût pour lui) qui sont inscrits à la cote d’une bourse de valeurs désignée.

Contrats de rente

Tous les régimes peuvent généralement détenir diverses rentes en capitalisation et polices à fonds réservés. De plus, les REER, FERR et REEI peuvent investir dans certaines autres rentes qui respectent des conditions précises\(^7\).

Placements prévus par règlement

Les types de placement suivants sont prévus par règlement pour tous les régimes\(^8\) :

- un intérêt dans une fiducie ou une action du capital-actions d’une société qui était un placement enregistré pour une fiducie régie par un régime\(^9\);
- une action du capital-actions d’une société publique, incluant certaines sociétés de placement hypothécaire;
- quelque obligation, billet ou titre semblable de divers types de société;
- une unité d’une fiducie de fonds commun de placement;

\(^5\) Définition de « placement interdit » à l’article 204.
\(^6\) Tel qu’il est défini au paragraphe 248(1).
\(^7\) Voir supra, note 4.
\(^8\) Article 4900 du Règlement.
\(^9\) Un « placement enregistré », tel qu’il est défini au paragraphe 204.4(1), comprend généralement divers instruments de placements communs vendus comme placements pour les régimes de report de l’impôt et expressément approuvés par le ministère des Finances. Une liste est disponible dans la Gazette du Canada à www.gazette.gc.ca. Voir également l’article 4900(5) du Règlement.
une option, un droit de souscription ou un droit semblable émis par une personne ou une société de personnes qui confère au détenteur le droit d’acquérir un bien qui constitue un placement admissible ou de recevoir, en remplacement de la livraison du bien, un règlement en espèces si le bien est une action du capital-actions, une unité ou une créance de l’émetteur et que l’émetteur n’est pas une personne rattachée;

- un titre de créance entièrement garanti par une hypothèque ou un instrument semblable relatif à un bien immeuble situé au Canada si le débiteur n’est pas une personne rattachée;

- un titre de créance garanti par une hypothèque si le titre de créance est administré par un prêteur agréé sous le régime de la Loi nationale sur l’habitation et assuré en vertu de cette loi;

- une pièce d’or ou d’argent ayant cours légal ou un lingot;

- une action du capital-actions de certaines petites entreprises ou sociétés admissibles exploitant une petite entreprise, un intérêt d’un commanditaire dans une société de personnes en commandite de placement dans des petites entreprises et une participation dans une fiducie de placement dans des petites entreprises10.

Cette liste a évolué avec le temps et comprend maintenant diverses formes de placements étrangers qui étaient auparavant restreints. Plus récemment, à cause de la mise en application des règles sur les placements interdits, il est nettement plus difficile pour une action d’une société privée d’être considérée comme un placement admissible. (Voir plus loin la rubrique « Action de société privée ».)

PÉNALITÉS ANTI-ÉVITEMENT

La Loi prévoit un certain nombre d’impôts de pénalité et de règles anti-évitement destinées à empêcher de possibles abus relativement aux régimes enregistrés, comme des placements et des opérations inappropriés11. La discussion qui suit porte sur les règles sur les placements non admissibles, les règles sur les placements interdits et les règles de l’impôt sur les avantages.

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10 Les règles applicables aux placements dans des petites entreprises varient selon les régimes : voir les articles 4900(5) à 4900(14) du Règlement et l’article 4900(15) du Règlement proposé.

11 Par exemple, l’impôt en vertu de la partie X.1 sur les excédents de contribution à un REER, l’impôt en vertu de la partie X.4 sur les versements excédentaires à un REEE, l’impôt de l’article 207.02 sur l’excédent CELI, l’impôt de l’article 207.03 sur les cotisations de non-résident à un CELI, des pénalités pour l’utilisation d’un bien enregistré à titre de garantie en vertu de l’article 206.3 et des paragraphes 146(10) et 146.3(7) et l’impôt en vertu de la partie X.5 sur les paiements de revenu accumulé versés à un REEE.
PEU DE TEMPS APRÈS L’ENTRÉE EN VIGUER DE LA DISPOSITIONS ORIGINALES RELATIVES AUX CELI, LE Gouvernement a mis en place des pénalités et des règles anti-évitement plus sévères. Les règles anti-évitement, applicables après le 16 octobre 2009, ciblent les cotisations excédentaires intentionnelles et les opérations de transferts d’actifs (« swaps ») qui visent à procéder à un transfert de valeur d’un compte enregistré à un autre, et à empêcher la croissance, à l’abri de l’impôt, de revenu de placement attribuable à des cotisations excédentaires intentionnelles, des placements interdits et des placements non admissibles.

Le gouvernement était également préoccupé par le nombre croissant de stratégies de planification fiscale « agressives » au moyen d’un REER et d’un FERR, incluant, par exemple, le dépouillement de REER (arrangements en vertu desquels on effectue des retraits non imposables de fonds d’un REER). En conséquence, le budget fédéral de 2011 a élargi aux REER et aux FERR les règles anti-évitement bonifiées applicables aux CELI, (avec certaines modifications, au besoin).

Les possibilités de planification fiscale abusive au moyen de REEE et de REEI sont moindres. La conception de ces régimes vise des objectifs très précis et leurs conditions d’enregistrement assurent que le titulaire (ou souscripteur) et l’émetteur les respectent. Par exemple, un REEI ne peut être ouvert que pour le bénéfice d’un particulier qui a droit au crédit d’impôt pour personne handicapée (CIPH). Dans le cas d’un REEE, un impôt additionnel de 20 pour cent du montant retiré comme paiement de revenu accumulé versé décourage l’utilisation de ce régime à des fins non prévues.

Pour ces raisons, les règles anti-évitement applicables aux REEE et aux REEI ne sont pas aussi élaborées que celles qui s’appliquent aux REER, aux FERR et aux CELI. Néanmoins, les REEE et les REEI sont assujettis à des pénalités en cas de

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13 Tels qu’ils sont définis au paragraphe 207.01(1).


16 Voir la définition de « personne admissible au CIPH » au paragraphe 146.4(1) et à l’alinéa 146.4(4f).

17 Paragraphe 204.94(2). Les paiements de revenu accumulé représentent généralement des montants non utilisés comme paiement d’aide aux études et non admissibles au transfert par roulement à un autre régime enregistré.
placements non admissibles, et les REEI sont également assujettis à des impôts de pénalité sur certains avantages et certaines opérations comportant une contrepartie inadéquate.

**PLACEMENTS NON ADMISSIBLES**

L’acquisition ou la détention par un régime enregistré d’un placement qui est un placement non admissible entraînent des conséquences fiscales défavorables.

**REEE**

Une fiducie régie par un REEE est redevable d’un impôt de 1 pour cent pour tout mois au cours duquel elle détient un bien qui est un placement non admissible à la fin de ce mois. L’impôt de 1 pour cent est calculé sur la juste valeur marchande (JVM) du placement non admissible au moment de son acquisition\(^{18}\). De plus, si une fiducie régie par un REEE acquiert un placement non admissible ou détient un bien qui cesse d’être un placement admissible et qu’elle n’en dispose pas dans les 60 jours suivants le moment où le bien est devenu un placement non admissible, le ministre du Revenu national peut révoquer l’enregistrement du régime\(^{19}\). La fiducie devient alors imposable comme une fiducie non testamentaire\(^{20}\).

**REEI, REER, FERR et CELI**

Le titulaire d’un CELI ou le rentier d’un REER ou d’un FERR doit payer un impôt de pénalité pour chaque année civile au cours de laquelle la fiducie a acquis un placement non admissible, ou au cours de laquelle le bien détenu par la fiducie devient un placement non admissible. Cet impôt est égal à 50 pour cent de la JVM du placement non admissible au moment où le bien a été acquis ou est devenu un placement non admissible\(^{21}\). Un impôt de pénalité semblable s’applique à une fiducie régie par un REEI si la fiducie acquiert un bien qui est un placement non admissible ou si un bien détenu par la fiducie cesse d’être un placement admissible\(^{22}\). Cet impôt peut être remboursé ou faire l’objet d’une renonciation dans certaines circonstances. (Voir plus loin la rubrique « Mesures transitoires et autres mesures d’allégement ».)

De plus, le CELI, le REER, le FERR ou le REEI doit payer l’impôt en vertu de la partie I (aux taux applicables à une fiducie non testamentaire) sur tout revenu provenant d’un placement non admissible détenu dans l’année. Le revenu provenant d’un placement non admissible comprend les dividendes en capital et l’excédent

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\(^{18}\) Paragraphe 207.1(3).

\(^{19}\) Paragraphe 146.1(11).

\(^{20}\) Paragraphe 146.1(11).

\(^{21}\) Paragraphe 207.04(1) et (2).

\(^{22}\) Article 206.1.
total des gains en capital sur les pertes en capital\textsuperscript{23}. Contrairement au REEE, ces régimes ne sont pas tenus de disposer du placement dans les 60 jours.

Pour les REER et les FERR, l’impôt de 50 pour cent sur les placements non admissibles remplace le montant que le rentier devait auparavant inclure dans le revenu et déduire du revenu ainsi que l’impôt de pénalité de 1 pour cent par mois pour la fiducie\textsuperscript{24}. Les règles actuelles s’appliquent au placement non admissible acquis par un REER ou un FERR après le 22 mars 2011 et au placement acquis avant le 23 mars 2011 qui est devenu pour la première fois un placement non admissible après le 22 mars 2011. Dans le cas du CELI, les règles s’appliquent après 2008.

**PLACEMENTS INTERDITS**

Les règles sur les placements interdits ne s’appliquent qu’aux REER, FERR et CELI, et elles visent à :

empêcher l’acquisition par le régime enregistré d’un particulier de placements dans des sociétés à actionnariat restreint ou qui comportent un risque significatif d’être conçus en vue de canaliser des rendements disproportionnés vers un régime enregistré (et de contourner effectivement les plafonds de cotisation) ou de faciliter une dévaluation intentionnelle du placement (afin d’éviter l’inclusion ultérieure d’un montant dans le revenu)\textsuperscript{25}.

Il est important de savoir que même si un placement est un placement admissible, il peut néanmoins être considéré comme un placement interdit.

**IMPÔT DE PÉNALITÉ SUR LES PLACEMENTS INTERDITS**

L’impôt de pénalité sur les placements interdits est identique à celui qui s’applique sur les placements non admissibles. Pour les CELI, les REER et les FERR, cet impôt annuel est égal à 50 pour cent de la JVM du placement interdit au moment où la fiducie acquiert le bien ou au moment où le bien est devenu un placement interdit pour celle-ci\textsuperscript{26}. Il peut être remboursé ou faire l’objet d’une renonciation dans

\textsuperscript{23} Paragraphes 146(10.1), 146.2(6), 146.3(9) et 146.4(5) applicables au REER, au CELI, au FERR et au REEI, respectivement.

\textsuperscript{24} En vertu des anciens paragraphes 146(10) and 146.3(7), le rentier d’un REER ou d’un FERR était tenu d’inclure dans son revenu la JVM du placement non admissible acquis par le REER ou le FERR et il avait droit à une déduction compensatoire si le placement avait fait l’objet d’une disposition en vertu des anciens paragraphes 146(6) et 146.3(8). La fiducie devait payer l’impôt de pénalité de 1 pour cent par mois en vertu des anciens paragraphes 207.1(1) et (4).


\textsuperscript{26} Paragraphes 207.04(1) et (2).
certaines circonstances. (Voir plus loin la rubrique « Mesures transitoires et autres mesures d’allégement ».)


Le titulaire ou le rentier peut également être assujetti à un l’impôt de 100 pour cent sur les avantages sur tout revenu et gain en capital réalisé qu’il est raisonnable d’attribuer à un placement interdit dans le régime. (Voir plus loin la rubrique « Impôt sur les avantages ».)

**Qu'est-ce qu'un placement interdit?**

Un placement interdit peut généralement être décrit comme un placement auquel le titulaire d’un CELI ou le rentier d’un REER ou d’un FERR est rattaché de près, y compris :

- une dette du titulaire ou du rentier;
- une dette, une action ou une participation dans une société, une fiducie ou une société de personnes dans laquelle le titulaire ou le rentier a une participation notable;
- une dette, une action ou une participation dans une société, une fiducie ou une société de personnes ayant un lien de dépendance avec le titulaire ou le rentier;
- un intérêt ou un droit sur tout placement décrit ci-dessus;
- une action qui a cessé d’être une action admissible d’une société déterminée exploitant une petite entreprise d’une société à capital de risque ou une part d’une coopérative déterminée, à tout moment après que l’action a été acquise.

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27 Canada, ministère des Finances, « Part XI.01 Taxes — Expansion of the Transitional Relief for Certain Prohibited Investments Held by an Individual’s RRIF or RRSP », lettre d’intention publiée le 12 février 2013; le ministère des Finances a indiqué qu’il recommandera le maintien du statut de bien jouissant de droits acquis aux fins des règles fiscales sur les placements interdits et les avantages si un REER ou un FERR acquiert de nouvelles actions lors d’un échange d’actions portant sur un bien jouissant de droits acquis dans le cadre de certaines réorganisations de sociétés (comme une réorganisation papillon), dans la mesure où aucune contrepartie autre qu’en actions n’est incluse dans l’opération et que l’échange a lieu à la JVM.

28 Disposition d’entrée en vigueur du paragraphe 207.04(1).

29 Voir la définition de « placement interdit » au paragraphe 207.01(1) proposé et à l’article 4900(15) du Règlement proposé en remplacement de l’article 5001 du Règlement.

30 Voir la définition d’« actionnaire déterminé » aux paragraphes 207.01(4) et 248(1). Un particulier détient une participation notable dans une société s’il est propriétaire, seul ou de concert avec des personnes avec lesquelles il a un lien de dépendance, d’au moins 10 pour cent des actions émises d’une catégorie donnée d’actions du capital-actions de la société.
Les biens suivants sont expressément exclus de la définition de placement interdit (après le 22 mars 2011)31 :

- certaines hypothèques assurées (et instruments semblables);
- certains droits sur l’actif d’une société de placement à capital variable réglementée ou placements enregistrés qui suivent une politique raisonnable en matière de diversification, si le fonds commun de placement ou l’entité de placement enregistrée est dans sa phase de démarrage de 24 mois ou dans sa phase de liquidation de 24 mois;
- certains droits sur l’actif qui se conforment à un critère à sept volets et qui peuvent donc être considérés comme des placements de portefeuille sans lien de dépendance.

Aux fins de la troisième exclusion, le critère à sept volets examine la relation entre le titulaire ou le rentier du régime enregistré et l’émetteur du placement pour déterminer si le titulaire ou le rentier est en position de manipuler la valeur du placement ou la répartition du revenu. Ce critère exige que toutes les conditions suivantes soient réunies32 :

- Le particulier sans lien de dépendance détient au moins 90 pour cent de la JVM de l’ensemble des droits sur l’actif de l’émetteur.
- Le particulier sans lien de dépendance détient au moins 90 pour cent de la JVM totale de l’ensemble des droits sur l’actif et des dettes de l’émetteur.
- Le particulier sans lien de dépendance détient au moins 90 pour cent des voix pouvant être exprimées à l’assemblée annuelle de l’émetteur.
- Les conditions spécifiques de chaque part ou unité détenue par le régime enregistré sont identiques ou essentiellement similaires à celles d’un droit sur l’actif donné détenu par un particulier sans lien de dépendance (droit sans lien de dépendance).
- La JVM du droit sans lien de dépendance qui présente les mêmes conditions spécifiques (ou des conditions essentiellement similaires) correspond à au moins 10 pour cent de la JVM totale des droits sur l’actif de l’émetteur qui présentent les mêmes conditions spécifiques (ou des conditions essentiellement similaires).
- Le titulaire ou le rentier n’a pas de lien de dépendance avec l’émetteur.

31 La définition de « bien exclu » au paragraphe 207.01(1) proposé, qui remplace l’actuel article 5000 du Règlement. Avant le 23 mars 2011, les seules exclusions prévues à l’article 5000 du Règlement comprenaient certains prêts hypothécaires assurés (et instruments semblables) et certains fonds communs de placement réglementés pendant la période de démarrage de 24 mois du fonds.

32 Alinéa c) de la définition de « bien exclu » au paragraphe 207.01(1) proposé.
Aucun des objets principaux de la structure de l’émetteur, ou des conditions du droit sur l’actif, ne consiste à faciliter la mise en œuvre d’opérations ou d’événements qui pourraient modifier la JVM du placement détenu par le régime enregistré d’une manière qui ne se manifesterait pas dans un contexte commercial ou financier normal où des parties sans lien de dépendance traitent librement, prudemment et en toute connaissance de cause.

Cette exclusion peut s’appliquer, par exemple, si un particulier et un ou des membres de sa famille proche détient plus de 10 pour cent d’une seule catégorie d’actions d’une importante société de placement à capital variable sans lien de dépendance possédant plusieurs catégories d’actions représentant différents fonds et que la participation en actions est minime par rapport à la capitalisation de la société dans son ensemble.

On traite plus loin de façon plus détaillée des règles sur les placements interdits pour certains placements détenu conjointement sous la rubrique « Incidence du resserrement des règles de pénalité applicables à des placements spécifiques ».

**IMPÔT SUR LES AVANTAGES**

Un impôt de pénalité s’applique également à certains « avantages »33 tirés d’opérations destinées à tirer profit des attributs fiscaux du CELI, du REER, du FERR ou du REEI. L’impôt sur les avantages ne s’applique pas au REEE.

**IMPÔT DE PÉNALITÉ SUR LES AVANTAGES**

L’impôt sur les avantages est égal à 100 pour cent de la JVM du bénéfice obtenu ou, dans le cas d’un prêt ou d’une dette, du montant du prêt ou de la dette34. De même, dans le cas d’un dépouillement de REER35 (dont on traite plus loin), l’impôt est égal au montant du dépouillement de REER36.

L’impôt est payable par le rentier ou le titulaire du régime enregistré, mais si l’avantage est fourni par l’émetteur du régime enregistré ou par une personne qui a un lien de dépendance avec celui-ci, c’est l’émetteur qui est redevable de l’impôt. Dans certaines circonstances, il peut y avoir renonciation à cet impôt. (Voir plus loin la rubrique « Mesures transitoires et autres mesures d’allégement ».)

Pour les REER, le nouvel impôt sur les avantages remplace l’ancienne pénalité imposée à l’émetteur qui était égale au plus élevé de 100 $ et de la valeur de l’avantage37. L’impôt sur les avantages s’applique tant aux REER qu’aux FERR.

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33 Tel qu’il est défini au paragraphe 207.01(1) proposé pour le CELI, le REER et le FERR, et au paragraphe 205(1) pour le REEI.
34 Article 206.2 pour le REEI et article 207.05 pour le CELI, le REER et le FERR.
35 Tel qu’il est défini au paragraphe 207.01(1) proposé.
36 Alinéa 207.05(2)c).
37 Paragraphe 146(13.1) abrogé.
relativement aux opérations effectuées, au revenu gagné, aux gains en capital accumulés et aux placements acquis après le 22 mars 2011\(^\text{38}\).

Dans le cas des REEi et des CELI, l’impôt de 100 pour cent sur les avantages s’applique généralement à compter du moment où ces régimes sont entrés en vigueur (pour les années d’imposition postérieures à 2007 dans le cas du REEi et pour les années d’imposition postérieures à 2008 dans le cas du CELI). Cependant, pour les CELI, les règles élargies de l’impôt sur les avantages qui visent les cotisations excédentaires intentionnelles, les opérations de swap et le revenu de deuxième génération attribuable à des cotisations excédentaires intentionnelles, des placements interdits et des placements non admissibles s’appliquent après le 16 octobre 2009.

**Qu’est-ce qu’un avantage?**

Un avantage s’entend généralement de tout bénéfice, prêt ou dette tributaire de l’existence du régime enregistré, sous réserve de certaines exceptions et inclusions précises. Compte tenu des variations dans les règles, il est nécessaire de passer en revue les exceptions et inclusions précises qui visent les CELI, les REER et les FERR séparément de celles qui s’appliquent aux REEi.

**Le REEi**

Un avantage relativement à un REEi\(^\text{39}\) s’entend de tout bénéfice ou prêt subordonné à l’existence d’un REEi, à l’exception :

- de tout paiement d’aide à l’invalidité;
- de toute cotisation versée par le titulaire du REEi ou avec son consentement;
- de tout transfert admissible d’un REEi en faveur d’un autre pour le même bénéficiaire;
- de toute subvention canadienne pour l’épargne-invalidité ou de tout bon canadien pour l’épargne-invalidité ou de toute somme versée en vertu d’un programme provincial désigné;
- de tout bénéfice provenant de la fourniture de services de gestion ou de placement relatif au régime;
- de tout prêt visant à permettre le versement d’une cotisation au REEi qui est consenti dans le cours normal des activités du prêteur (avec des modalités de remboursement raisonnables).

Pour déterminer s’il y a un avantage, un bénéfice comprend tout paiement ou toute attribution d’une somme à un REEi qui est présenté comme un rendement sur placement relatif aux biens détenus par le régime, mais qu’il n’est pas raisonnable

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\(^{38}\) Paragraphe 207.01(7) proposé et ARC document no 2011-0418161E5, 3 février 2012.

\(^{39}\) Défini au paragraphe 205(1).
de considérer comme étant conforme à des conditions qui s’appliqueraient sur le marché libre (entre personnes sans lien de dépendance)\(^{40}\).

**CELI, REER et FERR**

Un avantage relativement à un CELI, un REER ou un FERR\(^{41}\) s’entend généralement de tout bénéfice ou tout prêt ou toute dette qui est subordonné à l’existence du régime, à l’exception :

- de tout bénéfice provenant de la fourniture de services de gestion ou de placement relatif au régime;
- de tout prêt sans lien de dépendance;
- de toute distribution effectuée par le régime au titulaire ou au rentier;
- du paiement ou de l’attribution faite directement au régime par l’émetteur;
- de tout bénéfice provenant d’un programme d’encouragement offert à une vaste catégorie de clients de l’émetteur du régime (ou une personne qui lui est liée), si aucun des objets principaux du programme ne consiste à permettre au titulaire ou au rentier de profiter d’une exemption d’impôt prévue par la partie I.

La dernière exclusion notée ci-dessus, ajoutée par les propositions législatives de décembre 2012, permet aux institutions financières d’utiliser des encouragements promotionnels (comme une réduction des frais ou des remises en argent) pour vendre leurs produits.

Un avantage comprend aussi expressément un bénéfice qui représente une hausse de la JVM des biens détenus dans le régime enregistré si la hausse est attribuable\(^{42}\) :

- à une opération ou un événement qui ne se serait pas produit dans un marché libre ou dans un contexte de placement entre des parties n’ayant entre elles aucun lien de dépendance, si l’opération ou l’événement a pour objet principal de permettre à une personne de profiter d’une exemption de l’impôt prévu par la partie I à l’égard du régime enregistré — par exemple, l’émission d’actions ordinaires au CELI ou au REER d’un employé principal pour une contrepartie nominale dans le cadre d’un gel successoral\(^{43}\);
- à un paiement pour des services (ou un paiement reçu au titre ou en règlement d’un tel paiement) fournis par le titulaire ou le rentier du régime,

\(^{40}\) Définition d’« avantage » au paragraphe 205(1).

\(^{41}\) Alinéa a) de la définition d’« avantage » au paragraphe 207.01(1) proposé.

\(^{42}\) Alinéa b) de la définition d’« avantage » au paragraphe 207.01(1) proposé.

ou par une personne qui a un lien de dépendance avec le titulaire ou le
rentier (par exemple, un dividende discrétionnaire plutôt qu’un salaire versé
à des employés clés d’une société privée si les actions de cette dernière sont
détenu clans un régime enregistré);

- à un paiement d’un rendement sur placement (incluant intérêt, dividende,
loyer ou redevance) ou à un paiement du produit de disposition, relativement
dess biens détenu hors régime par le titulaire ou le rentier, ou par une
personne avec laquelle il a un lien de dépendance (par exemple, un
rendement sur un placement détenu dans le cadre d’un régime enregistré
qui est lié à un second type de placement détenu hors régime, si le
rendement de chaque composante du placement vise à faire passer un
revenu dans le régime)\textsuperscript{44};

- à une opération de swap (dont on traite plus loin);

- à un revenu de placement non admissible déterminé (essentiellement un
revenu de deuxième génération) qui n’a pas été versé par le régime dans les
90 jours de la réception d’un avis de l’Agence du revenu du Canada (ARC)
exigeant la distribution du montant\textsuperscript{45}.

Un avantage comprend également un revenu ou un gain en capital
attribuable à\textsuperscript{46}:

- un placement interdit;

- dans le cas d’un CELI, une cotisation excédentaire intentionnelle au
régime\textsuperscript{47};

- dans le cas d’un REER ou d’un FERR, certaines sommes reçues par le rentier
(ou une personne avec laquelle il a un lien de dépendance) qui n’auraient pas
été payées si ce n’était des biens détenu par le régime, si la somme
représentait un paiement pour des services fournis par le rentier (ou une
personne avec laquelle il a un lien de dépendance), un rendement sur
placement (incluant intérêt, dividende, loyer ou redevance) ou un produit de
disposition (par exemple, un rendement sur un placement ou un produit de
disposition d’un placement détenu hors du régime enregistré qui est lié à un
deuxième type de placement détenu à l’intérieur du régime, si le rendement
sur chaque composante du placement vise à retirer le revenu du régime pour
faire bénéficier une personne d’un traitement fiscal préférentiel non

\textsuperscript{44} Pour un exemple portant sur des opérations immobilières, voir Amanjit Lidder, « Current
Issues Forum », dans \textit{2011 British Columbia Tax Conference} (Toronto : Fondation canadienne de

\textsuperscript{45} Définition de « revenu de placement non admissible déterminé » au paragraphe 207.01(1)
proposé et au paragraphe 207.06(4).

\textsuperscript{46} Alinéa c) de la définition d’« avantage » au paragraphe 207.01(1) proposé.

\textsuperscript{47} Telle qu’elle est définie au paragraphe 207.01(1).
disponible à l’intérieur du régime, comme celui qui s’applique aux dividendes et aux gains en capital)\textsuperscript{48}.

Finalement, un avantage comprend un dépouillement de REER à l’égard du régime (dont on traite plus loin) et un « bénéfice visé par règlement »\textsuperscript{49}. Le Règlement ne contient actuellement aucun bénéfice.

Compte tenu de la vaste liste des avantages, les particuliers devront suivre de près l’administration de leurs régimes enregistrés pour s’assurer qu’ils ne seront pas assujettis par inadvertance aux règles de l’impôt sur les avantages.

**Opérations assujetties aux règles de l’impôt sur les avantages**

Certaines opérations effectuées dans le cadre d’un CELI, d’un REER ou d’un FERR entraîneront l’application des règles de l’impôt sur les avantages. Un impôt de pénalité peut également s’appliquer aux opérations effectuées dans le cadre d’un REEI pour une contrepartie inadéquate. Voici un aperçu des types d’opération que l’impôt de pénalité vise à empêcher.

**Opérations de swap**

Les opérations de swap (généralement, des opérations d’achat et de vente entre comptes) peuvent donner lieu à un transfert de valeur à partir ou en faveur d’un régime enregistré tout en évitant l’inclusion d’un montant dans le revenu lors du retrait ou le respect des plafonds de cotisations (voir l’exemple 1 ci-dessous). Les règles applicables à de telles opérations visent à empêcher que l’on exploite les fluctuations du cours du marché de titres pour effectuer un transfert de valeur en faveur ou à partir d’un régime enregistré et éviter l’impôt sur toute plus-value.

Généralement, une opération de swap renvoie à un transfert de bien entre un REER, un FERR ou un CELI et le titulaire ou le rentier du régime (ou une personne qui a un lien de dépendance avec lui). Toutefois, la définition d’« opération de swap » exclut expressément les opérations suivantes\textsuperscript{50}:

- une distribution en règlement de la participation du titulaire ou du rentier (qui peut se produire lors du changement d’un émetteur du régime à un autre);
- un paiement au régime qui constitue une cotisation, une prime ou un transfert permis à un FERR (comme un transfert de fonds d’un régime de pension agréé en faveur d’un FERR)\textsuperscript{51};

\textsuperscript{48} Supra, note 44.

\textsuperscript{49} Alinéas d) et e) de la définition d’« avantage » au paragraphe 207.01(1) proposé.

\textsuperscript{50} Définition d’« opération de swap » au paragraphe 207.01(1) proposé.

\textsuperscript{51} Les transferts permis sont prévus à l’alinéa 146.3(2)(f).
tout transfert d’un placement interdit ou d’un placement non admissible effectué à partir du régime, moyennant contrepartie, dans des circonstances où le rentier ou le titulaire a droit au remboursement de l’impôt de pénalité (voir plus loin la rubrique « Remboursement de l’impôt de pénalité »)52;
- tout transfert de bien entre les régimes enregistrés du rentier qui sont tous deux des REER ou des FERR, ou tout transfert de bien entre deux CELI du même titulaire.

En ce qui a trait au dernier élément, un transfert entre un CELI et un REER ou un FERR du même particulier n’est pas visé par l’exception et il est considéré comme une opération de swap.

L’augmentation de la JVM d’un régime enregistré qui est de quelque façon attribuable (directement ou indirectement) à une opération de swap est considérée comme un avantage. Cela comprend toutes les augmentations futures de la JVM du régime enregistré qu’il est raisonnable de considérer comme étant attribuables à l’opération de swap initiale. L’ARC a indiqué que cela comprend tout dividende, intérêt ou autre somme payée sur le titre ayant fait l’objet du swap et toute plus-value de ce titre ou d’un bien y substitué et tout revenu de deuxième génération53.

L’impôt sur les avantages s’applique aux opérations de swap portant sur un CELI effectuées après le 16 octobre 2009; dans le cas d’un REER et d’un FERR, les opérations de swap effectuées après juin 2011 sont généralement assujetties aux règles de l’impôt sur les avantages. Une règle transitoire permet cependant une opération de swap devant être effectuée avant 2022 pour retirer tout bien d’un FERR ou d’un REER qui, s’il demeurait dans le régime, donnerait lieu à l’impôt prévu à la partie XI.01. (Voir plus loin la rubrique « Mesures transitoires et autres mesures d’allégement ».)

Dépouillement de REER
Les règles sur le dépouillement de REER visent des opérations, comme certaines opérations de swap, qui permettent le retrait d’un montant d’un REER ou d’un FERR en franchise d’impôt. Le libellé original de la définition de dépouillement des REER dans la Loi incluait toute somme obtenue par le rentier par suite d’une opération ou d’une série d’opérations dont l’objet principal était de permettre au rentier (ou à une personne ayant avec lui un lien de dépendance) d’obtenir un bénéfice relativement à des biens détenus dans le cadre du REER ou du FERR (sous

52 Les propositions législatives de décembre 2012 précisent que la contrepartie payée au régime enregistré sur un swap d’un placement non admissible ou interdit à l’extérieur du régime est également exonérée de l’impôt sur les avantages.
réserve de certaines exceptions précises). La définition n’était pas limitée aux diminutions de la JVM du bien du REER ou du FERR.

En réponse aux préoccupations soulevées par cette signification large, les propositions législatives de décembre 2012 précisent qu’il n’y a dépouillement de REER qu’en cas de réduction de la JVM du bien détenu dans le cadre du REER ou du FERR résultant d’une opération ou d’une série d’opérations dont l’un des objets principaux consistait à permettre au rentier (ou une personne ayant avec lui un lien de dépendance) d’obtenir un bénéfice par suite de la réduction. Selon la définition modifiée\(^{54}\), un dépouillement de REER exclut ce qui suit :

- une somme incluse dans le revenu du rentier ou de l’époux ou conjoint de fait du rentier;
- une somme retirée en vertu du régime d’accession à la propriété ou du régime d’encouragement à l’éducation permanente;
- certains transferts permis entre REER et FERR;
- le principal d’une créance qui est un « bien exclu » (qui s’entend généralement d’hypothèques assurées et instruments semblables)\(^{55}\).

Si le bien est retiré d’un REER ou d’un FERR au moyen d’une vente au rentier du REER ou du FERR en échange d’une contrepartie dont la valeur est inférieure à la JVM de ce bien, l’opération sera considérée comme un dépouillement de REER\(^{56}\), et la différence entre la JVM du bien et la contrepartie sera considérée comme un avantage, sauf si le montant est inclus par ailleurs dans le revenu du rentier\(^{57}\).

L’exemple qui suit illustre une opération de swap et un dépouillement de REER que les règles visent à empêcher.

**Exemple 1**

Sarah approche de la retraite et elle avait 150 000 $ dans son REER et 10 000 $ dans son CELI à la fin de l’année précédente. Pendant l’année en cours, elle verse une cotisation de 5 000 $ dans son CELI et utilise les fonds pour acquérir 500 actions ordinaires de Pubcie au prix de 10 $ l’action. Quelques mois plus tard, le prix de l’action de Pubcie passe à 13 $ et Sarah transfère les 500 actions dans son CELI pour une contrepartie de 6 500 $ comptant provenant de son REER. Cette opération n’a rien de répréhensible car il n’y a aucun changement dans la JVM du CELI ou du REER.

Supposons maintenant que quelques semaines plus tard, le prix des actions revient à 10 $ et que Sarah transfère de nouveau les actions à son CELI pour 5 000 $ comptant. La JVM de son CELI s’établit maintenant à 16 500 $ (10 000 $ + cotisation

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\(^{54}\) Définition de « dépouillement de REER » au paragraphe 207.01(1) proposé.

\(^{55}\) Définition de « bien exclu » au paragraphe 207.01(1) proposé.

\(^{56}\) ARCan° 2012-0439211E5, 6 octobre 2012.

\(^{57}\) Paragraphes 146(9) et 146.3(4).
de 5 000 $ + 6 500 $ − 5 000 $) et celle de son REER, à 148 500 $ (150 000 $ − 6 500 $ + 5 000 $). Sarah a fait passer une valeur de 1 500 $ de son REER à son CELI, qu’elle pourra recevoir en franchise d’impôt quand elle retirera les fonds de son CELI. Si Sarah avait retiré le même montant directement de son REER, elle aurait été assujettie à l’impôt sur le revenu de la partie I.

Si un tel transfert devait se répéter encore et encore, Sarah pourrait profiter de la volatilité du marché boursier pour faire passer le montant de son REER à son CELI et retirer le montant supplémentaire de son CELI en franchise d’impôt. Cependant, selon les règles de l’impôt sur les avantages, la hausse de la JVM du CELI résultant du swap et la baisse de valeur du REER (donnant lieu à un dépouillement de REER) seraient toutes deux assujetties à l’impôt sur les avantages de 100 pour cent. Cette double imposition pénalise Sarah pour n’avoir pas respecté les plafonds de cotisation à l’égard du montant transféré à son CELI et avoir évité l’impôt de la partie I sur le transfert effectué à partir de son REER.

Comme on l’indique dans l’exemple, il n’y a rien de répréhensible dans le fait de faire simplement passer un bien du CELI du titulaire à son REER en échange d’une contrepartie en argent ou autre d’une valeur égale. C’est l’opération subséquente qui rend la première répréhensible. Plutôt que de simplement cibler la deuxième opération abusive, l’impôt sur les avantages s’appliquera à tout transfert de bien à partir d’un CELI en faveur d’un REER ou d’un FERR, ou à partir d’un REER ou d’un FERR en faveur d’un CELI. L’ARC s’attend à ce que de nombreux émetteurs de REER et de FERR cessent simplement d’effectuer des opérations de swap interdites en vertu des nouvelles règles58. Dans ce cas, les particuliers qui souhaitent déplacer des placements entre comptes enregistrés et non enregistrés pour améliorer l’efficience fiscale de leurs portefeuilles de placement (comme un swap hors régime enregistré d’un placement portant intérêt pour un placement avec rendement sous forme de dividendes à l’intérieur d’un régime) devront liquer leurs placements et les racheter de sorte qu’ils pourraient devoir engager des frais d’opération supplémentaires ou subir des pertes cumulées à l’intérieur du régime.

Cotisation et distribution en nature

Les cotisations en nature à un régime enregistré sont toujours permises, dans la mesure où le placement est un placement admissible. L’émetteur d’un régime qui accepte une cotisation en nature d’un placement non admissible risque de se voir imposer une pénalité59.

La cotisation d’un placement admissible est considérée comme ayant été effectuée à la JVM du bien au moment du transfert. Le gain en capital est inclus

58 ARC document n° 2012-04392611E5, 16 octobre 2012.
59 Paragraphes 207.01(5) et 162(7).
Dans le revenu du particulier et toute perte en capital est réputée nulle\(^{60}\). De même, un CELI, un REER ou un FERR peuvent effectuer des distributions en nature. C’est l’émetteur du régime qui détermine la JVM du bien. Si cette valeur n’est pas déclarée de façon appropriée, le particulier pourrait obtenir un avantage et l’émetteur du régime pourrait être assujetti à l’impôt sur les avantages\(^{61}\).

**REEI — Contrepartie inadéquate**

Les règles de l’impôt sur les avantages applicables aux REEI ne s’appliquent pas expressément aux opérations de swap ou au dépouillement de REEI, mais les règles sur les REEI prévoient un impôt de pénalité distinct sur les dispositions et acquisitions de bien d’un REEI moyennant une contrepartie inadéquate.

De façon semblable à l’impôt sur les avantages sur le dépouillement de REER, si un bien d’un REEI fait l’objet d’une disposition pour une contrepartie inférieure à la JVM ou si ce bien est acquis pour une contrepartie supérieure à la JVM, le titulaire du REEI est redevable d’un impôt de pénalité égal à la différence entre la JVM du bien et la contrepartie\(^{62}\). Dans certaines circonstances, cet impôt peut faire l’objet d’une renonciation. (Voir plus loin la rubrique « Renonciation à l’impôt ».)

**INCIDENCE DU RESSERREMENT DES RÈGLES DE PÉNALITÉ APPLICABLES À DES PLACEMENTS SPÉCIFIQUES**

Si l’on s’inspire des récentes interprétations techniques de l’ARC comme guide, la discussion qui suit porte sur l’incidence du resserrement des règles de pénalité pour des types précis de placement couramment détenus par des régimes de report du revenu.

**Actions de société privée**

Les restrictions imposées aux placements en actions de société privée à l’intérieur d’un régime enregistré empêchent les contribuables de contourner les règles sur les plafonds de cotisation et d’utiliser le régime enregistré pour mettre à l’abri de l’impôt un revenu excédentaire réalisé dans le cadre d’opérations avec lien de dépendance. Des exceptions permettent cependant aux REER, aux FERR, aux CELI

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61 Paragraphe 207.05(3).

62 Paragraphes 206(1) et (2).
et aux REEE de détenir des placements sans lien de dépendance dans certaines sociétés privées. Récemment, les exceptions prévues pour les REER et les FERR ont été resserrées pour empêcher les placements en actions de société privée qui sont des placements interdits.

Auparavant, les actions d’une société privée représentaient des placements admissibles pour un REER ou un FERR si la société était soit une société admissible dont le rentier n’était pas un actionnaire désigné, soit une société déterminée exploitant une petite entreprise (« société déterminée EPE ») dont le rentier n’était pas un actionnaire rattaché. Les critères sont semblables, si ce n’est que le critère de la société admissible doit être respecté tout au long de la période au cours de laquelle le régime enregistré détient les actions, alors que le critère applicable à la société exploitant une petite entreprise (SEPE) n’a à être respecté qu’au moment de l’acquisition des actions par le régime. Par conséquent, la plupart des placements en actions de société privée antérieurs au 23 mars 2011 étaient probablement admissibles en vertu du critère applicable aux sociétés déterminées EPE.

Règles actuelles applicables aux actions de société exploitant une petite entreprise


Selon les anciennes règles, un particulier est un « actionnaire rattaché » s’il est propriétaire, directement ou indirectement, d’au moins 10 pour cent des actions émises d’une catégorie du capital-actions de la société ou d’une société liée à celle-ci. À cette fin, le particulier est réputé être propriétaire des actions dont sont propriétaires des personnes avec lien de dépendance. Est expressément exclu de la définition d’« actionnaire rattaché » le particulier qui n’a aucun lien de dépendance avec la société et dont le coût du placement est inférieur à 25 000 $.

Le critère des placements interdits maintient le seuil de 10 pour cent. Cependant, les actions représenteront un placement interdit si la société ne

63 Article 4900(6) du Règlement.
64 Ancien article 4900(12) du Règlement.
65 Article 4900(14) du Règlement.
66 Le critère relatif aux sociétés admissibles prévu à l’article 4900(6) du Règlement continue de s’appliquer en plus de l’obligation pour les actions de ne pas constituer un placement interdit.
67 Définition d’« actionnaire rattaché » à l’article 4901(2) du Règlement. Ces règles continuent de s’appliquer aux fins du critère sur les sociétés déterminées EPE à l’article 4900(12) du Règlement pour les REEE.
maintient pas son statut de SEPE en tout temps\(^68\). L’exception du 25 000 $ a été supprimée. Les exemples qui suivent illustrent ces changements.

**Exemple 2**

Faits et hypothèses :

- SEPEcie est une société canadienne qui exploite une entreprise activement au Canada.
- Le particulier A a acheté 15 pour cent des actions ordinaires de SEPEcie au prix de 15 000 $.
- Au moment de l’acquisition des actions, SEPEcie était une société déterminée EPE.
- Le particulier A n’est lié à aucun autre actionnaire de SEPEcie.
- Tous les actionnaires sont canadiens.

Conséquences fiscales :

- **Changements antérieurs au budget de 2011** : Le particulier A détient une participation de plus de 10 pour cent, mais n’est pas un actionnaire rattaché à cause de l’exemption relative au coût. Par conséquent, les actions constituent un placement admissible et peuvent être transférées dans le REER du particulier A.
- **Changements postérieurs au budget de 2011** : Le particulier A détient une participation de plus de 10 pour cent dans SEPEcie, ce qui représente une participation notable. Par conséquent, les actions constituent un placement interdit et un placement non admissible et elles ne peuvent être transférées dans le REER du particulier A.

L’exemple 3 illustre l’impact des modifications de l’article 4900(14) du Règlement et de l’article 4900(15) proposé d’écoulant du budget de 2011.

**Exemple 3**

Faits et hypothèses :

- Le 1\(^e\) avril 2011, Acie est admissible à titre de SEPE.
- Le 1\(^e\) avril 2011, le particulier A a acheté 5 pour cent des actions de Acie directement et en a acquis un autre 4 pour cent par l’entremise d’un REER.
- Les actions de Acie ne constituaient pas un placement interdit le 1\(^e\) avril 2011.
- En 2012, Acie a utilisé ces bénéfices pour effectuer un important placement dans une société en exploitation américaine de sorte que Acie n’est plus admissible à titre de SEPE.

\(^{68}\) Article 4900(15) du Règlement proposé, remplaçant l’actuel article 5001 du Règlement.
Conséquences fiscales :

- Les actions ont été achetées après le 22 mars 2011 et sont devenues un placement interdit en 2012 quand Acie a cessé d’être une SEPE. Par conséquent, les actions ne constituent plus un placement admissible.

Sans l’exception relative à l’absence de lien de dépendance et au coût, il est dorénavant plus difficile pour les actions d’une société privée d’être considérées comme un placement admissible. Plus important encore, on devra suivre les actions de près pour s’assurer qu’elles ne deviennent pas un placement interdit assujetti à l’impôt de 50 pour cent sur leur valeur et à l’impôt sur les avantages de 100 pour cent sur le revenu (incluant les gains en capital)\(^6\). Pour un actionnaire qui possède une participation notable dans l’entreprise, il pourrait être difficile d’effectuer un swap de fonds ou de biens de valeur équivalente en échange des actions de la société privée.

L’exemple 4 illustre les droits acquis dont bénéficient les placements admissibles avant le 23 mars 2011. Il est fondé sur un document de l’ARC publié en février 2013\(^7\).

*Exemple 4*

**Faits et hypothèses** :

- Le particulier B était propriétaire de 5 pour cent des actions de Bcie par l’intermédiaire d’un REER et il n’était lié à aucun autre actionnaire.
- Bcie était une SEPE au moment de l’acquisition de ses actions par le REER du particulier B, avant le 23 mars 2011.
- Les actions de Bcie constituaient un placement admissible au moment de leur acquisition.
- En 2012, Bcie a entrepris la liquidation de l’entreprise et la vente de ses actifs, de sorte qu’elle n’est plus admissible à titre de SEPE.

**Conséquences fiscales** :

- Comme les conditions prévues à l’article 4900(12) du Règlement n’ont à être respectées qu’au moment de l’acquisition des actions par le REER, la liquidation et la perte du statut de SEPE n’ont eu aucune incidence sur le statut de placement admissible en 2012.
- Un placement acquis avant le 23 mars 2011 par un REER ou un FERR qui était un placement admissible à cause de l’article 4900(12) du Règlement conservera son statut de placement admissible en vertu de cette disposition après le 22 mars 2011, même si cette disposition est depuis limitée aux REEE.

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\(^6\) Cependant, l’impôt de 50 pour cent ne s’appliquera pas aux actions détenues le 22 mars 2011 qui sont devenues pour la première fois un placement interdit avant le 4 octobre 2011 selon la règle sur les droits acquis du paragraphe 207.04(1) (disposition d’entrée en vigueur).

\(^7\) ARC document n° 2011-0426041E5, 21 février 2013.
L’ARC a noté que des placements qui sont des placements admissibles à cause de l’article 4900(14) du Règlement ne le seront plus si, à quelque moment, la société cesse de respecter les critères applicables aux SEPE. Cependant, dans la mesure où un placement acquis par un REER ou un FERR avant le 23 mars 2011 était admissible en vertu de l’ancien article 4900(12) du Règlement, il ne deviendra pas un placement interdit en vertu des nouvelles règles. Toutefois, l’impôt de pénalité sur les placements interdits et l’impôt sur les avantages s’appliqueront si les actions acquises avant le 23 mars 2011 sont devenues un placement interdit par ailleurs après le 4 octobre 2011 (par exemple, si plus de 10 pour cent des actions sont détenues par le rentier et des personnes ayant avec lui un lien de dépendance). (Pour des détails sur l’allégement disponible à l’égard des placements interdits détenus au 23 mars 2011, voir plus loin la rubrique « Mesures transitoires et autres mesures d’allégement ».)

**Hypothèques**

Une hypothèque relative à un bien immeuble situé au Canada constitue un placement admissible pour tous les régimes enregistrés dans la mesure où le débiteur n’est pas une personne rattachée71. Si le débiteur est une personne rattachée, l’hypothèque peut toujours être admissible si elle est administrée par un prêteur agréé sous le régime de la Loi nationale sur l’habitation et assuré en vertu de cette loi ou par un assureur privé de créances hypothécaires72.

La position de l’ARC est que l’enregistrement du régime pourrait être compromis et/ou certaines dispositions concernant les avantages ou les penalités pourraient s’appliquer si le taux d’intérêt hypothécaire et les autres modalités ne reflètent pas la pratique commerciale normale et que l’hypothèque n’est pas gérée par le prêteur agréé comme il le serait s’il s’agissait d’une hypothèque sur un bien immeuble appartenant à un étranger73.

L’ARC a confirmé qu’une hypothèque assurée ne constitue pas un placement interdit et qu’elle continue donc d’être admissible comme placement dans un régime de report de l’impôt74. Cette position est compatible avec les propositions législatives de décembre 2012, qui incluent l’hypothèque assurée décrite à l’article 4900(1)j.1 du Règlement comme « bien exclu » dans le contexte des placements interdits75.

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71 Définition de « personne rattachée » à l’article 4900(1)) et à l’article 4901(2) du Règlement.
72 Article 4900(1)j.1 du Règlement.
74 ARC document no 2012-0467151E5, 7 mars 2013.
75 Alinéa a) de la définition de « bien exclu » au paragraphe 207.01(1) proposé.
Droits de souscription, options et titres convertibles

Généralement, un droit de souscription, une option ou un titre semblable qui donne au titulaire le droit d’acquérir un bien qui est un placement admissible (ou de recevoir, en remplacement de la livraison du bien, un règlement en espèces) peut constituer lui-même un placement admissible76.

Dans plusieurs interprétations techniques récentes, on a demandé à l’ARC si l’impôt de 50 pour cent sur les placements interdits s’appliquait si le REER ou le FERR devait échanger un placement interdit avant le 23 mars 2011 pour un nouveau placement interdit après le 22 mars 2011.

Dans une interprétation technique,77 l’ARC a indiqué que si une fiducie régie par un REER ou un FERR est propriétaire d’actions et des droits de souscription connexes acquis avant le 23 mars 2011 qui constituent un placement interdit et que l’exercice des droits de souscription donne lieu à l’acquisition d’actions après le 22 mars 2011, l’impôt de 50 pour cent s’appliquera et sera calculé sur la JVM des actions à la date d’acquisition. Le fait que l’impôt ne s’appliquait pas à ces droits de souscription parce qu’ils avaient été acquis avant le 23 mars 2011 n’est pas pertinent. L’ARC ajoute qu’il en irait de même dans le contexte d’options, de titres convertibles et autres échanges de titres.

Une interprétation technique semblable78 portait sur les dettes convertibles. Essentiellement, si un nouveau titre est un placement interdit et qu’il a été acquis après le 22 mars 2011, l’impôt de 50 pour cent s’appliquera au placement interdit, en dépit du fait que l’impôt ne s’appliquait pas par ailleurs au titre convertible original parce qu’il avait été acquis avant le 23 mars 2011.

Parts de sociétés coopératives

Dans une récente interprétation technique79, l’ARC a indiqué qu’une part d’une société coopérative peut constituer un placement interdit si un titulaire ou un rentier d’un régime a une participation notable dans celle-ci. L’ARC ajoute qu’une part d’une société coopérative initialement admissible peut constituer un placement interdit si, après l’acquisition, la coopérative a cessé d’être une « coopérative déterminée ».80

77 ARC document n° 2012-0453301C6, 12 septembre 2012.
78 ARC document n° 2012-0446031E5, 6 septembre 2012.
79 ARC document n° 2012-0441781E5, 22 novembre 2012.
80 Article 4900(15) du Règlement proposé, remplaçant l’article 5001 du Règlement, et définition de « coopérative déterminée » à l’article 4901(2) du Règlement.
**Bien entiercé**

Un bien entiercé est détenu par une fiducie pour quelqu’un jusqu’à ce que certaines conditions convenues soient respectées. En général, un titre sujet à une mise en main tierce ne peut pas être transféré ni vendu, mais il peut donner au propriétaire bénéficiaire le droit de voter ou de recevoir des dividendes pendant que le titre est entiercé.

L’action sujette à une mise en main tierce peut constituer un placement admissible si toutes les conditions suivantes sont respectées81 :

- l’action a été émise à une fiducie régie par un régime;
- l’actionnaire détient tous les droits de propriété;
- des actions, identiques à celle qui est sujette à une mise en main tierce, sont des placements admissibles.

Dans une récente interprétation technique82, on a demandé à l’ARC si un CELI peut détenir un bien sujet à une mise en main tierce, à savoir une part constituée d’une action ordinaire et d’un demi droit de souscription. L’ARC a confirmé sa position de longue date décrite ci-dessus, et déclaré que tant et aussi longtemps que le bien entiercé respecte les critères et que l’action et le droit de souscription sous-jacents sont des placements admissibles, le bien entiercé serait également un placement admissible. L’ARC a aussi indiqué qu’il faut utiliser une méthode appropriée pour déterminer la valeur du droit de souscription.

**Société de placement hypothécaire**

En général, une action d’une société de placement hypothécaire (SPh) peut constituer un placement admissible dans la mesure où la SPh ne détient aucune dette d’une personne rattachée83. De plus, tant et aussi longtemps que le titulaire du régime n’a pas une participation notable dans la SPh, l’action ne constituera pas un placement interdit. Deux interprétations techniques portant sur la question de savoir si un CELI peut détenir des actions d’une SPh confirment cette position84.

**Commerce de devises**

Comme on l’a vu précédemment, les devises représentent généralement un placement admissible pour les régimes enregistrés. Les options en devises qui sont cotées sur une bourse étrangère désignée représentent également des placements admissibles.

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81 IT-320R3, supra, note 73, au paragraphe 5.
82 ARC document no 2012-0433811m4, 2 mai 2012.
83 Article 4900(1)c) du Règlement.
Les contrats de change négociés hors cote ne sont pas admissibles car le marché hors cote n’est pas une bourse de valeurs désignée. De plus, si un contrat à terme est coté sur une bourse de valeurs désignée mais que le risque de perte excède le coût du contrat, celui-ci est expressément exclu comme placement admissible. En outre, la fiducie régie par un régime qui s’engage dans des négociations en devises spéculatives peut être considérée comme exploitant une entreprise et donc être imposable en vertu de la partie i. Les contrats devraient refléter des conditions commerciales où des parties sans lien de dépendance traitent librement; autrement, on pourrait conclure qu’ils permettent le transfert artificiel de valeur dans le régime, de sorte que les règles de l’impôt sur les avantages s’appliqueront85.

**Placements dans des fonds communs de placement**

Les placements dans des fonds communs de placement constituent généralement des placements admissibles, mais ils peuvent constituer des placements interdits si le titulaire du régime détient une participation notable et que le placement n’est pas un bien exclu86. Comme on l’a décrit précédemment sous la rubrique « Placements interdits », certains placements dans des fonds communs de placement détenus pendant la période de démarrage ou de liquidation de 24 mois de l’émetteur seront considérés comme des biens exclus et ils ne seront pas assujettis aux règles sur les placements interdits. Certains placements de portefeuille sans lien de dépendance seront également considérés comme des biens exclus.

**Mesures transitoires et autres mesures d’allégement**

Un certain nombre de mesures précises prévoient un allégement des règles de pénalité.

**Règles transitoires applicables aux REER et aux FERR**

**Choix relatif au bénéfice transitoire provenant d’un placement interdit**

Rappelons que l’impôt de 100 pour cent sur les avantages s’applique au revenu provenant de placements interdits détenus après le 22 mars 2011 et aux gains en capital accumulés après cette date et attribués à ces placements. Cependant, un choix peut être effectué pour que l’impôt de 100 pour cent sur les avantages ne

85 Sous-alinéa b)(i) de la définition d’ « avantage » au paragraphe 207.01(1) proposé, et ARCDocument no 2010-0356811E5, 5 janvier 2011.
s’applique pas dans la mesure où le revenu ou les gains admissibles sont retirés annuellement du REER ou du FERR. Le revenu et les gains admissibles pour une année d’imposition sont diminués de toute perte en capital subie dans l’année qui est attribuable à un placement qui était un placement interdit le 23 mars 2011 et qui s’est accumulée après le 22 mars 2011. Le montant net est appelé « bénéfice transitoire provenant d’un placement interdit ».

Initialement, cet allégement n’était disponible que pour le revenu gagné et les gains en capital réalisés avant 2022, mais cette date a depuis été supprimée. Ce changement est une bonne nouvelle pour les particuliers qui détiennent des placements non liquides dans des sociétés privées qui sont devenus des placements interdits le 23 mars 2011 et qui ne disposent pas des fonds nécessaires pour procéder au swap du placement hors du REER ou du FERR.

Pour tirer avantage de cet allégement transitoire, le rentier devait produire un choix avant le 2 mars 2013. De plus, le bénéfice transitoire provenant d’un placement interdit pour une année civile doit être retiré dans les 90 jours suivant la fin de l’année, et le retrait ne peut être réglé par un transfert à un autre régime enregistré du rentier.

Le montant du retrait est inclus dans le revenu de l’année et il est imposé au taux d’impôt marginal du rentier (comme tout retrait régulier d’un REER ou d’un FERR).

**Swap de placements non admissibles et de placements interdits**

Une règle transitoire permet d’effectuer une opération de swap avant 2022 pour retirer tout bien d’un REER ou d’un FERR qui, s’il demeurait dans le régime, donnerait lieu à l’impôt de pénalité de 50 pour cent. Les particuliers devraient identifier les placements susceptibles de devenir des placements interdits ou non admissibles et en prévoir leur retrait avant 2022 ou la restructuration de leur portefeuille de façon à respecter les règles.

Dans une opération de swap d’un placement non admissible ou d’un placement interdit, il est important de s’assurer que le REER ou le FERR reçoit pour le bien une contrepartie à la JVM; autrement, le swap peut être considéré être un dépouillement de REER. À cet égard, il faut faire preuve de prudence si la valeur du placement n’est pas facile à déterminer (comme dans le cas des actions d’une société privée).

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87 Paragraphe 207.05(4) proposé.
88 Supra, note 27.
89 Défini au paragraphe 207.01(1) proposé.
90 Formulaire RC341 de l’ARC, « Choix relatif à un bénéfice transitoire d’un placement interdit dans un REER ou un FERR ». Initialement, le choix devait être produit avant juillet 2012; la date limite a cependant été prolongée pour laisser plus de temps aux particuliers pour déterminer s’ils avaient besoin de demander un allègement transitoire.
91 ARC document n° 2012-0445851E5, 16 octobre 2012.
Remboursement de l’impôt de pénalité

Dans le cas du CEL, du REER et du FERR, l’impôt de pénalité de 50 pour cent peut être remboursé si le placement fait l’objet d’une disposition au plus tard à la fin de l’année civile qui suit l’année au cours de laquelle l’impôt est calculé (ou à une date ultérieure que l’ARC juge raisonnable). Aucun remboursement ne sera accordé si le titulaire ou le rentier savait ou aurait dû savoir, au moment où le bien a été acquis, que celui-ci était ou deviendrait un placement non admissible ou un placement interdit\(^{92}\).

De plus, si la demande de remboursement de l’impôt de la partie xi.01 n’est pas produite dans les trois ans après la fin de l’année pertinente, le particulier pourrait ne pas recevoir le remboursement auquel il a droit (sous réserve des dispositions d’allégement)\(^{93}\).

Des dispositions de remboursement semblables (avec des conditions similaires) s’appliquent pour l’impôt de pénalité sur les placements non admissibles d’un REEI\(^{94}\).

Il n’y a aucune disposition de remboursement de l’impôt mensuel de 1 pour cent sur les placements non admissibles d’un REEE.

Allégement de la double imposition

Si à un moment donné, un placement est à la fois un placement interdit et un placement non admissible, il est réputé ne pas être un placement non admissible aux fins de l’impôt de pénalité de 50 pour cent et de l’impôt de la partie i applicable au revenu que tire la fiducie du placement\(^{95}\). Cette règle d’allégement assure que le titulaire ou le rentier n’est assujetti qu’à un seul impôt de pénalité pour le placement et le revenu provenant du placement.

Pour le REER et le FERR, cette règle d’allégement s’applique aux placements interdits qui ont été acquis après le 22 mars 2011, ou qui ont été acquis avant le 23 mars 2011 et qui sont devenus pour la première fois des placements interdits après le 4 octobre 2011. Il s’applique aussi aux placements non admissibles qui ont été acquis, ou qui sont devenus pour la première fois des placements non admissibles, après le 22 mars 2011.

L’ARC est d’avis que cette règle d’allégement ne s’applique pas lorsque des actions non admissibles d’une société privée acquises avant le 23 mars 2011 sont toujours détenues après le 22 mars 2011 et sont considérées comme un placement interdit le 23 mars 2011 (par exemple, si une personne liée au rentier détient plus de 10 pour cent des actions de la société). Dans ce cas, le placement continuera

\(^{92}\) Paragraphe 207.04(4).

\(^{93}\) Article 207.07 et paragraphe 164(1.5).

\(^{94}\) Paragraphes 206.1(4), 207(2) et 207(4).

\(^{95}\) Paragraphe 207.04(3).
d’être considéré comme un placement interdit et un placement non admissible, et le revenu gagné et les gains en capital accumulés provenant du placement (après le 22 mars 2011) pourraient être assujettis à la fois à l’impôt sur les avantages levé sur le rentier et à l’impôt régulier de la partie I levé sur la fiducie. Dans un tel cas, le choix relatif au bénéfice transitoire provenant d’un placement interdit procurerait un allègement de l’impôt sur les avantages; cependant, si le choix n’est pas produit à la date prévue, le rentier devrait demander à l’ARC une renonciation à l’impôt de la partie XI.0196.

**DISPOSITION ET NOUVELLE ACQUISITION RÉPUTÉES**

Quand un bien détenu dans un CELI, un REER, un FERR ou un REEE cesse d’être un placement non admissible ou un placement interdit, la fiducie régie par le régime est réputée avoir disposé du placement à ce moment pour un produit égal à sa JVM à ce moment et l’avoir acquis de nouveau à un coût égal à cette JVM97. On assure ainsi que l’impôt régulier de la partie I applicable à la fiducie ou que l’impôt sur les avantages applicable au rentier ou au titulaire cesse de s’appliquer à tout revenu ou gain accumulé provenant du placement après cette date98.

Cette règle tient compte des circonstances où un particulier ne souhaite pas disposer d’un placement donné détenu dans un régime enregistré qui est un placement non admissible ou un placement interdit. Ce peut être le cas de titres qui constituent un placement interdit parce que les placements que détient le particulier à l’intérieur du régime enregistré et hors régime représentent une participation notable et qu’il serait plus souhaitable pour lui de disposer des titres qui sont détenu hors du régime enregistré pour réduire sa participation dans l’entité (par exemple, pour générer des pertes en capital qui peuvent servir à neutraliser des gains en capital imposables, ou pour continuer à mettre à l’abri de l’impôt le revenu de dividendes sur les titres détenus dans le régime enregistré).

La disposition réputée d’un placement non admissible ou d’un placement interdit est considérée comme une disposition aux fins des règles de remboursement. Par conséquent, il n’est pas nécessaire que le régime dispose véritablement du placement pour que le titulaire ou le rentier ait droit à un remboursement de l’impôt de pénalité.

Une règle semblable de disposition et de nouvelle acquisition réputées s’applique lorsque le bien détenu par un CELI, un REER ou un FERR devient un placement non admissible ou un placement interdit. Cette règle assure que tout gain accumulé avant la date où le placement est devenu un placement non admissible ou un placement interdit n’est pas assujetti à l’impôt sur les avantages.

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97  Paragraphe 206.1(6), et paragraphe 207.04(5) existant, qui doit être remplacé par le paragraphe 207.01(6) proposé.

98  Selon les paragraphes 146(10.1), 146.2(6), 146.3(9), 146.4(5) et 207.05(1).
Renonciation à l’impôt

L’ARC a le pouvoir de renoncer à certains impôts de pénalité.

REER, FERR et CELI

L’ARC peut, à sa discrétion, renoncer à tout ou partie de l’impôt de pénalité de 50 pour cent ou de l’impôt de 100 pour cent sur les avantages si elle estime qu’il est juste et équitable de le faire, compte tenu des circonstances, incluant expressément ce qui suit:

- l’impôt fait suite à une erreur raisonnable;
- la mesure dans laquelle l’opération ou la série d’opérations qui a donné lieu à l’impôt a également donné lieu à un autre impôt prévu par la Loi;
- la mesure dans laquelle des paiements ont été faits sur le régime enregistré de la personne.

Les propositions législatives de décembre 2012 ont supprimé l’obligation additionnelle de retirer sans délai les montants donnant lieu à l’avantage. L’ARC a publié des instructions et des exemples de circonstances dans lesquelles elle pourrait accorder une renonciation. L’ARC a indiqué qu’elle [traduction] administrera les dispositions de renonciation de façon juste et souple pour encourager l’observation volontaire des nouvelles règles et inciter les contribuables à prendre les devants et à corriger des situations qui échappent aux nouvelles règles, en particulier celles qui concernent des placements antérieurs au 23 mars 2011.

REEI

L’ARC peut aussi, à sa discrétion, renoncer à tout ou partie de l’impôt payable par les REEI à l’égard de diverses dispositions de pénalité (incluant l’impôt payable pour une contrepartie inadéquate, l’impôt payable sur un placement non admissible et l’impôt sur les avantages). Une renonciation sera accordée dans des circonstances semblables à celles qui sont décrites ci-dessus. L’ARC n’a pas émis de lignes directrices précises sur les demandes de renonciation pour les REEI, mais compte tenu de la similitude dans le libellé de la disposition, il est probable que la forme de la demande et les conditions pour qu’elle soit prise en considération de façon favorable soient semblables à ce qui est décrit ci-dessus.

99 Paragraphe 207.06(2) proposé.
100 ARC document n° 2011-0430141E5, 2 février 2012.
101 Ibid.
102 Article 206.4.
REEE
Il n’y a aucune disposition de renonciation dans le contexte de l’impôt mensuel de 1 pour cent sur les REEE qui détiennent des placements non admissibles.

Retraits à partir de comptes de retraite avec immobilisation des fonds et de fonds de revenu de retraite immobilisés
À cause des restrictions imposées au retrait de fonds des comptes de retraite avec immobilisation des fonds et des fonds de revenu de retraite immobilisés, il pourrait être impossible pour le rentier d’en retirer des sommes, ce qui donne lieu à l’impôt de pénalité. L’ARC a cependant recommandé ce qui suit pour atténuer toute conséquence fiscale négative selon les règles de pénalité103 :

- la somme peut être retirée du REER ou du FERR non immobilisé du rentier plutôt que du régime immobilisé. (Il n’est pas obligatoire que le retrait soit fait à partir du régime particulier.)
- Un placement interdit pourrait faire l’objet d’un swap à partir du régime immobilisé pour une contrepartie à la JVM pour éviter que l’impôt sur les avantages s’applique à de futurs gains sur un tel placement.
- Les lois provinciales sur les pensions devraient être examinées pour déterminer s’il existe d’autres options, comme les transferts entre régimes ou la possibilité d’une certaine désimmobilisation.

L’ARC a aussi indiqué que le retrait d’un bénéfice transitoire provenant d’un placement interdit d’un FERR peut servir de contrepartie aux fins de respecter l’obligation pour l’émetteur du FERR de payer le montant minimum du FERR104.

CONCLUSION
Comme les régimes enregistrés d’épargne constituent une composante importante des portefeuilles de placement et des régimes financiers canadiens, il est important que les conseillers fiscaux et leurs clients sachent quels types de placements les divers régimes peuvent détenir. Les règles anti-évitement plus resserrées prévues pour les REER, les FERR et les CELI ont ajouté de nouvelles difficultés qui exigent un suivi plus strict des placements détenus dans les régimes enregistrés d’épargne et des opérations qui y sont effectuées. Les nouvelles règles de pénalité peuvent également alourdir le fardeau de la conformité.

103 ARC document no 2012-0456601i7, 18 février 2013.
104 ARC document no 2012-0453161C6, 5 octobre 2012.
Les impôts de pénalité doivent être payés et déclarés annuellement sous peine de pénalités additionnelles. Il sera donc important de revoir annuellement les changements dans la JVM des régimes enregistrés pour être en mesure de déterminer le montant de tout avantage, et d’examiner plus fréquemment les portefeuilles de placement pour établir si des placements sont devenus non admissibles ou interdits. Il pourrait être difficile de déterminer si un placement n’est pas conforme aux règles sans savoir quels placements sont détenus par des membres de la famille et d’autres personnes avec lien de dépendance. Dans de nombreux cas, il sera important de retirer sans délai les placements qui ne sont pas conformes aux règles. Dans le cas de placement dans une société privée, cela pourrait exiger une évaluation adéquate des actions.
THE CRA’S TAX TRANSPARENCY INITIATIVES: IMPLICATIONS FOR A CORPORATE GOVERNANCE RESPONSE

Dan Misutka and Lauchlin MacEachern

In recent years, perceptions of widespread aggressive tax planning by corporations have led Canada and other nations to implement legislation and administrative policies compelling or encouraging corporations to adopt more transparent practices. This article describes some of the global context for recent tax transparency initiatives. It also discusses some corporate governance considerations in relation to the Canada Revenue Agency's (CRA's) desire for Canadian corporations to voluntarily disclose perceived high-risk or uncertain tax positions (Canada's version of the enhanced tax relationship with corporations). The authors suggest that the voluntary adoption of more transparent disclosure practices by Canadian corporations can be consistent with their best interests. However, a number of barriers exist that inhibit the establishment of effective enhanced relationships between corporations and the CRA, including institutional limitations that result from the failure of the CRA to establish enhanced audit and dispute resolution practices. The authors suggest that the success of Canada's tax transparency initiative depends on the CRA's willingness and ability to remove these barriers and to demonstrate that, in adopting more transparent disclosure practices, corporations can realize meaningful benefits.

KEYWORDS: AGGRESSIVE TAX PLANNING ▪ AUDITS ▪ CANADA REVENUE AGENCY ▪ OECD ▪ TAX AVOIDANCE ▪ TRANSPARENCY

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INTRODUCTION

At the 2012 annual conference of the Canadian Tax Foundation, Canada Revenue Agency (CRA) officials expressed a desire for cooperative disclosure by corporate taxpayers of transactions entered into that involve an element of risk or uncertainty from a tax perspective.¹ That statement was made in the course of broader discussions covering other recent tax transparency initiatives adopted by the CRA. Similar initiatives have been adopted or are under consideration by tax authorities across the globe. Tax transparency is also actively promoted by the Organisation for Economic Co-operation and Development (OECD).

In the last three or four years, tax transparency has emerged as a key transglobal public policy objective. It is based on a desire among tax authorities to combat international tax evasion and aggressive tax-avoidance practices. Tax transparency is also promoted in the context of efforts to streamline bureaucracies in the face of resource constraints, and it is seen as a politically acceptable way for debt-laden governments to increase tax revenues without necessarily raising tax rates.

Finally, public and political pressure continues to focus on amounts of tax paid by corporations, and some notable allegations of unscrupulous tax-avoidance schemes have been widely reported in the press.2

It is important for Canadian corporations, particularly large corporations, to appreciate the political context in which the CRA’s tax transparency policies have emerged. Obviously, there are prospects for reputational risks related to tax avoidance. Large corporations in Canada are now compelled to focus on governance issues related to tax-risk assessment policies. Indeed, forcing such analysis onto the corporate governance agenda is a primary goal of the CRA’s policies, as it is for tax administrations in other jurisdictions.

Yet the political context also informs the framework for appropriate corporate governance responses. At first blush, it might seem that the answer to allegations of unacceptable levels of aggressive tax avoidance is simple: Canada has a general anti-avoidance rule (GAAR), and the courts are the best arbiter of what amounts to abusive tax avoidance. While this is true, GAAR and the role of the courts are only part of the suite of multidisciplinary considerations that may influence corporate governance responses in the context of tax transparency and compliance.

Unfortunately, political debates do not always strive for correctness, as to either fact or law. Corporate governance policies need to incorporate a broader framework of considerations to respond to a tax transparency context that is not focused exclusively on tax-law principles.

The CRA’s expressed desire for cooperative disclosure is a call for enhanced relationships between the CRA and corporate taxpayers. Enhanced relationship programs have been formally adopted in some other countries. In Canada, to this point, the CRA’s efforts in this area have been directed at promoting voluntary cooperation. However, the CRA has suggested that the adoption of corporate governance practices that include programs to identify and assess tax risk at the highest levels of corporate management, as well as certification of tax items, is a factor in the CRA’s risk-based audit initiatives for large corporations. The risk-based audit program thereby incorporates features of an enhanced relationship program.

With this in mind, our primary focus in this article is to consider recent tax transparency initiatives from a particular corporate governance perspective. Although a multifaceted review of governance practices is certainly warranted, we suggest that in the process of reacting to public policy initiatives, corporations should also not lose sight of traditional corporate governance objectives. There is a danger that tax policy

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in this area may be informed by a political characterization of abusive tax avoidance, rather than by the legal meaning of tax avoidance. To help prevent such a result, corporations should participate in identifying a broader range of possible benefits that can be realized by both parties to an enhanced relationship.

To achieve real success, Canadian corporations and the CRA should both appreciate the fact that legitimate tensions can exist between the objectives of tax authorities and corporate objectives to which corporate governance practices are directed. It is important not to let competing objectives frustrate the process.

We therefore suggest that Canadian corporations should seek to establish enhanced relationships with the CRA where possible. However, in doing so, they need to be prepared to incorporate tax risk into governance policies that encompass a broader range of considerations than those that are normally of concern to tax managers.

Canadian corporations should accept the CRA’s call for enhanced relationships at face value, so that they will be in a position to seek meaningful reciprocation from the CRA. In particular, corporations should aspire to secure benefits from participation that are suitable to their particular tax issues, and should be prepared to support a high ground position in the event of uninformed political debate. One would hope, though, that any public debate in Canada on the issue of tax transparency will not become as politically charged as it has been elsewhere. For example, in the United Kingdom, investigations by the House of Commons Public Accounts Committee into transfer-pricing practices of notable multinational companies (Starbucks, Amazon, and Google) attracted significant negative public commentary from members of Parliament as well as public interest groups.3

In the interest of trying to realize mutual benefits from Canadian tax transparency initiatives, it is important for both sides to appreciate the full breadth of the benefits that may be achieved. On the one hand, corporations stand to gain by, among other things, reducing compliance costs and receiving an expeditious review of transactions that carry an element of risk (which will lead to greater certainty with respect to tax positions and thus assist corporate planning). On the other hand, the government stands to gain if it is able to better focus its audit operations on high-risk taxpayers, thereby efficiently allocating public funds and, ideally, collecting higher levels of tax revenue in the process.

To date, the benefits that corporate taxpayers can expect to receive from Canada’s tax transparency initiatives have essentially been defined by the CRA. Consistency of practice and overall realization of stated benefits are not widely known. Any measurement of the success of current programs is limited to those corporate taxpayers that have undergone a risk-based review.

It seems clear that cooperating with the CRA in its tax transparency campaign will require corporations to adapt, to some degree, to the prevailing political landscape. However, corporate governance principles may require that in addition, corporations enter into an enhanced relationships with the CRA with a view to promoting their self-interest. To the extent that corporations strive to overtly define and then realize the benefits that they hope to gain from the relationship, such efforts will be consistent with their best interests.

CORPORATE GOVERNANCE CONSIDERATIONS

Corporations have attracted a certain amount of public and political scrutiny over the past couple of decades, as a result of financial scandals and economic downturns. Regulatory responses to those issues have been directed mainly to corporate governance practices.

More recently, the focus of public and political scrutiny has shifted to corporate tax policy. The concept of tax governance has been floated as a vehicle for an appropriate corporate response, with the suggestion that corporations adopt new tax governance practices as a subset of their overall corporate governance practices. Such recommendations, to this point, have been predominantly reactive.

In that context, it is worthwhile to briefly revisit certain foundational corporate governance principles. In Canada, the duties of corporate directors have been enshrined in federal and provincial legislation. For example, section 102(1) of the Canada Business Corporations Act⁴ (CBCA) provides:

(1) Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation.

Pursuant to section 121 of the CBCA, directors may delegate certain management powers to corporate officers. Section 122(1) then sets out the responsibilities of directors with respect to the performance of their duties:

(1) Every director and officer of a corporation in exercising their powers and discharging their duties shall
   (a) act honestly and in good faith with a view to the best interests of the corporation; and
   (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

In Peoples Department Stores⁵, the Supreme Court of Canada has established that the director’s duties described in sections 122(1)(a) and (b) of the CBCA are separate and distinct duties, which are designed to secure different ends. The duty in section 122(1)(a) is a fiduciary duty, commonly referred to as a duty of loyalty. It requires

⁴ RSC 1985, c. C-44, as amended.
⁵ Peoples Department Stores Inc. (Trustee of) v. Wise, 2004 SCC 68.
that, in resolving competing interests, directors are obliged to act in good faith with a view to the best interests of the corporation.6

The court reiterated and elaborated on this view in the subsequent case of *BCE Inc.*:

> The fiduciary duty of the directors to the corporation originated in the common law. It is a duty to act in the best interests of the corporation. Often the interests of shareholders and stakeholders are co-extensive with the interests of the corporation. But if they conflict, the directors’ duty is clear—it is to the corporation: *Peoples Department Stores*.7

Section 122(1)(b) of the CBCA imposes a different duty—a duty of care—that has been held to be more open-ended. This provision enshrines the longstanding common-law principle that directors must satisfy a duty of care or risk being found to be grossly negligent with respect to the affairs of the corporation. As the Supreme Court noted in *Peoples Department Stores*, section 122(1)(b) puts pressure on directors to establish good corporate governance rules, the existence of which may provide a defence to allegations that they have breached their duty of care.8

In practice, corporations have adopted the concept of active monitoring as a means, among other things, of helping directors to discharge their duty of care. Active monitoring relates to the active supervision of management and corporate initiatives by directors directly, or through board committees. It implies that directors are charged with oversight of the strategic direction of the corporation and of the decisions and actions of management in implementing corporate strategy, without taking part in the day-to-day management of the corporation.9

New internal controls put in place by corporations as a governance practice have mostly been prompted by Canadian securities regulators in response to similar requirements legislated by the US government in the Sarbanes-Oxley Act.10 One such example is the requirement imposed on chief executive officers (CEOs) and chief financial officers (CFOs) to file certificates stating that they are responsible for establishing and maintaining disclosure controls and procedures, and internal controls in respect of financial reporting.

The purpose of internal controls, implemented as a corporate governance practice, is as follows:

> Internal controls are put in place to keep a corporation on course toward profitability goals and achievement of its mission, and to minimize surprises along the way. They enable management to deal with rapidly changing economic and competitive environments, shifting customer demands and priorities, and restructuring for future growth.

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6 Ibid., at paragraphs 32, 33, and 47.
7 *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69, at paragraph 37.
8 *Peoples Department Stores*, supra note 5, at paragraphs 57 and 63.
Internal controls promote efficiency, reduce risk of asset loss and help ensure the reliability of financial statements and compliance with laws and regulations. They are not limited to financial matters.\(^{11}\)

However, at the root of such measures is a concern with the protection of financial stakeholder interests.

In the United Kingdom, regulations have been imposed requiring the senior accounting officer (SAO) of certain large qualifying companies to certify annually that he or she has established and monitored accounting arrangements capable of supporting accurate tax returns across all major taxes.\(^{12}\)

In Canada, the CRA has suggested that clear corporate governance frameworks that ensure that all tax risks are properly identified and addressed on a timely basis is an important factor in its new risk-based approach to audits of large corporations.

There may well be an interesting argument that the types of financial stakeholder interests that should compel modification of corporate governance practices in Canada are not necessarily commensurate with the interests of tax authorities, who seek to ensure that tax-risk assessments are consistent with their views of abusive tax avoidance. However, it is beyond the scope of the present discussion to pursue that argument here, or to delineate all of the possible stakeholder interests that corporate directors in Canada must keep in mind when managing the affairs of a corporation. Directors perform a wide range of duties. Moreover, they may pursue a wide range of corporate social objectives that, while legitimate, may not clearly be informed by the legal duty of care.

As previously mentioned, consideration of context is important in the present tax transparency environment. In some jurisdictions, calls for tax transparency policies have been founded on views about corporate responsibility and even morality. This political context is discussed in more detail later in this article.

**THE ENHANCED RELATIONSHIP**

It is important to first understand the concept of the enhanced relationship. According to the OECD,

the enhanced relationship is based on establishing and sustaining mutual trust between taxpayers and revenue bodies. This can be achieved through the following behaviours:

- in dealings with taxpayers, revenue bodies demonstrating understanding based on commercial awareness, impartiality, proportionality, openness through disclosure and transparency, and responsiveness; and
- in dealings with revenue bodies, taxpayers providing disclosure and transparency.\(^{13}\)

\(^{11}\) Dorval, supra note 9, at 138.

\(^{12}\) See Finance Act 2009 (UK), 2009, c. 10, section 93 and schedule 46.

The expectation in an enhanced relationship is that both the corporation and the revenue body will do more than is required by statute in order to establish and maintain mutual trust.

The question then arises as to how the best interests of a corporation are correlated with the establishment of a successful enhanced relationship. Whatever the breadth of the stakeholder interests that are of concern to corporations, for the purpose of the present discussion it suffices to say that the best interests of Canadian corporations will continue to be legitimately defined by the protection of shareholder value and the realization of profit. In order to achieve true success in the implementation of voluntary tax transparency initiatives, public authorities might do well to appreciate the legitimate point that corporations will be motivated to enter into an enhanced relationship if (among other reasons) it is in their best interests to do so.

One might suggest that an important measure of the success of tax transparency policies in Canada should be the ability to preserve enhanced relationships where the parties disagree. In such cases, it should be incumbent upon the CRA to recognize that legitimate corporate objectives can be inconsistent with the government’s objectives without causing a change in the corporation’s risk status. Care should be taken to ensure that subjective views of abusive tax planning do not damage the relationship.

Tensions can arise where the parties to the enhanced relationship have different objectives. There are a number of possible sources of tension between tax authorities and corporate taxpayers. As acknowledged by various tax authorities who have established transparency initiatives, there is a requirement for trust between the parties. Furthermore, both parties must be willing to accept a certain amount of give-and-take in approaching tax compliance matters, in order to make the relationship work.

Corporations, for their part, would be well advised to step back and consider how tax-risk analysis is aligned with their broader corporate objectives, including important social policy objectives and reputational concerns. However, we also suggest that the best interests of Canadian corporations are served by recognizing what they might be giving up in entering into the enhanced relationship requested by the CRA. Corporations should be assertive in communicating to the CRA the steps that they have taken in fostering an enhanced relationship, and they should seek to ensure that such steps are recognized by the CRA in the form of meaningful improvements to procedures for audits and dispute resolution. Moreover, corporations should not be content to allow the CRA to define the range of benefits that might arise, but should seek to tailor the benefits to their specific issues and objectives.

These suggestions are not inconsistent with other legitimate corporate concerns. Careful blending of tax-risk analysis with other corporate priorities can lead to a meaningful enhanced relationship with the CRA. If the CRA’s suggestion that real benefits can be achieved is taken at face value, it is incumbent upon corporations to ensure that meaningful benefits are realized. By that measure, the best interests of corporations are served by going beyond the adoption of merely reactive governance
measures and working to seeking to establish and maintain an enhanced relationship with the CRA that produces tangible benefits, specific to the circumstances of the particular corporation.

**THE CRA’S CURRENT TAX TRANSPARENCY INITIATIVES**

**Risk-Based Approach to Audit**

As noted above, the CRA’s risk-based audit program incorporates principles of an enhanced relationship.

The program was introduced in 2010, when the CRA instituted a new approach to audits of Canadian large-business taxpayers. 14 Under the program, all large-business taxpayers are assigned to one of three categories—high risk, medium risk, or low risk—according to the CRA’s assessment of the taxpayer’s level of tax compliance. As described below, the risk assessment takes into account a range of indicators, including but not limited to the taxpayer’s history of compliance.

All large-business taxpayers will be subject to audit every year, but compliance approaches will be tailored to each taxpayer and will vary from full-scope audits to limited compliance assurance reviews, depending on the taxpayer’s risk assessment. Risk ratings by the local tax services office (TSO) will be calibrated at the regional level to ensure consistency and accuracy within the region, and will then be further calibrated at the national level to ensure national accuracy, consistency, and quality. 15

The risk-based audit approach is being phased in over a five-year period (commencing in 2010-11) during which the CRA expects to contact all Canadian large-business taxpayers. As part of the initiation of its risk-based approach, the CRA began meeting with senior representatives of large-business taxpayers for the purpose of explaining its new approach to large-business compliance, providing the particular taxpayer with the results of the CRA’s risk assessment, and understanding how the taxpayer manages tax risk at its highest governance levels. 16

With regard to the risk-assessment process, each taxpayer will be assessed annually on the basis of the latest information available to the CRA. The CRA has indicated 17

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15 These details about the operation of the program were provided by the CRA at a meeting organized by the Tax Executives Institute in December 2012; see “Tax Executives Institute Meeting with CRA,” December 4, 2012, response to question 7 (www.tei.org/news/SiteAssets/Pages/2012-Canadian-Liaison-Meetings/2012_CRA_Responses_Income_Tax.pdf).

16 Ibid., response to question 12.

that once the five-year phase-in period is complete, it will consider revisiting taxpayers to review their rating. A taxpayer’s risk assessment will be based on several techniques, including

- analysis of historical audit results and behavioural patterns;
- review of the risk analysis provided by the taxpayer’s TSO, along with other relevant information (including effective tax rate analysis comparing rates for large-business taxpayers with average rates within their industry); and
- a determination of whether the taxpayer may be participating in tax-planning schemes.

The following risk factors will also be given consideration:

- Audit history;
- Industry sector issues;
- Unusual and/or complex transactions;
- Corporate structure;
- Major acquisitions and disposals;
- International transactions;
- Corporate governance;
- Participation in aggressive tax planning; and
- Openness and transparency.18

The CRA noted, in particular, that the lack of a formal method of identifying and responding to corporate tax risk (that is, tax governance), in the absence of other mitigating controls, will weigh against the taxpayer in the risk-assessment process.19

According to the CRA, taxpayers can reduce the cost of a CRA audit by embracing the new approach to large-business compliance—specifically, by establishing good corporate governance principles related to tax decisions and by freely, openly, and frankly sharing information with the CRA (the enhanced relationship).20 The CRA has listed the following examples of approaches available to taxpayers to prevent audit disputes:

- Establishment of clear corporate governance frameworks that ensure all tax risks are properly identified and addressed on a timely basis.
- A good governance approach may include:
  - A sound framework to manage tax risks and comply with tax obligations
  - A strong in-house tax capability
  - Reporting requirements that ensure that significant tax risks are elevated to decision makers such as the CFO, CEO, the Board or its Audit Committee

18 Ibid.
19 Supra note 15, response to question 12.
20 See “CRA/TEI Liaison Meeting,” December 7, 2010, responses to questions 1(a) and (d); see www.tei.org/news/Pages/TEICRA2010IncomeTaxLiaisonMeeting.aspx.
corporate tax planning

- Appropriate review and sign off procedures for material transactions
- An effective tax risk mitigation capability including the business’s relationship with the applicable tax jurisdictions
- Capacity to regularly evaluate the effectiveness of tax governance systems
- Meeting the CRA on a regular basis to openly discuss tax management strategies adopted by businesses.
- Ensuring clear and accurate documentation is readily available and shared with CRA to fully explain differences between accounting and taxable income as well as other business issues.
- Informing CRA on a timely basis of changes undertaken to the business (e.g. acquisitions, mergers, new foreign affiliates, new/different transfer pricing transactions, etc.).
- Soliciting CRA’s opinion regarding the tax treatment of risky transactions through meetings with the LFCM [Large File Case Manager] or by seeking Advance Pricing Arrangements or Rulings.
- Responding to CRA’s questions openly and in a timely manner including making available to CRA on timely basis foreign based documentation.21

Real-time audits will act as a complement to this new approach. In addition, the action of informing the CRA of contentious tax issues in advance and a willingness to cooperate with the CRA in an open and transparent manner will be taken into consideration, along with other risk factors, in determining the taxpayer’s risk category.22

Finally, the CRA is undertaking a detailed analysis, which will continue throughout the five-year phase-in period, to determine whether there is a correlation between the risk rating assigned to a file and the actual results of the audit, and to ensure the consistency of the application of the criteria for the program.23

While the new risk-based approach involves transparency on both sides,24 few details have been released regarding how the CRA intends to improve its own transparency, apart from notifying large-business taxpayers of their risk rating and disclosing the factors that contributed to that rating.

To date, there is no formal CRA publication outlining the CRA’s risk-based approach to audits. There is also, at this time, no formal administrative process by which a taxpayer can dispute its risk-assessment rating. Presumably, without any such administrative process, a taxpayer could seek judicial review of the CRA’s determination of its rating in the Federal Court of Canada.25 Clearly, if things get to that point, an enhanced relationship has broken down.

21 Ibid.
22 Ibid.
23 Supra note 17.
Preparing for a Meeting with the CRA

Reasonable suggestions have been made that taxpayers should provide good explanations of their organization’s tax compliance and be able to address the relevant factors identified by the CRA to explain why the organization deserves a lower risk rating. Supporting documentation should be available, and the representative should demonstrate an understanding of any tax risks that the corporation is undertaking. Such materials may include any internal risk assessments, identification of outside tax and legal advisers, and a description of the types of major transactions that the organization undertakes, as well as their frequency. Knowing which transactions may invoke CRA scrutiny, maintaining a good tax analysis of those transactions, and preparing a clear and concise explanation for the CRA should be helpful.26

While a taxpayer is required to provide information to the CRA that is related to the administration and enforcement of the Income Tax Act,27 there is no legal obligation for taxpayers to identify uncertain tax positions (UTPs) to the CRA.

The CRA has identified 12 topics that will help prepare corporate officials for its discussion on corporate governance to manage tax risk.28 These can be summarized as follows.

1. **internal tax function**: details regarding the corporation’s internal tax function, including the number of staff, and their roles and responsibilities
2. **framework for identifying and assessing tax risks**: details of any formal framework for identifying and assessing the major tax risks associated with normal ongoing operations, and of steps taken to address material risks, along with details about the individuals who oversee tax-risk management
3. **tax-risk reviews**: extent and frequency of tax-risk reviews
4. **involvement of directors and senior management in tax matters**: a summary of the tax matters that the board of directors and senior management get involved in
5. **tax intermediaries**: use of tax intermediaries and the extent of their involvement in tax-risk management
6. **monitoring of non-compliance risk**: how the taxpayer monitors the risk of non-compliance and what steps are taken when a potential issue is identified
7. **systems and processes**: what systems and processes exist to ensure that data and information for tax purposes are accurate, reliable, and maintained in accordance with the legislation and with CRA policy
8. **external tax advisers**: details regarding the use of external advisers for tax planning and fee arrangements for this work (for example, payment on a contingency basis)

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27 RSC 1985, c. 1 (5th Supp.), as amended.
28 Taken from a standard form letter sent by the CRA to large-business taxpayers with respect to meeting to discuss the new risk-based audit approach.
9. **tax strategy**: consistency of the corporation’s tax strategy with the overall business strategy
10. **risk-management committee**: details of any risk-management committee, including its members, their roles, and whether the CRA can access minutes of the meetings
11. **top five tax priorities**: the corporation’s top five priorities with respect to tax
12. **other information**: an open discussion of any other information regarding tax risk that the taxpayer believes is relevant to the CRA’s understanding of the business and its risk assessment

**PREASSESSMENT REVIEW OF LARGE CORPORATIONS’ TAX RETURNS**

The CRA has recently begun reviewing T2 returns filed by large corporations prior to the issuance of an initial assessment. Although this review is not a regular audit, the requests for information from the CRA can be extensive and may include the following:

- an explanation as to why the depreciation of assets or the additions or deductions to the reserves reported on schedule 1 (net income/loss for income tax purposes) do not reconcile with amounts reported on the general index of financial information or the amounts reported on the taxpayer’s financial statements;
- a detailed breakdown of all lines included on schedule 1; and
- a revised schedule 8 (capital cost allowance) because the capital cost allowance claimed in certain classes appears to exceed the permitted rates and recapture information is incomplete.

According to the CRA, preassessment reviews are consistent with its move toward audit currency, and they provide the CRA with a more accurate risk assessment of the subject taxpayer.29 Such detailed requests are generally made by the large-file case manager, while automatic adjustments to filed returns (adjusting carryover balances, for example) resulting in the issuance of an initial assessment that differs from the return filed by the taxpayer are generated by the CRA’s initial assessing systems.

Goods and services tax registrants are also subject to enhanced preassessment reviews designed to assist the CRA in identifying high-risk cases.30 Such reviews may include requests for further information and documents regarding revenue sources and input tax credits claimed.

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29 Supra note 15, response to question 6.
Reportable Transaction Rules

New reportable transaction rules have recently been enacted in section 237.3 of the Act. An in-depth analysis of the rules is beyond the scope of this article. For our purposes, it is sufficient to summarize the reportable transaction rules as generally being triggered where two of three hallmarks contained in the definition of “reportable transaction” in new subsection 237.3(1) are present. These hallmarks reflect characteristics of certain aggressive tax-avoidance transactions, including contingency fees, contractual protection for the taxpayer with respect to the expected tax benefit, and confidential protection prohibiting any disclosure of the details of the transactions.

It is noteworthy that the failure of similar reportable transaction initiatives undertaken in the United States led to the implementation of the current filing requirements related to UTPs (discussed in a later section of this article). This is confirmation of the fact that tax authorities are monitoring the effectiveness of measures targeted at aggressive tax planning and may well pursue further initiatives where previous measures are considered ineffective.

Joint Audits with Foreign Tax Authorities

Another audit initiative of the CRA is to conduct joint audits with foreign tax authorities. According to the OECD, a joint audit represents a new form of coordinated action between tax administrations and involves the following:

- two or more countries joining together to form a single audit team to examine an issue(s)/transaction(s) of one or more related taxable persons (both legal entities and individuals) with cross-border business activities, perhaps including cross-border transactions involving related affiliated companies organized in the participating countries and in which the countries have a common or complementary interest;
- the taxpayer jointly makes presentations and shares information with the countries; and
- the joint audit team will include Competent Authority representatives, joint audit team leaders and examiners from each country.

The OECD has stated that joint audits should result in quicker issue resolution, more streamlined fact finding, and more effective compliance. Joint audits would also have the potential to shorten examination processes and reduce costs, both for revenue authorities and for taxpayers.

One of the goals of joint audits is to anticipate and resolve areas of potential audit disagreement by avoiding them in the first place, particularly in the area of transfer pricing.

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33 Ibid., at 2.
The CRA’s position is that a joint audit is a collaborative process in which tax authorities and the taxpayer should form a common understanding of the taxpayer’s circumstances, interpretations of transactions, and the significance and sufficiency of documentation. A joint audit is not an advance pricing agreement (though one could result from a joint audit) or a mutual agreement procedure under a tax treaty.34

The CRA is currently conducting a joint audit pilot project with the US Internal Revenue Service (IRS). One objective when performing such audits is to have the taxpayer and the tax authorities review, discuss, and agree to a transfer-pricing methodology, and memorialize any agreement with respect to transfer-pricing methodology for the audit years.

CONTEXTUAL CONSIDERATIONS
An essential recommendation of this article is that Canadian corporations should aim to align their participation in tax transparency initiatives with their best interests. This is consistent with the suggestion that reviews of corporate governance policies should be more than simply reactive.

However, we are not so naive as to suggest that Canadian corporations can entirely control the process. In fact they cannot. As already described, most of the CRA’s tax transparency initiatives impose compliance obligations.

In addition, there is a wider context. That context can be divided into three distinct areas: OECD initiatives, transparency initiatives adopted by other countries, and the political context. These are discussed in more detail below.

OECD INITIATIVES
As noted, the OECD has been a significant advocate of international tax transparency and has promoted the exchange of information between tax authorities for some time. There are various ongoing OECD initiatives that fall under the rubric of tax transparency.

In 2001, the OECD established the Global Forum on Tax Transparency and Exchange of Information for Tax Purposes. This organization has grown to include 116 member jurisdictions, the European Union, and 12 international organizations as observers. The global forum’s mandate is to ensure that all jurisdictions adhere to the same high standard of international cooperation in tax matters, the terms of which are set down in its terms of reference.35 The global forum conducts peer reviews of its member jurisdictions’ laws and practices with respect to the exchange of information with other tax administrations.

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In 2002, the OECD produced the Agreement on Exchange of Information on Tax Matters. This document is the template for hundreds of tax information exchange agreements (TIEAs) that have been entered into between countries around the world, pursuant to which information is shared between tax authorities. Confidentiality provisions with respect to information that is exchanged are also included in the OECD’s model TIEA.

In 2008, the OECD published the Study into the Role of Tax Intermediaries, which discusses how an enhanced relationship between tax authorities and taxpayers can result in a decreased demand for aggressive tax planning and how tax authorities that assess taxpayers’ compliance risk can more efficiently allocate their audit resources. For example, the study explains that while tax intermediaries (tax advisers) develop aggressive tax plans for their clients, it is the taxpayers who decide whether to implement such plans. Accordingly, taxpayers represent the “demand side of aggressive tax planning” while tax intermediaries represent the “supply side of aggressive tax planning.” In sum, “[i]f the demand can be reduced, the supply of aggressive tax planning would also fall.” To persuade taxpayers to enter into this relationship, the study suggests a carrot and stick approach, noting that taxpayers who opt to disclose to the tax authorities only information that is required by law risk a higher risk-assessment rating and thus higher audit compliance costs. At the same time, the study urges tax authorities to assist taxpayers that do participate in the enhanced relationship by offering earlier disclosure and resolution of tax issues (through rulings or otherwise), preferably in real time.

The study also provides an outline of the OECD’s recommendations for the establishment of an enhanced relationship between tax authorities and taxpayers and for risk-assessment procedures (using similar factors to those now cited by the CRA with respect to its risk-based audit program). For example, the study notes that

[a] key theme from consultations was a demand that, in order for taxpayers to provide this level of [enhanced] disclosure, revenue bodies should provide detailed rules on their requirements. The Study Team does not share this view and believes that a relationship based on trust and openness cannot be based on detailed rules; it must be based on broad principles. Countries with initiatives based on enhanced relationship concepts . . . have not used rules-based frameworks but have left the parties to establish the appropriate level of disclosure.

37 Supra note 13.
38 Ibid., at 5.
39 Ibid., at 6.
40 Ibid., at 41.
41 Ibid.
Other suggestions include the following mechanisms that may assist in building the enhanced relationship:

- **A unilateral statement or declaration by the revenue body setting out how it intends to work.** 42 This would include what the revenue body asks of taxpayers and tax advisers, and the consequences for them if they do not provide what is asked for. It would then be for taxpayers to decide how to respond.

- **A charter adopted jointly by or on behalf of all stakeholders setting out how all participants intend to work together.** 43 This would include what all the participants—the revenue body, taxpayers, and tax advisers—are expected to do and the consequences for each of them if they do not meet those expectations.

- **A formal or informal agreement between the revenue body and a specific taxpayer.** Each agreement could be tailored to suit the specific needs of the particular taxpayer. The agreement could specify how the revenue body and the taxpayer intend to work together and how the agreement could be terminated.

In 2009, the Group of Twenty (G20) affirmed their commitment to tax transparency, stating:

We stand ready to take agreed action against those jurisdictions which do not meet international standards in relation to tax transparency.44

We agree . . . to take action against non-cooperative jurisdictions, including tax havens. . . . We note that the OECD has today published a list of countries assessed by the Global Forum against the international standard for exchange of tax information.45

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42 As noted ibid., at 46, footnote 3, “Switzerland has a ‘Code of Conduct for Tax Authorities, Taxpayers and Tax Advisers’ [sic]. This code of conduct provides a very basic list of ‘dos’ and ‘don’ts’ which apply not only with respect to communications between tax advisors and the tax administration, but ultimately with respect to any citizen approaching an administrative authority. The Code of Conduct is supported by the Federal Tax Administration, by cantonal tax administration, and by the ‘Schweizerische Treuhandkammer.’ A copy of the code of conduct can be found at: [www.estv.admin.ch/dokumentation/00078/00733/index.html?lang=en]. In addition the Study Team also noted the 2006 draft code of conduct developed by KPMG’s Tax Business School which sets out to develop a ‘voluntary code of conduct focused around behaviours [to] help set the environment for trust. The [code] could regulate the behaviour of taxpayers, tax collectors and tax advisers and could be devised and regulated by that group.’ David F. Williams for KPMG’s Tax Business School, A Code of Conduct for Tax, October 2006, at 4.”

43 For example, this is broadly the approach used by the Netherlands in horizontal monitoring and by the United States in its compliance assurance program (CAP).


Since 2009, hundreds of TIEAs have been entered into by countries across the world and the OECD’s global forum has been active in conducting peer reviews of countries’ tax transparency laws and practices. Other reported results of the global forum’s peer reviews are that, in response to the forum’s recommendations, member jurisdictions have introduced amendments to their laws that include the following:

- the end of strict bank secrecy laws for tax purposes;
- the elimination of practices such as domestic tax interest requirements, which prevented effective exchange of information; and
- the elimination or immobilization of bearer shares in a number of countries, as well as the elimination of other non-transparent practices (such as failing to require that enterprises keep proper accounting records).

In addition to establishing guidelines for governments and tax administrations to achieve greater tax transparency, the OECD follows the various tax transparency initiatives that are being undertaken by tax administrations across the globe. It has summarized many of those initiatives in a recent report, thereby keeping tax authorities informed about policies and strategies being pursued in other jurisdictions.

The reviews of countries’ tax transparency laws and practices undertaken by the OECD’s global forum have, to date, been evaluated on the basis of an information exchange upon request, as the international standard. The OECD prepared a report for the Group of Eight (G8) summit in June 2013, analyzing how nations might implement a new automatic exchange standard in a multilateral context. On June 18, 2013, the G8 agreed to commit to the establishment of the automatic exchange of information between tax authorities as the new global standard, and to work with the OECD to develop a multilateral model to implement this standard.

46 The OECD publishes each countries’ review results online: www.oecd.org/tax/transparency.
**Tax Transparency Initiatives in Other Jurisdictions**

A variety of tax transparency initiatives have been adopted in other jurisdictions. Below we provide a few examples of initiatives introduced by the respective tax administrations of the United States, the United Kingdom, and Australia.

The success or failure of such initiatives is monitored by other OECD nations, including Canada.

**United States—Uncertain Tax Positions**

A UTP is, generally, an item for which the tax treatment is unclear or is a matter of dispute between the taxpayer and the tax authority. A UTP may be recorded in a taxpayer’s financial statements as a current or deferred tax asset or liability, depending on the circumstances (such as whether the UTP affects the cost base of an asset) and depending on the applicable accounting standards followed by the taxpayer.

The United States now requires certain taxpayers with $50 million in assets (reduced to $10 million in assets as of 2014) to file form 1120 (known as “schedule UTP”) with their US income tax return listing their UTPs in circumstances where the taxpayer or a related person has recorded a reserve in its audited financial statements with respect to such position or expects to litigate a tax position. Schedule UTP does not require that any amount with respect to the UTP be disclosed, but it does require that UTPs be ranked in order of size and that a brief description of the tax position, relevant facts, relevant statutory provisions, and information describing the nature of the issue be provided.

The IRS has provided some comfort to taxpayers that it generally will not assert that privilege has been waived by a taxpayer where an otherwise privileged document has been provided by the taxpayer to its independent auditor for purposes of assisting the auditor in determining the adequacy of the reserves for contingent tax liabilities recorded in the taxpayer’s audited financial statements.51 The IRS has also assured taxpayers that it will not routinely share information reported on schedule UTP with other foreign tax authorities; however, such information sharing may be required where a reciprocal arrangement with the foreign tax authority applies and where such information is relevant for the foreign tax authority. In the IRS’s view, the latter factors would not be present in many cases.52

The IRS has released statistics for the first two years of schedule UTP filing, and the numbers indicate that 1,677 taxpayers (out of more than 5,000 public corporations) reported an average of 2.5 positions per schedule UTP filed with respect to the 2011 taxation year.53 This indicates that the majority of large US corporations did not file schedule UTP on the basis that they did not have any UTPs to report.

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51 See IRS Announcement 2010-76, 2010-41 IRB 432.

52 See IRS Announcement 2010-75, 2010-41 IRB 428.

United Kingdom—Senior Accounting Officer Certification

As previously mentioned, the United Kingdom has introduced regulations requiring the SAO of certain large qualifying companies to certify annually that he or she has established and monitored accounting arrangements capable of supporting accurate tax returns across all major taxes. Penalties may be assessed to both the company and the SAO personally for non-compliance.

Very generally, a qualifying company must be incorporated in the United Kingdom in accordance with the Companies Act 2006 and must exceed a particular turnover and/or balance sheet total amount (generally, a turnover amount of more than £200 million and a balance sheet total of more than £2 billion) for the preceding financial year. Where a company is a member of a group, the responsible officers must aggregate the company’s turnover and/or balance sheet totals with those of other UK incorporated companies in the same group to determine whether it is a qualifying company.

An SAO is the director or officer of a company who, in the company’s reasonable opinion, has overall responsibility for the company’s financial accounting arrangements. Each qualifying company must identify its SAO.

The SAO must carry out a main duty to ensure that the company establishes and maintains appropriate tax accounting arrangements to allow tax liabilities to be calculated accurately in all material respects. The SAO must also file with HM Revenue & Customs (HMRC) a certificate for a financial year stating whether the company had appropriate tax accounting arrangements. If the company did not have appropriate tax accounting arrangements, the SAO must explain what the shortcomings were.

A penalty may be imposed

- on a qualifying company if it fails to notify HMRC of the name of its SAO;
- on the SAO if he or she fails to meet his or her main duty (though a defence is available if the SAO has a reasonable excuse); or
- on the SAO if he or she fails to give HMRC a certificate within the required time, or if he or she provides a certificate that contains a careless or deliberate inaccuracy.

The United Kingdom has also imposed a risk-based approach to tax audits, which the SAO provisions complement by virtue of their focus on making a company’s tax-risk management a continuously important issue at the senior management level.

HMRC has stated that the requirement that the SAO take reasonable steps to ensure that the company establishes and maintains appropriate tax accounting arrangements will in general

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54 See supra note 12.
55 (UK), 2006, c. 46.
involve the SAO having in place mechanisms for identifying, on an ongoing basis, the risks which might result in the tax returns not being accurate in all material respects and ensuring that processes and controls are in place for managing and monitoring these risks.\textsuperscript{56}

HRMC has also stated:

We expect CRMs [customer relationship managers] to continue to discuss what the SAO is doing to discharge their responsibilities as part of maintaining their understanding of the business and carrying out the Business Risk Review. These discussions might include:

- How the business has identified and managed any significant tax risks arising from a particular major business or legislative change;
- The process the business has for ensuring the sensitive decisions taken outside the tax function are consistent with the organisation’s tax policy;
- How the tax policy is communicated throughout the organisation and how adherence to this is monitored.\textsuperscript{57}

Consequently, the SAO regulations are one more initiative being pursued to enhance taxpayer transparency to the revenue authority, to raise the importance of tax-risk management on the corporate governance agenda, and ultimately to change the corporate culture and attitude with respect to tax-risk management.

**Australia—Publication of Tax Paid by Large Corporations**

Australia recently announced and enacted a statutory requirement that otherwise private tax information of large corporations be published for public viewing. Specifically, the name, business number, total income, taxable income, and tax payable of any corporate tax entity with total income of A$100 million or more, or with any minerals resource rent tax or petroleum resource rent tax, is now required to be published.\textsuperscript{58} The stated objective of this proposal is to enable the public to better understand the corporate tax system and engage in tax policy debates, as well as to discourage aggressive tax-minimization practices by large corporate entities.\textsuperscript{59}

\textsuperscript{56} United Kingdom, HM Revenue & Customs, “Senior Accounting Officer (SAO): Core Script for Customers [sic] Relationship Managers (CRMs)” (www.hmrc.gov.uk/large-businesses/sao-script.pdf).

\textsuperscript{57} Ibid.

\textsuperscript{58} See sections 3C, 3D, and 3E of the Taxation Administration Act 1953, No. 1, 1953, as amended.

In response to this proposal, the Tax Institute has stated:

The Assistant Treasurer’s media release of 4 February 2013 notes that transparency will “allow the public to better understand the business tax system and engage in debates about tax policy.”

However, the tax system is complex and contains a multitude of bespoke tax treatments and concessions that have been specifically developed over time in conjunction with Government policy.

There is a high risk that the disclosed information will result in misunderstanding, especially without the necessary context about the business tax system and the particular facts and circumstances of the company. That is, the proposed disclosures risk causing widespread confusion rather than illumination, ultimately detracting from the objective of tax transparency.60

The Tax Institute also noted that

it is our view that an appropriate rate of taxation can only be imposed on such profits via well-conceived and drafted tax laws, and in conjunction with our international treaty and trading partners. That is, a taxpayer’s obligation to pay their “fair share” of tax in Australia cannot be imposed via any means other than clearly defined laws, as made by the Australian Government. Taxpayer obligations should begin and end with compliance with the tax law.

We concur with the view that our taxation laws should reflect the values of the taxpaying community. As such, we welcome an informed debate about the appropriateness of current tax settings as well as the merits of any changes to our tax system being considered.

Transparency as to the tax affairs of certain taxpayers may assist in informing such a debate—if the information is meaningful, relevant and explained and debated in context.61

Despite these concerns, the Australian Parliament moved swiftly to introduce this initiative and to enact it as law.62

Political Context

As previously noted, arguments about corporate responsibility and even morality have accompanied calls for improved tax transparency in certain public interest and political spheres. Underlying the public pressure is the contention that aggressive tax-avoidance planning is pervasive among corporations.

61 Ibid., at 1.
In the United Kingdom, a number of tax-avoidance practices have been highlighted by public interest groups as being particularly egregious, and there is at least some evidence of reputational damage suffered as a result of public pressure. There seems to be little doubt that corporations are paying more attention to tax transparency initiatives, both from a corporate governance perspective and from a public relations perspective.

In response to public and political pressure, Starbucks UK announced in late 2012 that it would decline to claim available deductions for certain intercompany charges in 2013 and 2014 and would make a $16 million payment to HMRC in each of the next two years, over and above its lawful corporate tax liability.63

The very effort to place responsibility for tax-risk analysis on higher-level corporate managers is based on the view of tax authorities that such management-level responsibility will necessarily cause corporations to become more circumspect and less prone to engage in off-the-shelf tax-avoidance planning.

Some reactions to efforts to curb aggressive tax-avoidance planning through tax transparency initiatives reveal underlying tensions between corporations and tax authorities, with some commentators pointing to the importance of the rule of law in governing the relationship between taxpayers and tax authorities.64

There has been no suggestion in the extensive media coverage of the Starbucks matter that the company avoided the lawful determination of its tax liability. It is noteworthy that the United Kingdom is in the throes of public debate related to the introduction of a general anti-avoidance provision.

It is important to note that in Canada there are numerous examples of situations where the CRA has argued that corporate taxpayers have engaged in abusive tax avoidance and the courts have disagreed. As the Supreme Court of Canada observed in its recent decision in Copthorne,

> [t]he most difficult issue in this case is whether the avoidance transaction was an abuse or misuse of the Act. The terms “abuse” or “misuse” might be viewed as implying moral opprobrium regarding the actions of a taxpayer to minimize tax liability utilizing the provisions of the Income Tax Act in a creative way. That would be inappropriate. Taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability (see Duke of Westminster).65

One might suggest that certain elements of tax transparency equate to an attempt by tax authorities to make an end run around principles articulated in the Duke of


65 Copthorne Holdings Ltd. v. Canada, 2011 SCC 63, at paragraph 65 (emphasis added).
The Westminster decision. The Supreme Court of Canada has confirmed the legitimacy of such principles on a multitude of occasions. Recently, the Federal Court of Appeal held that allegations of egregious or repulsive conduct and assertions of immorality are not relevant to considerations of whether expense should be disallowed under the Act.

At the 2011 Canadian Tax Foundation annual conference, a CRA representative remarked that

[in the private sector, your objective is to try to minimize taxes for your client; in government, it is to make sure that, in our opinion, the right amount of tax is assessed. Those are two diametrically opposed views.]

In this context it is not trite to point out that Canada values the rule of law and thus should not allow extraneous considerations to enter into the debate about the lawfulness of tax-planning initiatives. It is also correct to point out that the CRA should not adopt policies that introduce unacceptable levels of discretion, in a manner that is inconsistent with established legal principles. In the end, it is the legal amount of tax that is germane.

There is a tremendous amount of subjectivity involved in tax authorities’ concluding that the prevalence of unacceptable tax-avoidance schemes requires an extrajudicial administrative response based on considerations of what is the “right” amount of tax. Certainly one would expect that tax authorities would have their own views about the abusive nature of particular planning schemes. However, in the many GAAR cases that have come before the courts, the CRA’s views of abusive tax avoidance have not always carried the day.

Nevertheless, political debate in some circles would entirely dismiss the notion of legal compliance with tax obligations in favour of subjective notions of fair, per-country, taxation. Given the developments described above, political context needs to be kept in mind, and governance policies should look to ensure that corporations adopt practices that can withstand public scrutiny.

ESTABLISHING ENHANCED RELATIONSHIPS: OPPORTUNITIES AND OBSTACLES

Notwithstanding the international political context, it is important to realize that the CRA has a real interest in establishing enhanced and mutually beneficial relationships with Canadian corporations.

68 Mar et al., supra note 24, at 3:2.
Yet there are real challenges for Canadian corporations in deciding to enter into an enhanced relationship. Even in the case of corporations that adopt governance practices that are consistent with the CRA’s recommendations, there is no assurance of receiving broad levels of reciprocal benefits.

Beyond the savings that low-risk corporations might realize from limited compliance reviews, current CRA practices suggest that there are limited benefits that can result from an enhanced relationship. We note the following points:

- There have been no announcements of new practices adopted to ensure expeditious review of transactions that involve an element of uncertainty and that are brought forward on a voluntary basis.
- There have been no announcements of changes to the CRA’s rulings processes that would apply to low-risk taxpayers.
- There continue to be a large number of open tax years for Canadian corporations relating to unresolved audits or disputes, and no announcements of CRA practices that would seek to address this issue for low-risk taxpayers.
- The CRA has not made a meaningful commitment to discussions about alternative dispute resolution procedures, even though the implementation of such procedures could serve to reduce the number of active appeals before the Tax Court and thereby allow the CRA to focus on speedier resolution of significant disputes.
- The CRA has not yet, in any substantive way, adopted real-time audit practices even for low-risk corporations.

Moreover, as regards the CRA’s practice of measuring “tax earned by auditor” (TEBA), the Tax Executives Institute (TEI) at its 2011 TEI-CRA liaison meeting pointed out that

> [o]rganizational behaviour theory posits that the behaviour of individuals and groups is strongly influenced by the metrics used to measure performance. In other words, “you get what you measure.” TEBA is a metric used by CRA to evaluate and allocate audit resources to individual Tax Services Offices (TSOs), TEI questions whether TEBA is an appropriate metric to motivate auditors and TSOs to perform in the best interests of the Agency.\(^70\)

In response, the CRA stated:

> TEBA, is only one component of the overall measurement framework used to evaluate taxpayers’ compliance rate, as well as the performance of the Audit program in the Agency. No individual quotas are assigned to any auditor.\(^71\)

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\(^70\) Supra note 17, at question 8.

\(^71\) Ibid., response to question 8.
However, despite the CRA’s insistence that its auditors are not assigned any TEBA quota, skepticism in the minds of tax practitioners appears to persist.72

It is also noteworthy that other international jurisdictions have adopted enhanced relationship programs with a broader range of benefits. Recently, questions have been raised as to the availability of government resources to ensure the success of their programs. In the United Kingdom, it has been suggested that if an enhanced relationship program were to be adopted that merely required taxpayers to devote more resources to make disclosures, with little added benefit, it is unlikely that the program would work.73

CONCLUSIONS

If “tax governance” can be viewed as corporate governance related to tax, it is clear that corporations should review their tax governance processes to ensure that they focus on actively managing tax-risk items. Certainly, this goes beyond the types of frameworks and controls that ensure that reporting is accurate and that filings and elections are made on a timely basis.

Keeping in mind the current political context, corporations need to be concerned about managing tax risks not simply because of the potential financial implications in the event of significant tax reassessments, but also because of the potential reputational risks. Addressing these concerns is a multifaceted effort, requiring better communications between tax functions, business functions, legal functions, and even public relations functions. The processes should ensure that such communications are brought before the board and senior management, so that appropriate decisions can be made as to the management of risk.

However, decisions about management of risk should also be informed by the true legal reasons for the tax risks in the first place. Are the risks related to unclear interpretation of statutory provisions? What are the policy reasons underlying the provisions in issue that have led to tax benefits? Can the CRA be shown to be taking an assessment position that is inconsistent with public policy objectives, or even with the case law? Overall, there is often more to the story than might be gleaned from allegations of aggressive tax planning.

Corporations should be prepared to point out, if necessary, that responding to tax risks and managing tax risks can often be frustrated by inordinately long delays in obtaining assurance from the CRA as to transactions with uncertain tax consequences. In addition, a strained dispute resolution process often hampers the expeditious management and resolution of legitimate UTPs.

72 See Mar et al., supra note 24.

Corporations should also strive to ensure that the CRA has a clear understanding of their business functions and corporate objectives. To this end, they should take steps toward an enhanced relationship with the CRA. To the extent that corporations choose to voluntarily disclose uncertain or risky items to the CRA, they should do so on the explicit understanding that the CRA will agree to quickly take a position on the matter and agree to be bound by a favourable ruling, or otherwise will agree to the expeditious resolution of any disputes flowing from the disclosure.

To the extent that Canadian corporations must be more vigilant in anticipating reputational issues related to tax, they will be assisted by

- documented governance processes related to tax-risk management,
- implementation of controls that allow for full consideration of all facts and legal considerations,
- documented efforts to expeditiously resolve disputes that they have undertaken, and
- in some circumstances, a well-developed public relations and communications strategy on matters relating to taxes.

However, what is more important to the effective administration of the Canadian tax system is that large corporations and the CRA work diligently and in good faith toward developing and maintaining mutually beneficial enhanced relationships. A strict focus on reputational issues related to tax will simply not produce the benefits that are achievable through enhanced relationships. Reduced levels of off-the-shelf planning may indeed result, but it is doubtful that the goals of a more efficient allocation of audit resources and the collection of higher levels of tax revenue will be realized.

Hugh Ault is one of the leading thinkers in the field of international taxation. In this brief article, he reflects upon the origins of the current international tax principles; identifies some of the reasons for the growing problem of double non-taxation; explains the role of the Organisation for Economic Co-operation and Development (OECD) and its recent work on transparency, exchange of information, and base erosion and profit shifting (BEPS); and offers insights on solving the problems of BEPS.

Ault traces the sources of the current international tax principles to the work of the League of Nations in the 1920s. In particular, he quotes the following statement in a 1927 report prepared by the league’s Committee of Experts on Double Taxation and Tax Evasion: “The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and only once.”1 Ault notes, however, that subsequent developments focused more on providing for the relief of double taxation than on ensuring that double non-taxation does not take place. Tax competition among countries is one of the reasons for such developments. According to Ault, some countries welcomed the creation of tax-planning structures that reduced the tax burden on their multinational enterprises operating in foreign countries, and they facilitated double non-taxation in order to enhance tax competitiveness.

Ault points out that it was only recently that the problem of double non-taxation caught the attention of politicians. Companies such as Starbucks, Amazon, Google, General Electric, and other non-US-based companies were identified by the media as having very low effective tax rates. This occurred at a time when governments were enacting austerity programs, facing budget deficits, and raising value-added tax rates on ordinary consumers. Political leaders in the Group of Eight (G8), the Group of Twenty (G20), and the OECD, with affiliations across the political spectrum, generally agree on the need for change in international tax rules and on giving the

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1 At 1195, quoting from the report prepared by the Committee of Experts on Double Taxation and Tax Evasion (League of Nations Publications, 1927), at 23.
OEC a timetable to produce technical analyses and proposed plans of action. Notably, the OECD took relatively little time to generate its recent BEPS report.2

How can countries address the BEPS problem? In Ault’s view, the OECD is the appropriate forum to which to turn for a solution, even though it lacks the political breadth of the United Nations (UN). As Ault points out, the UN does not have the necessary technical knowhow or experience to carry out the difficult technical analysis that the BEPS issues demand. It is necessary to go back to some fundamental and unresolved questions regarding the basis on which taxing rights are allocated. For example, what is the scope of source taxation? More particularly, what constitutes “source” for tax purposes? At present, there is no clear economic definition or well-defined legal concept of source. Ault suggests that

what we really should have is an updated set of the “Four Wise Men” who are credited with the development of the basic pattern of rules that we have been operating under since the League of Nations work in the 1920s.3

J.L.


The report on revised section E on safe harbours in the OECD’s transfer-pricing guidelines, approved for release in May 2013, provides new guidance on safe harbours to enable countries to reduce transfer-pricing compliance costs. It also provides greater certainty for cases involving smaller taxpayers or less complex transactions.

According to the OECD, this report represents a change in the OECD’s stance on the use of safe harbours. Its previous guidance had a somewhat negative tone regarding transfer-pricing safe harbours. That tone, however, did not accurately reflect the practice of OECD member countries, a number of which have chosen to include safe-harbour provisions in their transfer-pricing regimes. The new guidance set out in the report encourages the use of bilateral or even multilateral safe harbours in order to minimize compliance costs without creating problems of double taxation or double non-taxation. To facilitate negotiations between tax administrations, the report includes sample memorandums of understanding (MOUs) for competent authorities to establish bilateral safe harbours for transfer-pricing cases involving low-risk manufacturing services, low-risk distribution services, and low-risk research and development (R & D) services.


3 At 1201. The “four wise men” were Professor Edwin Seligman (of the United States), Sir Josiah Stamp (of the United Kingdom), Professor G.W.J. Bruins (of the Netherlands), and Professor Luigi Einaudi (of Italy).
A “safe harbour” in the context of a transfer-pricing regime is defined as

[a] provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country’s general transfer pricing rules.4

It is a substitute for more complex obligations under the general transfer-pricing regime. For example, a safe harbour could allow taxpayers to establish transfer prices by applying a simplified transfer-pricing approach provided by the tax administration. A defined category of taxpayers or transactions may be exempted from the application of all or part of the general transfer-pricing rules, such as documentation requirements. However, the report clearly states that safe harbours do not include administrative simplification measures that do not directly involve determination of arm’s-length prices, such as simplified documentation requirements, or exemption from such requirements, in the absence of a pricing determination.

As to the pros and cons of safe harbours, the report identifies the benefits of safe harbours as including simplification of compliance, greater certainty, and administrative simplicity. The main concerns with the use of safe harbours include inconsistency with the arm’s-length principle in reporting taxable income, increased risk of double taxation or double non-taxation when such provisions are adopted unilaterally, facilitation of inappropriate tax planning, and issues of equity and uniformity. In cases involving smaller taxpayers or less complex transactions, however, the report maintains that the benefits may outweigh the problems. It recommends that countries manage any concerns through the negotiation of bilateral or multilateral safe harbours.

The report includes three sample MOUs that are intended to facilitate bilateral safe-harbour negotiations. Each sample contains the following key elements:

- a preamble;
- a description of a “qualifying enterprise” that specifies what the enterprise shall not or may not do;
- a description of “qualifying transactions”;
- determination of the taxable income of the qualifying enterprise on the basis of a percentage (within a specified range) of the total costs of a low-risk manufacturing services enterprise or a low-risk R & D services enterprise, or a percentage of the total net sales of a low-risk distribution services enterprise;
- agreement between the competent authorities that the qualifying enterprise in one contracting state does not give rise to a permanent establishment of its associated enterprise resident in the other contracting state;
- elections and reporting requirements; and
- conditions for termination of the agreement.

4 Paragraph 4.100 of the revised section.
The new guidance on safe harbours should be welcomed by taxpayers, especially contract manufacturers, contract distributors (or commissionaires), and contract R & D providers. There has been increasing concern about the use of these arrangements to shift profits away from the country where activities are conducted.

J.L.


The OECD prepared this report at the request of the G8 for the Lough Erne summit in June 2013. It outlines four concrete steps needed to put in place a global, secure, and cost-effective model of automatic exchange of information (EOI). The G20 finance ministers had already endorsed such a model as the new standard, at their meeting in April 2013. The rationale seems to be clear: since tax evasion is a global issue, a global solution is required. A global model minimizes costs of administration and compliance, and is in every country’s interest.

The four steps set out in the report are as follows:

1. enacting broad framework legislation to facilitate the expansion of a country’s network of partner jurisdictions;
2. selecting the legal basis for automatic EOI;
3. adapting the scope of reporting and due diligence requirements, and coordinating guidance; and
4. developing consistent or compatible information technology standards.

Each step has a potential time frame. As to step 2, the report suggests that the Convention on Mutual Administrative Assistance in Tax Matters and bilateral tax treaties should provide a clear legal basis for comprehensive automatic EOI with safeguards protecting confidentiality. Within the European Union, directives provide a specific legal framework for automatic EOI regarding interest income and certain other types of income between EU members.

The proposed new standard of automatic EOI is part of the global initiative in addressing the problem of tax-base erosion through profit shifting by multinational corporations. The OECD sees itself as having a clear mandate from the G8 and the G20 to take a leadership role in this area.5

J.L.

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5 See the discussion in the review of Ault’s article above, and supra note 2.
Starbucks is one of several multinational corporations that have recently come under public scrutiny with respect to their strategies for shifting income to low-tax jurisdictions—or, as Kleinbard puts it, creating “stateless income.” In this article, Kleinbard uses Starbucks as an example of stateless-income tax planning to show how income may be subject to tax (if at all) only in a jurisdiction that is neither the source of the factors of production through which the income was derived nor the country of residence of the corporate group’s parent company. In particular, Kleinbard demonstrates the central role that intangibles play in stateless-income tax planning, and the ease with which multinational firms can turn a simple business model into intangible assets for which royalties must be paid:

The idea that a subsidiary can own intangibles developed by the parent and harness them to commercial use without subjecting the income they generate to tax where the business and customers actually are located is the core reason that base erosion cannot be addressed unless the OECD member states dismantle their traditional institutional acquiescence to conspicuously non-commercial modes of business organization.6

Kleinbard draws two lessons from the Starbucks case study. The first lesson is quite alarming: If Starbucks can organize itself as a successful stateless-income generator, any multinational firm can. Kleinbard notes that as a roaster, marketer, and retailer of specialty coffee, Starbucks follows a classic bricks-and-mortar retail business model and is not driven by hugely valuable identifiable intangibles that are separate from its business model. The second lesson relates to the fundamental opacity of international tax planning. According to Kleinbard, neither investors in a public firm nor the tax authorities in any particular jurisdiction have a clear picture of what that firm is up to. Indeed, it is not even realistic to expect a source country (the United Kingdom in the case of Starbucks) to evaluate the probative value of a multinational enterprise’s claim that its intragroup dealings necessarily reflect the arm’s-length principle by virtue of alleged symmetries in tax treatment of expense and income across the group’s affiliates.

Kleinbard suggests that the remedy begins with genuine transparency. National governments should recognize their common interest in combatting stateless-income tax planning and require their tax and securities agencies to promulgate rules providing a uniform worldwide disclosure matrix for actual tax burdens by jurisdiction. Kleinbard makes it clear that tax transparency is not a substitute for substantive reform of the international tax regimes, but argues that it would awaken the public and politicians to the massive amounts of tax avoidance known only to tax specialists today. As far as the United States is concerned, as a starting point, the geographic source-of-income rules should be developed to reflect the economic source of income

6 At 1526.
and should be protected “at every turn from tax slicing and dicing through arbitrary intragroup structures for the siting of group intangibles or capital.”

J.L.


Drawing on the literature on optimal tax theory and Weisbach’s extension of the theory to line drawing in the tax law, this paper proposes four principles to deal with the problem of behavioural distortion and illustrates the application of those principles to the problems of income shifting by multinational corporations. Seto raises some interesting points for consideration in undertaking substantive tax reforms.

Seto identifies four specific problems of distortion in the current US taxation of multinational corporations that have resisted solution for decades. First, with respect to the rules that apply where a multinational group distributes any part of its earnings upstream, the US tax law appears to treat multinationals with a US parent less favourably than their foreign competitors. Second, the US tax law provides significant incentives for multinational corporations to locate plant, personnel, and other productive capacity offshore. Third, the law creates strong incentives to use transfer pricing and other income-shifting techniques to move income artificially from US to foreign members of the multinational group. Fourth, the 35 percent tax on repatriation of foreign subsidiary income to US parents clearly inhibits such repatriation.

What are the possible causes of and solutions to the above problems? Seto suggests that the cause is the violation by the current rules of the principle of relative indifference and its corollaries. For example, while multinational corporations are indifferent as to where the parent company is incorporated, the tax law uses place of incorporation as a basis for claiming tax jurisdiction. The solution is to subject all multinational groups to the same US rules. Similarly, while multinational corporations are indifferent as to which member of the group earns the income, the tax law attributes income to each member, and that is why transfer pricing has long been, and remains, a major problem. The solution is to subject corporate profits to the same taxes regardless of where within the group profits are formally located.

Seto proposes a structure for the tax system that ignores factors to which multinationals are relatively indifferent and instead taxes whatever it is that multinationals seek to maximize. One factor that multinationals want to maximize is sales.

7 At 1535.

The four principles he proposes are the following:

1. Tax liability should not turn on factors to which the taxpayer is relatively indifferent.
2. The least distortive tax base for any taxpayer is whatever that taxpayer would seek to maximize in the absence of taxation.
3. If what the taxpayer would seek to maximize in the absence of taxation is a number already computed for non-tax purposes, tax administration costs will be minimized if the tax base equals that reported number.
4. Taxpayers should be classified for tax purposes by reference to whatever it is that they would seek to maximize in the absence of taxation.

Seto maintains that consistent application of the above principles should result in rules that minimize distortions and sheltering of income. The idea that tax should be imposed on what taxpayers actually care about is intuitively appealing. The current international tax rules, such as transfer pricing, are divorced from business reality by attaching a premium to factors that taxpayers would not care much about in the absence of taxation.

J.L.


These two papers discuss possible responses to the problem of international income shifting from a US perspective.

The paper by Gravelle provides a good overview of the problems of income shifting by US-based multinational enterprises and tax evasion by US citizens. Gravelle identifies the key US tax rules relied upon by taxpayers in tax planning, such as the “check-the-box” provisions. According to Gravelle, most proposed reforms to address profit shifting would involve

- changing the tax law, such as repealing or limiting deferral;
- limiting the ability of the foreign tax credit to offset income;
- reforming the check-the-box provisions; or
- adopting formulary apportionment.

The paper by Grubert and Altshuler evaluates various proposals for the reform of the US international tax system, including
• dividend exemption;
• full current inclusion;
• a type of dividend exemption (modelled on the approach adopted in Japan) with an effective tax rate test subject to an exception for an active business;
• a dividend exemption coupled with a minimum tax; and
• repeal of the check-the-box rule.

In particular, Grubert and Altshuler consider two versions of dividend exemption with a minimum tax: a country-by-country minimum tax, and a minimum tax based on overall foreign income. To compare these proposals with the current law, the authors re-evaluate the efficiency cost of the dividend repatriation tax and find that the burden of avoiding repatriation is higher than that found in previous studies, particularly for profitable high-tech foreign businesses. They find that the minimum tax with expensing for real investment has many advantages. The minimum tax is basically a tax on large excess returns in low-tax jurisdictions, and it would be more effective in discouraging income shifting than repeal of the check-the-box rule. Between the two versions of minimum tax, Grubert and Altshuler suggest that the overall version deserves serious consideration, since it is much simpler.

The minimum tax on multinational corporations is an interesting idea. This type of tax has been imposed in a domestic context as an anti-avoidance measure in Canada and other countries. It will be interesting to see if it receives the kind of consideration in the United States that is suggested by Grubert and Altshuler.

J.L.


This article is a thoughtful examination of the meaning of “intangibles” and “ownership” in the context of transfer pricing generally and, in particular, the OECD’s 2012 discussion draft on revisions to the treatment of intangibles under its transfer-pricing guidelines.⁹

The meaning of “intangibles” and “ownership” is of fundamental importance in international tax law. In the ordinary world of business or economics, corporations enter into transactions in the marketplace with a view to maximizing their own profit. The prices fixed through contracts represent the value of the exchange and the bargain agreed to by parties that have adverse interests. In such a world, contractual prices, transactions, and ownership of property are important to the parties,

and are recognized and protected by law. The law provides the framework for the integrity of the exchange and protects the value of such exchange. Tax law takes the profits of each corporation as a starting point.

Different considerations come into play in the world of transfer pricing, where transactions take place between members of a multinational corporate group. In that world, it is not the price of intragroup transfers or the profit of individual members that matters, but rather the overall profit of the composite firm. Even though members of the firm may use contracts and enter into transactions, the contractual prices do not necessarily represent the value of the exchange. While the firm is indifferent as to prices or the resulting profit to each specific member, tax law focuses on the profit of each member. When the firm’s profit arises from something of value that only the firm possesses, such as goodwill or knowhow (“intangibles”), national tax laws struggle with determining the appropriate value and allocating it to the relevant jurisdictions.

The OECD’s transfer-pricing guidelines\(^\text{10}\) suggest ways to capture the economic value that is inherent in a firm even though that value may not necessarily be transferred according to typical transactions on which transfer-pricing analysis generally depends. The guidelines use terms, such as “intangibles” and “ownership,” that may not be easily transplanted into national tax laws, which generally defer to private law for the meaning of such terms. In this article, Wilkie unpacks the meaning of “intangibles” and “ownership” “inside the box” (according to the OECD transfer-pricing paradigm), explains the relevance of the meaning of these terms “outside the box” (in general law), and identifies ways of interpolating “the box” into the domestic tax laws of OECD member countries.

Wilkie describes the transfer-pricing paradigm as “the practical encapsulation of the arm’s length standard given its contemporary and conventional existence by the Transfer Pricing Guidelines.”\(^\text{11}\) He suggests that the paradigm rests on two fundamental propositions:

1. Observable “transactions” take place between counterparts that convey a property or limited rights to the use of that property from one party to the other, or that involve the provision of services.
2. Such transactions should take place without distortions induced by common ownership of the parties.

The paradigm adopts various guidelines to test related parties’ dealings according to independent “like” arrangements thought to be comparable. The paradigm requires the existence of transactions, and will hypothesize the existence of transactions if they would not otherwise exist.

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11 Wilkie, at 226.
The transfer-pricing “box” seems to contain three dimensions:

1. What is a “transaction”?
2. What is the object of that transaction?
3. What does “transfer” mean?

In the context of transfer pricing,

a “transaction” is a legally effective exchange between two parties through a contract of some kind, by which each parts with and acquires something that in the mind of the other is of equivalent value.12

The “something” is an element of “property”—either an object of a typical kind or “rights” in relation to such an object. That object can be defined such that the contracting parties can identify it and access to it by others is excluded. There is a generally acknowledged and observed concession that rights to an object are not “at large.” Thus, a “transaction” involving property seems to have three hallmarks: the existence of property, transferability by way of compensated exchange, and exclusivity of interest or entitlement.

What happens when one or more of the hallmarks are missing—for example, the object of exchange cannot be seen, or there is no exchange in the conventional sense, or an exchange occurs in a mélange of mutual exchanges that might be said to constitute the essence of a firm? The solution seems to lie in hypothesizing transactions, or “squeezing the proverbial round peg into the square hole.”13 In relation to certain notions of intangibles, there is an acceptance of underlying property-law tenets without much inquiry about them—what they mean, their origins, the context in which they could have meaning, their suitability, and other like considerations that are necessary, given the significance of that law for ordering otherwise potentially limitless and disputatious conduct in relation to a relevant object. Wilkie writes:

The result is a kind of hybrid analytical framework that employs the language of commercial law and accounting convention when it may really be indifferent to them or, because of an absence of adversity of interests or other underlying intrinsic features of them, has no need for them, and in fact is concerned with something else entirely—detecting “value transfers” and then finding a home for them in a country’s fiscal law, on the assumption that there is an expected and reasonable correspondence between the allocation of income according to “transfer pricing” and a fiscal allocation of tax income.14

12 Ibid., at 228.
13 Ibid., at 229.
14 Ibid., at 229-30.
According to Wilkie, the OECD discussion draft correctly discerns that “intangibles” includes the kinds of rights to which the law gives definition and affords protection (patents, trademarks, copyright, etc.) as well as some notions of value that the law may not recognize (such as “goodwill,” “knowhow,” or even “marketing intangibles”).

Drawing on Roman-law and English-law precedent, Wilkie suggests that

- an intangible is a right of some kind;
- that right must be given definition and significance in some fashion that allows it to exist; and
- the right must be capable of being owned.

In law, “ownership” may mean “the entirety of the powers of use and disposal allowed by law,” or the “bundle of rights,” including “the right of indefinite use, the right of unrestricted disposition and the right of enjoyment unlimited in duration.”

However, the law offers no general statement of what a “right” is as an abstraction or what “ownership” means in relation to it. Further, the notion of ownership is useful only in relation to the objects and objectives of its use. In an adversarial or regulatory context, the notion of ownership has a use to assist in establishing the relative entitlements of adverse parties and adjudicating disputes. In the transfer-pricing context, such notion of ownership may have no place, since there is no adversity or dispute, and transfer pricing is not concerned with the adjudication of rights. Transfer pricing deals with the question of measuring, detecting, and avoiding distortions of profit where profit may be manipulated because there are no rights to be contested and there is no external discipline on potential manipulation.

Context matters. In the context of transfer pricing, the OECD discussion draft focuses on transfers of “economic value.” Contracts are regarded as relevant, but not controlling; “entitlement” is not limited to legal conventions; “intangibles” may be, but are not necessarily, property in a legal sense; and “ownership” is a relevant notion.

The OECD, essentially, envisages an “intangible” and “ownership” to connote what is necessary to explain the outcome of a functional analysis measuring “entitlement” to “intangible” related “returns” based on the integrated conduct of the members of the whole “firm” to the generation of profits.

The “intangible” is thus a manifestation of functions performed as part of an integrated, multiparty, composite “firm” or business. Wilkie is sympathetic to the OECD’s approach. He agrees that transfer pricing establishes its own purposes, which condition the responses to intercompany transfers.

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15 Ibid., at 231.
16 Ibid., at 238.
In recognition of the fact that the OECD offers only “guidelines,” not “laws,” the OECD notions of “intangibles” and “ownership” need to be bridged with domestic tax laws in order to take effect. Wilkie considers several ways of bridging, including a legal interpretation approach (the Canadian approach) and the adoption of the OECD transfer-pricing guidelines as domestic tax laws (the UK and Australian approach). In conclusion, Wilkie notes that accommodating the OECD’s approach into domestic laws is significant not just in the transfer-pricing context, but also in the context of asserting source-country tax jurisdiction.

J.L.

Carl Levin and John McCain, Memorandum to Members of the Permanent Subcommittee on Investigations re Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.) (Senate Homeland Security and Governmental Affairs, May 21, 2013), 40 pages

This fascinating report by a US Senate subcommittee shows how one multinational company—Apple Inc.—has structured its business operations to avoid US and foreign taxes. It is seldom that the public gets a peek into the tax planning of a major company, particularly one as profitable as Apple. The headline finding is that Apple appears to be particularly adept at creating “stateless income”—income that is not taxable in any country. This is a step beyond shifting income to a low-rate jurisdiction and is remarkable also for the huge sums involved. It appears that Apple may be as innovative in avoiding tax as it is in developing technology. It also appears that the major policy problem in international taxation is no longer double taxation but double non-taxation.

This revelation of sizable amounts of stateless income has important implications for tax policy. With respect to tax policy making, the economic and social effects are significant. As the report notes, “[Apple’s] actions disadvantage Apple’s domestic competitors, force other taxpayers to shoulder the tax burden Apple has cast off, and undermine the fairness of the U.S. tax code.” For tax policy research, the implication seems to be that variations in tax burdens across companies may be less a question of deliberate policy choices (such as, in Canada, accelerated class 29 capital cost allowance deductions, which reduce the marginal effective tax rate on manufacturing) and more a question of differences between companies in their tax aggressiveness and their ability to access planning opportunities (for example, for soft drink manufacturers, a significant brand name and other intellectual property can facilitate sophisticated income shifting, similar to that discussed below for Apple).

Apple organizes its business in geographic segments. Operations for North and South America, including the United States, are headquartered in California; operations for the rest of the world, including Europe, the Middle East, India, Africa,

17 For a discussion of stateless income, and a similar example of creative tax planning (in this instance, involving Starbucks), see the article by Edward Kleinbard reviewed above.

18 Subcommittee report, at 5.
Asia, and the Pacific, are headquartered in Ireland. Apple develops its products through R & D conducted primarily in the United States. The materials and components for Apple products are sourced globally. The finished products are typically assembled by a third-party manufacturer in China. Distribution centres are headquartered in the United States and Ireland.

The United States taxes domestic corporations on their worldwide income. However, the US tax code allows companies to defer taxes on active business income until that income is returned to the United States. The subcommittee’s investigation found that Apple has $145 billion in cash, cash equivalents, and marketable securities, of which $102 billion is held offshore (although between 75 and 100 percent of those assets are held in accounts at US financial institutions).19

Ireland has been Apple’s favourite jurisdiction for parking offshore income. The two major offshore affiliates discussed in the subcommittee’s report are Apple’s primary offshore holding company, Apple Operations International (AOI), and its primary intellectual property rights recipient, Apple Sales International (ASI).

Apple’s shocking revelation to the subcommittee regarding AOI is that although it has been incorporated in Ireland since 1980, it has not declared tax residence in Ireland, or in any other country. Consequently, it has not paid corporate income tax to any national government in the past five years, despite receiving $30 billion in income between 2009 and 2012. How is this possible? Apple has exploited a difference between Irish and US tax residence rules. Ireland uses a central management and control test to determine tax residence, while the United States determines tax residence on the basis of the entity’s place of formation. Apple explained that although AOI is incorporated in Ireland, it is not a tax resident of Ireland, because AOI is neither managed nor controlled in Ireland. (Rather, AOI’s management and control is located in California.) Apple also maintained that because AOI was not incorporated in the United States, it is not a US tax resident under US tax law either. Further, Apple informed the subcommittee that it does not believe that AOI qualifies as a tax resident of any other country.

The subcommittee raises a question as to the legality of this arrangement. While, as noted, the United States generally determines tax residence on the basis of the place of incorporation, a shell entity incorporated in a foreign tax jurisdiction could be disregarded for US tax purposes in some situations—for example, if that entity is controlled by its parent to such a degree that the shell entity is nothing more than an instrumentality of its parent. The subcommittee holds out some hope that this rule could apply here: “While the IRS [Internal Revenue Service] and the courts have shown reluctance to apply that test, disregard the corporate form, and attribute the income of one corporation to another, the facts here warrant examination.”20

19 Ibid., at 19.
20 Ibid., at 23.
Similarly, ASI, a second Irish affiliate, also pays very little tax. Although Ireland’s corporate tax rate is officially 12 percent (not a high figure), Apple told the subcommittee that through negotiations with the Irish government, it had obtained a special rate, which, for the last 10 years, has been 2 percent or less; in 2011, it was 0.05 percent, or about $10 million on pre-tax earnings of $22 billion.21 Even this low rate is perhaps more than Apple is legally required to pay: Apple claims that ASI is exempt from tax in Ireland since its central management and control is in the United States. ASI also appears not to be taxable in the United States, for the same reasons discussed for AOI above. Thus, Apple contends that both of its Irish subsidiaries earn stateless income.

The means by which Apple shifted its income to the two main Irish subsidiaries (AOI and ASI) is perhaps unsurprising, although it is helpful to see these methods documented in some detail. For ASI, one method seems to be straightforward transfer pricing. ASI contracted with Apple’s third-party manufacturer in China to assemble Apple products and acted as the initial buyer of those finished goods. ASI then resold the finished products at a higher price to foreign affiliates around the world. Although ASI is an Irish incorporated entity, only a small percentage of Apple’s manufactured products ever entered Ireland. Rather, title was transferred between the third-party manufacturer and ASI, while the products were shipped directly to the eventual country of sale. Once there, the products were resold by ASI to the relevant Apple distribution affiliate, which then sold the goods to either end customers or Apple retail subsidiaries. Apple’s distribution process suggests that the location of its affiliates in Ireland was designed primarily to facilitate the concentration of offshore profits in a low-tax jurisdiction, and appears to have no business purpose.

For AOI, the main source of income was a cost-sharing arrangement for intellectual property in which the economic rights to Apple’s intellectual property were held in Ireland. The subcommittee noted several questionable aspects of this agreement. First, the bulk of Apple’s R & D efforts are conducted in California, yet under the cost-sharing agreement, a disproportionate amount of the resulting profits remains outside of the United States. Second, the transfer of intellectual property rights to Ireland appears to play no role in the way Apple conducts its commercial operations. Third, the cost-sharing agreement does not in reality shift any risks or benefits away from Apple, the multinational corporation; it only shifts the location of the tax liability for Apple’s profits. Finally, Apple’s transfer of the economic rights to its intellectual property to Ireland has no apparent commercial benefit apart from its tax effects. Although Apple has operations in numerous countries around the world, it does not transfer intellectual property rights to each region or country where it conducts business. Instead, the transfer of economic rights is confined to Ireland alone, where, as noted, the company enjoys an extremely low tax rate.

Canadians should be aware that the effect of Apple’s tax planning is to shift profits out of other developed countries as well. The subcommittee notes that in 2011,

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21 Ibid., at 20-21.
for example, 84 percent of Apple’s non-US operating income was booked in AsI. This left very small earnings, and correspondingly small tax liabilities, in other countries.

In 2011, for example, only $155 million in earnings before taxes were recorded in Apple’s UK affiliates. Apple also had no tax liability in its French and German retail affiliates that same year. Through this foreign profit shifting, Apple is able to reduce its effective foreign tax rate to below 2%.22

In a statement released before the subcommittee hearing, Apple confirmed that AOI and AsI are not tax-resident in either Ireland or the United States. However, Apple noted that AOI’s dividend income receipts are post-tax income, in that they are paid out of funds that have already borne tax in the countries where they were earned. Apple also noted that AOI’s investment income earned on its cash holdings is taxable to Apple Inc. as subpart F income, because AOI is a controlled foreign corporation that is wholly owned by Apple Inc. However, no figures are given for the amount paid in respect of any of these taxes.23 Apple further claimed that it “does not use tax gimmicks”24 and that it “complies fully with both the laws and [the] spirit of the laws.”25 Apple noted that it is “likely the largest corporate income taxpayer in the US, having paid nearly $6 billion in taxes to the US Treasury in [fiscal year 2012].”26 However, again no figures are provided regarding the amount of foreign taxes paid.

A.M.


Both of these studies utilize 2000-2009 data from the T3010 information return required to be submitted to the Canada Revenue Agency by all registered charities in Canada.

22 Ibid., at 40.
24 Ibid., at 2.
25 Ibid., at 1.
26 Ibid., at 2. This is much higher than the $2.5 billion in taxes for fiscal year 2011 reported in the subcommittee report, at 39.
The first study examines returns for all charities, but focuses particularly on small charities (those with total annual revenues under $100,000), which represent 55 to 60 percent of all charities.27 The intent is to assist the managers of small charitable organizations by providing information on the number and type of fundraising activities undertaken by such charities. The most common fundraising method is the use of collection plates or boxes. Other popular fundraising methods are special events, sales of products, direct mail campaigns, and corporate donations and sponsorships.28 Approximately 40 percent of small charities use just one method, and another 30 percent use two.29 Tables are included to show how these results vary across provinces.

The second study examines in particular the weaknesses of the T3010 as a source of information about fundraising methods. Methods not tracked by the T3010 are noted, and suggestions are made for ways of improving the form.

A.M.


The Canadian personal income tax is based on the individual as the tax unit. Thus, if one shares the opinion expressed by the authors of this paper—that ability to pay should be based on family income—the current tax system is unfair to single-earner couples. For example, the paper shows that a family with a single earner making $70,000 a year pays 30 percent more in taxes every year than a family with two partners making $35,000 a year. A single-earner family taking in $120,000 a year pays the same amount of income tax as a dual-earner couple making $141,000 between them.

The Conservatives proposed in the 2011 election to introduce changes in the tax law that would allow individuals to transfer up to $50,000 of income from one member of a couple to another, provided that the family had a dependent child under the age of 18. (The new rules would be introduced once the government had returned to a balanced budget.) This, of course, is only one way to implement the idea of using the couple as the tax unit. In particular, it assumes that there are no economies of scale in living together as a couple; in other words, the costs of two people living together are the same as the costs of two people living apart.

Krzepkowski and Mintz are not concerned with the appropriateness of a $50,000 limit or the application of income splitting only to families with minor children,

27 Brouard et al., at 13.
28 Ibid., at 22.
29 Ibid., at 24.
both of which appear to be restrictions that would be hard to maintain over time.\textsuperscript{30} Instead, they address the general question of the fairness of income splitting (keeping the no-economies-of-scale assumption).

Interestingly, they conclude that income splitting would give too much of a tax break to single-earner couples. The problem is that those couples would continue to get the spousal credit, which implies that a spouse not in paid employment is a dependant (“another mouth to feed”) rather than a worker providing valuable home production services (child care, home cleaning, etc.)—services that a dual-earner couple would probably have to pay for. Thus, Krzepkowski and Mintz appear to suggest that the spousal credit should not be available to couples using income splitting; instead, the lower-income spouse would be given a new tax credit to be calculated on the basis of his or her employment income. The intent is to allow the lower-income spouse (the secondary earner, in economics terminology) to have at least a small amount of untaxed labour income. The proposal is interesting in that it acknowledges the well-known disadvantage of using the couple as a tax unit, namely, that the lower-income spouse suffers a tax increase and is therefore induced to leave the labour market. No revenue cost estimates are provided.

A.M.


This short report is unique in the literature on tax avoidance in that it focuses on the big four accounting firms and how their business activities are believed to contribute to the problem. Two of its conclusions are particularly notable and controversial.

1. The UK tax authority is no match for the big four:

   HMRC [HM Revenue & Customs] is not able to defend the public interest effectively when its resources are more limited than those enjoyed by the big four firms. . . . For instance HMRC has 65 transfer pricing specialists whereas the big four firms alone have around 250.\textsuperscript{31}

2. When HM Treasury (the UK equivalent of Canada’s Department of Finance) hires the big four for advice on policy, it creates a perception that the big four wield undue influence on the tax system. The committee cites, by way


\textsuperscript{31} At 6.
of example, one instance where KPMG advised the government on the controlled foreign company and patent box rules, and then produced marketing brochures highlighting the role that its staff had played in advising the government.32 As the committee notes,

we have seen what look like cases of poacher, turned gamekeeper, turned poacher again, whereby individuals who advise government go back to their firms and advise their clients on how they can use those laws to reduce the amount of tax they pay.33

While I have no direct knowledge of what may have happened in the United Kingdom, my own experience is that in the Canadian context, the latter comment is totally offbase. The Department of Finance needs experienced practitioners to contribute their services, and, to my knowledge, no ethical problems have arisen.

A.M.


The content of this internal audit report issued by the Department of Finance is, for the most part, positive and unsurprising. However, one interesting fact is that the number of full-time employees in the Tax Policy Branch fell by 10 percent (from 176 to 159) between 2010-11 and 2011-12.34 Evidently, the federal government’s policy of general containment of public service costs has applied to Finance as well as other departments and agencies.

It is also interesting to note that employees of the Tax Policy Branch seem to be happy with their jobs: 81 percent of branch staff report that they derive satisfaction from their work, compared to 76 percent for Finance staff department-wide, and 76 percent for the federal government as a whole.35

A.M.

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32 At 10.
33 At 4.
34 At paragraph 4.2.4.2.
35 At paragraph 4.2.3.