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Current Tax Reading
J.L. Ilsley and the Transition to the Post-War Tax System: 1943-1946

Colin Campbell*

PRÉCIS
Déjà en 1943, le gouvernement canadien avait déplacé son attention du financement de l’effort de guerre vers la planification et le financement de la reconstruction d’après-guerre, y compris l’adoption possible de plusieurs programmes importants d’aide sociale. Cela signifiait qu’il continuerait de dépendre, comme en temps de guerre, d’une base de fiscalité élargie touchant les particuliers et les sociétés et qu’il devrait prendre de nouveaux arrangements avec les provinces pour la poursuite ou la modification des accords de location fiscale conclus en 1941. À titre de ministre des Finances, J.L. Ilsley avait la responsabilité première de cette initiative. Bien que les propositions du gouvernement n’aient pas fait l’unanimité à la Conférence fédérale-provinciale prolongée de 1945-1946, la transformation du régime fiscal canadien effectué en 1943 est demeurée essentiellement intacte.

ABSTRACT
By 1943, the Canadian government had turned its attention from financing the war effort to planning and financing post-war reconstruction, including the possible adoption of several major social welfare programs. This involved continuation of the wartime reliance on the expanded personal and corporation income taxes and making new arrangements with the provinces for the continuance or modification of the tax rental agreements reached in 1941. As minister of finance, J.L. Ilsley had primary responsibility for and led this effort. While the government’s proposals met only partial acceptance at the extended 1945-46 Dominion-Provincial Conference, the transformation of the Canadian tax system effected by 1943 remained substantially intact.

KEYWORDS: HISTORY ■ FEDERAL-PROVINCIAL ■ TAX SYSTEMS ■ TAX POLICY ■ ECONOMIC POLICY ■ SOCIAL POLICY

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INTRODUCTION

The delivery of the March 2, 1943 federal budget marked the end of a major transformation of the Canadian tax system, presided over by J.L. (James Lorimer) Ilsley, minister of finance from July 1940. As I have described elsewhere, the demands of financing Canada’s war effort had brought about the greatest changes in the Canadian tax system since Confederation. By 1943, personal and corporation income taxes had become the single largest source of federal government tax revenue, tax rates had been raised to levels previously unthought of, and the personal income tax had been extended to most working Canadians, collected by source deductions from wages and salaries. Through the tax rental agreements of 1941-42, the provinces (and, in some provinces, municipalities) had vacated the corporation tax and personal income tax fields for the duration of the war in return for fixed tax-rental payments from Ottawa.

By the spring of 1943, eventual victory for the Allied forces in the war was more or less certain, and the revolution in Canadian public finance brought about by Canada’s involvement in the conflict had reached a temporary equilibrium. Total federal government expenditures reached a high point of $5.322 billion in 1943-44 (compared to about $500 million in 1938-39), about 90 percent of which was accounted for by war spending. Tax revenues were equal to slightly more than half of expenditures; the balance was financed by borrowing, largely from the public through successive Victory Loan campaigns. With the end of the war in sight, the attention

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2 For a summary of revenue and expenditure data for 1939-40 through 1947-48, see the table in the appendix to this article.
of both the public and the government turned to planning for post-war social and economic policy.

In the United Kingdom, Sir William Beveridge had issued a report in November 1942 proposing the introduction of a comprehensive social security system. The report received wide publicity on both sides of the Atlantic, and in early December 1942 Canada’s prime minister, William Lyon Mackenzie King, discussed it at some length with US President Franklin Delano Roosevelt. In January 1943, King read a speech by Beveridge suggesting that Winston Churchill could cap his political career by putting the Beveridge proposals into effect. King was inspired to do likewise, believing that the social security scheme described in the Beveridge report reflected his own views:

That programme I made very much my own from the days I was Deputy Minister of Labour. It is all set out in my *Industry and Humanity*. I should be happy indeed if I could round out my career with legislation in the nature of social security.

On January 12, King proposed to the Cabinet that the Throne Speech for the pending session of Parliament should include an announcement of the government’s intention to introduce legislation for a national social security program. In the event, the promise in the Throne Speech did not lead to legislation in 1943 (although, as discussed below, planning for post-war and related social security issues moved much closer to the centre of attention in the policy-making machinery of the civil service), but it did set out the direction that the King government proposed to take. King’s position was driven by both principled conviction and electoral considerations. King was ideologically committed to the modern welfare state and had committed the Liberal Party to its achievement, in principle, in 1919; but despite holding power for 14 of the next 21 years, he had done relatively little to attain that goal. In part, this was because King placed a high value on preserving social harmony and avoiding societal division. As a result, he was reluctant to take action without the support of a perceived national consensus. The combined effect of the Depression of the 1930s and the early years of the Second World War hastened the emergence of such a consensus.

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3 See *The Diaries of William Lyon Mackenzie King*, December 5, 1942 (www.collectionscanada.gc.ca/king/index-e.html) (herein referred to as “Mackenzie King diaries”).
4 Ibid., January 10, 1943.
6 Mackenzie King diaries, supra note 3, January 12, 1943.
8 See the discussion of this point in David J. Bercuson, “Introduction,” in King, *Industry and Humanity*, supra note 5, at xx-xxv.
Political developments in late 1942 and 1943 indicated a rising demand from the electorate for policies designed to banish the privation and uncertainty of the 1930s—to translate victory against fascism on the battlefield into a reformed (or at least improved) social order. By 1943, the Commonwealth Co-operative Federation Party (CCF) had identified itself as the main proponent of social reform, and its rising fortunes worried King. When public opinion polling began in Canada in 1941, the CCF had the support of about 10 percent of the electorate.9 In August 1943, the Ontario CCF narrowly missed winning the provincial election (in which the Liberals were defeated and a minority Conservative government was returned to power); and in the same month, the King government lost four Liberal seats in federal by-elections—one each in Saskatchewan and Manitoba to the CCF, one in Quebec to a Labour-Progressive (Communist) candidate, and another in Quebec to the Bloc Populaire. A September 1943 national Gallup poll showed that the CCF had a narrow lead over both Liberals and Conservatives. Polling also indicated that Canadians were more interested than either Britons or Americans in “reform” in general. The federal Conservative Party, for its part, had embraced in principle a broad program of social security at the Port Hope Conference in September 1942,10 and in November 1942 had replaced Arthur Meighen as leader by the former Progressive premier of Manitoba, John Bracken.11

These developments suggested both that a national consensus on social security reform was emerging and that King and the Liberal Party might pay a price for ignoring it. In the fall of 1943, King took further action. The national advisory council of the Liberal Party was convened to discuss post-war policy, passing resolutions endorsing a post-war full employment policy and social welfare measures that included enhanced old age pensions and family allowances. At a Cabinet meeting in November 1943, King asked ministers to write to him with “their ideas as to government reconstruction policy,” which might be included in the Throne Speech setting out the government’s policies for 1944.12

The result of this process was a set of federal policy proposals that included family allowances, a contributory pension scheme (and augmented non-contributory old age pensions), a national health insurance program and a coordinated federal-provincial “shelf” of public (largely infrastructure) investments. The proposals were designed to improve the welfare of individual Canadians and to ensure a high level of post-war economic activity and employment. They engaged the tax system in two

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9 See the discussion of these political developments in Robert Bothwell, Ian Drummond, and John English, Canada, 1900-1945 (Toronto: University of Toronto Press, 1987), at 322-27.
11 Bracken insisted on adding “Progressive” to the name of the federal Conservative Party.
12 Letter from A.D.P. Heeney, Cabinet secretary, to J.L. Ilsley, November 29, 1943, Library and Archives Canada (herein referred to as “LAC”), Department of Finance records (RG 19), vol. 326.
ways: first, they involved federal expenditures several times higher than pre-war levels; and second, the authors of the proposals believed that their objectives could be achieved only by continuing the centralization of the tax system effected by the 1941 tax rental agreements. The policy in its final form was set out in the federal government’s proposals presented at the 1945-46 Dominion-Provincial Conference, discussed below.

For Ilsley and the Department of Finance, the issue was the direction of post-war tax and expenditure policy. Post-war reduction of military expenditures would eliminate the need for massive borrowing; and post-war tax revenue needs would depend on expenditure policy. Once that policy was determined, decisions were required about the necessary mixture and level of taxes. In addition, the expiry of the tax rental agreements after the end of the war13 had to be addressed. The challenge for Ilsley was how to finance the government’s plans—just as it was when he was faced with financing Canada’s commitment to the war effort. As finance minister, Ilsley was of course concerned about the cost of new programs. In 1941, he had resisted plans for health insurance on the basis of cost.14 In January 1943, after King had decided that references to social welfare legislation would be included in the Throne Speech, “Ilsley at once objected to what it would involve in the way of expenditures.”15 Unlike Ilsley, however, King was not responsible for financing the expenditures.

As discussed in more detail below, Ilsley played a central role in the federal attempt to continue the wartime tax arrangements into the post-war period, principally at the Dominion-Provincial Conference of 1945-46. The attempt was only partially successful, and the toll on Ilsley’s health effectively ended his tenure at Finance. Failure to reach agreement with the provinces on tax issues caused the federal government to abandon or postpone major parts of its post-war agenda. Failure was due to a number of factors: King’s unwillingness to support a direct confrontation with the provinces; Ilsley’s consistently (and perhaps rigidly) principled approach, which did not lend itself to compromise; and, most importantly, the constitutional and political reality that has made Canada one of the most decentralized federations in the world.

The result was by no means a total failure. The changes made to the tax system between 1939 and 1943—in particular, the reliance on progressive and near-universal income taxation—became permanent, and in due course became the norm for the

13 The agreements were to expire at the end of the first full fiscal year (of the particular province) following the date fixed for the cessation of hostilities. That date turned out to be September 5, 1945; thus, for most provinces, the agreements would expire on March 31, 1947. For New Brunswick, Nova Scotia, and Prince Edward Island, the expiry dates would be, respectively, October 31, November 30, and December 31, 1946.


15 Mackenzie King diaries, supra note 3, January 12, 1943.
provinces. The tax rental agreements were continued in seven provinces, largely ensuring that the “tax jungle” of the 1930s did not return. In this way, the federal government was able to finance higher post-war spending, and the anticipated post-war recession failed to materialize.

**POST-WAR RECONSTRUCTION POLICY**

By 1943, a considerable amount of thought had been given to post-war policy—what was generally referred to as “reconstruction”—within the federal civil service. As a result, an array of possible policy alternatives was available, flowing in part from initiatives taken by the minister of pensions and national health, Ian Mackenzie. Mackenzie, the mercurial representative of British Columbia in the Cabinet and a veteran of the First World War, had been the minister of national defence immediately prior to the war. Demoted in favour of Norman Rogers in September 1939,16 Mackenzie then took on the task of reconstruction planning. In December 1939, he was appointed chair of the Cabinet Committee on Demobilization and Rehabilitation,17 whose mandate was to consider issues related to veterans. An advisory committee of civil servants was constituted, which produced recommendations for a wide variety of veterans’ benefits, including war service gratuities, trade or professional training, loans to establish businesses or farms, special facilities for the disabled, and equality for female veterans.18 These recommendations were adopted by order in council19 and subsequently included in the Veteran’s Rehabilitation Act20 and related legislation. In February 1941, Mackenzie persuaded the Cabinet, first, to expand the mandate of the committee to encompass general post-war reconstruction issues21 and then, in March 1941, to reconstitute the advisory committee under the leadership of Cyril James, the principal of McGill University.22

The most notable product of the reconstituted committee (generally referred to as the Committee on Reconstruction) was the Marsh report. In December 1942, Leonard Marsh prepared a summary of the Beveridge report for the committee for consideration at its meeting on January 8, 1943.23 The committee then commissioned Marsh to produce a Canadian version of the Beveridge report, which was

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16 As described in my earlier article, Rogers’s unexpected death in June 1940 resulted in a Cabinet shuffle and Ilsley’s appointment as finance minister the following month: see Campbell, supra note 1, at 642.
17 Established by PC 4068 1⁄2, December 8, 1939.
18 For a detailed description of the veteran-related measures, see Walter S. Woods, Rehabilitation (Ottawa: Queen’s Printer, 1953).
19 Principally PC 7633, October 1, 1941 (replaced by PC 5210, June 30, 1944).
20 SC 1945, c. 35.
21 PC 1218, February 17, 1941.
22 Formalized by PC 6874, September 9, 1941.
23 See LAC, RG 19, vol. 3583. Marsh was the director of social research at McGill University and the committee’s research director.
submitted to the House of Commons Committee on Reconstruction and Rehabilitation in March 1943.\textsuperscript{24} The Marsh report’s proposals included economic policies to produce full employment, comprehensive pension and employment insurance plans, health insurance, and family allowances. The Committee on Reconstruction also produced a number of plans for a comprehensive health insurance scheme, which Mackenzie promoted, unsuccessfully, both in Cabinet and in House of Commons committees.

The shift in focus of the King government from the initial war emergency to post-war reconstruction had been anticipated by the most powerful group of federal civil servants, the Economic Advisory Committee (EAC). Formed in 1939 to coordinate the activities of the nation’s key financial and economic players—the Bank of Canada and the departments of Finance, Munitions and Supply, and External Affairs (with the participation of the Cabinet secretary)—the EAC decided in late 1942 that it should take control of reconstruction planning and so recommended to Cabinet.\textsuperscript{25} On December 23, 1942, the War Committee of the Cabinet approved the expansion of the role of the EAC to include responsibility for coordinating reconstruction planning.\textsuperscript{26}

By mid-1943, the EAC and the Department of Finance were considering family allowances as a major component of reconstruction policy;\textsuperscript{27} and by late 1943, family allowances were clearly the major social welfare policy under consideration (and the largest expenditure item under review by Ilsley).\textsuperscript{28} Family allowances satisfied

\begin{itemize}
  \item \textsuperscript{26} Letter from A.D.P. Heeney, Cabinet secretary, to Clifford Clark, December 26, 1942, LAC, RG 19, vol. 4660. The EAC’s functions were expanded to include reconstruction planning pursuant to PC 608, January 23, 1943. The Committee on Reconstruction was gradually wound down and formally dissolved on January 1, 1944. See PC 9946, December 31, 1943 and PC 169/93, January 7, 1944. The reassertion of control of reconstruction planning by the central economic organs—principally the Department of Finance and the Bank of Canada—is described in detail in Robert A. Wardhaugh, \textit{Behind the Scenes: The Life and Work of William Clifford Clark} (Toronto: University of Toronto Press, 2010), at 231-34, and Owram, supra note 14, at 279-91.
  \item \textsuperscript{27} Unsigned memorandum to W.A. Mackintosh, June 21, 1943, LAC, RG 19, vol. 304. The emergence of family allowances has been the subject of a number of detailed (and sometimes conflicting) studies. That issue is beyond the scope of this article, but interested readers should consult Guest, supra note 24; Raymond B. Blake, \textit{From Rights to Needs: A History of Family Allowances in Canada, 1929-1992} (Vancouver: UBC Press, 2009), at chapters 2 and 3; and Alvin Finkel, \textit{Social Policy and Practice in Canada: A History} (Waterloo, ON: Wilfrid Laurier University Press, 2006).
  \item \textsuperscript{28} See the discussion below of Ilsley’s letter of January 4, 1944 to King (in the text at note 52 and following) and an unsigned memorandum to Clifford Clark dated January 7, 1944, enclosing various cost estimates for the program; LAC, RG 19, vol. 304.
\end{itemize}
both the social welfare goal of alleviating poverty and the economic goal of supporting the system of wage and price controls. In August 1943, a report by the chair of the National War Labour Board, C.P. McTague, had recommended either abandoning wage controls for lower-paid workers (which Ilsley and other key advisers—the group known as “the brain trust”—believed would destroy the whole system of wage and price controls) or instituting family allowances. For Ilsley, who had consistently (and sometimes single-handedly) defended the wage and price control regime imposed in October 1941, family allowances were obviously an attractive option. A memorandum produced by the Department of Finance also pointed out that family allowances would serve the political goal of “bringing the Dominion government closer to the people of Canada” as a “benevolent and useful agency” rather than a “harsh collector and stern controller.”

As Robert Wardhaugh points out, Clifford Clark, the deputy minister of finance, also saw family allowances as a means of providing post-war fiscal stimulus and, by increasing the incomes of poorer families, reducing the need for federal government expenditure on low-income housing. Ilsley was clearly familiar with the issues involved. In a note to Ilsley dated June 13, 1943, the governor of the Bank of Canada, Graham Towers, referred to a conversation with him on wage stabilization policy and enclosed his (Irwin’s) letter and memorandum to Clark advocating family allowances as a means of increasing the income of poor families without a general increase in wages, which would have imperilled the wage control program. In October 1943, Clark forwarded to Ilsley that month’s edition of Labor News, which was devoted entirely to the family allowance issue, and later noted that Ilsley had read it.

While concerned about the cost involved, Ilsley loyally supported both the broader commitment of the King government to social security and the family allowance proposal. In a speech to the annual convention of the Trades and Labour

29 For a discussion of the repercussions of the McTague report, see Wardhaugh, supra note 26, at 254-55.

30 Unsigned and undated memorandum, “Children’s Allowances,” attached to unsigned memorandum to W.A. Mackintosh, January 7, 1944, LAC, RG 19, vol. 304. A revised version was provided to Ilsley on January 12, 1944.

31 Wardhaugh, supra note 26, at 262-65.

32 Letter from G.F. Towers to Ilsley, June 13, 1943, LAC, RG 19, vol. 304. The connection between the family allowance proposal and developing pressures in the wartime system of wage and price controls is clearly very strong, and the proposal served both economic and more purely social objectives. When the decision was made in mid-1944 to delay implementation of family allowances until July 1945 (by which time the war was expected to be over), the welfare objective became dominant, and defence of the proposal was couched entirely in terms of the social benefits of the program. None of this, of course, had any effect on the financing issues that Ilsley had to deal with.

33 Note from W.C. Clark to Ilsley, LAC, RG 19, vol. 304.
Congress in Quebec City in September 1943, Ilsley referred to a speech that King had delivered at a meeting of the American Federation of Labor in 1942, and stated:

The third objective he [King] specified was “social insurance against privation resulting from unemployment, from accident, from the death of the breadwinner, from ill health and from old age.” With this, I think, we are all in agreement now, and it is a matter of pressing ahead with preparations as rapidly as possible. I would hope myself that we can see created at the end of the war a comprehensive, unified scheme of social insurance. We must conceive and carry out social insurance with the same boldness and thoroughness with which we have raised the income tax for war purposes.\textsuperscript{34}

As discussed below, Ilsley also included family allowances as the principal item in the list of legislative proposals he submitted to King in early January 1944. At that point, the proposal had been discussed extensively for at least a year in the Department of Finance and at the Bank of Canada. Since Ilsley’s practice was to engage in detailed discussions with the brain trust about proposed policy measures,\textsuperscript{35} there can be little doubt that he had considered the family allowance proposal at length and that he fully understood it.

On at least two occasions, King suggested that Ilsley was opposed to family allowances, and some commentators have repeated that view.\textsuperscript{36} Ilsley missed most of the Cabinet meeting on January 13, 1944 at which family allowances were approved, because of a speaking engagement in Toronto, and Clifford Clark made the case for the proposal from the perspective of the Department of Finance. Before Ilsley left the meeting, King asked him if he supported the measure and later noted that Ilsley had hesitated and said, “I suppose I should; indeed I do—or words to that effect.”\textsuperscript{37} When the legislation was under final Cabinet review in June 1944, King again confided to his diary that Ilsley (along with T.A. Crerar, the minister of mines


\textsuperscript{35} Robert Bryce later recalled that “the department’s inner circle . . . met at Ilsley’s request on many evenings to debate at length difficult decisions which were going to confront him in cabinet.” Robert B. Bryce, \textit{Canada and the Cost of World War II: The International Operations of Canada’s Department of Finance 1939-1947} (Montreal and Kingston, ON: McGill-Queen’s University Press, 2005), at 6. Bryce served as deputy minister in the Department of Finance between 1939 and 1947.

\textsuperscript{36} For example, Blake, supra note 27, at 84-85 and 90.

\textsuperscript{37} Mackenzie King diaries, supra note 3, January 13, 1944. At the January 24 Cabinet meeting that approved the Speech from the Throne, Ilsley remarked that it was “very leftist” and should have something added to reassure the country that the government was not seeking “to outdo the C.C.F.” However, he did not oppose the reference to family allowances, and he was prepared to allow Mackenzie’s health insurance proposals to go ahead if they were supported by the provinces. Ibid., January 24, 1944.
and resources, and Angus L. Macdonald, the minister of defence for naval services) continued to oppose family allowances. The relevant Cabinet minutes (for June 14 and 15, 1944) are silent on this point.38 Both the minutes and King’s diary refer to the discussion of the quite secondary issue of whether a parent in receipt of a military dependant’s allowance could also receive the family allowance, and it is unclear whether the disagreement primarily centred on that issue and whether all three ministers took the same position.

Mitchell Sharp’s view was that Ilsley did not have “advanced ideas about social programs” and that Clark had sold King on the merits of family allowances. Sharp’s conclusion is probably the most accurate assessment of Ilsley’s position: “I don’t know if he [Clark] ever sold Ilsley but at any rate Ilsley accepted it.”39

**FINANCING RECONSTRUCTION**

As reconstruction moved into the centre of the government’s focus, the magnitude and method of financing reconstruction became a major concern. For Ilsley, this issue would largely displace that of financing the war. The content of the government’s reconstruction policy, like its decision to enter the war, was not of Ilsley’s making (though as a senior minister he had an important voice in setting that policy); he was, however, responsible for financing the policy choices and framing the required taxation policies. While he may have had misgivings about specific items of reconstruction policy, once they had been approved by Cabinet, he turned his attention to the appropriate financing measures.

When the EAC effectively took control of reconstruction planning, Ian MacKenzie’s planning for social welfare measures was viewed in the broader context of the government’s overall fiscal and economic policy. That policy was directed primarily to the management of the economy in the transition to peacetime and necessarily involved the tax system. In April 1943, the EAC considered a memorandum prepared by Alex Skelton40 discussing constitutional problems relating to post-war policy.41 The memorandum contemplated significant fiscal stimulus from the federal government, including a substantial public works program, direct assistance to the unemployed and lower-income individuals, and the eventual implementation of a

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38 See Cabinet Conclusions, June 14-15, 1944. The Cabinet Conclusions (minutes of Cabinet meetings) for 1944-1946 are found in LAC, RG 2, vols. 2636-2639, and a digital version can be accessed online at LAC (www.bac-lac.gc.ca/eng/discover/politics-government/cabinet-conclusions/Pages/cabinet-conclusions.aspx).


40 The head of the Research Department of the Bank of Canada and former secretary of the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois commission).

41 Minutes of meeting of the EAC, April 22, 1943, LAC, RG 19, vol. 4660; memorandum attached to the minutes. An earlier version of this memorandum dated April 3, 1943 is found in LAC, RG 19, vol. 3446.
comprehensive social security system (including old age pensions and health insurance) on a contributory basis by the federal government. The memorandum pointed out that the implementation of such a plan would have “important financial implications,” resulting in federal spending three to four times higher than that before the war; therefore, “[t]he Dominion must be assured the financial means to carry these burdens and to distribute them fairly.” Skelton argued that this required implementation of the Rowell-Sirois recommendations for the allocation of taxing power and the continuation of the tax rental agreements:

[T]he people, who must ultimately carry the burden of these Dominion financial responsibilities, must be protected against the inequities and inefficiencies that arise and develop when similar taxes are imposed by several taxing authorities. Consequently, it is of vital importance that the Dominion continue after the war to have the exclusive use of income and corporation taxes which has been secured for the duration of the war, and also that it obtain exclusive jurisdiction to impose succession duties.

The memorandum concluded that such readjustment should be effected by constitutional amendment (“the temptation to break a simple agreement . . . would in some instances be irresistible”) and that the provinces could be compensated by cash payments consisting of a “fixed minimum and a sliding scale of accretions.”

While the federal government’s position was to evolve over the next two years (particularly in abandoning any hope of formal constitutional amendment), its approach to fiscal and taxation policy did not change: federal financial requirements and management of the economy required exclusive federal occupancy of the progressive tax fields on the basis of efficiency and equity, with compensation to the provinces in the form of cash payments similar to those under the tax rental agreements. The further unstated assumption was that reliance on income taxation as the single principal source of federal revenue was to continue and that there would be no return to the pre-war tax structure. The Skelton memorandum did not consider possible provincial resistance to this policy but merely contemplated discussions with the provinces regarding the financial and constitutional arrangements necessary to effect post-war policy.

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42 Ibid., at 8.
43 See Canada, Report of the Royal Commission on Dominion-Provincial Relations (Ottawa: King’s Printer, 1940), book II, chapter III.
44 Memorandum attached to minutes, supra note 41, at 8.
45 Ibid.
46 That is, personal and corporation income taxes and succession duties. While the 1941 tax rental agreements prevented the provinces from imposing other corporate taxes such as capital or place-of-business taxes, there was no intention that the federal government would impose such taxes—they were proscribed in order to protect the corporation income tax base.
47 Memorandum attached to minutes, supra note 41, at 10.
The EAC, in its final report to Cabinet on the subject in November 1943, concluded:

The Report [the final version of the Skelton memorandum] points out that as between the Dominion and the provinces responsibilities are disproportionate to financial capacities. The provinces are constitutionally competent but financially unable to carry out comprehensive schemes of social security and reconstruction. Even if they were able, there would be a lack of coordination or uniformity in places when these are necessary. The Dominion lacks constitutional power to undertake such plans and reversion to the pre-war division of taxing power would leave it without the necessary financial capacity.48

Grant Dexter, the Ottawa correspondent for the Winnipeg Free Press, interviewed Clifford Clark, Graham Towers, and W.A. Mackintosh (special assistant to Clark at the time) in late 1943 and filed the following summary of their views:

[U]nderlying the whole post-war problem is the difficulty re income and corporation taxes and succession duties. For the period of the war, the Dominion has exclusive jurisdiction by agreements with the provinces which expire one year after the end of the war. Unless the [Rowell-]Sirois recommendations can be carried through and the B.N.A. [British North America] Act amended to give Ottawa exclusive jurisdiction in this field, the brain trusters see nothing ahead but frustration and impotence. The richer provinces will come back into these tax areas. The weaker provinces will have to do so, once the duality of taxation is re-established. The Dominion will be hamstrung on its whole post-war policy—since it will not be able to impose the taxation required to finance post-war reconstruction. If it did, the weaker provinces would be ruined.49

In hindsight, it appears that the federal government could have solved this problem by making equalization payments to the poorer provinces, in the form of either the national adjustment grants recommended by the Rowell-Sirois commission or equalization as eventually implemented in 1957, which would have allowed those provinces to avoid excessively high tax rates. These options, however, were evidently not on the federal agenda.

The EAC recommended that a federal-provincial conference should be convened to discuss the Rowell-Sirois recommendations, with the aim of reaching a “satisfactory solution.”50 The stage was set for a reprise of the 1941 conference51 as debate

49 Grant Dexter, memorandum of December 23, 1943, Queen’s University Archives (herein referred to as “QUA”), Dexter Papers. Clark, Towers, and Mackintosh were part of Ilsley’s inner circle (see supra note 35) and prominent members of the brain trust.
51 For a summary of the agenda, discussion, and outcome of the 1941 conference, see Campbell, supra note 1, at 650-54.
on the issue moved from the bureaucratic to the political level. As noted above, in November 1943, King had asked members of the Cabinet for their suggestions on post-war reconstruction policy in anticipation of the forthcoming session of Parliament. King’s opinion was that Ilsley’s response, set out in a letter of January 4, 1944, “clearly had been prepared by Clark and others in the department.” However, as both Robert Bryce and J.L. Granatstein have observed, Ilsley would not have accepted recommendations from his advisers that he did not understand and agree with; according to Bryce, he was a “fitting minister to match wits with Clark, Towers and Donald Gordon.”

In his response, Ilsley’s central concern was maintaining the capacity of the tax system to deal with the anticipated post-war responsibilities of the federal government, and the principal issue he identified was the relationship with the provinces. This he described as one of the “special difficulties” he faced. He said that the formulation of post-war policy “has been almost completely stopped because of the lack of certain key decisions in regard to this problem”—that is, the problem of financing substantially higher post-war expenditures. Ilsley enumerated those costs: interest on the national debt, which, by the end of the war, would have increased several times over; defence expenditures several times larger than those before the war; increases in the normal overhead costs of government; and “vastly increased” expenditures on “social security and social welfare activities.” The latter included “huge expenditures” for housing and construction projects, “substantial losses” in supporting floor prices for agricultural products, and unemployment relief assistance supplementary to unemployment insurance. Ilsley also advised King that, in a matter of days, he would bring to Cabinet legislation for a system of family allowances.

Ilsley maintained that the financial demands on the federal government after the war could only be managed by the continuation of the tax system that had been created between 1939 and 1943:

52 Letter from Ilsley to King, January 4, 1944, LAC, RG 19, vol. 326.
53 Mackenzie King diaries, supra note 3, January 6, 1944.
55 Bryce, supra note 35, at 4. Donald Gordon was then the chair of the Wartime Prices and Trade Board, responsible for wage and price controls.
56 In its final report, dated November 17, 1943, the Committee on Reconstruction recommended calling a dominion-provincial conference “to reach a solution of the problems created by the disparity between responsibility and financial capacity.” See LAC, RG 19, vol. 3977.
57 Letter of January 4, 1944, supra note 52.
58 He noted that the net national debt of $3.153 billion as at March 31, 1939 would reach $9 billion by March 31, 1944. By March 1946, it was $13 billion.
59 Letter of January 4, 1944, supra note 52.
60 Ibid.
I am convinced (as are my advisers) that it is quite impossible for the Dominion government to manage annual expenditures and national debts of the magnitude indicated, if we have to go back to our pre-war taxing system. Whether it is generally realized or not, it is the Dominion-Provincial Taxation Agreements which have made it possible for us to finance the war.\(^{61}\)

It was implicit in Ilsley’s position that the predominant place of progressive income taxation and significant income taxation of corporations would remain in place. He had forcefully restated his commitment to progressive income taxation in his speech to the Trades and Labour Congress in 1943:

During the war we have gradually built up the income tax in Canada to be a powerful instrument. We all agree that it is the fairest and the best tax. It is the best way of taxing on the basis of ability to pay. It is a foundation stone of social progress.\(^{62}\)

Ilsley viewed the post-war fiscal challenges as at least equal to those in wartime.\(^{63}\) In his letter to King dated January 4, 1944, he argued that maintaining the existing tax system was an absolute prerequisite to meeting post-war challenges:

In short, unless the Dominion retains exclusive control in the present income and corporation tax fields (and preferably also secures control of the succession duty field) we will find it quite impossible to solve Canada’s post-war financial and economic problems. This is a strong statement but I do not think it is exaggerated.\(^{64}\)

Ilsley was not unaware of the political difficulties raised by this course of action. He went on to say that the EAC had identified but underestimated those difficulties, and that settling the financial and constitutional relations with the provinces would have to wait a year or more. In the interim, and assuming continuance of the existing financial arrangements, the federal government could proceed with family allowances, unemployment assistance, and enhancement of the old age pension (postponing a universal contributory scheme until constitutional amendment was possible) and with a program of public works projects. This would “increase the Dominion’s prestige” and “furnish the electorate with concrete information as to the issues involved in any ultimate settlement.”\(^{65}\)

King used Ilsley’s letter of January 4 as the basis for the Cabinet discussions that followed on the policy agenda to be presented at the forthcoming session of Parliament. The Cabinet began discussing the proposals on January 6. King noted that it

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\(^{61}\) Ibid.

\(^{62}\) Ilsley, supra note 34, at 9-10.

\(^{63}\) “When related to the conditions and psychology that will then prevail, our post-war financial job will be even more difficult than the one which we have had to face during the war.” Letter of January 4, 1944, supra note 52.

\(^{64}\) Ibid.

\(^{65}\) Ibid.
reached a “sort of general understanding” on the proposals, but the “[t]he terrible problem is, of course, that of the divided jurisdiction.” On January 11, Cabinet approved the establishment of the new departments necessary for the reconstruction plan and agreed on the necessity of a conference with the provinces. Notwithstanding Ilsley’s reservations, a date in the spring of 1944 was proposed. The single most important component of the plan, family allowances, was discussed at length on January 13 and approved.

The Speech from the Throne, as finally settled, promised plans for “the establishment of a national minimum of social security and human welfare . . . as rapidly as possible,” subject to the requirement of “further consultation and close cooperation with the provinces.” Health insurance and contributory old age pensions would proceed only when provincial agreement was reached.

THE CABINET COMMITTEE ON THE DOMINION-PROVINCIAL CONFERENCE

In January 1944, Arnold Heeney, the Cabinet secretary, wrote to the provincial premiers suggesting a conference, and the following month, the Cabinet established a committee to oversee the federal government’s preparations. The committee would be chaired by T.A. Crerar and included Ilsley, Louis St. Laurent (the minister of justice), J.G. Gardiner (the minister of agriculture), Norman McLarty (the secretary of state), and Humphrey Mitchell (the minister of labour). In addition, the relevant parliamentary assistants were to form a “supervisory” committee, chaired by Brooke Claxton, and there was to be an advisory committee of officials to be chaired by Clifford Clark. The ubiquitous Alex Skelton was to serve as secretary of each committee.

66 Mackenzie King diaries, supra note 3, January 6, 1944.

67 Responsibility for implementing the reconstruction plan was to be shared among three new departments: Reconstruction, Veterans Affairs, and National Health and Welfare. See Mackenzie King diaries, supra note 3, January 11, 1944.

68 As discussed above, Ilsley missed most of that meeting because of a speaking engagement in Toronto, and Clifford Clark was brought in, in his stead, to explain and defend the proposal.

69 Canada, House of Commons, Debates, January 27, 1944, at 2.

70 Ibid. Ilsley resisted implementation of the health insurance proposal unless there was prior agreement with the provinces. King agreed: “[I] insisted on agreements being reached with the provinces first of all” and approved Ilsley’s position as “what obviously it was the duty of the Finance Minister to guard.” Mackenzie King diaries, supra note 3, January 24, 1944. The following day, Clark advised King that Ilsley would be relieved by the inclusion of the requirement for provincial agreement. Ibid., January 25, 1944.

71 Letters from A.D.P. Heeney to the provincial premiers, January 13, 1944, LAC, RG 19, vol. 4014. George Drew, the premier of Ontario, had previously suggested a conference on reconstruction, post-war employment, and financial relations.


73 Skelton had been deeply involved in the January 1941 Dominion-Provincial Conference.
From the beginning, Ilsley had mixed feelings about the conference. Following the February 14 Cabinet meeting, King noted that he “was astonished to hear Ilsley say that the conference would probably be the death of us though he was the one who advocated the necessity for it.”74 At the first meeting of the Cabinet committee on the conference, on February 17, Ilsley stated that he believed that the provinces would make very large demands for financial assistance in one form or another but that they would not be prepared to surrender the proposed tax fields to the Dominion and that the Conference would consequently result in a stalemate.75

King’s diary entries following a Cabinet meeting on February 24 suggest that Ilsley’s pessimism may have been in part a product of mental exhaustion.76 At the meeting, according to King, Ilsley “was almost on the point of breaking completely.” When they met after the meeting, Ilsley “began nearly to collapse, saying that the strain had become too great for him.” King feared that “another day might break him down completely” and suggested that he take a month’s vacation.77

Ilsley’s comment on the likely outcome of the conference signalled his intention to yield no ground in negotiating post-war tax arrangements with the provinces. He had already shown how determined he could be in pursuing principled solutions to the challenges he faced. In reshaping the tax system in the earlier part of the war, he had fought, successfully, to achieve a number of significant tax policy objectives—reliance on highly progressive and equitable income taxation, avoidance of inflation, and an equitable division of the tax burden on the provinces through the tax rental agreements. His refusal to compromise was supported by public opinion at the height of the war crisis. He must have suspected that the provinces would be less pliant in the flush of victory, but, as will be seen, he again fought stubbornly for what he had concluded was the correct policy.

Ilsley’s general reluctance to compromise annoyed King. When Ilsley resisted the suggestion that the 1944 budget could be framed as including tax reductions, King noted that “[h]is whole mind is in the direction of being consistent ad infinitum.”79 King’s concern was in building consensus, and that might require cutting the policy

74 Mackenzie King diaries, supra note 3, February 14, 1944.
75 Minutes of Cabinet Committee on Dominion-Provincial Conference, February 17, 1944, LAC, Claxton Papers, MG 32, vol. 141.
76 Ilsley had difficulty dealing with stress, and the unrelenting pressures of wartime Ottawa and a punishing workload led him to the verge of a nervous breakdown on several occasions.
77 Mackenzie King diaries, supra note 3, February 24, 1944. Ilsley subsequently spent part of March and April in California with his brother, Philip.
78 Except perhaps for the promise, when the tax rental agreements were negotiated in 1941, to allow the provinces to re-enter the income and corporation tax fields after the war.
79 Mackenzie King diaries, supra note 3, June 22, 1944. In August 1944, on the eve of the provincial election, taxi drivers in Quebec City went on strike to protest wartime restrictions on taxi fares.
cloth to fit the political realities: “a consistent course might become a wrong course.” In fact, both Ilsley and King had the same overall goal—marshalling public support for the wartime financing and inflation control measures—but they differed in their approach. Ilsley had consistently defended those policies on principled grounds, backed by his own reputation for austerity, integrity, and “telling it like it is.” In the crisis of 1940-41, this approach had been successful. Among the public at large, Ilsley was probably the best-known and most popular member of the government. Was his dogged adherence to the same approach in 1943-1946, in the face of opposition that he himself anticipated, a failure of political judgment or an act of political courage? The answer perhaps is that it was both. In any event, Ilsley’s anticipation of provincial resistance was prescient. His policy position placed him on a collision course with the larger provinces.

The agenda for the initial meeting of the Cabinet committee on the conference (presumably prepared by Skelton) set out the proposed preparatory work for the conference. This fell into two main areas: framing the federal government’s aims and proposals, which would constitute the agenda for the conference itself, and collecting background information and statistics that would support the federal position. The agenda suggested that in order to assist in the “popular goals of full employment and high income,” a number of constitutional amendments were essential, including provision for federal occupancy of the personal income tax, corporation tax, and succession duty fields; federal responsibility for contributory old age pensions and a “major portion” of health insurance costs; and federal power to implement treaties in areas of provincial jurisdiction. The agenda suggested that the federal approach should be to offer “such favourable financial terms” as would induce the provinces to agree, while still allowing them to “improve education, discharge their remaining welfare responsibilities,” and make public works investments. Finally, it proposed preparation of a comprehensive memorandum setting out the content and basis for the federal position.

At the initial meeting on February 17, 1944, the committee authorized Claxton and Skelton to prepare such a draft memorandum and to proceed with the background studies. The committee, however, decided that proposals for constitutional amendment should be kept to an absolute minimum, notwithstanding Crerar’s fear of the “endless controversy” that would result if the “allocation of tax powers was

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Ilsley resisted any weakening of wage controls, despite pleas from the provincial Liberal leader that it would affect the outcome of the election. King referred to Ilsley’s “customary obstinate stand” and commented that “a man who acts like Ilsley does in these matters, no matter how conscientious he may be, has not the political judgment which would justify recommending him for the position of leadership. His attitude has been the same from the day we began to discuss apples as they might affect his constituency.” Ibid., August 7, 1944.

80 Mackenzie King diaries, supra note 3, June 22, 1944.
81 Agenda for meeting of February 17, 1944, LAC, Claxton Papers, MG 32, vol. 141.
82 Minutes of meeting of February 17, 1944, LAC, Claxton Papers, MG 32, vol. 141.
not clearly and finally settled.”83 In particular, St. Laurent was concerned about overreaching by the federal side. For health reasons, Ilsley did not attend another meeting of the committee until May 1. In the meantime, St. Laurent continued his criticism of broad constitutional amendment.84 By June 1944, the proposed conference had been postponed, at least until the fall. The committee discussed timing at its August 3 meeting and concluded that the possibility of success would be greater if it avoided a “pre-election atmosphere”; by September, the decision had been taken to postpone the conference until after the next general election, which was expected to be called for the spring of 1945.85 In the meantime, Ilsley had prepared and delivered the 1944 budget.

**THE JUNE 26, 1944 BUDGET**

By comparison with the previous three budgets that Ilsley had brought down, the budget of June 26, 1944 was relatively straightforward. It included increases in a number of credits and allowances for individuals86 and a variety of concessions for corporate taxpayers,87 none of which had a material fiscal impact. For the first time since 1939, spending was expected to decline.88 In pre-budget discussions, the Cabinet had decided that family allowances (which were anticipated to have a net budgetary cost of about $200 million) would not go into effect until July 1, 1945, after the next election.89 This facilitated the repeal of the refundable tax imposed on individuals in 1942. The refundable tax was in reality a form of compulsory saving.90

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83 Ibid.
84 See minutes of March 16, 1944, LAC, Claxton Papers, MG 32, vol. 141, where St. Laurent criticized the “appearance of grasping for power for its own sake.”
86 Including credit for medical expenses incurred outside Canada, dependant allowances for in-laws and illegitimate children, and the deduction of alimony payments.
87 Including limited carryback and carryforward of losses, double depreciation allowances to encourage conversion of war industries, deductions for current research expenditures, tax credits for certain oil wells, lower excess profits tax for startup businesses, and a one-time 5 percent increase in base standard profits for the purposes of the excess profits tax.
88 Projected expenditure of $5.152 billion for 1944-45 was $170 million less than actual spending in 1943-44, and actual expenditure of $5.246 billion for 1944-45 was about $77 million less than in 1943-44: see appendix table 1, and Canada, Department of Finance, 1944 Budget, Budget Speech, June 26, 1944.
89 See Mackenzie King diaries, supra note 3, June 13, 1944. See also Cabinet Conclusions for June 13, 1944, supra note 38, where the Cabinet agreed with Ilsley’s position that “war requirements were greater than ever” and that exemptions should be left untouched. At that meeting and the meeting of June 15, 1944, there was final discussion and approval of the family allowance legislation. There is no record of any opposition or reservation by Ilsley with respect to family allowances other than in King’s diary entry.
90 The tax raised over the two years that the measure was in effect (a total of $269 million) was returned to taxpayers, with interest, in 1948 and 1949. For a more detailed discussion of the origins, purpose, and politics of the refundable tax, see Campbell, supra note 1, at 661.
and it was difficult to administer because several other forms of saving, including mortgage principal payments and certain life insurance and annuity premiums, could be used as offsets. This produced a flood of requests for administrative rulings and additional offsets, adding to the administrative burden of the Department of National Revenue.

Aside from the issue of administrative complexity, Ilsley also favoured abolition of the refundable tax rather than outright tax reductions (through increased exemptions) because, for him, tax reductions were inconsistent with the continued financial effort that he believed was still necessary for the war effort. The Cabinet, grasping at an opportunity to take political credit, equated abolition with reduction of tax. Ilsley strongly resisted such characterization and at one point threatened to resign over the issue, on the basis that such claims were a repudiation of his fiscal policy.91

King insisted that eliminating the refundable tax would give relief to taxpayers and that the government should take political credit for this rather than rely on Ilsley’s technical explanations. In a diary entry for June 22, 1944, he noted:

Ilsley came back by saying that he did not want to create the impression that we could afford any relief of taxation at this stage of the war and kept arguing on comparisons with the U.S. and Britain. However, the whole business seemed so complicated that even he could not explain the comparisons except by a statement so involved that anyone listening to it would become impatient. I tried to have him see that anything that was not easily and quickly explained would be worse than nothing. I told him it was absolutely necessary to keep the human side before the public.92

King then stressed the importance of presentation and insisted that Ilsley bring to Cabinet the portion of his draft speech dealing with the proposal. When this occurred the following day, King found the draft politically wanting:

[I]t gave no clear statement of the desire to effect relief to those who were experiencing hardships. . . . [T]here was no phrase in it that could be used as headlines in the press or which MPs [members of Parliament] or the public could take as the purpose in view that most of it was an effort at explanation so long in detail as to be confusing and irritating.93

After some discussion, Ilsley agreed that his draft “could be recast.”94 He did not, however, retreat on his underlying position.

The same conflict between King and Ilsley over competing approaches arose in respect of the last-minute addition to the budget of complete exemption of farm machinery from tariffs. Ilsley appears to have objected to choosing one category among many on purely political grounds:

91 See Mackenzie King diaries, supra note 3, June 22, 1944.
92 Ibid.
93 Ibid., June 23, 1944.
94 Ibid.
Ilsley keeps raising the question of how far we are to go. It appears impossible to do certain things unless pressure comes from some other direction. The answer to that is sufficient to [sic] the day is the evil thereof. Even if it did cause the manufacturers to vote against us, it would save them from voting for the C.C.F. as they apparently did in Saskatchewan.95

What King viewed as rigidity and a stubborn adherence to consistency in the face of political reality was a constant source of frustration to him and must explain, at least in part, his dislike of Ilsley. Nevertheless, King recognized Ilsley’s value to the government. This is evident in King’s assessment of the budget speech delivered by Ilsley on June 26. He noted that Ilsley’s presentation was “very good,” reflecting an emphasis on tax relief (which, King acknowledged, Ilsley had been “led to emphasize”) while not “[yielding] up any of his ground of the importance of all [on the home front] doing their part and continuing to make the necessary financial sacrifice.”96 King’s overall judgment was that

the statement was an exceptionally fine one, very statesmanlike, sound, far-reaching and in many respects exemplary. When he concluded, I made it [sic] a point of going to his seat and warmly congratulating him before the House. He has fought a very big battle.97

The Conservative response to the budget was predictable criticism of increases in non-war-related expenditures, along with demands that compulsory saving be retained and the basic exemption levels for income tax be raised.98 The CCF also preferred retention of compulsory savings, with higher exemptions and higher corporate taxes.99 Ilsley’s reply was that raising exemptions would cost more than eliminating compulsory savings, make inflationary pressures worse, increase the incentive for absenteeism, and largely benefit higher-income taxpayers.100

DEVELOPING THE RATIONALE FOR THE FEDERAL POSITION AT THE CONFERENCE

With the conference postponed until after the election, meetings of the Cabinet committee on the conference largely ceased until the early spring of 1945. The committee members and staff, however, proceeded with their preparation of voluminous background material and public finance statistics for inclusion in the federal brief,101

95 Ibid.
96 Ibid., June 26, 1944.
97 Ibid.
98 Canada, House of Commons, Debates, June 29, 1944, at 4337–43 (William E. Rowe).
99 Ibid., June 29, 1944, at 4348–51 (M.J. Coldwell).
100 Ibid., July 11, 1944, at 4714–23 (J.L. Ilsley).
together with a detailed memorandum, written by Skelton, setting out the proposed federal position and its rationale. A draft of the memorandum dated September 29, 1944 identified the objective of post-war planning as sustaining and raising the standard of living by expanding consumption. 102 “Full employment and high income” was the key to a “better life for all.” 103 Maintaining consumption at high levels depended on a more equitable distribution of income, and this could be achieved through a comprehensive social security program, including unemployment assistance for those ineligible for unemployment insurance. As Skelton noted, when the poor were guaranteed a high degree of economic security, they were more likely to increase their spending on consumption, rather than accumulate “excessive” savings or engage in “sterile hoarding.” 104 In addition, countercyclical spending on a shelf of preselected public works (particularly those in the transportation and resource development fields) was necessary to stimulate demand. All of this would be largely financed by the federal government, which also required revenue to service the greatly expanded national debt. Provincial spending on existing education programs and social services, and on investments that were “distinctly provincial and local in nature,” was also required. 105

To achieve these ends, the federal government required exclusive possession of the personal income tax, corporation tax, and succession duty fields, 106 so that it would receive the cyclically fluctuating items of revenue (as well as having responsibility for cyclically fluctuating expenditures such as unemployment assistance). The provinces would have reduced and more predictable expenditures, and would receive grants and subsidies from federal revenues to provide a revenue stream similar to that under the tax rental agreements, but with the added advantage that the flow of funds would not fluctuate with the business cycle. Skelton somewhat disingenuously described the proposed arrangement as “the financial requisite for real provincial autonomy.” 107 He also proposed special assistance for the poorer provinces in the form of “varying ratios of grants and subsidies” 108 and special federal rehabilitation and development projects.

102 Memorandum attached to the Progress Report, supra note 101.
103 Ibid., at 4.
104 Ibid., at 5-6.
105 Ibid., at 12.
106 Skelton added that along with exclusive responsibility, the federal government would undertake “major reforms” and “intensive exploitation” of these tax fields: ibid., at 14. As discussed below, this aspect of Skelton’s proposal was not adopted. It is interesting to note that the principal concern of both the federal and the provincial governments was to raise sufficient revenue to finance the growing demand for government services. There was little suggestion (apart from opposing arguments by some Conservative MPs) that spending should be reduced. The common assumption was that spending would have to rise significantly with corresponding exploitation of the available tax fields.
108 Ibid., at 13.
To compensate the provinces, Skelton proposed that they be provided with “considerably more financial margin” in the form of grants at least equivalent to the existing tax rental payments, plus net succession duty revenues, or about $100 to $110 million annually, inflated to reflect increases in national income. The memorandum proposed the division of the grant moneys among the provinces in the ratio of 50 percent on a per capita basis and 50 percent pro rata to personal income tax collections in the province.

These financial proposals, with relatively minor changes, were to form the basis of the federal position at the conference. They reflected the growing influence of Keynesian countercyclical economic theory in the Department of Finance and at the Bank of Canada, and a conviction that only the national government could deal with national problems. Even if the provinces did not agree, the federal government could carry out much of its agenda unilaterally. Skelton suggested that the provinces were in a weak position to oppose the financial proposals; faced with a federal offer to “buy the provinces out on very generous terms,”

[it] would be extremely difficult for any provincial government to justify to its own people the rejection of a very favourable cash transfer from the Dominion in favour of double taxing their own people to raise a smaller amount.

His theory was to be tested in due course.

Skelton produced an expanded and, in some respects, revised version of the memorandum, dated March 8, 1945. In it, he advanced four reasons for avoiding a return to the pre-war fiscal system:

1. Reliance on indirect taxes rather than progressive income taxes created levies on costs and the creation of impediments to production and investment. Because wealth created in one province might be taxed in another province, the poorer provinces were forced to levy taxes at very high and destructive rates. Even at these rates, those provinces could not provide adequate services and flirted with insolvency; consequently, they had little real financial autonomy.

109 Ibid., at 14-15.
110 Ibid., at 17.
111 See letter from T.A. Crerar to members of the Cabinet committee, March 8, 1945, enclosing a copy of the revised memorandum, LAC, Claxton Papers, MG 32, vol. 143. The memorandum is also found in RG 19, vol. 109.
112 Revised memorandum, supra note 111, at 30-32.
113 The poorer provinces perennially complained that their resources were exploited by corporations based in Ontario and Quebec, which sucked the profits out to their head offices. They also complained, more generally, that federal policies such as the National Policy had harmed the prairie and maritime provinces to the benefit of central Canada.
2. Countercyclical fiscal policies were required to counteract fluctuations in the levels of employment and income:

   Government expenditures, and more especially the relationship between expenditures and revenue, have become the balance-wheel of the economy. With government outlays, even under normal circumstances, rising to as much as one-third of the national income, they have necessarily become a dominant factor in the economic system.\textsuperscript{114}

   Further, unlike levels of exports or private investment, government expenditures were “most readily subject to control and direction towards influencing the level of employment.”\textsuperscript{115}

   Skelton also repeated his earlier argument that redistribution of income effected by progressive taxation and federal spending on programs such as family allowances or unemployment assistance and a public investment program would increase consumption spending and further stimulate the economy. The corollary of this argument was that the taxation sources that fluctuated the most in response to the business cycle should be in the hands of the federal government, “so that deficits . . . would be centralized in the authority which controls monetary policy”\textsuperscript{116} and the revenue flowing from those sources would be available to finance the redistributive and stimulative expenditure program.

3. The pre-war system was inequitable because the poorer provinces were not able to provide services to their residents roughly comparable to those provided in the richer provinces without greatly disproportionate levels of taxation (and even then found it difficult to do so).

4. The pre-war system did not provide the provinces with a predictable and dependable flow of revenue adequate for their constitutional responsibilities.

These arguments were at the core of the federal position and underlay the proposals made by Ilsley when the long-delayed federal-provincial conference convened in mid-1945.

The specific policy proposals advanced in the March 8 memorandum had not changed greatly in the six months since Skelton submitted his initial draft.\textsuperscript{117} The

\textsuperscript{114} Revised memorandum, supra note 111, at 36.
\textsuperscript{115} Ibid.
\textsuperscript{116} Ibid., at 32.
\textsuperscript{117} See supra note 102 and the related text. However, Skelton also included in the March 8 memorandum suggestions for significant changes in personal and corporation income taxes. These were apparently Skelton’s own views, not those of Finance; Bryce, in a marginal note to his copy of the memorandum wrote, with respect to the corporation tax changes proposed by Skelton, “Is this not entirely new to Dept. of Finance—why was it not cleared in any way . . . but why in hell is all this needed anyway—this is not to be given to the Conference.” See LAC, RG 19, vol. 109. Skelton’s proposals do not seem to have had any impact on subsequent policy decisions of the Department of Finance about the design of the corporate income tax.
personal income and corporation tax and succession duty fields would be exclusively occupied by the federal government in return for unconditional cash payments to the provinces. The latter would be “something more” than the tax rental payments and pre-war succession duty revenues. Skelton’s estimate of $110 million in September 1944 had been raised to $120 million. The payments would be increased in proportion to increases in national income.

Notwithstanding these “very generous” terms, Skelton conceded that Ontario, Quebec, and perhaps British Columbia might be better off rejecting the federal payment and imposing a 10 percent provincial corporation income tax; they would not, in his view, “freely surrender this bargaining point in the national interest.” Skelton believed that a dissenting province would have difficulty justifying such action to its residents, given that they would be faced with a provincial tax in addition to the federal corporation income tax and the possibility that certain desirable federal programs (for example, enhanced old age pensions) would be delayed, with the onus being put on the non-cooperating provinces. The federal government could also take the position that it was not bound indefinitely by its promise in 1941 to lower corporation income tax rates by 10 percentage points on expiry of the tax rental agreements, and it could hold out the threat of increased federal taxes “to carry out a desirable national programme.” Skelton suggested that, in the last resort, notwithstanding that its “public position should be a strong one,” the federal government should agree to “purchase” the corporation tax field from the provinces with the proceeds of a 10 percent tax imposed and collected at the federal level. Succession duties could be similarly purchased. The total additional cost of this final position was estimated to be about $25 million.

Skelton was personally optimistic that the federal government would emerge victorious. After interviewing Skelton and others involved in planning for the conference, Dexter prepared a memorandum noting their views on the government’s position. He summarized Skelton’s comments as follows:

Dominion-provincial relations—outlook bleak but not hopeless. True that election would probably weaken Dominion government. . . . True W.L.M.K. never put up a fight. But the kind of proposition he had in mind didn’t require spunk. The Dominion

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118 Together with the statutory subsidies under the Constitution Act, 1907, 7 Edw. VII, c. 11 (UK), section 1, the actual amount would be about $140 million.
119 Revised memorandum, supra note 111, at 41.
120 Ibid., at 42.
121 Ibid.
122 Ibid., at 43.
123 A number of officials in the Department of Finance shared this view. Indeed, Kenneth Eaton suggested that Skelton had “underestimated the bargaining power of the Dominion.” Memorandum from Kenneth Eaton to Skelton, February 16, 1945, LAC, RG 19, vol. 109, at 12.
should offer to buy out all or any provinces, and leave the offer lie. The weaker provinces would take it and the stronger would soon weary of their course.124

W.A. Mackintosh (who was then acting deputy minister of finance, at a time when Clark was ill) thought that, correctly presented, the government’s proposals should be acceptable to the provinces because their merits were clear:

Finance is the necessity and agreements would suffice. Given the right to place the burden fairly, the country can face the future and meet the problems. Denied the right, the country is hamstrung. It should be presented in this way—not centralization but rationalization of taxation. Moreover rationalization would place the provinces in a sounder position.125

In Clark’s view, provincial cooperation was essential:

[I]t is tax agreements or chaos.126

Dexter had also spoken to Ilsley, whom he found in “appalling physical condition” owing to his recurrent “nervous problem.” This may account, at least in part, for the negativity of Ilsley’s remarks as recorded by Dexter:

Dominion-provincial relations—pretty well hopeless. He saw it this way. After the election if they are still in office King will call a conference and put up a proposition. It doesn’t matter much what it is. The provinces will turn it down. The tax agreements will be terminated as soon as the war is over and the Dominion will vacate and cut its corporation taxes down to 30 per cent. Things will then go on as prewar. Just have to do the best possible under these conditions.127

Notwithstanding Ilsley’s pessimism, there is no indication that he had moved from his consistent position on federal-provincial financial relations or that he had abdicated the leadership role to the brain trust and other officials in the East Block involved in drafting the government’s proposals.

124 Frederick W. Gibson and Barbara Robertson, eds., Ottawa at War: The Grant Dexter Memoranda, 1939-1945 (Winnipeg: Manitoba Record Society, 1994), at 497, quoting from Dexter’s memorandum of March 1, 1945.
125 Ibid., at 498.
126 Ibid., at 500.
127 Ibid., at 497.
128 Most of the senior officials involved had offices in the East Block of the Parliament Buildings and were often referred to in terms of that connection (for example, “the East Block boys”).
PREPARATIONS FOR THE CONFERENCE, JUNE AND JULY 1945

The general election was held on June 11, 1945, returning the King government with a reduced majority and opening the way for the long-delayed conference with the provinces. In a letter to Bruce Hutchison, a journalist in Victoria, Dexter reported that Ilsley had wanted the conference to proceed immediately, so that he could reflect its conclusions in the 1945 budget. King preferred a date in the fall, and they had compromised by settling on August 6-10. Ilsley foresaw an initial one-week session at which the respective governments would present their proposals and appoint a number of continuing intergovernmental committees to carry out further detailed work. The conference would then reconvene in October. The budget would be brought down in the meantime, on the assumption that the existing federal-provincial arrangements would continue.

Dexter reported that Ilsley continued to worry about the conference, anticipating resistance from the provinces on the financial proposals. The minister’s strategy was to put indirect political pressure on the provinces:

[Ilsley] doesn’t believe the dominion can strong arm the provinces. Ottawa must be patient and succeed by persuasion, aiming arguments over the head of the provincial governments at the electors of the provinces. . . . The great thing, he thinks, is to present a bang up programme based on the transfer of the taxing power. The Dominion must show the country what can be done if the provinces will co-operate.

Dexter listed six main proposals identified by Ilsley: unemployment insurance (already “in the bag” but requiring partial federal funding), family allowances, unemployment assistance, a contributory old age pension plan, health insurance, and a “well integrated [plan] of public works in case unemployment develops.” “[The] idea is to show the cost and the need for a free shot at the income and [corporation] taxes.” A backup plan would be needed in case of failure; in that case, “[a]ll the gew gaws [would] of course go out the window”—including, presumably, contributory pensions and health insurance.

Ilsley’s plan was to repeat the tactic that had worked in 1941. At the January 1941 Dominion-Provincial Conference, Ontario, Quebec, and British Columbia had rejected implementation of the Rowell-Sirois recommendations but, in the face of the war emergency, had accepted, however ungraciously, the tax rental arrangements.

129 QUA, Dexter Papers, Dexter to Hutchison, June 21, 1945.
130 Ibid.
131 Ibid.
132 Ibid.
133 Ibid.
134 See Campbell, supra note 1, at 652-54.
Ilsley’s position in 1941 was strengthened by the absence of any coherent alternative plan from the provinces. His strategy reflected his approach to politics generally—to take a well thought out position, argue it on principled grounds, and refuse to compromise. Ilsley had already paid a price on this account. The nervous stress that led to his repeated near-breakdowns was caused, as King and other observers noted, in part by his unyielding and principled defence of wage and price controls.\textsuperscript{135} The coming battle with the premiers was to take a similar toll.

The format of the conference and the government’s strategy for securing the provinces’ agreement to its proposals were discussed at a meeting of the Cabinet committee on June 20, 1945. It was decided that the federal government would take control of the agenda by placing detailed proposals before the conference at the opening session, which would then be referred to a number of federal-provincial committees for detailed consideration. In the agenda for the Cabinet committee meeting, Skelton suggested that the federal government submit its proposals at the outset and give the provinces the opportunity to also submit proposals or make statements. Skelton continued:

No attempt should be made at this stage to reach agreement on either general principles or details, but an attempt only should be made to reach an agreement to consider the Dominion’s proposals and any alternatives.\textsuperscript{136}

The committee, at Ilsley’s suggestion, prepared a draft letter of invitation to the premiers,\textsuperscript{137} stating that the federal government intended to put proposals to the conference, that the provinces would have equal opportunity to do likewise, and that committees would be established to consider “the major proposals presented and any alternatives.” The wording made it clear that the agenda was to be driven by the federal proposals.

Other matters dealt with at the June 20 meeting included confirmation that the conference was to open on August 6 and that C.D. Howe (the minister of munitions and supply), Brooke Claxton, and J.A. MacKinnon (the minister of trade and commerce) had been added to the committee.\textsuperscript{138} Ilsley also noted that the 1946 budget would be brought down on the assumption that no agreement with the provinces would be reached.

\begin{footnotes}
\footnote{135} And, in particular, almost constant conflict with the combative minister of agriculture, J.G. Gardiner, over farm product prices. See Dexter memorandum of November 1, 1943 in Gibson and Robertson, supra note 124, at 446-47.
\footnote{136} Agenda for Cabinet committee meeting of June 20, 1945, at 2, LAC, Claxton Papers, MG 32, vol. 141 (emphasis in original).
\footnote{137} See minutes of the June 20, 1945 meeting, LAC, Claxton Papers, MG 32, vol. 141. The letter to the premier of Ontario dated June 21, 1945 is found in the same volume.
\footnote{138} Replacing Crerar, who did not run in the 1945 election and was subsequently appointed to the Senate, and Norman McLarty, who left the Cabinet at the same time as Crerar.
\end{footnotes}
In late July 1945, the federal government prepared a long and detailed brief setting out its proposals. The portion dealing with financial arrangements\textsuperscript{139} repeated in substance the objectives contained in Skelton’s memorandum of March 8:\textsuperscript{140} reorganization of the tax system to (1) encourage business investment, (2) enable the federal government to engage in countercyclical fiscal policy, (3) ensure a minimum standard for services in all provinces, and (4) provide a “dependable” financial base for the provinces. Attainment of these objectives required exclusive federal occupancy of the personal income and corporation tax and succession duty fields, which in turn would serve a fifth objective—to make it easier for Canada to enter into bilateral tax treaties with other countries.\textsuperscript{141} The brief also contained a statement that went to the heart of the federal position and identified what was to be the core issue in federal-provincial financial relations for the next several decades:

[The federal government] will clearly need to make full use of taxes on personal incomes, corporations and estates. Moreover, its revenue needs will be so great that duplication of these taxes by other governments would seriously restrict enterprise and output and would jeopardize Canada’s full employment programme.\textsuperscript{142}

Implicit in the federal position was the assertion that federal spending priorities were more important than provincial fiscal needs—the same argument successfully made in 1941 but now applied to peacetime. This was reflected in the initial federal offer to replace the tax rental payments of 1941. The provinces would receive an unconditional payment of $12 per capita, adjusted for the increase in the gross national product (GNP) since 1941.\textsuperscript{143} This would result in minimum aggregate payments of $138 million annually (compared to actual provincial receipts of $125 million in 1945 from tax rental payments, the statutory subsidies, and succession duties). Increases in GNP since 1941 would, however, increase this amount substantially.\textsuperscript{144} The brief does not provide the basis for arriving at the $12 per capita amount, but the preliminary report of the Committee on Financial Arrangements established by the Cabinet committee on the conference indicates that the amount was calculated by averaging the existing federal subsidies and tax rental payments to the provinces plus provincial

\textsuperscript{139} Memorandum of July 26, 1945, at 1-11, LAC, RG 19, vol. 110.

\textsuperscript{140} See supra note 111 and the related text.

\textsuperscript{141} This issue provoked virtually no discussion at the conference, and in subsequent years, provincial taxing powers provided no real obstacle to the development of Canada’s tax treaty network.

\textsuperscript{142} Memorandum, supra note 139, at 5.

\textsuperscript{143} The proposal in Skelton’s memorandum of March 8, 1945, which was repeated in a memorandum of June 15, 1945 (LAC, Claxton Papers, MG 32, vol. 141), that the payment be made in the ratio of 50 percent per capita and 50 percent pro rata to personal income tax collections in the province, had been abandoned.

\textsuperscript{144} The memorandum, supra note 139, at 9, estimated that, using GNP for 1944, the total would be $207 million.
succession duty revenues and increasing the resulting amount of $11 as required “to reduce the range of increase in population or per capita income within which Ontario or British Columbia would receive its irreducible minimum amount.”

In a memorandum to Dexter written in September 1945 (after the initial session of the conference), Hutchison (who had close ties to the BC government) reported that the $12 per capita amount was “based on a general average of the cost of government throughout all the provinces.” The offer therefore assumed that the provinces would remain at their pre-war revenue and spending levels, expressed as a proportion of GNP. In particular, they would be denied access to the tax fields that now accounted for a substantially higher proportion of the national income than in 1939 and also yielded revenue that tended to increase faster than national income. Moreover, while the federal proposals would relieve the provinces of some expenses, they effectively assumed that other provincial responsibilities such as education, transportation and other infrastructure, and many social services would remain, in relative terms, more or less at pre-war levels. This was not an assumption shared by, at least, the larger provinces, and it set the stage for a confrontation that confirmed Ilsley’s foreboding.

**THE DOMINION-PROVINCIAL CONFERENCE, AUGUST 6-10, 1945**

The federal delegation to the conference included all 20 Cabinet ministers and 55 public officials. The provincial delegations included varying numbers of ministers and, in all, 77 officials, of whom 25 were from Ontario. These numbers reflected the size and detail of the federal proposals as well as the lack of depth in the public service of most of the provinces. Ontario was the exception, and that province was eventually to produce the most substantial and comprehensive alternative to the federal plan.

Mackenzie King’s opening statement set out the federal government’s objectives in very general terms:

> [W]e are asking the provinces to go into partnership with the Dominion in a broad programme for the development of our national heritage, and the promotion of the welfare of the Canadian people.

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145 Preliminary Report of the Committee on Financial Arrangements, July 14, 1945, LAC, RG 19, vol. 109, at 7. The committee was chaired by W.A. Mackintosh and included both Skelton and Bryce.

146 Letter from Hutchison to Dexter, dated “Sept/45,” with memorandum attached, QUA, Dexter Papers.

147 Ranging from eight from Ontario to three from Prince Edward Island. See Canada, *Dominion and Provincial Submissions and Plenary Conference Discussions* (Ottawa: King’s Printer, 1946) (herein referred to as “Conference Discussions”), at vii to xi.

148 Ibid., at 6.
King’s statement was followed by statements by each of the premiers. George Drew, the premier of Ontario, presented a vigorous defence of “decentralization of a large measure of authority” and strong provincial governments. In particular, he defended the fiscal independence of the provinces:

Any arrangement . . . which provided for a centralized collection of the greater part of the tax requirements of provincial governments and made them mere annuitants of the central government would place the provincial governments under the control of the central government to an extent that meetings of the . . . legislature would become almost meaningless because of the limitations within which they would be called upon to legislate.

Drew also pointed to an imbalance in provincial and federal taxing powers, which he attributed to a fundamental weakness in the BNA Act: while the powers of the provinces were well defined and had been extended by the courts, the federal government had increasingly occupied the direct taxation field to which the provinces were limited. Confederation was, however, based on the “implicit understanding that the Dominion Government will leave the field of direct taxation open to the provinces of such an extent as will make it possible” for them to carry out their constitutional obligations. Tax-sharing agreements were needed that would “leave to the provincial governments that independence and vigor which enables them to carry out the obligations which have been imposed upon them, and which will be imposed upon them in even greater degree in the years ahead.”

In a diary entry, King commented that Drew “spoke very well.” He does not seem to have appreciated, at that point, the fundamental challenge that Drew had raised to the federal position. The federal financial offer gave to the provinces a stable source of revenue but one that was essentially static. Ontario’s tax rental payment under the federal proposals, in relation to the GNP, would be no greater than its revenues from corporation taxes and succession duties in relation to the GNP in 1939. As Skelton had pointed out, Ontario might well have been able to raise as much or more revenue by reimposing corporation taxes alone. The federal proposal implied a more active and dominant federal presence, managing the economy through countercyclical budgeting and the shelf of public works, providing for major welfare programs (unemployment assistance, old age pensions, and family allowances), and promoting and partially financing health insurance and other

149 Ontario statement, ibid., at 9.
150 Ibid., at 11.
151 Ibid., at 12.
152 Ibid.
153 Mackenzie King diaries, supra note 3, August 6, 1945.
154 And in fact may have been somewhat smaller, given the element of equalization inherent in the fixed per capita payment proposed.
health-related programs. This reflected both a pan-Canadian or nationalist view—providing similar benefits to Canadians in all provinces—and a conviction that provincial boundaries were irrelevant or an impediment to economic management and prosperity in the modern world. Drew challenged this view in principle in his opening address, and Ontario was to subsequently challenge the fiscal implications of the federal view, particularly the denial of access to the revenue potential of the previously rented tax fields, so clearly revealed in the financing of the war effort.

While it is tempting to project into the past more recent challenges to federal power by Quebec, in 1945 Ontario was the principal champion of provincial rights.\(^\text{155}\) With the exception of an extended plea for more funding from New Brunswick's premier, John McNair, and references to social credit theory by the premier of Alberta, Ernest Manning, the opening statements of the other premiers were brief statements of good intention. In a revealing interview with Bruce Hutchison in September 1945, however, Premier John Hart of British Columbia essentially echoed Drew’s criticism.\(^\text{156}\) Indeed, he went further, discounting the countercyclical budgeting theory that was one of the federal government’s chief arguments:

> It purports to be part of a scheme of full employment . . . tied to all sorts of social reforms . . . to provide the more abundant life for everyone and ample jobs. It is nothing of the sort. The federal government has no full employment policy.\(^\text{157}\)

As reported by Hutchison, Hart’s view was that

> [t]he scheme, in fact, is part of a plan to centralize power in Ottawa, reduce the power of the provinces and hand the control of the country, through finance, to the bureaucrats and the East Block boys who are talking generally through their hats, as proved in this scheme. [Hart] is opposed to the scheme on this broad ground of centralism which does not have the excuse of being part of any real full employment plan.\(^\text{158}\)

In a more practical vein, Hart pointed out that the fixed per capita payment proposed, based on averaging the costs of government over all the provinces, did not

\(^{155}\) While the premier of Quebec, Maurice Duplessis, praised decentralization and the compact theory of Confederation, he presented no systematic or reasoned attack on the federal position, or any real alternative, unlike Ontario, as discussed below. See Conference Discussions, supra note 147, at 20-21, for Duplessis’s opening remarks.

\(^{156}\) Memorandum attached to letter from Hutchison to Dexter, supra note 146. Hart was not the only premier critical of the presumed influence of the brain trust; Nova Scotia premier Angus L. Macdonald spoke of the “lurking fear” of the “tremendous power” of the civil servants and said that he “would not want to have anything to do with a provincial government if Dominion-provincial policy was to be framed by high civil servants in the Department of Finance or in the Bank of Canada.” See letter from Macdonald to T.A. Crerar, April 19, 1946, QUA, Crerar Papers, box 122.

\(^{157}\) Memorandum, Hutchison to Dexter, supra note 156.

\(^{158}\) Ibid.
provide enough money for a high-cost province like British Columbia and would yield substantially less than the province would realize by exploiting the income tax and succession duty fields itself. Hart predicted that

once the public understands the loss involved, it will revolt against it. The federal government’s plan to sell this pup as a full employment measure etc. has fallen flat.\footnote{159}

To Hutchison’s suggestion that the provincial government would be “lynched from the lamp posts then entwined with flowers outside his window” if it reimposed its pre-war taxes, Hart replied that “the people would rather pay taxes to the province instead of sending them east and in a fight between the two governments would favor their local government.”\footnote{160} This was very different from the political situation in 1941 and did not bode well for the federal position.

Hart’s alternative was very similar to that later put forward by Ontario. The provinces would receive a percentage of the income taxes and succession duties collected in the province and thus share in the revenue potential of progressive income taxation. For the poorer provinces, this would be supplemented by unilateral federal payments similar to those proposed by the Rowell-Sirois commission.\footnote{161}

Following the presentations by the premiers, each of the federal ministers then read into the record the relevant portion of the federal brief to the conference.\footnote{162} The federal financial proposals, read in by Ilsley, repeated the position and proposals previously set out in the memorandums prepared for the Cabinet committee.\footnote{163}

The premiers then presented, or were given the opportunity to present, their proposals. The most substantive presentation, by Premier Stuart Garson of Manitoba, was a long endorsement of the federal position. (Perhaps not surprisingly, Garson was to become the federal minister of justice in 1948.) Saskatchewan’s presentation, by Premier T.C. (Tommy) Douglas, was sympathetic to the federal position; Alberta’s Premier Manning merely presented a list of topics to be discussed. The premiers of Ontario (Drew) and Quebec (Maurice Duplessis) presented no substantive proposals at this stage of the discussions.

A Co-ordinating Committee, consisting of St. Laurent, Howe, Ilsley, and the nine provincial premiers, was constituted and met on August 9 to receive further explanation of the federal proposals. On August 10, the Co-ordinating Committee agreed to adjourn and resume discussions on November 26; in the meantime, the federal and any provincial proposals would be studied further. The full conference

\footnote{159} Ibid.
\footnote{160} Ibid.
\footnote{161} For further discussion of the positions of British Columbia and Ontario, as well as other provinces that presented formal briefs, see the text below at note 174 and following.
\footnote{162} Federal government proposals, Conference Discussions, supra note 147, at 55-118. The proposals had been released to the public a few days earlier.
\footnote{163} Ibid., at 111-18.
then adjourned, with agreement to reconvene at some date after November 26. Ilsley had delayed presenting the 1945 budget in anticipation of the results of the conference. The adjournment then forced him to bring down the budget without those results.

**THE OCTOBER 12, 1945 FEDERAL BUDGET**

The October 12, 1945 budget began the fiscal transition to peacetime but, like the 1944 budget, proposed no significant changes to the structure of the tax system or to tax rates. In the budget speech, Ilsley reviewed the war finance policy, including the “pay-as-you-go” policy adopted in 1939, and once again committed the government to significant reliance on the personal income tax:

> [T]here is no doubt that the personal income tax in the post-war period will continue to occupy a major place in our taxation structure. The extent and the nature of the requirements of the government will necessitate dependence on the personal income tax as a major element in the taxation system.

In the absence of an agreement with the provinces, Ilsley rejected “hasty and irretrievable steps in the modification and reorganization of our tax structure.” Total expenditures in 1945-46 were only marginally lower than in the previous year, with declining war and demobilization expenses being largely offset by increased debt charges and family allowance payments. The war exchange tax was abolished and reductions made in sales taxes. Personal income taxes were reduced by 16 percent in a full year and by 4 percent in the remaining portion of 1945. To eliminate the duplication of benefits for higher-income individuals who were already receiving the tax credit for dependent children and would also receive a family allowance, a tax was imposed on family allowance benefits, beginning at 10 percent for families with income exceeding $1,000 and increasing to 100 percent for families with income exceeding $3,000.

The excess profits tax was amended to remove the tax from many small businesses, and the excess profit rate was reduced from 100 percent to 60 percent.

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164 Canada, Department of Finance, 1945 Budget, Budget Speech, October 12, 1945, at 1. See Campbell, supra note 1, at 638-42, for discussion of the 1939 budget.

165 1945 Budget Speech, supra note 164, at 9.

166 Ibid., at 6.

167 About $100 million; see appendix table 1.

168 Imposed on non-sterling imports to conserve US dollar reserves.

169 The reduction in personal income tax payable applied to the aggregate of normal tax, graduated tax, and investment surtax.

170 The minimum standard profit base was increased from $5,000 to $15,000, and the basic 15 percent tax on sole proprietorships and partnerships was eliminated (leaving them subject to the excess rate).
The reductions were expected to result in $107 million in lost revenue in the remaining portion of the 1945–46 fiscal year, and in a full year $327 million (divided between roughly one-third from the sales and excise tax reductions and the balance from the personal and corporate income tax reductions).

The 1945 budget, in its revenue and expenditure profile was the last of the war budgets. The rapid decline of defence expenditures transformed the federal fiscal position after 1945. The principal effect of declining war expenditures was to eliminate the federal deficits (and consequential borrowing) so that, while total federal revenue declined, there was no material change in federal tax revenues. Ilsley’s concern to “protect the Treasury,” to use King’s phrase, did not easily yield to political pressure. The Liberal caucus wanted a $2,000 tax-free allowance for MPs. Facing relentless pressure from the caucus and from King, Ilsley would initially concede only $1,500, then $1,800, and conceded $2,000 only after pressure from the full Cabinet.

THE CO-ORDINATING COMMITTEE MEETINGS OF NOVEMBER 26-30, 1945 AND THE PROVINCIAL RESPONSE

The Co-ordinating Committee met again from November 26 to 30, 1945. British Columbia, Alberta, and Nova Scotia presented formal briefs at the meetings. Ontario, Saskatchewan, New Brunswick, and Manitoba presented briefs after the November meetings but before the next series of meetings from January 28 to February 1, 1946, and Nova Scotia submitted a further brief. At the meetings, British Columbia appears

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171 As a result of these changes, corporations with annual profits of $15,000 or more were subject to the 18 percent corporation income tax, the minimum 22 percent excess profits tax rate, and a 60 percent tax on profits generally in excess of 116½ percent of standard base profits.

172 In the result, total revenue from income tax and succession duties was about $100 million lower in 1945-46 than in 1944-45.

173 See Mackenzie King diaries, supra note 3, September 27, 1945 and September 28, 1945; and Cabinet Conclusions for September 28, 1945, supra note 38.

174 There does not appear to be a record of the November meetings of the Co-ordinating Committee. (The official report of the conference contains only Mackenzie King’s opening statement, copies of the formal briefs submitted by some of the provinces, and written responses by the federal government.) The Co-ordinating Committee established an Economic Committee, consisting of three officials (usually a mixture of elected and appointed officials) from each government, to report back to the Co-ordinating Committee after the year-end. The Economic Committee was chaired by the senior federal representative, Brooke Claxton, and Skelton was to act as secretary. (See Cabinet Conclusions, supra note 38, minutes of the meeting of November 29, 1945, and a press release dated November 30, 1945, LAC, Claxton Papers, MG 32, vol. 142.) The Economic Committee met six times between December 4 and 14, principally attempting to project the effect of the federal proposals on provincial budgets. No conclusions were recorded in the minutes of the committee. See LAC, Claxton Papers, MG 32, vol. 142.
to have proposed an arrangement that would combine the sharing of tax fields and a per capita payment.\textsuperscript{175} Ontario refused to disclose its position,\textsuperscript{176} but it was assumed to be similar. The federal concern was that the revenue of the richer provinces would grow faster than the per capita grants to the poorer provinces, the agreements would need frequent renegotiation, and “the dominion would not be so well fixed to do its job.”\textsuperscript{177} Dexter suggested that Skelton had toyed with a plan along the lines of the BC proposal, combining provincial taxes imposed at 1941 rates and a $7 per capita payment.\textsuperscript{178}

The formal provincial responses fell into two groups. Saskatchewan, Manitoba, New Brunswick, and Nova Scotia accepted the federal proposals for exclusive federal possession of the personal income and corporation tax and succession duty fields, but rejected the proposed rental payments as inadequate; all four provinces specifically asked for some form of special-needs subsidy to compensate for their limited fiscal resources relative to the other provinces. The positions taken by Alberta, British Columbia, and Ontario were quite different. None sought special-needs subsidies or equalization for itself; Ontario and British Columbia sought greater access to revenue from the taxes proposed to be rented, and Alberta sought both more money and a greater degree of autonomy in tax matters. The arguments presented by the provinces in both camps are summarized in the text that follows.

Nova Scotia sought assurances that the federal government would withdraw from areas of the direct taxation field that it had occupied for much of the war— principally gasoline, electricity, and amusement taxes—and that it would not enter any new areas of that field.\textsuperscript{179} Nova Scotia also asked how the $12 per capita figure had been determined and whether some form of equalization had been considered, in the form of either grants such as those proposed by the Rowell-Sirois commission or some kind of pooled sharing of the tax fields proposed to be rented. The federal government responded that a grant of a fixed per capita amount for all provinces

\textsuperscript{175} See Dexter’s memorandum of December 9, 1945, reporting a conversation with W.A. Mackintosh, QUA, Dexter Papers. The proposal apparently was for 5 percent sharing— presumably, 5 percent of the revenue from the rented fields. The poorer provinces would receive proportionately larger cash payments.

\textsuperscript{176} “Apparently, at the talks of the experts so far, the Ontario boys have succeeded in keeping all their cards face down.” Dexter’s memorandum of December 9, 1945, supra note 175, at 4.

\textsuperscript{177} Ibid., at 5.

\textsuperscript{178} Memorandum of December 20, 1945, QUA, Dexter Papers, at 5.

\textsuperscript{179} See Nova Scotia brief (dated November 28, 1945), Conference Discussions, supra note 147, at 215-18. Nova Scotia’s premier, Angus Macdonald was particularly concerned about federal occupancy of the minor direct tax fields. In a letter to T.A. Crerar dated January 16, 1946, he asked what guarantee Nova Scotia had that the federal gasoline tax would not eventually drive the province out of the field and complained that “if the same policy be pursued in other respects, [the] Provinces in a few years will find themselves in a position where they will be nothing more [than] recipients of grants from the Dominion Government with all their taxing powers gone.” QUA, Crerar Papers, box 122.
would be “equitable” and had “the advantage of simplicity and definiteness.”\textsuperscript{180} Nova Scotia replied that the federal position was “unsatisfactory” and suggested special fiscal-need grants as proposed by the Rowell-Sirois commission.\textsuperscript{181} In an earlier letter to Dexter, Premier Angus Macdonald had suggested:

One of the weaknesses of the Dominion proposals is that they simply follow the Confederation plan of subsidies based on population. In fact, there is nothing new in the Dominion proposals. The subsidy is greater, but the principle remains the same. Nova Scotia is presumed to be able to get along on the same basis as Ontario. This was a fundamental weakness I think of the Confederation pact, and therefore must be regarded as a weakness in the Dominion proposals.\textsuperscript{182}

The Saskatchewan brief was a lengthy and sophisticated commentary on every aspect of the federal proposals.\textsuperscript{183} Its comment on the fiscal proposals\textsuperscript{184} followed Nova Scotia’s in suggesting needs-based federal grants rather than payments based largely on population. Saskatchewan also preferred a Rowell-Sirois-type of national adjustment grant, but it was prepared to accept per capita rental payments provided that there were supplemental needs-based grants and guaranteed floor prices for farm products and crop insurance, to provide economic security for farmers.

New Brunswick echoed Nova Scotia’s concerns about federal incursions into direct taxation fields traditionally occupied by the provinces, and asked for a larger per capita fixed payment and a special-needs subsidy.\textsuperscript{185}

Manitoba accepted the federal proposal for occupancy of the major tax fields, which “would make possible a practical arrangement for the equalization of the revenue sources of the different provinces.”\textsuperscript{186} Like Nova Scotia, Manitoba called for supplemental subsidies based on special needs and for the province to have an “available field of taxation” to “preserve provincial autonomy.”\textsuperscript{187}

As noted above, Alberta, British Columbia, and Ontario raised different objections to the federal proposals, and suggested different approaches to revenue sharing, though they were united with the other provinces in resisting federal appropriation of provincial direct taxation fields.

\textsuperscript{180} Federal response delivered in writing, December 5, 1945: see Conference Discussions, supra note 147, at 219-20.

\textsuperscript{181} Reply, January 26, 1946; see Conference Discussions, supra note 147, at 315-17.

\textsuperscript{182} Letter from Angus L. Macdonald to Dexter, November 1, 1945, QUA, Dexter Papers.

\textsuperscript{183} See Saskatchewan brief (dated January 9, 1946), Conference Discussions, supra note 147, at 249-309. The quality of the brief presumably reflected the superior level of competence in the Saskatchewan public service—an advantage that served the province well in negotiating with its partners in the Canadian federation.

\textsuperscript{184} Conference Discussions, supra note 147, at 253-56.

\textsuperscript{185} See New Brunswick brief (dated January 24, 1946), ibid., at 311-13.

\textsuperscript{186} See Manitoba brief (dated January 26, 1946), ibid., at 318-26 (quoted text at 320).

\textsuperscript{187} Ibid., at 322.
Alberta anticipated “very substantial increases in revenue from corporation tax and income tax in the normal course of our internal development,” sought an increase in the proposed per capita rental payment to $16, and echoed the call of other provinces to halt further federal incursions into traditional provincial direct taxation fields.\(^{188}\) Alberta also sought to retain control of its corporation taxes as a means of controlling its internal economic development.\(^{189}\)

British Columbia took the position foreshadowed in Premier Hart’s interview with Bruce Hutchison in September 1944.\(^{190}\) The proposed federal per capita payment did not reflect the productive capacity of the provincial tax base, and the province would be substantially better off re-entering the rented tax fields. British Columbia therefore suggested federal payments at a minimum equaling the yield that the rented tax field would have produced at the rates in force when last levied by the province. The BC brief made no mention of fiscal needs payments to the poorer provinces.

Ontario’s brief provided the most substantial challenge to the federal position.\(^{191}\) As a backdrop to its counterproposals, Ontario advanced, as Drew had done at the August conference, a robust defence of the federal system and the importance of diffusing power as a means of defending democratic government and protecting civil and property rights. The brief noted the inability of the provinces to deal separately with national economic problems such as unemployment and regional disparity; however, it called, not for federal leadership, but for federal-provincial cooperation:

\begin{quote}
[N]one of these presents any insuperable difficulty under a Federal System in which there is effective and continuing cooperation between the Dominion and provincial governments. . . . The Federal System can meet all these problems by becoming in fact as well as in name a fully cooperative partnership.\(^{192}\)
\end{quote}

The brief also stressed the role of the Ontario government in economic development, particularly in transportation and hydroelectric infrastructure, education, and social services, implicitly challenging a dominant federal role in the economy.

It followed that provincial financial needs ranked on a par with those of the federal government and the federal proposals consequently fell short. Like British Columbia, Ontario would receive less under the proposed rental payments than its occupancy of the rented fields would produce, calculated by reference to the 1945 Ontario budget. With the passage of time, the disparity would widen because of the

\(^{188}\) See Alberta brief (dated November 26, 1945), ibid., at 207-13 (quoted text at 209).

\(^{189}\) Ibid., at 211. Alberta also proposed that provincial corporation taxes should be deductible against federal corporation taxes and that the province’s proceeds from such taxes should be deducted from any federal rental payments or subsidies.

\(^{190}\) See British Columbia brief (dated November 26, 1945), Conference Discussions, supra note 147, at 201-5.

\(^{191}\) See Ontario brief (dated January 8, 1946), ibid., at 225-48.

\(^{192}\) Ibid., at 231.
progressive nature of personal income tax and succession duties and the fact that the profits of corporations “[had] risen in greater ratio than their gross production.” Acceptance of the federal proposals would undermine the fiscal autonomy of the province and its ability to carry out its constitutional functions.

Unlike British Columbia, Ontario presented a detailed alternative to the federal proposals, the main features of which were as follows:

1. The federal and provincial governments would impose personal income and corporation taxes at rates determined by each government. The taxes would, however, be imposed using a common tax base and would be collected by the federal government as agent of the provinces. Further, a fairer system of allocating corporate profits among the provinces would be employed.

2. Only the provinces would impose succession duties, but they would do so under uniform provincial statutes that would resolve jurisdictional disputes.

3. A portion (10 percent) of personal income taxes, corporation taxes, and succession duties would be placed in a “national adjustment fund,” from which payments (“provincial adjustment grants”) would be made to the provinces, based on fiscal need. The grants would be administered by a continuing federal provincial coordinating committee composed of the respective heads of government.

4. The federal government should vacate and leave to the provinces a number of minor direct taxes, refrain from entering new direct taxation fields in the future, and give the provinces priority in taxing mining and logging operations.

The Ontario proposals presented several significant challenges to the position that the federal government had taken.

The proposal that provincial income and corporation taxes be imposed on a common tax base and collected at the federal level neutralized federal arguments about...
the complexity and cost of tax compliance. The proposal for uniform succession duty laws had a similar effect. The Ontario position largely ignored the Keynesian countercyclical budgeting arguments on which the federal proposals were based;\textsuperscript{199} and, while Ontario accepted the concept of a shelf of public works timed to fit the business cycle, it disputed exclusive federal control. Finally, the proposal for an adjustment fund addressed directly the most obvious defect in the federal proposals—the lack of an effective equalization mechanism. The absence of such a mechanism not only caused dissatisfaction among the poorer provinces, but also placed much more weight on the federal demand for exclusive possession of the personal income and corporation tax fields. Ilsley’s consistent argument, in 1941 and in 1945, was that the poorer provinces would have to impose very high rates of tax, and this would make it difficult for the federal government (in the absence of the war emergency) to effectively engage in countercyclical fiscal policies by constraining the rates of tax it could impose. An effective equalization policy would allow the poorer provinces to impose taxes at rates close to those of the richer provinces and avoid the very high rates that would inhibit federal fiscal policy. This shortcoming was to be rectified definitively in 1957; Ontario in a sense opened the door in 1946 by offering a portion of its own revenues for the purpose.

The Ontario response also belied Skelton’s rather facile optimism that public pressure would force the larger provinces to agree to the federal proposals. Ontario clearly was prepared to opt out (and in fact did) and reimpose at least some provincial taxes, notwithstanding any political risks.\textsuperscript{200}

\textsuperscript{199} Complete provincial autonomy in the imposition of the major progressive taxes was diametrically opposed to the federal stance. While it is difficult to identify with certainty the source of the skepticism shown by some provinces about Keynesian countercyclical fiscal theory (see supra note 157 and following, and the related text, with respect to British Columbia), it is surely of some significance that Harold Innis, probably the leading Canadian economist of his generation (who had at times advised Ontario), rejected Keynesian theory. In a letter to Angus Macdonald between sessions of the conference, he wrote, “I do not think centralization of taxing authority in these fields will tend to promote employment and prosperity throughout Canada. . . . [The federal policy makers] have been carried away by their enthusiasm for the possibilities of the Bank of Canada, by Keynes and Hansen, by their own bureaucratic interests and by the necessities of a war programme.” In particular, he warned Macdonald of the long-term effects on the maritime provinces: “Uniform monetary measures will not [accrue] to the advantage of all regions. . . . [F]ull employment is apt to mean prosperity on the St. Lawrence and the continued steady drain of population and revenues from the maritimes.” Nova Scotia Archives and Record Management, Angus L. Macdonald Papers, letter of February 13, 1946, vol. 898.

\textsuperscript{200} This is consistent with Hutchison’s assessment of the reaction of British Columbia voters: “He [Hart] is quite right about the B.C. public attitude, quite right that the B.C. people will not take this deal or anything else like it. . . . No government in this province could consider it.” Hutchison, memorandum, QUA, Dexter Papers.
On January 29, 1946, Ilsley, despite nervous exhaustion, presented a revised federal proposal to the Co-ordinating Committee, in response to provincial complaints that the initial plan did not provide sufficient revenue. At a Cabinet meeting on January 18, 1946, Claxton had reported for the Cabinet committee on the conference that the Economic Committee had concluded that “the financial proposals were the focal point of discussion and presented greater difficulties [than the public investment and social security proposals].” Claxton thought there was a “reasonable chance” that all provinces but Ontario would accept the new offer and that Ontario would eventually be forced to change its position if modifications were made to “the extent of the payments to be made rather than to basic principles.”

A committee was established, consisting of Clark, Towers, Mackintosh, and Skelton, to report to Cabinet on possible modifications to the original proposals. The committee’s recommendations were presented and approved at a Cabinet meeting on January 23. Under the revised federal proposal, the initial per capita payment would be increased, from $12 to $15, with provision for future adjustments in proportion to increases in the GNP from 1942. The calculation of the payment in any year would be based on the average population and GNP for the preceding three years.

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201 No formal record of the meetings was kept, but the conference secretariat noted the “chief points” as “rough minutes.” A copy is in LAC, Claxton Papers, MG 32, vol. 143.

202 On January 17, Ilsley told King that he “was finding it increasingly difficult to do any work” but that he owed it to King and his colleagues to “stick on, through this session, no matter how hard it was going to be.” Mackenzie King diaries, supra note 3, January 17, 1946.

203 See minutes, supra note 201, at 4-5; and a more complete summary following, ibid., at 21. Some members of the Cabinet wished to discuss the Ontario proposal first, but Ilsley, St. Laurent, and King persuaded their colleagues to present the revised federal proposal first. See Mackenzie King diaries, supra note 3, January 29, 1946.

204 Cabinet Conclusions, supra note 38, minutes for the meeting of January 18, 1946.

205 Ibid. King, perhaps less sanguine than Claxton, noted, “I can see it is going to be a very difficult week.” See Mackenzie King diaries, supra note 3, January 18, 1946.

206 Ibid.

207 Cabinet Conclusions, supra note 38, minutes for the meeting of January 23, 1946.

208 King noted that the “committee of experts, Clark, Mackintosh, Skelton, etc., have found it necessary to make an increase in the amount the Dominion should be prepared to pay; if agreement is to be reached with the provinces to increase from 12 to 15 millions the amounts to be given the provinces in lieu of their surrendering some sources of taxation. This was a compromise as between demand for 18 millions.” See Mackenzie King diaries, supra note 3, January 23, 1946. In referring to “millions,” King appears to have confused the proposed per capita amounts with the total rental revenues that a province might receive; the provinces were presumably asking for $18 per capita. King also voiced his misgiving about making “one government the taxing power and the other governments the spending power,” particularly because the “taxing business is the unpopular end”; however, he concurred with the recommendation. Ibid.
Further, the payment for a province would never be less than the greater of 150 percent of a province’s existing tax rental payments and $2 million. Ilsley estimated that the provinces would receive almost $200 million, compared to $125 million under the existing agreements and statutory subsidies. At the January 29 meeting of the Co-ordinating Committee, under questioning from the provinces, he repeated previous assurances that existing federal commodity taxes would not be increased, but refused to withdraw from that tax field unless the federal government received compensation. He also made no concession when Drew suggested that Ontario would reconsider its position if succession duties were left to the provinces.

King met with Ilsley, St. Laurent, Claxton, Clark, and C. Fraser Elliott (the commissioner of income tax) before the January 30 session to discuss the line that Ilsley should take in the meeting. He was concerned that it was too rigid in “irrevocably” insisting on federal occupancy of the succession duty field (a position he ascribed to Clark and Towers) but was reassured by Ilsley that “nothing was irrevocable.” Claxton and St. Laurent told King after the day’s session that Ilsley’s position (his repeated refusal to agree to federal withdrawal from the minor direct tax fields or to provincial occupancy of the succession duty field) was influenced by the view of Clark and Towers that they “could not map out the budget unless we had absolute control of the whole field of taxation.” At that point, King felt that a settlement was possible on the following day if the federal side promised no further encroachment on provincial tax fields absent a national emergency. This did not happen, and King was increasingly critical of what he saw as inflexibility in the position taken by Ilsley and the Department of Finance. He confided to his diary in connection with the refusal of Ontario and Quebec to give up succession duties:

Discussions largely on succession duties. Quite apparent neither Ontario nor Quebec will give up this field. Personally I do not blame them. I find myself very strongly of the position that Ont. and N.S. are taking, namely, that provinces should be left with certain definite fields of taxation, the dominion ditto, and subsidies reduced to as small a margin as possible. The finance dept. behind which is the Bank of Canada, have completely changed the generally accepted procedure which has been to keep as largely as possible the spending authority responsible for the tax-raising. I think their effort is in the direction of centralization of financial control. That may be desirable from the point of view of more effective administration, etc. from Ottawa’s end, but politically it will not be possible I believe for a long time to come.

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209 The minimum payment would never be less than $15 per capita based on the 1942 population.
210 These provisions were directed, respectively, at British Columbia and Prince Edward Island and had the effect of doubling the minimum payments to those provinces under the August 1945 federal proposals.
211 Minutes, supra note 201, at 9.
212 Mackenzie King diaries, supra note 3, January 30, 1946.
213 Ibid.
214 Ibid., January 31, 1946.
King also suggested, with the support of the minister of national revenue, J.J. McCann, that the provinces should have exclusive occupancy of electricity and gasoline taxation. Clark objected, and King did not press the point on the grounds that Clark (who had just returned to work after a long illness) was “in very poor shape. . . . He is liable to break down completely at any moment. Ilsley is not far from the same position.”215

King’s misgivings evidently had some effect. At the January 31 meeting of the Co-ordinating Committee, Ilsley raised the possibility of a federal commitment not to raise the minor direct taxes except in an emergency (Drew and Duplessis thought this “too indefinite”)216 and agreed to consider continued provincial succession duties with an offsetting lower per capita payment. At that point, the federal ministers thought that all of the provinces would agree to vacate the personal income and corporation tax fields. On February 1, King suggested to the premiers that an adjournment was necessary for the federal government to consider the succession duty issue, and Drew’s suggestion that the committee adjourn until April 25 was accepted. Ilsley summarized the outstanding issues as “whether some arrangement could be worked out by which the provinces which wished could continue to share the succession duty field, and whether the Dominion was prepared to make a commitment with respect to the remaining tax fields.”217 He concluded by warning the provinces that the dominion was not a “financial supplicant” and that the objectives of the federal proposals were “economic rather than fiscal.”218

Consideration of the succession duty issue continued. On March 6, Dexter had talked to Ilsley (and to Mackintosh at about the same time) and reported that at the brain trust meetings on the conference, St. Laurent had argued that Quebec had special rights to succession duty jurisdiction because of its distinct legal system.219 Dexter described the federal thinking as follows:

I gather from Bill [Mackintosh] that all hope of the Dominion gaining exclusive possession of succession duties is now gone. The new line is to exact due compensation from the provinces out of the proposed subsidies and for the Dominion, itself, to remain in the field. St. Laurent seems favorable to this but the boys have their fingers crossed. The Clark-Towers proposition now is that the Dominion agree to have this tax field shared by both jurisdictions. The Dominion, however, will deduct from its payments to each province, the amount which the province collects in succession duties. This would offer the maximum deterrent as it is thought unlikely that a province would choose to tax for money which it could obtain as a gift from Ottawa.220

215 Ibid.
216 Minutes, supra note 201, at 17.
217 Ibid., at 28.
218 Ibid.
219 Memorandum of March 6, 1946, QUA, Dexter Papers. “St. Laurent shocked the lads by basing his argument on the treaty of Paris, 1763.”
220 Memorandum, supra note 219.
Ilsley may have been less hopeful—Dexter reported that “Ilsley just glooms about this.”221 Ilsley’s concern persisted. On April 12, King confided to his diary that

Ilsley stated seriously a day or two ago he saw no hope of our reaching agreement on financial matters with the provinces and had come to the conclusion we were giving far too much money to them. He used the expression in dealing with this situation of increasing expenditures and trying to reduce taxation, he was like a man in a fog; did not know just where he was at all. This is about the position he is in with the financial worries he has now to contend with.222

As discussed below, others in the Cabinet shared Ilsley’s pessimism that the provinces would accept the revised proposals.

**RECONVENING OF THE CONFERENCE, APRIL 29-MAY 3, 1946**

The Cabinet met on April 23 to prepare for the resumption of the meeting of the Co-ordinating Committee. Ilsley did not think that provincial demands could be met. As King noted in his diary, “[Ilsley] did not see how it was going to be possible to balance these budgets and at the same time make any reduction in taxation; also keep up vast expenditures on social services.”223 King complained that “we have all been pushed into this new method of financing for which I think Keynes perhaps has been mainly responsible in influencing governments.”224 His impression was that Cabinet was doubtful that a settlement with the provinces would be reached when the conference reconvened.225

The Co-ordinating Committee met, as agreed, on April 25 and 26226 and decided that the full conference would reconvene on April 29 to consider the revised federal proposals in a public session.227 On April 27, the Cabinet once again discussed concessions to the provinces in respect of the minor tax fields, but Ilsley resisted any arrangement that would not compensate the federal treasury for any concessions: “[H]e said he felt terrible to think he would be leaving to his successor a position that was impossible to meet.”228 The only substantive change in the revised proposals

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221 Ibid.

222 Mackenzie King diaries, supra note 3, April 12, 1946. The expenditures that Ilsley referred to were apparently the costs of the social welfare programs proposed by the federal government at the conference. See ibid., April 11, 1946.

223 Ibid., April 23, 1946.

224 Ibid.

225 Ibid.

226 There does not appear to be any record of these meetings. King noted that St. Laurent answered various questions posed by the provinces, and Ilsley set out the federal position in more detail. “It was clear he was very tired.” Ibid., April 25, 1946.

227 See the report of the Co-ordinating Committee, April 29, 1946; Minutes, supra note 201, at 381.

228 Mackenzie King diaries, supra note 3, April 27, 1946.
was to accommodate provinces that wished to continue imposing succession duties. The tax rental payments to such provinces would be reduced by the yield of the province's duty at 1946 rates, and the duty paid would be fully credited against a taxpayer's federal succession duty liability to a maximum of 50 percent of that amount. The effect was to allow each level of government an equal share of succession duties without double taxation. The federal government also undertook not to enter the real estate and automobile licensing tax fields, and not to increase its taxes on gasoline, amusements, and parimutuel betting. It refused to withdraw from the latter fields without appropriate compensation from the provinces.229

When the conference reconvened, the revised federal proposals were presented, as described above. Drew followed immediately with a variation of the original Ontario proposal.230 Under the revised plan, Ontario would rent the personal income and corporation tax fields for payments that, together with federal withdrawal from succession duties, and from the taxes on gasoline, electricity, and parimutuel betting, would approximate the yield that the province would have realized if it had continued to impose the personal income and corporation taxes.231 In addition, Ontario wanted increased federal spending on pensions and reimbursement for foreign exchange losses on provincial and municipal borrowing. Drew repeated the proposal for a national adjustment fund for equalization purposes.

Duplessis followed Drew with a disjointed attack on the federal proposals, which relied largely on the compact theory of Confederation,232 and proposed no particular alternative. It was clear that Quebec would not accept the federal plan. Macdonald then presented Nova Scotia's position, which was typical of the views expressed by the poorer provinces but argued more tenaciously by Macdonald, notwithstanding his longstanding friendship with Ilsley. Nova Scotia was willing to rent the three tax fields (personal income and corporation taxes and succession duties) but insisted on the federal government's vacating of the gasoline, amusements, and parimutuel betting fields; it also requested an adjustment grant along the Rowell-Sirois lines.233 The responses of the other provinces were broadly similar: they were prepared, at least in principle, to rent the three tax fields,234 but all wanted more, in one form or another, from the federal government.

229 Specifically, the Cabinet authorized withdrawal of the federal taxes on gasoline and amusements, but only if compensated by reduced federal rental payments or reductions in federal social security spending. See Cabinet Conclusions, supra note 38, minutes for the meeting of April 27, 1946.
230 Minutes, supra note 201, at 391-408.
231 Based on an algebraic formula taking into account population and national income growth.
232 According to Duplessis, the federal proposals would be the death-knell of Confederation. See minutes, supra note 201, at 414.
233 Ibid., at 416-20.
234 Saskatchewan, Manitoba, and Alberta stated their willingness explicitly; British Columbia, Prince Edward Island, and New Brunswick, implicitly.
After the session, King met with Ilsley, St. Laurent, Howe, Clark, and Skelton and suggested that the provinces be given sole occupancy of the minor taxes in return for lower fixed payments. Clark objected that the federal government needed “all the fields to be able to meet what will be required in the way of taxes.”  

King blamed the bureaucrats for overcommitting to expenditures and noted that “Ilsley is too worn and tired and sensitive to expect anything from him [Clark] in the way of seeing other sides of the situation.”  

A similar meeting followed the April 30 session, and King repeated his suggestion. Clark again resisted, backed by Ilsley.

Ilsley replied to the premiers on May 1, flatly rejecting any further enrichment of the federal proposals on the basis of the fiscal needs of the federal government:

We came to the conclusion after checking up the total cost of the enormous commitments that we are undertaking under these proposals and the enormous cost of our ordinary commitments that we could not, having in mind our responsibility to the taxpayers who pay taxes to us—we came to the conclusion last week and I so stated in the Co-ordinating Committee, that we could not expand the proposals of the dominion any further so far as cost is concerned.

He followed with a long discussion of the various costs that would be assumed by the federal government under the various social security proposals and the ongoing ordinary expenditures at the federal level, together with the reductions in taxes made and contemplated.

Finally, Ilsley summarized his reasons for federal occupancy of the three major tax fields. First, taxes on income and business profits tapped the wealth produced by the nation as a whole, the distribution of which among the provinces was determined by historical factors, trade patterns, and national policies. Accordingly, it was fairer for these sources of income to be taxed at the national level and the proceeds used for national benefit. Conversely,

it was unfair for provincial and local governments to utilize these major taxes on incomes and profits, which vary so widely between provinces. . . . In this modern world, fairness requires national taxation of income.

Second, income and profit-based taxes were not suitable for the provinces because they were unstable and fluctuating, whereas the federal government, with its greater

235 Mackenzie King diaries, supra note 3, April 29, 1946.
236 Ibid.
237 Ibid., April 30, 1946: “Clark holds out very strongly . . . and Ilsley follows suit.” The meeting also “outline[d] in a way” Ilsley’s speech for the following day.
238 Minutes, supra note 201, at 499. LAC, RG 19, vol. 109 contains the Department of Finance calculations of the amounts involved.
239 Including removal of the excess profits tax. Ibid., at 500-1.
240 Ibid., at 505.
borrowing capacity, was able to accommodate such fluctuations. Third and most important, exclusive federal occupancy was necessary for the national employment and economic policy. This was the countercyclical budgeting argument: “social justice” required the greatest possible use of the progressive taxes, and economic management dictated that those taxes be imposed at the federal level, so that one province could not, for example, raise taxes at a time when economic conditions required reduced taxation. Ilsley also repeated the prior federal position that it would vacate the minor tax fields only if compensated.

King was unusually positive about Ilsley’s presentation:

Ilsley made this morning, I thought, an exceptionally fine speech. Indeed, I have heard him make no better speech. It is something that I think all Finance Ministers will in years to come have to take account of. I told him afterwards that I had never heard him speak as well. He spoke largely without notes, very carefully, discreetly, and persuasively. I felt, when he was through, I did not care how the conference went—that our position had been correctly placed on record.

The remainder of the conference was marked by a series of confrontations, principally between Ilsley and Drew. The flavour of those discussions is reflected in the opening words of Drew’s reply to Ilsley on May 1:

I shall do my utmost to be as restrained as I can under circumstances which I think invite anything but restraint. This has been an amazing presentation and I hope that every province here realizes that the veil is off and that the speech by Mr. Ilsley, which has just terminated, is a bald declaration by the dominion government that we can either take it or leave it, and that their promises, in fields ordinarily occupied in the past by the provinces, are to be redeemed by us although we were not consulted when the promises were made and new appetites created.

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241 Ilsley conceded that succession duties were less important but insisted on federal taxation, if not sole occupancy. One novel argument that he advanced was that the information gained by officials of the Department of National Revenue in collecting succession duties resulted in higher income tax collections. Ibid., at 506-7.

242 Ibid., at 499. Ilsley’s consistent refusal to make concessions on the minor tax fields, which were the principal obstacle to agreement with the provinces other than Ontario and Quebec, were not only criticized by King. Blair Fraser, the well-connected Ottawa correspondent for Maclean’s magazine, commented after the conference that “many people in the Ottawa camp feel the Federal Government’s big fumble was in failing to establish clearly enough the division between the provinces who differed with it only slightly and those basically opposed,” pointing out that seven provinces had accepted in principle and disputed only “relatively minor details.” Maclean’s, June 1, 1946, at 15.

243 Mackenzie King diaries, supra note 3, May 1, 1946. The strain on Ilsley was intense: “Ilsley said he had worked until two last night. He had felt, before going to bed, like a man who was nearly beside himself, and that the best he could do was to shoot himself. He was terribly depressed.” Ibid.

244 Minutes, supra note 201, at 514.
Duplessis followed, stating that

[t]he federal proposals cannot but lead definitely to centralization. The power to legislate is dependent upon the power to levy taxes and the federal proposals practically take away from the provinces the power to levy taxes.\textsuperscript{245}

He proposed a “clear, brief, positive and transitional agreement” for rental of personal income and corporation tax fields, the content of which was unclear but which was incompatible with Ilsley’s proposals. Duplessis concluded with the threat that “if the Ottawa proposals are in the nature of take it or leave it, I will leave it and take my train back to Quebec.”\textsuperscript{246}

At the opening of the session on the following day, May 2, St. Laurent defended the federal proposals and, in particular, defended Ilsley from the criticism that he had been too rigid:

[T]here does come a time when the amount which a responsible federal minister can agree to seeing transferred from federal collections to provincial expenditures must be considered and a line has got to be drawn. That is the point and the only point on which rigidity was manifested by the Minister of Finance. I think the Canadian public owe a debt of gratitude to the Minister of Finance for the rigidity which is to be found in his character. If there was not that rigidity in his character, this country after the six years it has gone through, would not be in the position in which it is in today.\textsuperscript{247}

Drew then announced that Ontario would accept a rental payment for personal income and corporation taxes of $12 per capita but only in connection with federal withdrawal from succession duties, and the gasoline, electricity, and other minor excise taxes.\textsuperscript{248} Ilsley estimated that the Ontario proposal, applied to all the provinces, would cost the federal government at least $100 million annually.\textsuperscript{249} The session ended without resolution.

The following day, May 3, Ilsley set out in detail the cost of the Ontario proposal—$102 million in lost tax revenue and $17 million or more in increased federal spending on pensions and foreign exchange premiums—and refused any further concession.\textsuperscript{250} Duplessis stated flatly that the federal proposals were unacceptable.

\textsuperscript{245} Ibid., at 529.
\textsuperscript{246} Ibid., at 531.
\textsuperscript{247} Ibid., at 551. King remarked in his diary that “St. Laurent spoke for Ilsley in opening the morning’s proceedings.” See Mackenzie King diaries, supra note 3, May 2, 1946.
\textsuperscript{248} See minutes, supra note 201, at 570-1. Drew also proposed that the federal government improve and pay for enhanced pensions for the elderly and the blind, and reimburse the provinces and municipalities for foreign exchange premiums on borrowing.
\textsuperscript{249} Ibid., at 574; see also the more detailed calculation put forward by Claxton, ibid., at 581.
\textsuperscript{250} “I say that the Dominion government is not prepared to incur further financial costs.” Ibid., at 587.
and left the meeting to return to Quebec. At the end of the afternoon session, Ilsley closed the conference, stating:

[I]t is quite obvious that to arrive at an agreement will be impossible this afternoon. The Premier of Quebec is not here, and in any event there is a very wide gap between the points of view that have been expressed and the decisions that have been taken, with the result that agreement at the moment is found to be impossible. . . . As the Prime Minister reminds me, I must proceed at once with the preparation of the budget.

Ilsley’s suggestion that the conference then adjourn sine die was accepted. The Cabinet carried out a post mortem on the conference on May 6. King indirectly criticized Ilsley for rigidity—the “rigidity of Clark and Towers”—in not making concessions to the provinces. When Ilsley reminded King that he had approved the federal brief for the conference, King responded, typically, that his approval was “completely conditional,” containing little in the way of “actual commitment.” King also failed to note that the Cabinet had considered and approved each modification to the original proposal.

THE JUNE 27, 1946 BUDGET

Ilsley brought down the 1946 budget on June 27. It was, as he said in the budget speech, the first wholly post-war budget. Projected expenditures were expected to be little more than half of those in the previous year at $2.769 billion, reflecting a decline in war and rehabilitation expenditures from about $4 billion in 1945-46 to about $1.3 billion. Revenues were anticipated to be $2.51 billion, producing a projected deficit of $259 million. Although the need for massive borrowing had disappeared, ongoing expenditure and tax levels were to be far greater than pre-war levels, and the primacy of income taxation established during the war remained. While, as discussed below, personal and corporation income taxes were reduced, their total share (together with succession duties) of federal revenue was projected only to decline from about 62 percent to 57 percent of total tax revenue. The transformation of the tax system effected between 1939 and 1945 was not to be reversed.

251 “From Quebec I shall expect a call to which I will gladly answer; a call for sincere cooperation with the federal government and with the provincial governments, on a solid, frank and fair basis, with a view to achieving the aims of Confederation and of improving, if appropriate, the means and methods available to us to achieve these aims. For this purpose, again I repeat the door is open, but as it would be undignified to remain on the door-step, I will expect a call in my office in Quebec City.” Ibid., at 601.

252 Ibid., at 624.

253 Mackenzie King diaries, supra note 3, May 6, 1946.

254 Ibid.

255 Canada, Department of Finance, 1946 Budget, Budget Speech, June 27, 1946, at 1.

256 Actual expenditures in 1946-47 amounted to $2.634 billion, of which $1.314 billion was war-related (including expenditures on veterans). See appendix table 1.
In response to the failure to reach agreement with the provinces and the pending expiry of the tax rental agreements,257 Ilsley proposed changes that both honoured the commitment given in 1941 to reduce post-war taxes so as to allow provinces to re-enter the rented fields and left the door open for provinces that wished to continue the rental arrangement.

The basic rate of tax on corporate profits was reduced from 40 percent to 30 percent, as agreed in 1941.258 To allow non-agreeing provinces to reimpose a corporation income tax without necessarily causing double taxation, Ilsley proposed that, so long as some provinces did not agree to rent their tax fields, agreeing provinces would impose a 5 percent tax on corporate profits (on the same tax base as the federal tax and collected by the federal government). The proceeds of the tax would be deducted from their rental payments. A non-agreeing province could then impose a 5 percent corporation income tax without imposing on its residents a higher tax rate than that applied in other provinces.

Personal income taxes were reduced, and residents of a non-agreeing province that imposed its own personal income tax would be allowed a credit for provincial income tax paid against federal tax payable, to a maximum of 5 percent of the federal tax.

The succession duty proposal from the conference was repeated: a resident of a non-agreeing province would be entitled to a credit against federal succession duty payable, to a maximum of 50 percent of the federal tax.

The effect of these proposals was that a non-agreeing province could impose income taxes and succession duties at rates of 5 percent of federal personal income tax, 5 percent of corporate profits, and 50 percent of federal succession duty rates without additional burden on its taxpayers.

For the agreeing provinces, the same rental offer last made at the conference was available.

Along with the reduction of personal income taxes, the rate structure was simplified. Exemptions were increased,259 and the flat-rate war tax and graduated tax were replaced with a single graduated schedule, ranging from 22 percent on the first $250 of taxable income to 85 percent on income in excess of $250,000.260 For business taxpayers, in addition to the changes in the corporation income tax described above, the tax on excess profits was reduced from 20 percent to 15 percent, to be eliminated entirely at the end of the 1946-47 fiscal year, and the tax remaining after the 1945 reductions was removed immediately from partnerships and sole proprietorships.

257 In most cases, on March 31, 1947. See supra note 13.
258 The combination of an 18 percent corporate income tax rate and a basic flat rate of 22 percent under the excess profits tax was replaced by a 30 percent corporate income tax rate.
259 The individual exemption was increased from $660 to $750 and the married exemption from $1,200 to $1,500.
260 The investment income surtax remained at 4 percent; the threshold was raised from $1,500 to $1,800. The tax credit for dependent children and the tax on family allowances that had been imposed in 1945 were replaced by a deduction of $100 for a child eligible for the family allowance and a deduction of $300 for other dependants.
Once again, Ilsley stated his belief that the “income tax is the fairest and best tax on which to rely for the bulk of our revenue.”

Ilsley also addressed growing public concern about perceived heavy-handedness in the administration of tax by proposing the establishment of a Tax Appeal Board to provide a convenient and inexpensive avenue of appeal on matters of fact and law (with further appeal to the Exchequer Court). That concern also extended to the numerous circumstances in which ministerial discretion could be exercised. Ilsley announced that an interdepartmental committee had already begun “a much-needed re-writing of the entire statute” (which eventually produced the 1948 Income Tax Act) and that the committee had been instructed to “explore carefully the possibility of reducing the number of discretions.”

By the time he delivered the 1946 budget, Ilsley’s health was precarious. The stress and resulting nervous exhaustion that had plagued him since at least 1943 had returned with a vengeance, and he had on several occasions told King he could not carry on. King relied heavily on Ilsley and was reluctant to let him go. Immediately following the budget, he arranged for Douglas Abbott to deal with the budget resolutions in Parliament and with the ongoing discussions with the provinces. In July, King appointed Ilsley as the Canadian representative on the United Nations Relief and Rehabilitation Administration Council, effectively to give him a European holiday. However, by early December Ilsley’s wife, Evelyn, had called Claxton to say that Ilsley “would have a complete breakdown if he did not get out at once.” Within a week, he had been moved to the Justice portfolio, replaced as minister of finance by Douglas Abbott.

**CONCLUSION**

Ilsley’s attempts to perpetuate the tax rental arrangements effectively ended his tenure as finance minister; they were, in some ways, “a bridge too far.” Abbott continued the negotiations with the provinces, further minor concessions were made, and seven of the nine provinces eventually entered into new tax rental arrangements in 1947; Ontario and Quebec remained outside. Over the following decade, the tax rental system continued to evolve in the face of unceasing provincial demands for more revenue. In 1962, the provinces resumed the imposition of income taxes at rates of their choosing, in an arrangement in some ways similar to the Ontario proposal of 1946.

Had the federal government’s proposals in 1945-46 been fully accepted, or successfully imposed, and maintained subsequently, they would have produced a much more fiscally centralized Canada. The attempt failed for a number of reasons.

261 Supra note 255, at 18.

262 For example, see Canada, Senate, Final Report of the Special Committee of the Senate on Taxation (Part One) (Ottawa: King’s Printer, 1946). The proposed Tax Appeal Board would not have jurisdiction to review the exercise of ministerial discretion.

263 Supra note 255, at 17.

264 Ibid., at 27.

265 Mackenzie King diaries, supra note 3, December 2, 1946.
Skelton’s initial suggestion for constitutional amendments was rejected by King and St. Laurent (and would likely have failed in any event), leaving the fundamental mismatch between growing provincial responsibilities in the health, education, and welfare areas and the provinces’ traditional revenue sources. The federal government could address certain aspects of these areas through direct spending on income support programs like old age pensions and family allowances; but, for the rest, it would have to use conditional grants.\(^{266}\)

More fundamentally, the federal proposals lacked sufficient political support. King’s unease during the conference reflected his acute sensitivity to public opinion; the ability of the Ontario and Quebec governments to refuse tax rentals and reimpose provincial taxes\(^ {267}\) without significant political cost proved him right. As noted above, by 1962, federal-provincial fiscal arrangements more closely resembled the Ontario proposals of 1946 than the federal proposals of 1945-46. The institution of equalization payments in 1957 had effectively removed the risk that poorer provinces would impose taxes at rates high enough to frustrate federal fiscal policy.

It is also unclear whether complete federal control over progressive taxes and rates was necessary for management of the economy. Regardless of the value or merits of Keynesian theory, Canadian governments have generally been able to respond to economic downturns with stimulative spending on a cooperative basis (witness 2008) notwithstanding significant levels of provincial income taxation.

The continuing features of the Canadian taxation system for which Ilsley was responsible—primary reliance on progressive income taxation, imposed broadly on the population and collected at the source, and significant corporate income taxation, coordinated with provincial taxation—have remained unchanged since the 1940s.\(^ {268}\) While the transformation was initially effected using the existing statute, by 1946, an entirely new and revised statute was in preparation,\(^ {269}\) so that a technical transformation followed the substantive changes. No finance minister before or since has presided over changes so far-reaching in Canadian tax and fiscal policy. And while Ilsley’s failure to fully realize the federal goals in 1946 may be attributable to the “rigidity” that King complained of, his pursuit of a principled policy result in a prolonged national crisis is surely one of the more edifying episodes in Canadian political history. He was, as King admitted, a man of “fine integrity.”\(^ {270}\)

\(^{266}\) Conditional grants had been rejected by the Rowell-Sirois commission and were generally considered to be a less-than-perfect solution.

\(^{267}\) Corporation taxes were reimposed immediately at rates equal to or higher than the 5 percent “tax room” given in the 1946 budget in both Ontario and Quebec, without political price. Quebec reimposed personal income taxes in 1954.

\(^{268}\) When the provinces began imposing their own taxes directly on income (as opposed to levying a percentage of the federal tax), they followed the principal design and policy features of the federal income tax.

\(^{269}\) Ultimately enacted as the Income Tax Act, SC 1948, c. 52.

\(^{270}\) Mackenzie King diaries, supra note 3, March 21, 1946.
APPENDIX TABLE 1  Federal Revenues and Expenditures, Canada, 1939-40 to 1947-48, in Thousands of Dollars and as a Percentage of Total Revenues or Expenditures

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Customs duties</th>
<th>Sales tax</th>
<th>Total excise tax</th>
<th>Personal income tax</th>
<th>Corporate income tax</th>
<th>Succession duties</th>
<th>Non-tax revenues</th>
<th>Total</th>
<th>War expenditure</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1939-40</td>
<td>104,301</td>
<td>18.6</td>
<td>141,121</td>
<td>25.1</td>
<td>166,028</td>
<td>29.5</td>
<td>45,407</td>
<td>8.1</td>
<td>77,920</td>
<td>13.9</td>
</tr>
<tr>
<td>1940-41</td>
<td>130,757</td>
<td>15.1</td>
<td>184,536</td>
<td>21.3</td>
<td>284,167</td>
<td>32.9</td>
<td>103,535</td>
<td>12.0</td>
<td>155,561</td>
<td>18.0</td>
</tr>
<tr>
<td>1941-42</td>
<td>142,392</td>
<td>9.6</td>
<td>246,553</td>
<td>16.6</td>
<td>453,425</td>
<td>30.6</td>
<td>296,139</td>
<td>20.0</td>
<td>321,004</td>
<td>21.6</td>
</tr>
<tr>
<td>1942-43</td>
<td>118,963</td>
<td>5.3</td>
<td>250,478</td>
<td>11.2</td>
<td>488,712</td>
<td>21.8</td>
<td>334,138</td>
<td>23.8</td>
<td>802,551</td>
<td>35.8</td>
</tr>
<tr>
<td>1943-44</td>
<td>167,882</td>
<td>6.1</td>
<td>339,256</td>
<td>12.3</td>
<td>680,619</td>
<td>25.1</td>
<td>813,435</td>
<td>29.4</td>
<td>780,097</td>
<td>28.2</td>
</tr>
<tr>
<td>1944-45</td>
<td>115,091</td>
<td>4.3</td>
<td>404,109</td>
<td>15.0</td>
<td>543,065</td>
<td>20.2</td>
<td>767,755</td>
<td>28.6</td>
<td>742,209</td>
<td>27.6</td>
</tr>
<tr>
<td>1945-46</td>
<td>128,877</td>
<td>4.3</td>
<td>326,253</td>
<td>10.8</td>
<td>496,910</td>
<td>16.5</td>
<td>691,586</td>
<td>23.0</td>
<td>712,030</td>
<td>23.6</td>
</tr>
<tr>
<td>1946-47</td>
<td>237,355</td>
<td>7.9</td>
<td>328,073</td>
<td>10.9</td>
<td>579,024</td>
<td>19.3</td>
<td>694,530</td>
<td>23.1</td>
<td>687,490</td>
<td>22.9</td>
</tr>
<tr>
<td>1947-48</td>
<td>293,012</td>
<td>10.2</td>
<td>383,012</td>
<td>13.3</td>
<td>660,758</td>
<td>22.3</td>
<td>659,828</td>
<td>23.0</td>
<td>591,161</td>
<td>20.6</td>
</tr>
</tbody>
</table>

Warfare State, Welfare State, and the Selling of the Personal Income Tax, 1942-1945

Shirley Tillotson*

PRÉCIS
Cet article porte sur les protestations des Canadiens à faibles revenus relativement aux incidences fiscales pour les particuliers du financement canadien de la guerre pendant la Deuxième Guerre mondiale. Il décrit les critiques liées aux modifications de 1942 à la Loi de l’impôt de guerre sur le revenu et les moyens par lesquels les Canadiens à faibles revenus ont manifesté leur désaccord, notamment par l’absentéisme, l’organisation ouvrière et la participation au débat public, tirant profit de leurs ressources en tant qu’électeurs (par l’entremise des partis politiques) et en tant que contributeurs éventuels aux campagnes pour l’épargne de guerre. Le ministre des Finances et d’autres ministres ont jugé que ces protestations pouvaient sérieusement nuire au financement de la guerre et au programme de stabilisation. En conséquence, le ministère des Finances et le ministère du Revenu national, ainsi que la Commission d’information en temps de guerre, ont répondu vigoureusement aux protestations par diverses campagnes de relations publiques et par une série de modifications à la loi fiscale. Ces réponses aux protestations ont contribué au processus, normalement perçu comme mené par une idéologie macro-économie ou de sécurité sociale, ou les deux, qui a conduit à la Loi sur les allocations familiales du Canada, un moment charnière de l’évolution de l’État-providence canadien. En mettant l’accent sur l’influence qu’ont eue les protestations par les contribuables à faible revenu sur la décision de renforcer l’État-providence, l’histoire dont il est question ici démontre comment l’opinion publique communautaire des années de guerre était également modelée en partie par des politiques de portefeuille intéressées.

ABSTRACT
This article examines lower-income Canadians’ protests around the personal income tax aspects of Canadian war finance during the Second World War. It describes criticisms of the 1942 amendments to the Income War Tax Act and the means by which lower-income Canadians registered their concerns, through absenteeism, labour organization, and participation in public debate, drawing on their resources as voters (through political parties) and as prospective contributors to war savings campaigns. The finance minister and others took these protests seriously as a threat to war finance and the stabilization program. Consequently, the Department of Finance and the Department of National

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Revenue, together with the Wartime Information Board, responded vigorously to the protests, through various public relations campaigns and through a series of amendments to the tax statute. These responses to tax protest contributed to the process, normally seen as driven by either macroeconomics or social security ideology, or both, that led to Canada's Family Allowance Act, a landmark in the evolution of the Canadian welfare state. By pointing to the influence of tax protest by smaller income tax payers on the decision to expand the welfare state, the story told here shows how the communitarian public opinion of the war years was also shaped in part by self-interested pocketbook politics.

**KEYWORDS:** PERSONAL INCOME TAXES • HISTORY • SOCIAL SECURITY • FAMILY • LABOUR • ANTI-INFLATION

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**INTRODUCTION**

Canada’s war finance policy during the Second World War has been a source of pride, and is still widely respected by economists and historians of politics and public finance. The federal government's income tax was made modern and effective, the Canadian economy was successfully reorganized for war purposes, and, with all that, the damage to Canadians’ standard of living during the war was slight. The readjustment to peacetime conditions was relatively smooth, and the nation's new fiscal capacity helped to build a more prosperous and caring society over the next 30 years. From having been a fractured and economically fragile nation in the inter-war years, with an incoherent and unjust tax “system,” Canada grew into a modern and well-governed country, rightly proud of the role it had played in the Second World War. Not a small amount of the credit for these results has gone to the Department of Finance and its successful launching of a mass income tax system as part of the overall project of war finance.1

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The general competence and decency of Finance Minister J.L. Ilsley, his colleagues in National Revenue, and other officials involved in shaping the government’s fiscal policy are evident in the archives and well established in the historiography. But the consensus around war finance policy and its objective soundness has been overstated.\(^2\) In a recent article, Colin Campbell represents Ilsley as the hero of a process between 1939 and 1943 by which the only possible program of “equitably shared financial sacrifice” to fund the war effort was designed and deployed.\(^3\) The opposition parties’ criticisms appear as slight, and their support for the fairness of the war budgets is asserted.\(^4\) In Campbell’s account, the voters do not have much of an impact, and some of them (“labour groups”) object only because they do not understand Ilsley’s policy.\(^5\) There was “potential for opposition” to the new mass income tax with its steeply progressive structure, Campbell acknowledges, but Ilsley “defused” it.\(^6\) The important tensions, for Campbell, lie within government and behind closed doors: between Prime Minister King (somewhat unprincipled) and Ilsley (the man of integrity), and between reasonable Ilsley and the difficult provincial premiers. To be sure, those inter- and intra-governmental negotiations are a necessary part of the war finance story. But Campbell’s emphasis on those aspects means that many other factors that were also important are missing from his story of the early war years. Mistakes and misjudgments in 1942 prompted spirited and reasonable challenges to Ilsley’s allegedly equitable design, and that opposition caused much worry in the departments of Finance and National Revenue. Their means of dealing with those worries in the following years, between 1942 and 1945, led the federal government to implement important social security measures. Seen in this context, difficulties in the early years of war finance become an intimate part of the welfare state’s history. And amendments in 1943 and 1944 that Campbell and other historians have described as cleaning-up details or “minor alleviations”\(^7\) were, I argue, actually significant: in the face of tax resistance and protest, changes in the law were meant to build consent.

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\(^2\) This is, of course, a matter of judgment and interpretation, but I find evidence of a too broadly drawn consensus in Slater’s internalist account (see, for example, his description of the building of consensus within the tax team in Finance: Slater, supra note 1, at 74) and Campbell’s summary of war finance (“equitably shared financial sacrifice could be done no other way”: Campbell, supra note 1, at 635). Perry acknowledges that there were criticisms of the war finance program, saying that “for many people” it was “the most oppressive aspect of the war.” But he leaves the summary assessment of the program to Finance Minister Ilsley—not the most objective of interpreters—with a long quotation from Ilsley’s October 1945 budget speech: Perry, supra note 1, at 337 and 338-40.

\(^3\) Campbell, supra note 1, at 635.

\(^4\) Ibid., at 664-67.

\(^5\) Ibid., at 661.

\(^6\) Ibid., at 664.

\(^7\) With respect to the 1943 budget measures, see Slater, supra note 1, at 68; with respect to the 1944 budget measures, see Perry, supra note 1, at 337. Campbell makes no mention at all of the few but important measures included in the 1943 budget that provided tax relief to low income earners: Campbell, supra note 1, at 663-64.
to the new level of personal income taxation, mainly among working-class and modestly paid middle-class Canadians.

My purpose in this article is to support these claims. To do so, I present the federal income tax policy process in 1942 in a different kind of context than Campbell chose. Most importantly, I bring into the story the voices of the new personal income taxpayers of 1942. I begin by describing the impact on lower-income Canadians of the income tax measures of the war’s early years. These measures created a huge cohort of new income taxpayers—one that was not only poorer, but also included more women, status Indians, and some racialized groups. The argument of my article is concerned with the impact of these new taxpayers on war finance and, through their tax bargaining, on the development of a more democratic Canada, one in which the material circumstances of the majority of citizens had a newly direct effect on federal policy. In the first third of the article, I explain the particular irritants that the new income taxpayers encountered, the methods of tax resistance available, and the problems that tax resistance presented to federal officials who were attempting to secure tax compliance, war savings participation, political stability, and a sense of common purpose. The rest of the article describes federal officials’ responses to these war finance worries, through various forms of persuasion and through specific statutory amendments. I argue that we can see in those responses the impact of the new income taxpayers, not only on tax policy, but also on the conceptualizing of liberalism. Keynesian macroeconomic theory had promised a new role for the state in managing things economic, modifying liberalism in a collectivist direction. It was not, however, economic theorists, but the masses of new taxpayers, pressuring wartime government into offering both tax concessions and income security measures, who moved the government toward selling tax policy in a framework of a more social liberalism.

The new taxpayers had this kind of impact only because the departments of Finance and National Revenue took consent—and resistance—to personal income taxation very seriously. Finance Minister J.L. Ilsley was tired and angry in August 1942, exhausted to the edge of breakdown on the eve of his great 1943 budget speech, and cracking at the seams in the summer of 1944 (as a distinguished visitor to Ottawa, J.M. Keynes, noticed). The criticisms made of his tax plans in the House represented serious opposition—on shop floors, in boardrooms, and in neighbourhoods. Even

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8 Here I state only slightly more emphatically what Perry wrote in the 1950s: Perry, supra note 1, at 333-34.
9 For evidence of Ilsley’s anger, stress, and fatigue, see memorandum, Grant Dexter to G.V. Ferguson, August 2, 1942, in Queens’ University Archives, Grant Dexter fonds, collection 2142, box 3, file 23, at 4; The Diaries of William Lyon Mackenzie King, February 5, 1943 (www.collectionscanada.gc.ca/king/index-e.html) (herein referred to as “Mackenzie King diaries”); Wardhaugh, supra note 1, at 277-78; and J.M. Keynes, quoted in Wardhaugh, supra note 1, at 261.
10 As I show in this article, Campbell seriously understates the scope and political weight of the opposition to Ilsley’s tax measures in 1941-1943. The evidence he supplies for public satisfaction is one letter from 1941 and an observation from war historian C.P. Stacey’s book on wartime policy: Campbell, supra note 1, at 664.
if all that Ilsley cared about was re-election, then this opposition would have been worrying enough. But more immediately important, opposition to his tax proposals mattered because it put in jeopardy the success of the Victory Loan campaigns and the solidity of the wage and price ceilings—the whole anti-inflation “stabilization” project. Ilsley and the others charged with war finance—Graham Towers of the Bank of Canada, Clifford Clark of Finance, and their less famous collaborators in National Revenue, Colin Gibson and C. Fraser Elliott—carried on their shoulders the burden of preventing a post-war crash or wartime inflation that would lead to privation and conflict, especially but not solely between classes. Their intellectual confidence was considerable, but there is good evidence that voices of their opponents and their worried supporters reached through that confidence and had real effects, not only on their mood, but also on their policy choices. What was deeply democratic in their responses to opposition is that, for the most part, when these government men encountered criticism of their policies, they did not dismiss it as “hostility” but took it as useful information that required a thoughtful response.11

As complaints of tax-related hardship proliferated in 1943, fiscal policy makers began to see that making a connection between taxes on small incomes and the development of a newly social state would be necessary if they were to persuade working-class Canadians to be compliant taxpayers and voluntary savers.

THE NEW TAXPAYERS’ BURDEN

By 1941, the number of Canadians who paid personal income tax at the start of the war (approximately 300,000) had more than doubled (see table 1). Many of these new income taxpayers were in a separate category, not paying the standard pre-war personal income tax (PIT), but instead paying a new tax on income, the national defence tax (NDT), introduced in the 1940 budget. The NDT was different from the PIT in four ways. First, unlike the PIT, the NDT was charged at a flat rate: 3 percent or 2 percent (with single individuals paying the higher rate and married persons the lower). In 1941, those initial low rates were raised to 7 percent and 5 percent, respectively. Second, under the NDT, an individual did not pay at all if he or she earned less than the exempt amounts ($600 or $1,200 in 1940, depending on marital status), but as soon as earnings exceeded that threshold, the specified tax rate applied to the individual’s total income. Third, instead of the PIT’s generous exemptions for dependent children, the NDT provided tax credits: each of a taxpayer’s children was worth $8 against the NDT bill. So, for example, a modestly paid wage earner who was supporting a wife and three children on $1,300 a year would owe $2 in NDT rather than the $26 (2 percent of $1,300) that he would have owed if married and childless. Finally, wage and salary earners had the NDT deducted by their employers from their pay packets, rather than being expected to save to pay an annual tax bill or pay in quarterly instalments. Through the NDT, hundreds of thousands of Canadians

11 See, for example, R.B. Bryce to David Rogers, January 12, 1943, Library and Archives Canada (herein referred to as “LAC”), Department of Finance records, RG 19, vol. 4030, file 129W-3.
TABLE 1  Comparison of Changes in Number of Personal Income Taxpayers as a Percentage of the Labour Force, by Gender, 1941-1951 (Estimated) and 1964 (Actual)\textsuperscript{a}

<table>
<thead>
<tr>
<th>Year</th>
<th>Male (M)</th>
<th>Female (F)</th>
<th>Total (T)</th>
<th>M</th>
<th>F</th>
<th>T</th>
<th>M/M</th>
<th>T/M</th>
<th>F/F</th>
</tr>
</thead>
<tbody>
<tr>
<td>1941</td>
<td>na</td>
<td>na</td>
<td>871,484</td>
<td>3,594,079</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>1943</td>
<td>na</td>
<td>na</td>
<td>2,163,354</td>
<td>&gt;3,594,079</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>1951</td>
<td>na</td>
<td>na</td>
<td>2,777,950</td>
<td>4,130,802</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>1964</td>
<td>3,774,343</td>
<td>1,526,876</td>
<td>5,301,219</td>
<td>5,273,700</td>
<td>2,458,700</td>
<td>7,732,400</td>
<td>71.6%</td>
<td>68.4%</td>
<td>62%</td>
</tr>
</tbody>
</table>

\textsuperscript{a} Since 1964 was the first year in which the Department of National Revenue reported numbers of personal income taxpayers (PITP) by gender, only the 1964 ratios are exact. I justify using male labour force figures as the denominator for the 1941, 1943, and 1951 estimated fractions on the grounds that women’s labour force participation patterns and rates of pay made them less likely than men to be income taxpayers in those years. One estimate of the proportion of women in the population of interwar income taxpayers was 12 percent in 1929-30. The gender-specific statistics for 1964 afford a measure of the difference between the breakdown by gender of the labour force and the breakdown by gender of PITP. By 1964, men constituted 62.2 percent of the total labour force but 71.2 percent of the total PITP. By 1964, women’s labour force participation had risen, and inflation had begun its work of imposing an income tax liability on an increasing number of low-paid workers. Still, women remained a smaller percentage of PITP (28.9 percent) than they were of the total labour force (31.8 percent). If the percentage of PITP who were male and the percentage of the labour force who were male corresponded in 1951 as they did in 1964, then knowing that 76 percent of the labour force was male in 1951, we can estimate that men constituted approximately 87.36 percent of total PITP in 1951. On those assumptions, male PITP in 1951 would be 2,426,817, and thus 58.7 percent of the male labour force. Actual PITP as a percentage of the labour force in 1951 could thus be as much as 9 points lower than the estimates reported in the table, and similarly lower for 1943 and 1941.

\textsuperscript{b} Owing to the lack of labour force census data for 1943, the number shown in the table for that year is the same as that reported for 1941, and is probably low.

(Table 1 is concluded on the next page.)
became income taxpayers in a small way on their small incomes. In addition, some of these new taxpayers also acquired a liability under the PIT, which, after the 1940 budget, was assessable on income over $750 (for a single individual) or $1,500 (for a married person).

The changes in 1940 and 1941 foreshadowed the really massive increase in the number of income taxpayers that followed from the 1942 budget. The PIT exemption was lowered, making the PIT and NDT exempt amounts the same: $660 for a single individual and $1,200 for a married person. The old familiar PIT was now called “the graduated tax,” and the new NDT was to be known as “the normal tax.” Earnings above $660 or $1,200 were now liable to the graduated tax as well as to the NDT on the earner’s whole income. Put simply, for the 1942 tax year, income earners, large and small, would make one tax payment, calculated on two different bases: (1) the amount earned in a year above an exempt amount (used to calculate the graduated income tax) and (2) the whole amount earned in a year (used to calculate the normal tax). And now, for the graduated tax, instead of exempting from taxation $400 (as in 1939) of income for each child, taxpayers would get, for each child, a credit of $108 against income tax they owed.\(^{12}\) Though the new rules seemed complicated, there was at least one major simplification: the various municipal and provincial income taxes were all gone. Between February 1941 and early 1942, the federal government had negotiated, somewhat aggressively, “wartime taxation suspension” agreements with the provinces, ending for the duration of the conflict the crazy quilt of municipal and provincial income taxes, old and new.\(^{13}\)

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\(^{12}\) Perry, supra note 1, at 361. The figure of $108 is the total of a $28 credit against the normal tax and an $80 credit against the graduated tax.

\(^{13}\) Slater, supra note 1, at 47-49; Wardhaugh, supra note 1, at 192-93; and Campbell, supra note 1, at 652-55 and 658-59.
many of those other income taxes had had their own distinctive definitions of income, exemptions, rates, and forms, the personal income taxpayer of 1942 might have been grateful to have fewer forms and rules to deal with. That benefit was not immediately noticed, however. Instead, Ilsley told his Cabinet colleagues, “[T]he budget was full of trouble. The small man is complaining bitterly for the first time.”

TAX TROUBLES AND RESISTANCE

Beginning the day after the budget speech on June 23, 1942 and continuing through to July 31, when the budget legislation was passed, Ilsley fielded near-constant complaints about the new income tax system. In this section, I set out the kinds of complaints prompted by the 1942 personal income tax measures from their beginning through to early 1945, the methods of resistance adopted by the new income taxpayers as the tax began to be implemented, and the larger political and morale concerns that Ilsley and others in government perceived as flowing from tax complaints.

The banner headline on the first budget story in the Toronto Globe and Mail highlighted taxation-as-coercion: in big type, the headline announced “Forced Saving Starts Sept. 1.” Under the new budget measures, not only would smaller incomes be taxed more heavily than ever before, but both the graduated and the normal tax would now be collected at each pay by employers. Some of what was taken was actually savings: it would be returned, with 2 percent interest, after the war’s end. But the dollars were deducted from the pay packet without any clear distinction between the savings (which would return) and the taxes (which would not). Employers were not required to supply a pay slip that recorded deductions, though some did. Ilsley promised that government certificates for the amounts saved would be issued to employees; however, the amount of savings would be calculated only after the taxpayer had filed a return and paid the tax, and the tax authority had assessed the return, made a refund, or required further payment—and then, and

14 Reference to this multiplicity as a chronic irritant since the 1920s may be found in Perry, supra note 1, at 302.

15 Memorandum, Grant Dexter to G.V. Ferguson, July 19, 1942, 2, Queen’s University Archives, Dexter fonds, collection 2142, box 3, file 23.

16 For a reference by Ilsley to the constant revising of his proposed income tax measures in response to repeated criticism, see Canada, House of Commons, Debates, July 31, 1942, at 5087.

17 “Forced Saving Starts Sept. 1,” Globe and Mail, June 24, 1942. For an example of continuing criticism in late August, see “Ilsley Denies Budget Harsh as It Seemed,” Globe and Mail, August 27, 1942.

only then, would the amount of savings be determined and officially receipted. The first certificates of refundable tax amounts would not be issued until December 1943. That process left lots of time for people to worry. And the savings cut into pay packets just as the tax did.

The compulsory savings portion of the newly deducted-at-source personal income taxes affected rich, poor, and corporations (on whose income there was also a savings deduction). But several other new features of income taxation were felt particularly by small earners. Of these, the most painful was the result of a measure that had been intended to protect smaller incomes. As noted, $660 was supposed to be exempt from a single person’s personal income tax (and $1,200 from a married person’s). However, the amount of the normal and the graduated tax liabilities combined could end up leaving a taxpayer with less than $660 (or $1,200). The tax designers had anticipated this notch problem and specified that the payment of taxes would not be allowed to reduce anyone’s income below one of those two thresholds. That was a good idea. But it had an unfortunate, even perverse, consequence, creating a new notch problem. Once the taxes kicked in, because the normal tax took 7 percent of total income starting at $660 or $1,200, and then the 30 percent graduated tax rate was applied to the first $500 above the exemption, what happened was that some lower-income taxpayers with no dependants (likely those who were middle-aged, with grown children or no children) were being taxed on 100 percent of their income over the $660 or $1,200 threshold, up to gross incomes of $733 or $1,362. In other words, on the first $73 or $162 over the exemption amounts, these people paid a 100 percent tax rate. In weekly terms, that $162 over a year meant that a married man without children would see disappear from his pay every week an amount that would feed him and his wife for about five days.

Not surprisingly, then, tax complaints from lower-income men and women soon flooded into the Department of Finance. In the weeks following the June 1942

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19 One group that felt disadvantaged was holders of government annuities, who were treated less favourably under the compulsory savings provisions than were holders of commercial insurance company products. These annuity holders were characterized by various members of Parliament (MPs) as having small incomes and including disproportionately stenographers, nurses, school teachers, clergymen, and people in business “in a small way.” Another category of low income earners were people employed intermittently, who were at risk of overdeduction from very small incomes. Toronto MP T.L. Church expatiated more generally on the tax hardships of low-income men and threatened that the increase in their taxes would make them unable to help support their impoverished relatives. Canada, House of Commons, Debates, July 31, 1942, at 5090-92; July 16, 1942, at 4312-13; and July 17, 1942, at 4328-29.

20 Perry, supra note 1, at 361-62.

21 Someone earning $1,362 in a 52-week year took home $26.19 a week: the 1942 taxes took $3.11 of that. The number of days over which that dollar amount would stretch (between 4.33 and 5.18 days at 30 or 36 cents per day) was calculated from the Health League of Canada’s figure of 30 cents per person per day quoted in the Globe and Mail’s “Homemaker Kitchen Library” column. The columnist’s own estimate was that 36 cents per person was the best she could manage for her own family, so the Health League may have exaggerated slightly how far one could stretch 30 cents: “Dear Neighbors,” Globe and Mail, June 8, 1942.
budget speech, Ilsley and his staff received hundreds of letters from Canadians who were anxious about how they were going to balance their own personal budgets. The minister and his staff read and replied to all of those letters, usually within a few days’ time. Material from them provided some of the content for the speeches and other public relations efforts aimed at the new income taxpayers. It was imperative that Ilsley convince Canadians that these taxes, which were causing so many of them sleepless nights, were both essential and fair. He knew that people could avoid income taxation even when the tax was deducted at source.

The records of the Department of Finance contain several volumes of letters (roughly a metre’s worth) written by members of the public to either Prime Minister King or Ilsley on income tax questions between 1940 and 1943. These files are organized alphabetically. Choosing files at random, my research assistant and I read and took notes on approximately 200 letters, specifically all of those from correspondents whose last names began with D, E, F, G, I, J, K, L, or M, plus a small series of letters on the income tax treatment of cost-of-living allowances. LAC, RG 19, vol. 452, files 111-14A-0-1 to 5, 111-14M, and 111-14E; vol. 453, file 111-134M; and vol. 449, file 111-14-827. Some aspects of the labelling of the files suggest that, extensive though they are, this set of files was sampled by the accessioning archivists, rather than preserved in their entirety. These letters came from a wide range of Canadians from all over the country, including a churchmouse-poor parson in Saint John, New Brunswick; a single female barrister in Regina; a sickly pensioner in White Rock, British Columbia; a young woman in a rural Quebec factory; and, in what looked like a furious, drunken scrawl, a Toronto worker barely surviving on a small wage and supporting his dependent father. Whether these letters expressed the full range of opinions among Canadians is unknowable, but they are the letters that officials in the Department of Finance (and sometimes the minister) saw. It was not a scientifically selected sample, but it was still, in some sense, the voice of the people. That the letters were taken into consideration is suggested by the fact that their essential points were summarized for Ilsley by Robert Bryce in a list compiled in late August or early September 1942: Questions Most Commonly Asked About the Income Tax in Correspondence, circa August 29, 1942, LAC, RG 19, vol. 3543, file Taxation. And on more than one occasion, Ilsley referred to the letters he had received as a source of his knowledge about people’s concerns. See, for example, J.L. Ilsley, Sharing the Cost of War: An Address Before the Trades and Labour Congress of Canada at Quebec City, September 1, 1943 (Ottawa: National Liberal Federation, n.d.), at 13; and “Income Tax Increases Are Defended by Ilsley,” Toronto Daily Star, July 18, 1942.

Replies in 1942 and 1943 were commonly dated as little as two to four days after the date of the writer’s original letter. Most went out over Ilsley’s signature; some, but not all, were initialled as having been composed by senior staff (assistants to the deputy minister) such as “AKE” (A. Kenneth Eaton), “JHP” (J. Harvey Perry), or “RBB” (Robert B. Bryce). Ilsley’s private secretary, Miss A.W. Wickwire, also wrote some of the replies. One satisfied citizen, whose letter from Ilsley had been written by Bryce, wrote, “I don’t think there is very much wrong with our government when a cabinet minister will take the time to advise an un-influential woman about her financial problems. It makes me more certain than ever that the Liberals in power do care what happens to the little person.” Mrs. Gladys G. Stacey to J.L. Ilsley, July 5, 1945, LAC, RG 19, vol. 3403, file 6529-6550.

Wage earners’ strategies for avoiding tax featured in debates about taxation in the House: see, for example, Canada, House of Commons, Debates, July 11, 1944, at 4723. In 1948, journalist Blair Fraser commented that not reporting tips and earning income through two different jobs were common ways of hiding income, methods frequently used during the war. These sorts of dodges seem to have been common knowledge. Blair Fraser, “Who Are the Tax Dodgers?” Madam’s Magazine, March 15, 1948, at 7.
Two mechanisms of tax avoidance that wage earners were quick to adopt following the 1942 budget were limiting their hours of work (“absenteeism”) and refusing overtime. One employer complained, for example, that “[s]ome of the girls have figured out that if they work fifty weeks at $13.00 a week they will not have to pay any taxes. . . . The result of this is that they work four or five days a week.”25 A shipyard worker in Port Arthur wrote to suggest that overtime work be tax-free and paid in war savings certificates. He believed that “a great many of the workers here take time off, to avoid paying taxes.”26 Finance officials also learned about organized labour’s views by means of the labour press surveys—monthly digests of themes in labour newspapers and magazines—compiled by the Wartime Information Board (WIB).27 In the spring of 1943, Finance was considering seriously advice from a payroll systems specialist about how to disguise the fact that working overtime immediately increased tax deductions.28 A group of civil servants convened by the WIB’s John Grierson in 1943 to address problems of “industrial morale” were told that “[m]any workers felt that deductions were so considerable on the sixth or seventh day of work that it was not worth their while to work more than five or six days a week.”29 J.L. Cohen, the labour member of the National War Labour Board, reported that “the problem of income tax deductions had been touched on in virtually every submission before the National War Labour Board during the course of its public inquiry” and urged those who were concerned with industrial morale not to brush aside labour’s concerns too lightly.30

The most pressing of these concerns came from families where a married woman was earning more than $660. In the early days of the debate on the 1942 budget, Ilsley heard from women like Violet Flaherty:

I am a woman of 48 & working in a munition factory with hundreds of others, and I am in a position to get the reaction of the workers as they come & go. The reaction to this latest tax is that all married women or at least 90 p[er] c[ent] of them are ready to stay home by the 1st of September [when the 1942 tax rates and deduction at source would come into effect]. I will state my own position[,] I have 5 children, my husband is a rubber worker. Last year we started to buy our own house. So this year I had the

26 James Duncan to Ilsley, April 16, 1943, LAC, RG 19, vol. 452, file 111-14E.
28 R.B.B. (Bryce), Memorandum for the Minister re: Proposal of Mr. Maddock and Mr. Bartram, February 5, 1943, LAC, RG 19, vol. 3543, file Taxation.
30 Minutes of Meeting of the Committee on Industrial Morale, supra note 29.
opportunity to help him out by going to work at the “Sunshine” plant, 6 miles from home. I make 25 [cents per] hour, 8 hours [per] day. Now as I understand, the government will take 7 of every 15 dollars I earn yet I must pay a girl to look after the children, [and I must] come home from work to wash the linen, iron it & cook the meals. Do you think that we married women will continue to work under the terms the government will enforce. It won’t pay us to go out at all. By the time we pay car fare & the girl[’]s wages, we won’t have anything left. So I, and I can safely say hundreds more will not work under the terms set by the government for Sept 1st 1942. (Being among the women I know their reaction better than most people.)

By the time Mrs. Flaherty put the case to Ilsley so clearly, he had already heard that married women were thinking of giving up on war work in response to his tax measures. While Mrs. Flaherty’s letter was on its way to Ottawa, the government had made a change to meet her criticism. Ilsley replied to say that he had already amended the statute with cases such as hers in mind: she would be taxed as single, but her husband would keep the married man’s level of personal exemption. As a result, the married couple’s total exemption would be $1,860, a bit more than the $1,500 that had been exempt from the graduated income tax in 1941. This was a fairly small concession, and it alleviated financial pressures in working-class families only slightly. A year later, as a letter from a married woman who had returned to her pre-war job in telegraphy explained, the costs and inconveniences associated with having both partners working meant that some patriotism was still required for a married woman to take up war work. Nonetheless, the government had responded to the protests of married women workers by amending the 1942 budget proposals before the new tax legislation was enacted.

Other distinctively situated groups would also threaten to withdraw their work in protest over their new tax liabilities. The Indian superintendent in Brantford, Ontario, Major E.P. Randle, pointed out that, reasonably in his view, the Six Nations people might well give up war work if their new incomes were taxed:

Some of them will do this as a matter of principle because they consider taxing them is an injustice and unfair. Others feel that after the tax is off and their daily expenses paid there is not enough left to make the long hours and the worry of [commuting by “inferior or difficult means of transportation”] worth while.

31 Mrs. Violet Flaherty to Ilsley, July 14, 1942, LAC, RG 19, vol. 452, file 111-14E.
32 Ilsley to Mrs. Violet Flaherty, July 17, 1942, LAC, RG 19, vol. 452, file 111-14E.
33 Mrs. Margaret G. Gillespie to J.L. Ilsley, April 30, 1943, LAC, RG 19, vol. 452, file 111-14E.
34 Major E.P. Randle to the Secretary, Indian Affairs Branch, September 22, 1942, LAC, Department of Indian Affairs and Northern Development records, RG 10, vol. 6821, file 493-1-6, part 1.
These workers would not have been alone in withdrawing their labour. At the Arvida, Quebec aluminum plant, some workers did so temporarily: tax protest played a part in the strike there in the summer of 1941.\textsuperscript{35} And in British Columbia in 1942-1944, Chinese-Canadian workers in the shipyards and sawmills went on strike to protest the way that new tax regulations imposed exceptional costs on men who were supporting wives and children back in China. Taxed as single men, on wages that reflected the racism of the local labour market, these workers could not always document their family support obligations in ways that met Ottawa’s standards. At first they struck on their own; then, as tax issues became more central for organized labour, the Chinese-Canadian workers’ tax protest won the support of the shipyard unions and the woodworkers’ union.\textsuperscript{36} The attempt to bring lower-income Canadians into the role of income taxpayer created new sorts of conflicts and alliances, making it a challenge for Finance and Revenue to secure cooperation from taxpayers and prompting new uses for existing organizations.

Beyond the worry about resistance among hourly wage earners, Ilsley also had to convince the slightly better off that a heavier income tax burden was fair and necessary. While the very poorest could only threaten to withdraw their labour, others had at their disposal a different means of tax protest: they could threaten not to buy war savings certificates or Victory Bonds, or, worse, to cash and spend those they had bought.\textsuperscript{37} (See figure 1.) In commenting on the new tax burdens, voices from this cohort claimed that the personal income tax took up anything that they had to spare: “They ask us to buy bonds, but with paying tax and other expenses how can we?” inquired the wife of an air force mechanic.\textsuperscript{38} A single woman earning a decent salary (for a woman) of $1,907.36 per annum ($27,266 in 2014 dollars) explained to Ilsley exactly what she spent her income on, and inquired of him how she could pay the new income tax: “What am I to do, drop this Insurance for my old age? Let my home people starve or go on relief? Subscribe nothing to the War Effort?”\textsuperscript{39} Another correspondent was incredulous that the government expected both income tax and war savings from him.\textsuperscript{40} In this opinion, he joined with Opposition leader R.B. Hanson, who had raised in the House the case of a clergyman who “receives in cash $1,500 out of which you intend to take $105 leaving him with the princely sum of $27 per week with which to feed, clothe, educate, pay for medical services, …”


\textsuperscript{37} For an example of the threat to sell, see Mrs. Annie Horncastle to Minister of Finance, December 10, 1941, LAC, RG 19, vol. 3404, file 7001-7050.

\textsuperscript{38} Mrs. Rexford Duckworth to Ilsley, March 15, 1943, LAC, RG 19, vol. 452, file 111-14E.

\textsuperscript{39} Miss W.E. Drummond to J.L. Ilsley, July 15, 1942, LAC, RG 19, vol. 452, file 111-14E.

\textsuperscript{40} Viv. H. Graham to Ilsley, July 21, 1942, LAC, RG 19, vol. 452, file 111-14E.
Figure 1

Resentment of the burden of income taxes threatened the success of the war savings campaigns. The volunteer leaders of the War Finance Committee could rely on prominent businesses, such as the T. Eaton Co., themselves major holders of war loan bonds, for support in countering the combination of tax resentment and resistance to the bond sales drive. This Eaton-sponsored ad appeared in the Toronto Globe and Mail, April 18, 1944, in support of the 1944 Victory Bond campaign.

and dental care etc. etc. etc. etc. and then apparently buy some war saving certifi-
cates and bonds with the balance.41

Threats to the purchase of war savings products mattered because the revenue
that those products generated was nearly as important as tax revenue (and more
important than direct taxation) in financing war expenditure. Looking back on
1942–43 in his March 1943 budget speech, Ilsley celebrated the relatively equal
contributions to the federal budget of, on the one hand, tax revenues (of all kinds)
and, on the other, borrowing: 52 percent tax to 48 percent borrowing. He also
noted how much the contribution of direct taxation had grown, constituting now
two-thirds of total tax revenues. That amounted to direct tax revenue of approxi-
mately $1.4 billion, compared to the $2.423 billion to be raised by borrowing.42
Quite apart from its own value as a source of revenue, personal income taxation
mattered because it might threaten the new income taxpayers’ willingness to save.

The success of the borrowing program depended importantly on participation
by small buyers. To be sure, the vast majority of the Victory Loan issue was pur-
chased by financial institutions, big business, and possessors of substantial fortunes.
But the bankers who ran the National War Finance Committee (NWFC) persistently
urged wage earners to purchase war savings products, in order to reassure the big
institutional buyers. As Bank of Montreal president and NWFC head George Spinney
pointed out to a group of bankers in 1942, it was in the interest of banks, as large
holders of government of Canada bonds, that many Canadian voters should also
own such bonds:

It is sometimes difficult to get the public at large to realize that any development
which might harm the investment portfolio of banks and insurance companies is
against their own interests. It is less difficult, however, to convince a man that his own
interests are imperilled if some move is on foot [sic] which might affect the worth of a
War Savings Certificate or Bond which he has in his own bureau drawer or safety
deposit box.43

If government was going to be committed to a program of market support that
would shore up the price of bonds, the optics of protecting the small investor would
be helpful.44 Ilsley pointed out that it was the government’s “deliberate policy” to

41 Ibid. The quoted passage is Graham’s paraphrase of Hanson’s remarks as reported in the
_Montreal Herald_. Hanson’s actual remarks can be found in Canada, House of Commons,
_Debates_, July 20, 1942, at 4442.

42 Canada, House of Commons, _Debates_, March 2, 1943, at 840–42.

43 A.W. Rogers to General Manager, The Bank of Nova Scotia, December 12, 1941, confidential
enclosure entitled “The National War Finance Committee and the Chartered Banks,” dated
December 9, 1941, included with Memorandum of a Meeting in Ottawa on Thursday, December
11, 1941 at 1 a.m. in the Office of G.W. Spinney, The Bank of Nova Scotia Archives, RG086/
oi/0007/o000/o178, as quoted in Robert L. Ascah, _Politics and Public Debt: The Dominion, the
Banks and Alberta’s Social Credit_ (Edmonton: University of Alberta Press, 1999), at 105.

44 Ascah, supra note 43, at 105.
ensure that Canadian bonds were widely held: he estimated that 60 percent of
income earners would also be recipients of bond interest after the war.\textsuperscript{45} He did not
want payouts of interest to bondholders to be seen in the future, as they had been
in the past, as draining earnings from the pockets of modest earners into the coffers
of the rich.\textsuperscript{46} As a First World War veteran, A.W. Frazer, put it, if tax revenues went
largely to serve a vast national debt held by the wealthy, then government would
be just the same old “gang of bond collectors.”\textsuperscript{47}

The relationship between war savings and tax policy was also noted by CCF
members of Parliament (MPs). From the outset of the war, the leader of the CCF (the
Co-operative Commonwealth Federation), M.J. Coldwell, had called for the “con-
scription of wealth” through the taxation of capital gains. In demanding this change
in tax policy, the CCF drew attention to the real difference between taxing income
and taxing wealth—that income taxation bore down more heavily on small incomes.
When the NDT was introduced, Coldwell distinguished it as a wages tax, rather than
an income tax, and called for the taxation of capital gains, along with a further tax
on capital in the form of a dominion succession duty.\textsuperscript{48} In their tax thinking, social-
ists (by no means politically marginal in 1942-43 in Canada) had begun to take into
account the potential revenue that could be reached through taxing investments,
especially those war loan bonds on which the wealthy had earned tax-free income.\textsuperscript{49}

In 1941, Coldwell made this point by sending Ilsley a letter from a veteran and Sas-
katchewan farmer, William Casey Teneycke, whose views, Coldwell said, exempli-
fied those expressed in many other letters he had received. A “plain hardboiled
Canadian” who wanted nothing to do with “any of the isms,” Teneycke asserted that
“the common producer class” was “taxed for everything we have or can get while
the monied class buy war bonds for our children of future generations to pay. . . .
Why do you not tax the rich the same as you do us for all they got?” After calling
for conscription more generally, he concluded, “If you took all their money by tax-
at ion there would be no war debt after the war as you would have all the money
already.” That money could then be “justly divided among the people who won the
war and not as after the last war be in the control of a few bloated millionaires and
their useless offspring.”\textsuperscript{50} This was far from a sophisticated technical statement of
how to tax capital, but the general drift was clear. In the Department of Finance,
Robert Bryce tried to devise more subtle ways of conscripting wealth, by minimizing

\textsuperscript{45} Canada, House of Commons, Debates, June 26, 1944, at 4172.
\textsuperscript{46} This worry is expressed in R.B. Bryce, Notes on 1942-43 Financing and the Conscriptio
\textsuperscript{47} A.W. Frazer to Ilsley, October 30, 1942, LAC, RG 19, vol. 2704, file 500-1.
\textsuperscript{48} Canada, House of Commons, Debates, September 9, 1939, at 55, and June 28, 1940, at 1230.
\textsuperscript{49} Richard Toye, “Keynes, the Labour Movement, and ‘How To Pay for the War’ ” (1999) 10:3
Twentieth Century British History 255-81, at 277.
\textsuperscript{50} Coldwell to Ilsley, June 9, 1941, with enclosure from Wm. Casey Teneycke, LAC, RG 19,
vol. 2704, file 500-2.
the returns offered by the Victory Loans to big capital. His proposals were no more successful than was Coldwell’s advocacy of capital gains taxation. But it is worth noting the full range of ideas about war finance that critics expressed, and the continuing impact of dissatisfaction with the methods that had been initiated during the First World War.

The anti-capitalist currents of the interwar years had made bankers aware of the risk to capital posed by the power of the mass electorate: the February 1942 victory of a CCF candidate over a wealthy Conservative alarmed investors. Although the CCF’s motion to require interest-free war loans had been defeated in the House in February 1942, the party’s popularity (especially in the western provinces) was a matter of lively speculation. Staving off a socialist threat and thus preserving political stability was closely connected to the viability of the war loan program. In September 1943, George Spinney (still the head of the NWFC) found out that the worry about the CCF’s popularity extended to New York, where fears of growing support for the party threatened Victory Bond sales. The first question Spinney heard from his banking friends there was, “What about the threat of the C.C.F. Party?” As the fifth Victory Loan campaign approached, the New York bankers’ remarks served to “impress upon [Spinney’s] mind afresh” the importance of “confidence.” Writing to Clifford Clark, Spinney warned that “[a] good many people throughout Canada” were “fidgety and perplexed” about inflation and “worried over the infiltration of C.C.F. theories.” He and Clark discussed asking the CCF’s Coldwell to make a public statement that would quiet alarm by affirming the party’s commitment to honouring public debt (which included not reducing the return to investors by taxing their capital gains). Clark worried that Coldwell could do more harm than good to the market for Canadian bonds if he refused or elaborately hedged his support. Coldwell ended up making an almost perfectly anodyne statement about the complete safety of investing in war bonds. Only the initiated would have suspected a reference to capital gains taxation in his comment that “disagreeing

51 See Bryce, supra note 46. My assertion that the measures that Bryce proposed in this memorandum were not taken up is based on my reading of the wartime budget speeches and on Robert Ascah’s brief discussion of this document (Ascah, supra note 43, at 111). However, a close examination of the work of the Victory Loan committee would be necessary to determine whether the quite subtle methods of rationing access to Victory Loan subscriptions might have been accomplished quietly.

52 “Surprise Motion Follows Rejection of Coldwell Plan,” Globe and Mail, February 19, 1942. Raymond Blake summarizes the literature that emphasizes the CCF political threat as key in prompting King’s move to develop a social security program; Blake also disputes that view. As I argue below, I think Blake is right to emphasize the social security move as somewhat autonomous from partisan considerations, but I suggest that the CCF threat was more than just an electoral worry. Raymond B. Blake, From Rights to Needs: A History of Family Allowances in Canada, 1929–92 (Vancouver: UBC Press, 2009), at 73–74 and 297, note 79.


with the government’s war finance methods” was not a reason to boycott the Victory Loan campaign.55

One other challenge to the success of the new income tax (and the success of the Victory Loan campaigns) was something more subtle than organized protest or the complaints of individual letter writers, and its impact on tax rhetoric and even tax policy is harder to assess. That challenge was the force of rumour. Stories about tax evasion brought the fairness of income taxation into question; rumours about savings certificates or bonds discouraged voluntary savings. Most commonly, there were rumours that other taxpayers were getting away with evasion. Some of these were expressions of the usual general suspicion that the corporations and the rich were getting off lightly. Others, more specifically, alleged “the hiding of sales and income by small storekeepers; the renting of three or four rooms in home after home to bring in as much as $20 weekly with never a thought of declaring that income; an instance of ‘another source of extra income’ of $50 a week that was never likely to be traced and therefore ‘forgotten to be declared,’ and so on.”56 There were also rumours that the government might make it illegal to cash bonds and savings certificates or, conversely, that all income tax would be refunded after the war.57 And, finally, there was resentful talk of income tax money being wasted through incompetent or partisan spending. Listed as rumours number 210 and 239 by the WIB’s “Rumour Clinic,” these stories of waste were apparently common.58 They showed up in the questions raised by union leaders in Montreal, too: union members had told their leaders that “things were not being done as economically as possible” in the plants where they worked.59 Rumours such as these filled in gaps in knowledge, and gave expression to fears, anger, and mistrust. Mutterings of this sort could help people to feel justified in evasion or reduce their willingness to invest in war savings, putting self-interest before social interest. The Finance and Victory Loan people attempted to allay mistrust and calm feelings by feeding stories to the press and by supplying answers for use by the WIB’s Rumour Clinic. In this material, they emphasized collective responsibility and the social value of the work of government employees.60

56 A. Edington to W.C. Clark, July 7, 1942, LAC, RG 19, vol. 4030, file 129W-2. These and other rumours were implied in the questions summarized in R.B. Bryce, Questions About Income Tax, the Budget, and War Saving Raised During Tour of the Minister of Finance Through Ontario [sic], August 24-29, 1942, LAC, RG 19, vol. 453, file Taxation.
58 “C” (likely W.C. Clark) to R.B.B. (Bryce), April 14, 1943, and Memorandum from W.C. Clark to Reg Hardy (Ottawa Press Gallery), April 21, 1943, LAC, RG 19, vol. 4030, file 129W-2. The Rumour Clinic sent its materials, rebutting rumours, to 30 newspapers each week.
60 See, for example, the memorandum from Clark to Hardy, supra note 58.
In the next section, I will discuss other efforts by Finance and Revenue to overcome the new taxpayers’ resistance. We shall see that the sense of community that many Canadians recall from the war years was carefully cultivated, in part to serve the purposes of war finance.

RESPONSES TO RESISTANCE

In describing the forms of resistance triggered by the new income tax, I have already indicated two kinds of responses by tax and revenue authorities. One was revision of the income war tax amendments proposed in the 1942 budget; this revision was designed to fend off a tax-driven withdrawal of labour—that of married women employed in war-related jobs. The other kind of response was rhetorical or educational: the example we have already seen is the initiative taken by Finance officials in supplying responses to the fiscal rumour mill. In what follows, I examine the campaign of persuasion that was carried out in responding to citizens’ letters and crafting public relations materials, as well as in one of Ilsley’s key wartime speeches to labour and in his budget speeches of 1943 and 1944. I draw connections between that tax rhetoric and the terms in which family allowances were introduced in 1944, arguing that the government’s strategy was designed both to legitimate personal income taxation beyond the period of war finance and to secure tax compliance from the new income taxpayers during the war. I conclude with a discussion of the particular tax relief amendments of 1943 and 1944, and show how they too served these purposes, while also protecting the overall financial system and the federal government’s ability to borrow.

The democratic response was imperfect; not all publics were equally successful in having their professed needs met. But Finance and Revenue both made serious attempts to engage citizens in an intelligent discussion of war finance, and to respond in ways that balanced the collective project of war finance with the needs of individuals or particular groups. These were self-consciously democratic leaders, confident that all of the publics were intelligent and reachable by appeals to justice and an idea of the common good. They were liberals whose idea of the common good rested on mutual interests, more than on mutual responsibility, but that was, in its own way, a form of social liberalism.

EDUCATING THE TAXPAYERS

The respect that fiscal policy makers showed the public extended even to those whom they believed to be, on the one hand, in the grip of socialist or social credit error, or, on the other, in the grip of somewhat anti-statist obsessions with waste and bloated public expenditures. For example, Finance was not willing to accept the CCF and Social Credit view that no interest should be paid on Victory Bonds, but it did provide no-interest bonds as an option for those Canadians who thought that they should not be paid for the money they loaned for the war effort.61 Another sign

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61 Slater, supra note 1, at 81, table 7.1; and Ilsley to John F. Macdonald, Esq., December 30, 1940, LAC, RG 19, vol. 2704, file 500-2.
of Finance’s democratic commitment at this time was Clifford Clark’s requiring his staff to respond to letters from Canadians who proposed unorthodox fiscal or monetary schemes. This work was sometimes burdensome.62 But in maintaining a civilized tone and by supplying evidence, argument, and reading suggestions, the patient efforts of Harvey Perry, Robert Bryce, Kenneth Eaton, W.C. Ronson, and others to explain and justify the federal government’s war financing policy, one Canadian at a time, must impress anyone who reads these files.

For example, it might have seemed to these Finance officials that Oliver Wright of Glansworth, Ontario, was simply a cranky old Gladstonian when he wrote, “Wherever high taxes are discussed, this matter of unnecessary employees comes up, and if something is not done to rectify it, you are going to have difficulty in making collections.”63 No one in Finance knew who Wright was; in fact, they had to make a special effort to find his return address. However, Ilsley had his assistant deputy minister, W.C. Ronson, compose a reply. Ronson wrote a 1,000-word, information-packed response to Wright. He apologized to the department’s typist for its length, saying, “My only excuse for so long a letter is the importance I attach to a complaint of this nature.”64 This was the work of a man convinced of the merits of government policy and possessed of the belief that the citizen/taxpayer could be persuaded by reason and evidence to share his conviction. In the same way, a multi-letter exchange between the First World War veteran A.W. Frazer and Bryce impresses. Frazer was impassioned and somewhat CCF-leaning. He and Bryce disagreed on some basic points. But each made his case and acknowledged the merits of some aspects of the other’s perspective.65 The Finance officials were capable of dismissing writers they knew to be doctrinaire—for example, the authors of Toronto’s The Printed Word and Horace Brittain of the Citizen’s Research Institute of Canada, on the right, or committed opponents of capitalism, on the left.66 But even to those, the replies from Finance noted their differences, rather than simply ignoring the

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62 Clark’s policy of requiring full and helpful responses to the department’s many incoming letters, something Bryce recalled as having been an irritating burden, was clearly of political value, however much Bryce sometimes doubted the ability of his letters to persuade the economic amateurs who wrote in to offer solutions to the Great Depression or the problems of war finance. Robert B. Bryce, Maturing in Hard Times: Canada’s Department of Finance Through the Great Depression (Montreal and Kingston, ON: McGill-Queen’s University Press, 1986), at 228.

63 Oliver Wright to Ilsley, January 20, 1941, LAC, RG 19, vol. 3543, file Taxation.

64 W.C.R. (Ronson) to Miss Wickwire, undated transmitted note (likely February 2, 1941). The letter went out over Ilsley’s signature, to Oliver Wright, February 3, 1941, LAC, RG 19, vol. 3543, file Taxation.


66 R.B. Bryce to Davidson Dunton, February 24, 1944, LAC, RG 19, vol. 4030, file 129W-3; Memorandum to Dr. Clark from R.B.B. (Bryce), pencil notation by A.K.E. (Eaton), October 27, 1942, LAC, RG 19, vol. 3543, file Taxation.
warfare state, welfare state, and the selling of the personal income tax

grounds of disagreement. Ilsley and his staff took seriously the democratic work of explaining and justifying policy to citizens who chose to participate in open debate.

Finance, Revenue, and the NWFC also worked with the WIB to craft a public relations campaign that would encourage tax compliance and voluntary savings. Themes for this campaign were generated in part through an interdepartmental committee on industrial morale. (“Industrial morale” was the bloodless term for the problem of “intolerable strain and worry” among people who earned less than $3,000 per year that WIB correspondents had reported in their summary of responses to the 1943 budget.) Convened in March 1943 by John Grierson of the WIB, this committee considered how to address such problems, and broader ones too: industrial morale problems also included wildcat strikes, overtime refusal, the demand for collective bargaining rights, and the expectation of other measures of respect (discussed in the hearings of the National War Labour Board between April and June 1943). The labour conflicts of 1941-42 form an essential part of the background to the tax rhetoric and policy of 1943-44.

Bryce told Clark that he hoped the committee on industrial morale would be useful to Finance in helping to put across “certain ideas with regard to taxation, and possibly with regard to borrowing, as well.” Bryce or Eaton attended the committee’s meetings between March and July, telling the group that Finance had “a considerable amount of data from letters received” on the subjects of compulsory saving and tax on overtime pay, and that the department was “seriously concerned with the relationship of income tax deductions to absenteeism and industrial morale.” In May, the WIB’s labour liaison, David Petegorsky, followed up by asking Bryce to let him know what sort of industrial morale objectives Finance wanted to see addressed. Bryce’s reply made it clear that he knew that both rational argument and emotionally compelling persuasion were necessary if “the working man and his

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67 See, for example, Ilsley (“WCC”) to Phineas Pfunder Onderdonck, September 14, 1943, LAC, RG 19, vol. 3402, file 6301-6400.

68 “Public Reaction to the 1943 Budget,” report of WIB correspondents’ communications “two or three days” after the March 2 budget, LAC, RG 19, vol. 4030, file 129W-6.

69 That context is described in Canadian labour history surveys such as Bryan D. Palmer, *Working-Class Experience: Rethinking the History of Canadian Labour, 1800-1991*, 2d ed. (Toronto: McClelland and Stewart, 1992). An important monograph on one significant strike is Laurel Sefton MacDowell, “Remember Kirkland Lake”: *The History and Effects of the Kirkland Lake Gold Miners’ Strike, 1941-42* (Toronto: University of Toronto Press, 1983). During the war labour board hearings in the spring, labour executive Aaron Mosher noted organized labour’s frustrated aspirations to be represented on wartime administrative bodies. Without giving labour a seat at the table, he pointed out, government could not expect to get the workers’ “whole-hearted support of the war effort.” Canada, National War Labour Board, *Proceedings*, report no. 1-13 (Ottawa: King’s Printer, 1943), at 131.


wife,” who were in his view “the bulk of Canadian citizens,” were to help make war finance work. The department, he wrote, was interested to see that our major financial and economic policies, the reasons for them and the effects of them, are properly understood by the working man and his wife. In particular we are interested in their understanding of the taxes that affect him, the need for saving, and the whole price and wage stabilization program. We want labour to understand our tax measures and to be convinced that they are necessary and equitable, so that they will cause the least possible dissatisfaction and loss of productive effort. We very much need the cooperation of workers and their families in our savings program. Furthermore, and perhaps more difficult than all the others, we would like to see labour sufficiently well convinced of the need for avoiding inflation that they would refrain from pressing for higher wage rates which would mean higher prices.

We believe that an understanding of the real issues will help to promote these ends. . . . [W]e don’t believe that understanding or acquiescence [alone] is enough; we believe there is need for some emotional drive, particularly on such things as savings campaigns, where more is needed than mere acceptance of measures. In other words, I think it is true to say that the Finance Department would like to see an effort made to arouse some mass support and mass feeling behind the economic measures that have been devised to make it possible to fight the war without inflation. This, I realize, will take some real salesmanship.72

In short, Bryce believed that most Canadians could be persuaded to share his belief in the government’s tax policy and act enthusiastically on it. Petegorsky later sent him recent US poll data showing that most Americans did not actually believe that “higher taxes” for “everyone” could help keep prices stable: 57 percent thought that there was no connection between prices and taxation, and 19 percent thought that higher taxes would raise prices.73 If the same level of incomprehension prevailed in Canada, as it likely did, there was indeed work to be done.

In the latter half of 1943, the WIB, Finance, and Revenue developed educational and promotional material aimed directly at workers, both unionized and non-unionized, to combat tax protest and to persuade wage earners that demands for increased pay were inflationary and therefore self-defeating. Revenue’s contribution to this campaign included a 14-page, pay-packet-sized pamphlet. It was produced and circulated sometime between June 1943, when the tidal wave of new income tax returns (over 2 million of them) hit the crowded desks in Revenue, and December 1943, when the department began to issue refundable tax certificates.74 The front cover of the Revenue pamphlet showed a puzzled worker, a middle-aged man, bombarded

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74 “Answers to Your Questions About Income Tax Deductions,” undated, circa 1943, City of Toronto Archives, fonds 200, series 361, subseries 1, file 42. The likely date of this document was determined from statements within the document and information about when the certificates began to be issued.
by questions such as “Is too much deducted?” and “Is overtime worth while?” The 
back cover gave the gist of the pamphlet’s message: “False rumours” about the un-
fairness of the income tax were “based on misunderstandings and half truths.” In 
particular, the “refundable portion . . . will be repaid to you with interest,” despite what 
workers may have heard to the contrary. Inside the text-heavy pamphlet, there was 
more detail on why the income tax was fair (the rich and businesses pay more), the 
advantages of payroll deduction (no tax debt to hang over the worker’s head), and 
why certificates for the refundable amount were slow to appear (for faster results, 
Revenue would have had to hire and then fire an army of temporary workers). 
Overdeductions were possible, if unlikely, but they would be refunded. And over-
time always resulted in the worker having more income. Detailed calculations were 
provided for the arithmetically inclined to peruse. In December, display ads making 
these points in cartoon form were circulated to company newsletters and personnel 
managers. In what may be a first, the joy of a tax refund cheque was illustrated. And 
in a further emotional appeal, there was the rhetoric of solidarity in the fight against 
Hitler.75 (See figure 2.)

As well as the information campaign aimed at the new income taxpayers, the 
anti-inflation campaign targeted both wage earners and consumers. Before 1943, 
anti-inflation themes appeared mainly in the advertising of insurance companies, 
banks, and investment dealers.76 “Sound money” was a perennial concern of these 
large investors in public bonds. The government’s advertising campaign around 
inflation ramped up, however, following the labour activism of 1941-1943. Aside 
from the occasional notice concerning particular price controls,77 the first of the 
Finance-driven anti-inflation ads, a sternly official one, appeared in December 1943 
(see figure 3). In 1944, over the course of the year, government of Canada ads offered 
an education in economics in cartoon form, presenting images of workers and war-
rriors together as heroes, images of interconnectedness, and a message of individual 
responsibility.78 Though wage and price controls were central to this education
In December 1943, the Wartime Information Board provided employee publications with advertisements designed to reassure employees that the personal income tax was fair to them. The ads were supplied in an ad mat format, allowing publishers to select the images that best addressed the concerns of their readers.

Source: Library and Archives Canada, Department of Finance records, RG 19, vol. 4030, file 129W-3.
INCOME TAX IS A FAIR TAX! It's based on your total income. Higher incomes, higher rates. BUT, you pay NO tax if you are single and earn less than $660 a year. Married and earn less than $1,200 a year.

NO, AND HERE'S WHY... Because — If too much has been deducted you either pay less at the end of the year or your money is refunded after your return tax is filed.

WHY PAY-AS-I-EARN? LUMP SUM PAYMENT OF TAXES You’d have to borrow and you'd go into debt.

PAY-AS-YOU-EARN You pay in 12 monthly instalments, as you earn.

WHY TAX OVERTIME? Because — Income tax is a fair and democratic tax. The more you earn the more you pay.

WHY WORK OVERTIME? BECAUSE CANADA NEEDS YOUR TIME FOR VICTORY AND YOU CAN USE YOUR OVERTIME EARNINGS FOR VICTORY BONDS AND CERTIFICATES FOR THE FUTURE.

ISSUED BY WARTIME INFORMATION BOARD. PRODUCED BY NATIONAL FILM BOARD.
In 1943-44, the Canadian government conducted an anti-inflation advertising campaign. This advertisement (the first to appear) was published in the Globe and Mail on December 16, 1943.

campaign, at least three of the anti-inflation ads included increased taxation among the list of measures being employed to control inflation. As organized labour fought during 1943 and 1944 to raise the wages of the poorest workers to something like subsistence level, union officials had to answer these messages from the government of Canada: it had become harder to argue that perhaps a little inflation would not be so bad.

**Ilsley’s 1943 Speech to the Trades and Labour Congress of Canada**

In addition to speaking to wage earners and consumers generally, Ilsley made a special effort to recruit the assistance of organized labour in fighting the tax protest elements of the industrial morale problem. His emblematic effort was a speech that he made at the September 1943 annual meeting of the Trades and Labour Congress of Canada. This speech, later reprinted by the National Liberal Federation, with an approving foreword from the *Toronto Daily Star*, was also supplied by Finance officials in the fall of 1943 when they answered letters complaining about taxation of the cost-of-living bonus. In the speech, Ilsley attempted to address every argument and rumour that had been raised in letters to his department from working-class Canadians. He acknowledged that some thought that inflation was an “invented . . . bogey.” He showed that he understood the doubts about the forced savings amounts. He repeated the concerns about tax falling on incomes that were already too low, tax on overtime, and tax on cost-of-living bonuses. Some of his answers to these concerns spoke effectively to labour’s concerns about tax fairness, while others would have been less convincing. He was certainly on common ground with his labour audience when he defended the principle of progressivity and pointed out that it underlay the taxation of overtime earnings. But in some of the other ways he framed his messages of social solidarity and a positive role for the state, his views on what solidarity meant would not have made sense to the socialist members of his audience: it was not socialism but social liberalism that he was selling.

A key element in Ilsley’s argument was that taxing “even the lower brackets” was necessary in order to get “even half as much in taxes as this war is costing us.” This assertion makes sense only on a rather curious understanding of “the lower brackets.” Ilsley seems to have been defining the term in the same way that the *Globe and Mail* editors in 1946 defined “the small income group”: those who earned “$5,000 a year

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80 Rationing, price control, and taxing the income of better-paid workers was the package of measures that Aaron Mosher of the Canadian Labour Congress offered as the way to prevent inflation. National War Labour Board, *Proceedings*, supra note 69, at 130-31.

81 Ilsley, *Sharing the Cost of War*, supra note 22.

82 Ibid., at 5.

83 Ibid., at 11-12.
or less” ($68,791 in 2014 dollars). While these are, literally, “lower” incomes in relation to upper incomes, even the best-paid unionized industrial workers among those Ilsley was addressing in 1943 rarely earned above $4,000. And in assessing the necessity of income tax contributions from “the lower brackets,” it is worth noting that personal income taxation in total, across all income levels, contributed only 23 percent of all tax revenue in 1943. Exactly how much the lower brackets contributed during 1943, we do not know in precise terms: the taxation statistics for that year reported tax for broad occupational groups rather than by income class. The first wartime income tax statistics reported by income brackets were the 1945 estimated income tax statistics published in 1946’s Canada Year Book. These give some broad orders of magnitude as to the scale of income tax assessments, and show how little need there was in war budgets for the many small and painful payments by low income earners.

As many in Ilsley’s labour audience would have been aware, from their experience during the Depression, taxing the poor served symbolic rather than balance sheet purposes. Those purposes had been imported into the federal tax system along with other features of special provincial income taxes such as those introduced in British Columbia and Manitoba in the 1930s. The BC and Manitoba taxes had been broad-based, charging a small flat rate on all incomes. Unlike the graduated taxes aimed at higher income earners—“soak the rich” taxes—these new provincial income taxes had been “show them the price” taxes; that is, they were intended to make lower income earners tax-conscious, so that they would understand that they shared in the obligation to finance activities of the state, especially activities such as unemployment relief that were likely to benefit them or their families directly. In arguing that every cent of low-income workers’ taxes was essential, Ilsley was also drawing on an older, elite vocabulary of tax fairness according to which, in fairness to those who paid income taxes at higher, progressive rates, the working poor had to carry a burden whose weight they would feel.

84 “Who Pays the Piper!” Globe and Mail, May 29, 1946.
85 Perry, supra note 1, at 626-27.
86 Dominion Bureau of Statistics, Canada Year Book, 1943-44 (Ottawa: King’s Printer, 1944), at 824-25 and 858-60; and Dominion Bureau of Statistics, Canada Year Book, 1946 (Ottawa: King’s Printer, 1946), at 935-36.
87 Perry, supra note 1, at 360.
88 I discuss “show them the price” income taxation in more detail in chapter 4 of my work in progress, The Power To Govern: Taxpayers and Democracy in Canada, 1915 to 1971. In the 1939 Senate debate on the Special War Revenue Act, former prime minister Arthur Meighen argued for a dramatic lowering of income tax exemptions “so that the whole population, or nearly the whole of it, will be tax conscious.” Canada, Senate, Debates, September 12, 1939, at 37. Resistance to those taxes had been considerable, inspiring (among other angry reactions) a constitutional challenge on behalf of modestly paid civil service workers in Manitoba. James Forbes Appeal No. 92 of 1936 v. The Attorney General of Manitoba (Canada), [1936] UKPC 88. The politics of interwar taxation—sales as well as personal income taxation—are covered in chapters 3 to 6 of my work in progress, The Power To Govern, supra.
As a result of adopting this perspective, Ilsley, like other finance ministers before him, overstated the need for the nickels and dimes of income tax tribute from the less well-paid workers. In 1945, the 425,000 Canadians (17.9 percent of all personal income taxpayers) who were assessed on incomes under $1,000 ($13,758 in 2014 dollars) contributed just under 3 percent of total individual income tax revenues. That low-income group might well have wondered if the total $19,032 they contributed would have been noticed if it had been spread across the tax bills of the 2,800 Canadians who were assessed on incomes over $25,000 ($340,760 in 2014 dollars). Redistributing the tax burden in this way would have amounted to taking an additional $6.79 out of each of those high earners’ pockets, and would have helped to ease the strain on the household budgets of many low income earners: according to the Health League’s estimates, a single person could eat for about three weeks on that amount. So when Ilsley argued that the small contributions from the smallest taxable wages were necessary to finance the war, he was asking for considerable scrimping in return for a trivial tax contribution—1.42 percent of the total federal tax revenue (direct and indirect taxation together), based on the 1945 tax statistics I have used here. The rhetoric of the responsibility of the small earner was thus more about preventing the poor from being free-riders and making them see themselves as tax-conscious taxpayers than it was about buying bombers and feeding the troops. The same rhetoric would be summoned up again in 1946 and after to make the case that the social security state required the multitude of low-income Canadians to continue to pay income tax. Reading the same 1945 tax incidence figures that I drew on above, the Globe and Mail’s editorial writers in 1946 concluded that the data left “no doubt as to who will pay the cost of social security. It will be the small wage earner.” This was “show them the price” tax talk. When labour leaders charged that the wartime income taxes were too heavy on lower incomes, it was not that they misunderstood tax policy; rather, they recognized an old familiar discourse of tax fairness.

As discussed above, the elite view of tax fairness emphasized that all should contribute to the goods that tax dollars bought. Oliver Wendell Holmes famously said that in paying our taxes, the good we buy is civilization. During the war, Holmes’s assertion seemed literally true: at stake was the preservation of a democratic society. As a benefit argument for income taxation (if you benefit, you should pay), that notion of fairness could work both for and against a positive role for the state. On the

89 See supra note 21 for the basis for this calculation, which assumes a food budget of 30 cents per day.
90 Perry, supra note 1, at 626-27; Canada Year Book, 1946, supra note 86, at 935-36, table 5, “Individual Income Tax Estimates, Taxation Year, 1945.”
one hand, taxes were simply the tools of a democratic people’s common purpose. On the other hand, by taxing low incomes beyond what wage earners could bear, those who opposed a more active state could deliver an anti-statist lesson of tax consciousness—don’t expect much from the state because it will cost you—along with the rhetoric of social solidarity.

The other message of social liberalism in Ilsley’s 1943 Trades and Labour Congress speech was his emphasis on individual Canadians’ role as income taxpayers in maintaining price stability. In making his pitch to labour to accept his income tax measures in the name of fighting inflation, Ilsley urged them to consider the “financial and business economy,” a system in which their individual choices about working overtime would have systemic effects. It was not only a sense of togetherness or mutual responsibility, but also an impersonal system—the economy—that bound all together in a web of choices and consequences.93 “Stabilization,” a condition of that system, was eminently a social good created collaboratively by the choices of governments and individual citizens.

In addition to associating the new income taxes with paying for the war and with inflation prevention, Ilsley invoked social goods in the form of social security. He argued that the “financial capacity” that the nation had developed during the war must be applied to “the improvement of the Canadian standard of living.”94 “Financial capacity” meant borrowing methods as well as tax methods, of course. Indeed, the two were always intertwined. Like the mass income tax, widespread sales of dominion bonds to small investors would continue, as Canada Savings Bonds, after the war. But Ilsley’s 1943 use of “financial capacity” in his speech to some of Canada’s most influential labour leaders also referred to tax capacity, and in particular to the income tax that the labour movement’s members were being asked to pay. In a year when income tax protest was one of a cluster of sore points in labour relations, it made sense that Ilsley would say that, after the war, the income tax designed for war finance would be put to use for those social security purposes that the labour movement had long advocated. It was not only good politics to do so, but also a sign of the emerging social liberalism: the justifications for the stabilization policy, the war finance methods, and the social security measures were all shot through with a social liberal vocabulary of “togetherness”—an ideal of connectedness in which individuals’ self-interested actions were linked by macroeconomic mechanisms to social goods.


94 Ilsley, Sharing the Cost of War, supra note 22, at 15.
The Budget Speeches of 1943 and 1944

Ilsley's budget speeches were substantial statements of this social liberalism. Having read floods of mail and torrents of questions about the new mass income tax of 1942, Ilsley in 1943 made one of his most memorable defences of the citizenship of contribution in the budget speech delivered on March 2, 1943:

Taxes and loans are not exactions from the people by a government. They are weapons which the people through their elected representatives and the free methods of democracy have fashioned for their own use and their common purpose.\(^95\)

In the same speech, he also gave a fine short lesson on what kinds of borrowing are inflationary and what kinds are not. He defended the 1942 tax measures, showing that Canadians were paying a larger percentage of their personal income in income taxes than were Americans or the British. He insisted that wage and price controls would continue, along with restrictions on corporate profits. He maintained that the democratic methods of war finance were those that inhibited inflation, and he stood by those methods on principle. And he appealed for help, especially in support of the Victory Loan campaigns. It was not until 1944, however, that his budget speech brought together social spending, tax relief, and the good of the economy in a discussion of measures aimed at low-income taxpayers.

The rhetoric of that speech was shaped by Prime Minister King. Three days before the budget was to be presented, King had Ilsley read out the budget speech in Cabinet. King had been thinking hard about how to play up the linkages between inflation prevention, social security, and working-class tax protest. Without wanting to absolve King of all his faults, I read his advice to Ilsley on how to present the 1944 budget speech as showing, not mere vote-counting, but an appreciation of the connections between household budgets, public budgets, and stabilization.\(^96\) King was urging that the budget speech show that the government knew that the taxation of personal incomes was causing “real hardship.” He wanted Ilsley to emphasize that the government had chosen a means of tax relief that would not only put money in the hands of “persons of low income” (social support) but also prevent “men quitting their work because of additional earnings which bring them into higher [tax] brackets” (response to tax protest). Ilsley should also emphasize the government’s effective “battle against inflation” and its decision to bring in a system of family allowances. All of this would show that “there was real relief in taxation though without yielding any principles.”\(^97\)

\(^95\) Canada, Department of Finance, 1943 Budget, Budget Speech, March 2, 1943, at 1.

\(^96\) King’s point was not to change any of the agreed-upon measures, but to ensure that the rhetoric was right. The decisions had been made in Cabinet 10 days earlier: Mackenzie King diaries, supra note 9, June 13, 1944.

\(^97\) Mackenzie King diaries, supra note 9, June 23, 1944.
Ilsley’s speech on June 26, 1944 did all of these things. He even managed to respond to the Victory Loan campaigners’ worries that ending the compulsory savings part of the personal income tax would make their job harder. The elimination of compulsory savings (the refundable tax) was the budget’s core measure of tax relief, and Ilsley defended this relief explicitly as a means to prevent absenteeism and “special difficulty and hardship.” His other recommendations, he explained,

were thoroughly in keeping with the greater emphasis that we shall be placing on family welfare after the war. With the introduction of family allowances we are taking a great stride forward in improving the position of those with low incomes and family responsibilities.

None of these tax measures had a single cause; all of them were presented within a framework that linked macroeconomics, greater income security of poorer families, and tax relief in response to tax protest.

In this framework, none of the three elements can be discounted because they were all of a piece. Here, a perspective that includes tax policy makes the connections clear. For example, I both agree and disagree with the historian Raymond Blake, who suggests that some scholars have overemphasized the part played by wage control in the creation of the family allowance. He bases this position on a dichotomy between humanitarian social security projects and “cold-blooded” macroeconomics, a binary opposition that the social worker and prominent federal civil servant George Davidson used in the 1940s. If we accept this dichotomy, however, we miss seeing the moment in 1942, as most earners were becoming income taxpayers, when the tax system began to appear as a tax-transfer system, linking taxation and income assistance. When Robert Bryce made the case for family allowances to W.A. Mackintosh in January 1943, when Bank of Canada Governor Graham Towers made the case to the Canadian Manufacturers’ Association in June 1943, when Clifford Clark made the case to Cabinet in January 1944, and when King made the case in the House that June, each man pointed out the tax dimension of the family allowance program. The program was not as costly or unprecedented as it might seem, they emphasized, because there was already, in effect, “spending” on child welfare in the form of tax provisions—tax-exempt income before the war and deductions from tax payable during the war. The only difference with family allowances was that benefits delivered through the tax system would be replaced with transfer payments that would extend that amount of income support to low-income parents. Tax fairness and social welfare were thus tightly tied together in a policy that had the additional welfare effect of preserving the price ceiling.

98 Canada, Department of Finance, 1944 Budget, Budget Speech, June 26, 1944, at 10.
99 Ibid., at 11.
100 Blake, supra note 52, at 42.
101 Ibid., at 63-64, 73, 82, and 91-92; Canada, House of Commons, Debates, July 25, 1944, at 5329; and Perry, supra note 1, at 396.
Tax measures had both macroeconomic and welfare effects. Stabilization measures not only protected capital; they also meant, for low-income people, a measure of protection from the dangers both of inflation in the prices of necessities and of job cuts driven by deflation. There are reasons to distinguish among methods of delivering social assistance, but in 1942-1945, when these tax and welfare measures were being designed and first delivered, the tax dimension of the story shows us that personal income tax relief, inflation control, and social spending had common origins—the new ideology of social security. In this sense, Blake is right to point out the thick context of social security discourse that surrounded the birth of the family allowance. But for King and Ilsley, social security included stabilization; an unstable dollar threatened both the poor and the rich. Their tax program connected social security and stabilization policy; their response to lower-income Canadians’ tax resistance became an occasion to explain those connections.

**NEGOTIATED CONCESSIONS, 1942-1944**

While the rhetorical reorientation and signs of respect for workers as “the bulk of Canadian citizens” were important, the impact of public opinion also appears concretely in the actual changes made to the tax law in 1942, 1943, and 1944. The “minor alleviations” of those budgets were not trivial. As measures taken in response to lower-income Canadians’ expressions of distress, they should be seen in the same frame as collective bargaining law and the family allowance, as part of wartime democracy’s slow working toward a recognition that the material conditions of the majority of Canadians had to have more of an impact on public policy. Or, to put it differently, the personal income tax, along with, more obviously, conscription and wage and price controls, made the national state so much more intimately involved in daily life that a responsiveness to popular opinion was newly important as a means of legitimating state power. On an array of tax matters, from those affecting the poor to those affecting taxpayers in “special” circumstances, Finance and Revenue listened to the concerns raised by taxpayers and took steps to address those concerns. Most of these steps were related to variations in family obligations and the relation between savings and taxation. In this respect, it is easy to see how modifications of personal income taxation would come to be connected to the child welfare and old age security dimensions of the nascent welfare state.

As we have already seen, the first modification to the mass-based personal income tax was the concession granted in response to the immediate threat of married women’s refusal to work. The other protest-inspired change in July 1942 was also family-related. In class terms, the protesters were mostly wealthy or at least middle-class, but the concession was limited by Ilsley’s concern to avoid undermining the progressivity of income taxation (its claim to class fairness). The protesters were divorced men who paid part of their income out to their former wives, as alimony. The alimony payers tended to be relatively well off because lower-income couples

102 Blake, supra note 52, at chapter 2.
settled the terms of their separation in family court, rather than paying the higher costs of a parliamentary divorce. The complaint of the divorced men was that the tax law forced them to pay income tax on the money that the courts required them to give to their ex-wives, as though the alimony were part of the ex-husband’s income. Ilsley agreed with the protesters that the divorced wives should pay tax on the alimony payments that they received: the tax authority would permit the alimony payers to subtract from their tax bill the amount of income tax now paid by their ex-wives. The men would still be paying more tax than they would have if the full alimony amount had been subtracted from their gross income; for Ilsley, however, that richer exemption would have been contrary to the spirit of taxing on ability to pay and the legitimating class fairness of that spirit.

During the summer and fall of 1942, income taxpayers, mostly the new ones, continued to tell Ilsley about the problems that they faced as a result of the new tax measures. In the March 1943 budget, Finance responded to some of these complaints, making few changes, but significant ones. The nasty notch problem with the 100 percent tax rate was partially remedied. In the income ranges where there was a risk of 100 percent marginal tax rates, there would be new regulations to limit the rate to 66 percent, of which half would be refundable savings. In two other measures, Finance responded to complaints that were both class- and region-based. Both were about the kinds of savings that could reduce the refundable tax. After March 1943, Ilsley conceded, payments on dominion government annuities—mainly held by people with modest incomes—would be allowed for that purpose. The other concession concerning savings was that payments on mortgage principal for a home “owned” by a taxpayer’s wife would be allowed as a reduction of the refundable tax. Home-owning families of all classes often kept their family home in the wife’s name, for municipal tax reduction. They had not liked it when federal taxation counteracted that benefit. But Quebecers had particularly disliked not being able to claim payments made from a husband’s income to a wife’s asset, because Quebec’s marital property regime left them unable to shift ownership back to the husband to secure the federal tax break. In the March 1943 budget, Ilsley gave in on these points, even while continuing, as I suggested above, to hold a hard line.

In the June 1944 budget, as I noted in the discussion above of Ilsley’s budget speech rhetoric, the main material concession was the elimination of the refundable part of the personal income tax. Ilsley acknowledged that, even with the capping at

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104 1943 Budget Speech, supra note 95, at 17-18.
66 percent of the tax imposed within the lower income strata, the effective rate was still very high. He also admitted that refundable tax certificates could not be provided quickly. And though he refused to state publicly what he had vigorously argued in Cabinet, that income taxation was motivating absenteeism and refusal of overtime, he acknowledged that morale might have been adversely affected. And so, while insisting that war savings were more important than ever, he terminated the savings portion of the personal income tax. This measure would cost the war chest between $110 million and $115 million, amounts that would have to be made up by voluntary contributions. As a bit of face-saving, Ilsley argued that the campaigns for voluntary savings were now more effective than they had been in the summer of 1942 and so the argument for compulsory savings was less compelling. Moreover—and this was the message that lower-income Canadians had succeeded in communicating—he appreciated that voluntary savings provided some flexibility in personal budgets. The tide of letters that had landed on the Finance desks in 1942-43 had made vividly clear that, even with careful budgeting, the wartime income tax had left people on modest incomes without anything to spare, and often with less than they needed to eat and pay their bills.

Members of the other parties in the House had called, and would continue to call, for higher exempt amounts for both the normal and graduated tax. As King had urged, Ilsley rejected this strategy: higher exemptions overall would produce relief for the rich as well as the poor, unlike the targeted relief measures that the opposition were proposing. And, in a theme that echoed Ilsley’s September 1943 Trades and Labour Congress speech, and that would be repeated by others in post-war tax planning, he reiterated that the contributions of the many small taxpayers were an essential part of the revenue. The forms of tax relief that Ilsley offered were therefore aimed at cases of “special hardship” that had emerged in the first two years of the “pay-as-you-earn” regime. Several of these dealt with medical expenses or the expenses of people with disabilities. The majority had something to do with family. One measure that had been frequently requested since 1917 was that an income earner who supported in-laws could have tax relief by means of an equivalent-to-a-child exemption or credit. That measure was introduced in the 1944 budget.

105 King wrote in his diary that Ilsley “claims that working men just won’t work when they are at the point that increased wages means getting into a higher category of taxation”: Mackenzie King diaries, supra note 9, June 13, 1944. In Parliament, Ilsley said he was “not in position to judge how far this [tax avoidance causing absenteeism and refusal to work overtime] is true.” But he acknowledged it might be a “contributing factor.” 1944 Budget Speech, supra note 98, at 9.

106 1944 Budget Speech, supra note 98, at 10.

107 Canada, House of Commons, Debates, June 26, 1944, at 4531-32.


109 1944 Budget Speech, supra note 98, at 11.
Another of the family measures was that any children dependent on the taxpayer, regardless of biological relationship, could be claimed for tax purposes. That concession removed the glaring injustice of an unmarried mother being unable to claim a tax credit for her “illegitimate child” unless she legally adopted the child. Earlier protests on the disqualification of “illegitimate” children in British Columbia had emphasized the expense of adopting even if there were two parents; this issue only worsened the irritation in BC coastal communities where the ordinary practice of common-law marriages among aboriginal people meant that the tax inspectors did not recognize many children when calculating taxes owed in common-law households.\textsuperscript{110} Ilsley also introduced a measure that would provide relief for elderly couples where the wife's small investment income risked creating a tax bill that the couple could not afford. This measure helped people who had been able to save—by definition, those who had had middle-class or better incomes during their earning years. But the letters that Ilsley had received from such couples made it clear that at least some of the beneficiaries of this provision would be low-income taxpayers. The beneficiaries of the other family measure were in a different category: in 1944, the alimony payers got the more generous exemption they had demanded in 1942—complete elimination of any tax liability on the amount that they paid to their ex-wives.\textsuperscript{111} Still, overall, these “special hardship” measures were aimed at making the new income tax less punishing for the poor by easing the conflict between tax paying and the demands of family support on a breadwinner’s income.

Some problems remained.\textsuperscript{112} But the tax relief that Ilsley’s budget had provided meant immediately reduced deductions at source for many of the new income taxpayers, and politically this was useful to the Liberals. As Prime Minister King had speculated, compared with other measures, the ones they offered in 1944 meant that

\begin{quote}
...a much larger number of people will be helped in a way that will give them more money at once, albeit their own money, and that in relieving burdens on those of the lower class and making for a better feeling over a larger number, the yielding up of income [tax] may prove to be a preferable course.\textsuperscript{113}
\end{quote}

In justifying his approach, King had impressed on Clifford Clark that holding on to every legitimate cent of tax revenue risked giving the CCF victory in the next election, and if that happened, “the whole financial position” including the work of the

\textsuperscript{110} Canada, House of Commons, Debates, April 20, 1943, at 2368; James Coleman for D.M. MacKay (British Columbia Indian commissioner) to Indian Affairs Branch, January 11, 1944 and enclosure, F. Earl Anfield, Indian agent to D.M. MacKay, British Columbia Indian commissioner, January 6, 1944, LAC, RG 10, vol. 6821, file 493-1-6, part 2.

\textsuperscript{111} 1944 Budget Speech, supra note 98, at 11.

\textsuperscript{112} Canada, House of Commons, Debates, July 12, 1944, at 4781.

\textsuperscript{113} Mackenzie King diaries, supra note 9, June 13, 1944.
Victory Loan people would be seriously harmed.\textsuperscript{114} Here, King’s worry about the CCF threat was not merely mindless vote-counting: he felt “it was necessary to emphasise this [threat to the financial system from the CCF] strongly.”\textsuperscript{115} “Tax policy that was too hard on lower-income Canadians put too much at risk. Forgoing some income tax revenue from small incomes was necessary in order to protect Canada’s ability to borrow and to protect Canadians’ investments in government bonds, both of which King deemed would be imperilled if the mass of voters were to turn sharply leftward.

\textbf{CONCLUSION}

Wars create a sense of community, but not without some help. Whether in enlistment, or grocery shopping, or tax paying, Canadians did not easily let go of their pre-war differences and grievances. In organizing war finance, Ilsley, Towers, Gibson, and their officials had to deal with legacies of bitterness and conflict that fed suspicion and tax resistance. First World War veterans had reason to believe that bondholders’ rights to interest payments had been put ahead of their needs for unemployment relief. The Victory Loan campaigners were selling bonds to a public that was no longer quite so innocent about the risks and rewards that awaited the small investor compared to those available to big capital. Nor were all segments of the public now easily convinced that Canada’s shortage of high income earners was a “stubborn fact”\textsuperscript{116} that justified taxing lower and lower incomes. People on the left had started to think about broadening the income tax base in another way—by redefining taxable income to include income previously sheltered as capital gains.

In response to these and other threats to capital, the Liberals marketed government bonds to small investors, so as to make as many Canadians as possible, in their own interest, into supporters of protections to investment capital. In addition, they vastly broadened the income tax base by taxing smaller incomes, rather than broadening the taxable base in ways that targeted capital. They also actively sold “sound money” policies, using public education to engage broad participation in making those policies work. All of these steps were justified by a commitment to preserving and protecting the “financial and business system.” And all required mass consent and participation. The Finance Department’s spirited and genuine attempts to enlist Canadians in the government’s war finance policy, to listen to criticism, and to respond with reasoned argument show how the need to win taxpayers’ consent was

\textsuperscript{114} Ibid., June 23, 1944. King’s key sentence is, “They would deal with the financial situation in a way which would make all efforts at saving etc. pretty much at naught.” “Make . . . pretty much at naught” in this context certainly indicates something harmful: “render pretty much futile” might be synonymous and a more recognizable idiom.

\textsuperscript{115} Ibid.

\textsuperscript{116} Canada, House of Commons, Debates, June 24, 1940, at 1024. Campbell quotes this same phrase from J.L. Ralston’s 1940 budget speech as though it was simply a point of fact: Campbell, supra note 1, at 645.
contributing toward a democratic style of public administration and a more social form of liberalism. The Finance rhetoric established links between public borrowing, currency stability, social security, and taxation that, though Keynesian in complexion, were conceived in support of the immediate projects of selling bonds, collecting taxes, preventing labour strife, and disarming the CCF. In this rhetoric, the new income taxpayers were being told that they were interconnected in multiple ways, whether caring and mutualistic ones or through impersonal systems operating in markets for credit and consumer goods. This was a social liberalism that also relied importantly on recognizing the self-interest of individuals as a necessary consideration in designing public policy.

This powerful, but potentially unstable, mix of appeals was addressed to people who, collectively, had come into a position of real power. The labour of the new income taxpayers, their tax compliance, and their savings were all essential to the war effort. The labour movement harnessed some of that power for the project of collective bargaining, but the impact of the new taxpayers’ power was also delivered in less organized and less class-specific ways, such as individuals’ letters, references to those letters in the House by MPs, and the reporting of those references in newspapers. To make the war finance scheme work, Ilsley (and sometimes Clark) had to bring the voice of the ordinary tax grumbler and not just the well-soaked rich into the privy council chamber. In doing so, they shifted the income taxpayer from the elite position that he (or less often she) had occupied in municipal income taxation and in federal income taxation before the war. Paying direct taxes to the federal government was now a feature of daily, working-class life; for many more Canadians, the categories of citizen and taxpayer now increasingly overlapped. The legacy of war finance was a more socially active state, but the new income taxpayers of that new state were addressed in a quasi-collectivist discourse that blended social responsibility and individual self-interest. Complaints about the burden of income taxes on household budgets were present at the birth of the new taxpayer, and individualist pocketbook politics would continue to play a part in post-war citizen engagement. For better or for worse, the new taxpayer would also become a new breed of citizen—socially minded, to be sure, but always also tax-conscious.
The Disjunction Between Corporate Residence and Corporate Taxation: Is Improvement Possible?

Geoffrey Loomer*

PRÉCIS
Dans cet article, l'auteur analyse le concept de résidence d'une société, l'accent étant mis plus particulièrement sur les lois britannique et canadienne. Si on accepte la prémisse voulant que l'imposition des sociétés soit justifiée, il y a néanmoins une disjonction entre une imposition significative selon le pays de résidence et les définitions actuelles de résidence d'une société dans la loi nationale et les conventions fiscales. Cette disjonction existe parce que les diverses significations juridiques attribuées à la résidence d'une société exigent peu en manière d'attachement économique au supposé État de résidence. L'auteur commence par un bref examen du phénomène de la mobilité des entreprises motivée par la fiscalité, puis fait un résumé des mesures prises par le gouvernement pour répondre à cette mobilité. Dans le corps de l'article, il soutient que les concepts de résidence qui avaient pour but à l'origine de faire état des importantes activités de gestion d'entreprise ont été en grande partie éclipsés par les critères de constitution en société prévus par la loi au Royaume-Uni et au Canada, et ont été autrement affaiblis par des interprétations judiciaires de « centre de gestion et de contrôle » lorsqu'appliqués aux multinationales. L'auteur soutient alors que bien que le concept de « siège de direction effective » dans les conventions soit prometteur parce qu'il pourrait dénoter une gestion réelle et importante, cette interprétation a été jusqu'à présent écartée par les tribunaux supérieurs, du moins dans le cas des sociétés. Des causes récentes portant sur la résidence des fiducies sont indiquées parce qu'elles illustrent une approche contrastante, et peut-être préférable, à la résidence d'une entité. Étant donné que les formulations actuelles de résidence d'une société semblent comporter des lacunes, l'auteur propose des pistes concernant la façon de les améliorer pour se concentrer sur la réalité ou l'irréalité objective de l'établissement d'une entreprise.

ABSTRACT
In this article, the author analyzes the concept of corporate residence, with particular reference to the law in the United Kingdom and Canada. Accepting that the taxation of

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corporations has some justification, there is nonetheless a disjunction between meaningful residence-based taxation and current definitions of corporate residence in domestic law and tax treaties. This disjunction occurs because the various legal meanings ascribed to corporate residence require little in the way of economic attachment to the purported home state. The author begins with a brief review of the phenomenon of tax-driven corporate mobility, followed by a summary of government responses to corporate mobility. In the main body of the article, he argues that residence concepts that were originally intended to reflect substantial activities of corporate management were largely eclipsed by legislated incorporation tests in the United Kingdom and Canada, and were otherwise devitalized by judicial interpretations of “central management and control” when applied to multinational enterprises. The author then argues that although the treaty concept of “place of effective management” has promise because it could denote real and substantive management, to date this interpretation has been eschewed by higher courts, at least in the case of corporations. Recent cases on the residence of trusts are noted because they illustrate a contrasting, and perhaps preferable, approach to entity residence. Given that current formulations of corporate residence appear to be deficient, the author makes tentative suggestions regarding how corporate residence definitions could be improved to focus on the objective reality or unreality of corporate establishment.

**KEYWORDS:** AVOIDANCE ■ CORPORATIONS ■ RESIDENCE ■ MULTINATIONALS ■ CANADA ■ UNITED KINGDOM

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INTRODUCTION

Corporate residence for income tax purposes is a beleaguered concept. It suffers from two related problems. First, those concerned with the broad contours of tax policy often advocate reducing the traditional adherence to capital export neutrality and its prescription of “worldwide” taxation based on residence, if not abandoning corporate income tax completely.¹ Even if we accept that residence-based corporate taxation is justified in principle, there is the further problem that corporate residence has a legal meaning that is dislocated from what one might regard as its essential commercial attributes. The concept of residence might be understood to convey social and economic attachment, and even political obligation, to the home country: it has been observed that residence taxation “requires the attribution to companies of a characteristic that serves the same function as the residence of individuals, defining a strong nexus for taxation based on personal attachment to the jurisdiction.”² Yet, the various legal meanings ascribed to corporate residence require little in the way of economic attachment, such as premises, personnel, or business activities within the home state. For this reason, corporate residence has been described as “ectopic.”³ An unsurprising incident of this state of affairs is that multinational enterprises (MNEs) are able to adopt foreign statehood with ease, while governments and revenue administrations complain about so-called exploitation or abuse of corporate residence for tax-avoidance purposes. Against this background, this article provides an analysis of the continuing disjunction between meaningful corporate taxation and the prevailing definitions of corporate residence in domestic law and tax treaties, with particular reference to the law in the United Kingdom and Canada, and asks whether improvement is possible.

It is important to note at the outset what the purpose of this article is not. First, the purpose is not to defend the archetypal American tax system, wherein foreign active business profits, whether remitted as branch profits or dividends, are subject to worldwide taxation with foreign tax credits if and when they are remitted.⁴ It is

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² Robert Couzin, Corporate Residence and International Taxation (Amsterdam: IBFD, 2002), at 5.


⁴ The literature defending or criticizing US international tax rules is vast. For a useful description of the underlying principles, see J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, “Fairness in International Taxation: The Ability-To-Pay Case for Taxing
accepted that Canada’s exemption system for foreign affiliate dividends\(^5\) and the United Kingdom’s more recently adopted exemption system for foreign profits\(^6\) are defensible, provided that the underlying profits are actually “foreign,” which is itself a difficult determination to make.\(^7\) Nor is the purpose to advocate some radical renovation of the international tax regime generally. The goal is more modest.

In this article, it is assumed that residual corporate income taxation based on a corporation’s residence, with appropriate exclusions for foreign business profits, is relevant and should continue to be relevant. This assumption involves both a positive and a normative claim. I have argued elsewhere that although the role of corporate income taxation in countries’ tax systems may be attenuated, this form of taxation remains important to public finances.\(^8\) The same assumption underlies other scholarship advocating improvements to international tax rules,\(^9\) and is obviously fundamental to recent efforts by governments and the Organisation for Economic Co-operation and Development (OECD) to rescue tax systems from what has been called “aggressive international tax planning”\(^10\) or, more recently, “base erosion and profit shifting” (BEPS).\(^11\) Although the dominant trend is to use a territorial system,

\(^5\) Mainly subsection 90(1) and paragraph 113(1)(a) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.


\(^7\) It is well known that determining the source or sources of income in an international setting is complex and susceptible to disagreement. See, for example, Hugh J. Ault and David F. Bradford, “T axing International Income: An Analysis of the U.S. System and Its Economic Premises,” in Assaf Razin and Joel Slemrod, eds., Taxation in the Global Economy (Chicago: University of Chicago Press, 1990), 11-52.


in which active business profits are taxed only where they are earned, the current OECD consensus is to reserve the taxation of other important forms of income—noteably interest, royalties, and capital gains on assets other than real property or investments deriving their value principally from real property—to the state of residence, and to accept that residence should be determined on an entity-by-entity basis. In this context, one can hardly argue that corporate residence, and taxation based on such residence, is irrelevant. As for the normative claim, I have argued elsewhere that residence-based taxation is justified if residence is regarded as a sort of residual home source—that is, if it represents a substantial economic interest in the home state—and is not justified if there is no economic interest in the home state.12 In other words, after allowing for foreign taxation of foreign business profits (preferably exempting both branch profits and intercorporate dividends from further taxation), it is justifiable to tax income streams that are not easily sourced to another jurisdiction, such as interest, royalties, certain capital gains, and possibly other income derived from general administrative or oversight functions, in the state of residence of the entity entitled to this income, if residence in that state means something. Such taxation is difficult or impossible to justify if residence is devoid of meaning.

The difficulty, of course, is that corporate residence as currently understood may not be particularly meaningful, and thus may not be a satisfactory gauge of a substantial economic interest in the purported home state. The term “meaningful,” like the terms “real,” “actual,” “genuine,” and “substantial,” appear throughout the case law on corporate residence and are used at various points in this article. These terms can, of course, mean different things to different people. For the purpose of this article, I treat these terms as synonymous, each conveying the existence of non-tax characteristics that connect a corporation to a particular state and that cannot be modified or undone without inviting non-tax consequences. Characteristics denoting “real” or “substantial” establishment in a jurisdiction include premises and personnel. In contrast, the criteria for “artificial” or “formal” establishment—which I regard as neutral rather than negative terms—include incorporation and registration in a jurisdiction.

Although few readers will consider it contentious that corporate residence entails little in the way of non-tax characteristics, I reiterate the point by beginning with a brief review of the phenomenon of tax-driven corporate mobility, followed by a summary of government responses to corporate mobility. In the main body of the article, I argue that residence concepts that were originally intended to reflect substantial decision-making activities of corporate management within a state were largely eclipsed by legislative adoption of an incorporation test and were otherwise

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devitalized by judicial interpretations of the last 50 years. Looking first at the domestic law of the United Kingdom and Canada, it is argued that the incorporation test is a de jure standard that bears no relation to economic activity, while the central management and control test is little better because it constitutes a “highest functions” paradigm that is easily manipulated. Particular attention is given to *Wood v. Holden*\(^\text{13}\) and its ramifications. In the following section, I argue that although the treaty concept of place of effective management has promise because it could denote real and substantive management, to date this interpretation has been eschewed by higher courts, and its importation into domestic law has been resisted by governments. Recent cases on the residence of trusts are noted because they illustrate a contrasting, and perhaps preferable, approach to entity residence. In the conclusion, it is suggested that the United Kingdom and Canada should consider repealing their statutory incorporation tests and should consider introducing, both in domestic law and tax treaties, a renewed “place of effective management” test that restores the focus on the location of autonomous decision making.

**THE CONTINUING RELEVANCE OF CORPORATE RESIDENCE**

**Globalization and Corporate Mobility**

One aspect of economic globalization is the emergence of the true MNE, whose scope of activity makes it difficult to regard the enterprise as having one home country.\(^\text{14}\) The United Nations Department of Economic and Social Affairs observed over 40 years ago that “[t]he dramatic growth of multinational corporations in the postwar period has been accompanied by unprecedented growth in the number of affiliates.”\(^\text{15}\) The UN Conference on Trade and Development observed more recently that the “universe” of the largest MNEs expanded rapidly in the 1990s and the 2000s, slowing only during the global downturn of 1999-2001 and following the global financial crisis of 2008-9.\(^\text{16}\) This can be seen as a positive phenomenon to the extent that MNEs drive much foreign direct investment (FDI), which according to the United Nations serves to generate employment, raise productivity, transfer skills and technology, enhance exports, and generally contribute to the economic welfare of developing countries.

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\(^{13}\) *Wood v. Holden*, [2005] STC 789 (Ch. D.); aff’d. [2006] STC 443 (CA).


At the same time, in the absence of political globalization and a concurrent evolution of multilateral tax arrangements, MNEs equipped with sophisticated tax advice engage in various self-help activities to minimize their global tax burdens. This may involve the establishment of foreign subsidiaries with little in the way of premises or employees, often referred to as “special-purpose vehicles” or “special-purpose entities,” to facilitate the movement of dividends, interest, royalties, and other payments into low- or zero-tax states. Taken to the extreme, sophisticated tax planning may allow an MNE to create what Ed Kleinbard describes as “stateless income.” Such practices are borne out in the data regarding destinations and values of FDI. The UN reports mentioned above illustrate the extent to which MNEs operate via networks of affiliates located in low-tax states and reveal the massive inflows into these states, particularly as a percentage of gross domestic product. More specifically, Canadian and UK official statistics on inward and outward FDI illustrate the dominance of particular jurisdictions, including Bermuda, the Cayman Islands, Ireland, Luxembourg, and the Netherlands, as well as Barbados (relevant to Canada) and the Channel Islands (relevant to the United Kingdom). To see even more specific illustrations of the use of special-purpose vehicles in foreign jurisdictions, one can simply review decided cases of the last 50 years involving international tax strategies: some of these cases involved direct challenges to purported offshore residence, while numerous others involved the application of controlled foreign company (CFC) rules or transfer-pricing rules or allegations of treaty shopping and other abuses. Whether the taxpayer’s strategy was held to be effective (which it

17 Edward D. Kleinbard, “Stateless Income” (2011) 11:3 Florida Tax Review 699-773. One might reply that the income is not exactly stateless; rather, the income is directed to an entity that is legally established in a zero-tax state while having no economically substantial connections to that state.


20 Discussed at length below.

21 There are too many cases to mention. Examples from the United Kingdom include Floor v. Davis, [1978] Ch. 295 (CA); aff’d. [1980] AC 695 (HL) (Cayman Islands); Furniss v. Dawson, [1984] AC 474 (HL) (Isle of Man); Craven v. White, [1989] AC 398 (HL) (Isle of Man); Broom Holdings Limited v. IRC, [1997] STC 1179 (CA) (the Netherlands); and Indofood International Finance Ltd. v. JP Morgan Chase Bank, [2006] STC 1195 (CA) (Mauritius and the Netherlands). Examples from Canada include Spar Oil Ltd. v. The Queen, 81 DTC 5168 (FCA) (Bermuda); Indalex Ltd. v. The Queen, 88 DTC 6053 (FCA) (Bermuda); The Queen v. Irving Oil Ltd., 91 DTC 5106 (FCA) (Bermuda); Univar Canada Ltd. v. The Queen, 2005 TCC 723 (Barbados); MIL (Investments) SA v. The Queen, 2006 TCC 460; aff’d. 2007 FCA 236 (Cayman Islands and
often was) is not the point here; these cases show the frequent and varied uses of affiliates in convenient jurisdictions.

Recent waves of threatened and actual emigrations of corporate headquarters, particularly from the United States, are confirmation that tax burdens influence not only the location of FDI by MNEs but also the ultimate home of MNEs. In the United States, this practice became known as the corporate expatriation or inversion. Several US inversions occurred in the late 1990s and early 2000s, attracting both public attention and academic commentary.22 The US Congress passed legislation in 2004 making it more difficult for American corporations to undergo a direct or indirect acquisition by a new foreign parent corporation, hoping to prevent what some commentators viewed as “unpatriotic” emigrations.23 Ten years later, a new wave of US corporate inversions is again attracting public and political outcry. These inversions are not achieved through the creation of a parent shell in a zero-tax jurisdiction, but rather through a merger with an established, commercially viable entity in a jurisdiction with a lower corporate tax rate and a participation exemption for foreign profits: the popular jurisdictions are Ireland, the Netherlands, Switzerland, the United Kingdom, and Canada.24 Although the United Kingdom suffered its own wave of high-profile corporate emigrations in the years preceding the financial crisis,25 the United Kingdom and Canada now appear to be benefactors of the global competition for corporate headquarters.

Tax Policy Responses

Movements of companies, capital, and profits away from traditionally high-tax states, whether to a pure tax haven or simply to a jurisdiction that offers tax advantages, obviously threaten the original states’ public finances. The standard policy response in the United Kingdom, Canada, and elsewhere has not been to question whether these movements reflect commercial reality. The usual response has been

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23 For an explanation of the legal changes, see Yariv Brauner, “United States,” in Residence of Companies, supra note 12, 855-84, at 866, referring to section 7874 of the US Internal Revenue Code of 1986, as amended. I take no view on whether corporate inversions are “unpatriotic.”

24 For example, Kevin Drawbaugh, “Corporate Foreign Tax Moves Have Bedeviled US for Decades,” Reuters online, August 18, 2014 (www.reuters.com/article/2014/08/18/us-usa-tax-inversion-rules-idUSKBN0G0B020140818). While many inversions involve pharmaceutical companies, the most notorious of the recent transactions, at least from a Canadian perspective, is the merger of Tim Hortons with Burger King: see, for example, Pete Evans, “Tim Hortons, Burger King Agree to Merger Deal” CBC News online, August 26, 2014 (www.cbc.ca/news/business/tim-hortons-burger-king-agree-to-merger-deal-1.2746948).

25 See, for example, Jonathan Cooklin, “Corporate Exodus: When Irish Eyes Are Smiling” [2008] no. 6 British Tax Review 613-23.
to assume that the legal form of corporate residence (and thus corporate emigration) is immutable, and to try to stem the outflow of corporate income through measures that, on the one hand, enhance the perceived competitiveness of the corporate tax system and, on the other hand, grasp at offshore corporate income via anti-avoidance rules and administrative censure.

The competitiveness story is well known. Both the United Kingdom and Canada have sought to increase the attractiveness of their corporate tax systems to MNEs by reducing statutory corporate tax rates and by adopting or enhancing exemption regimes for foreign profits, among other changes. At the same time, CFC rules have been maintained and strengthened, limitations on interest deductibility have been explored, and treaty-shopping arrangements have been challenged. The details of these rules and initiatives are beyond the scope of this article; a brief discussion of the recent OECD publications regarding BEPS should suffice. The OECD states that the concept of BEPS “relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation” and also to “arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.” The BEPS report addresses the role that jurisdiction to tax plays in BEPS opportunities, drawing attention to the massive levels of FDI made into or through smaller jurisdictions, including Barbados, Bermuda, the British Virgin Islands, Luxembourg, and the Netherlands, while the BEPS action plan criticizes “practices that artificially segregate taxable income from the activities that generate it,” making specific reference to “shell companies that have little or no substance” and “layers of legal entities” in the context of treaty shopping. In response, the OECD highlights the need for internationally coordinated CFC legislation, transfer-pricing rules, treaty anti-abuse rules, and other anti-avoidance provisions.

In these documents, the OECD says very little about corporate residence formulations or their potential for exploitation. Perhaps the matter of corporate residence was thought to be too granular to address at an intergovernmental level, or perhaps the concept was thought to be too well established in the international tax regime to warrant interference. In my view, corporate residence is one matter that should be addressed, not least because it underlies many of the avoidance strategies and necessary responses that the OECD has identified. If a financing subsidiary in Bermuda

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27 See thesis, supra note 8, at chapters 5-7.

28 BEPS action plan, supra note 11, at 10.


30 BEPS action plan, supra note 11, at 10, 13, and 18.

or the Cayman Islands, or a royalties conduit in Luxembourg or the Netherlands, is a letterbox corporation with no premises or employees, should revenue administrations not be prepared to ask whether the entity is actually established in its purported home state before invoking CFC rules or raising a treaty-shopping argument?

It is nonetheless important to accept the possibility of a foreign corporation being a “real” resident of the intended residence state, even if its location is motivated by tax concerns. It is clear that modern MNEs operate through extensive networks of foreign affiliates, including special-purpose vehicles that may serve valuable functions. There may be good commercial and tax reasons for an enterprise to segregate particular functions into particular entities and to locate these entities in low-tax jurisdictions or, indeed, to move its corporate headquarters to a low-tax jurisdiction. A key question in either case should be whether the affiliate or parent company has been meaningfully established in the ostensible state of residence, such that its residence conveys a substantial economic interest there.

To answer that question from the point of view of UK or Canadian law, one must start with the relevant domestic law. As discussed in the next section, residence concepts in domestic laws were originally intended to reflect the fact that autonomous decision-making activities of corporate management were occurring in the state—arguably an indication of a substantial economic interest—but may fail to convey this meaning today.

**CORPORATE RESIDENCE IN DOMESTIC LAW**

**Background**

If we were to consider where a corporation’s “centre of vital interests” lies, we would seek a combination of all elements that contribute to a corporation’s existence and operation: shareholder creation and control, recognition of status by law, management and administration, and day-to-day business activity. In practice, different states rely on different features for domestic law purposes: some states determine the residence of corporations by employing formal concepts, such as the location of incorporation, registered office, or statutory seat; others may use less formal concepts, such as the place of central management and control or the place of effective management. The common theme is that the existence or occurrence of the selected feature in the taxing state results in the entity’s income being subject

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32 This is a term used in the individual dual residence tie-breaker article in many tax treaties.


to comprehensive taxation for domestic law purposes, such that we might speak of fiscal “allegiance” rather than fiscal residence,\(^{35}\) echoing the term used in the early international tax studies of the League of Nations.\(^{36}\) Further, the presence of the selected feature in the taxing state—and resulting comprehensive tax liability—generally results in the entity being entitled to the benefits of the state’s double taxation conventions or tax treaties,\(^{37}\) subject to dual residence rules and any anti-avoidance rules that may apply. It is thus rather important which features of an entity’s existence and operation are chosen by a state as the determinants of the entity’s residence/fiscal allegiance, because this decision triggers comprehensive tax liability—typically mitigated by foreign tax credits or foreign income exemptions—and tax treaty entitlements.

In the United Kingdom, the decision concerning the particular corporate characteristics to be used to denote residence/fiscal allegiance was originally left to the judiciary. The principles that emerged from the early cases were, like many other legal principles relevant to tax, subsequently adopted in Canada.\(^{38}\) It is not a coincidence that the judicial development of a formulation of corporate residence in the United Kingdom occurred at much the same time as the judicial elucidation of separate corporate personality. By the time that \textit{Salomon} was decided, the English judiciary was willing to accept that a corporation was a “real thing” with a “real existence,”\(^{39}\) consistent with the real entity view of the corporation that was prevalent in the late 19th century.\(^{40}\) It followed that corporations could have, by analogy with


\(^{37}\) Organisation for Economic Co-operation and Development, \textit{Model Tax Convention on Income and on Capital} (Paris: OECD, July 2010) (henceforth referred to as “the OECD model”), articles 1 and 4(1) and paragraphs 1, 3, and 8-8.8 of the commentary on article 4. The OECD released the 2014 \textit{Update to the OECD Model Tax Convention} (Paris: OECD, 2014) (www.oecd.orgctp/treaties/2014-update-model-tax-convention.htm) (hereinafter referred to as “the OECD 2014 update”) shortly before this article was finished. The OECD 2014 update does not purport to change any of the treaty provisions or commentary referred to in this article, with one exception (see note 181). It does, however, contain important proposals regarding the meaning of “beneficial owner” (see paragraphs 34, 41, and 48).


\(^{40}\) For a more extensive discussion of theories of the nature of a corporation and the relevance of these theories to corporate taxation, see the thesis, supra note 8, at chapter 3; and Reuven S. Avi-Yonah, “Corporations, Society, and the State: A Defense of the Corporate Tax” (2004) 90:5 \textit{Virginia Law Review} 1193-1255.
an individual, real features. In 1922, Isaacs J of the Australian High Court observed that as business corporations increasingly assumed the functions of individuals, “so more and more the law attributes to them conceptually and by analogy individual attributes in keeping with the social functions they are in fact performing.”\textsuperscript{41} One such attribute is residence.

This is not to say that corporate residence was an unprompted judicial invention. The English judiciary of the late 19th century had no choice but to ascribe residence to corporations for the purpose of applying the income tax law as Parliament had written it. Viscount Sumner later observed that “[r]esidence is not inherent in a company in the nature of things, and residence for the purpose of taxation is a matter for express legislation.”\textsuperscript{42} Because the UK Parliament had not (until 1988) enacted a test of residence for corporations, the courts “felt bound to make the Acts work as they found them.”\textsuperscript{43} The Income Tax Acts of 1842 and 1853 imposed a duty in respect of “the annual Profits or Gains arising or accruing to any Person residing in” the United Kingdom, which was extended to all “Bodies Politic, Corporate, or Collegiate, Companies, Fraternities, Fellowships, or Societies of Persons, whether Corporate or not Corporate.”\textsuperscript{44} Thus, the earliest cases on corporate residence rightly begin by positing the question: is the relevant corporation “a person residing in” the United Kingdom\textsuperscript{45} and therefore subject to the UK’s national tax jurisdiction?\textsuperscript{46}

Corporations in the United Kingdom were subject to income tax in the same sense as individuals until March 1965, when a separate corporation tax regime was introduced.\textsuperscript{47} Canada enacted income tax legislation in 1917 that applied generally

\textsuperscript{41} Australasian Temperance and General Mutual Life Assurance Society Ltd. v. Howe (1922), 31 CLR 290, at 310 (HCA).

\textsuperscript{42} Egyptian Delta Land and Investment Co. Ltd. v. Todd, [1929] AC 1, at 11 (HL).

\textsuperscript{43} Ibid., at 12.


\textsuperscript{45} Whether a corporation is a person residing in a place actually involves two questions: (1) is a corporation a person, and (2) if so, where does it reside? Thus, it is accurate to use the word “resident” as an adjective, denoting a quality of the person taxed. This is consistent with the jurisprudence on the residence of individuals, in which the terms “resident” and “residence” are considered to represent a quality of the person charged: Levene v. IRC, [1928] AC 217 (HL); Lysaght v. IRC, [1928] AC 234 (HL); and Thomson v. Minister of National Revenue, [1946] SCR 209.


to individuals and corporations,\textsuperscript{48} which remains the pattern today,\textsuperscript{49} although of course there are certain rules applicable solely to corporate taxpayers. The important point is that both systems are based on the recognition of a corporation as a person; accordingly, one must start from the proposition that the worldwide income of a corporation is subject to tax in the country if it is resident there.\textsuperscript{50}

As indicated above, there are various factors that could be selected by legislators or judges as indicia of corporate residence, ranging from those that are essential to the commencement or recognition of the corporation’s existence, through to those that are associated with the pinnacle of the corporation’s activities, and on to those that are germane to the corporation’s day-to-day business activities. The current law in the United Kingdom and Canada relies on factors drawn from different parts of this spectrum. First is the incorporation test, which provides that a corporation is deemed to be resident in the United Kingdom\textsuperscript{51} or Canada\textsuperscript{52} if it is incorporated there, subject to certain transitional provisions. Of equal or greater significance is the test of corporate residence developed in the common law. The leading case is of course \textit{De Beers Consolidated Mines Ltd. v. Howe}, which decided that a company resides where its “central management and control” is actually exercised.\textsuperscript{53} As explained below, central management and control has been characterized as the axis or pinnacle of a corporation’s activities. Management and control thus conceived is independent of factors that underlie the corporation’s existence—notably, incorporation, registration, and shareholder control—and is removed from a corporation’s practical management or daily business activities.

In the case of dual resident companies, the resolution of residence for tax treaty purposes is expressly given effect for domestic law purposes. Specifically, where a company is resident in the United Kingdom under either of the above formulations, but is also resident in a treaty partner state according to its domestic laws, and pursuant to the applicable treaty preference criterion (discussed below) the company is regarded as resident only in the treaty partner state, the company is deemed not to be resident for UK tax purposes.\textsuperscript{54} This is known as the “treaty non-resident rule.” An equivalent rule exists in Canada.\textsuperscript{55} These rules serve to maintain consistency between treaty outcomes and domestic law.

\textsuperscript{48} The Income War Tax Act, SC 1917, c. 28, section 2 (“person” and “taxpayer”).
\textsuperscript{49} Subsection 248(1) (definitions of “person” and “taxpayer”).
\textsuperscript{50} CTA 2009 sections 2 and 5; and subsection 2(1) of the Act.
\textsuperscript{51} CTA 2009 sections 14-15 and schedule 2. See the text accompanying note 78.
\textsuperscript{52} Subsection 250(4). See the text accompanying note 76.
\textsuperscript{54} CTA 2009 section 18.
\textsuperscript{55} Subsection 250(5).
Residence Based on Incorporation

Common-Law Rejection of Incorporation Test

Incorporation and registration are the most formal of factors that could be relied on to establish a corporation's residence. The location of a corporation’s creation or registration is analogous to an individual’s place of birth or citizenship; this can usefully be called “nationality.” For individuals, these factors are closely associated with the private international law concept of domicile. Obviously, a corporation is unlike a human being; it is not born and cannot form an intention of living in a particular society. It is therefore difficult to think of the citizenship or domicile of a corporation. Yet, for the purposes of private international law, a corporation’s domicile is considered to be the country of its incorporation,\(^\text{56}\) and for the purposes of tax law some countries do base their jurisdiction on the domicile of legal entities, meaning the place of their incorporation or registration.\(^\text{57}\)

It is well known that the United States relies on incorporation to determine worldwide taxing jurisdiction with respect to corporations, much as it relies on citizenship (among other considerations) to determine jurisdiction over individuals.\(^\text{58}\) English law charted a different course, deciding in the early cases that corporate residence should be based on factors more substantive than incorporation. The distinction can be traced to two influences. First, the English courts were more willing to adopt realist theories of the nature of the corporation, in contrast to the American adherence to the legal entity/fiction theory.\(^\text{59}\) Second, there was a concern about tax avoidance.

Before elaborating on these two influences, an observation should be made with respect to the judgments that preceded De Beers. Reading the 19th century cases in isolation might give one the impression that the place of incorporation or registration was considered critical to corporate residence. However, it must be borne in mind that most corporate business was then organized in the form of a single corporation with foreign branches or agents. It is not surprising that the judiciary stressed the location of incorporation and registration when this generally coincided with the location of directorial control—what was sometimes styled the “seat” of the enterprise. In Cesena Sulphur/Calcutta Jute Mills, Kelly CB highlighted the place of incorporation as a relevant factor but assumed this would be coexistent with


\(^\text{57}\) Both the United Kingdom and Canada have concluded tax treaties where the residence article mentions domicile as a possibly relevant criterion, echoing the wording of the OECD model, supra note 37, at article 4(1).

\(^\text{58}\) See, for example, Daniel N. Shaviro, Decoding the US Corporate Tax (Washington, DC: Urban Institute Press, 2009), at 103–4; and Yariv Brauner, “United States,” in Residence of Companies, supra note 12, 855–84, at 865–75.

\(^\text{59}\) Farnsworth, supra note 56, at 56–63.
the place where the governing bodies met and exercised their powers (which in these cases was England). Thus, the court mentioned incorporation only to buttress the conclusion that had already been drawn on the basis of central management and control.

The judicial rejection of an incorporation test is evident from *De Beers*, decided 30 years later. The De Beers company was incorporated and registered in South Africa, which is also where it carried on most of the functions of its diamond-mining business. The taxpayer’s counsel relied on a number of American authorities to support the argument that a corporation is a “legal persona whose only residence is the place of its incorporation” and that it has no legal existence abroad. This idea is intrinsic in the legal entity/fiction theory of the nature of the corporation. The House of Lords rejected this position. Lord Loreburn, with whom the other lords concurred, observed that “[i]n applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual.” Recognizing that a company cannot “eat or sleep,” he reasoned that one should look to where the company “keeps house and does business.” Crucially, Lord Loreburn thought it appropriate in the context of the income tax statute to determine residence on the basis of a corporation’s activities—where it keeps house and does business—rather than its existence:

Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad.

This statement evidences a concern about the avoidance of UK taxation (“escape the appropriate taxation by the simple expedient of being registered abroad”) and a belief that corporate taxation is justified by the benefits that a state provides to corporate businesses (“in England under the protection of English law”). The latter idea may be referred to as a corporation’s “franchise to do.” It is apparent that Lord Loreburn did not think corporate taxation was justified by the “franchise to be”—that is, by incorporation in a particular state.

Subsequent cases reaffirmed the view that incorporation was not a viable test of corporate residence. For example, in *Bradbury v. English Sewing Cotton Co.* Lord

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60 Cesena Sulphur/Calcutta Jute Mills, supra note 46, at 445-46; compare Alexander, supra note 46, at 30-32.
61 Discussed beginning at the text accompanying note 84.
62 De Beers, supra note 53, at 456. Similar submissions were made in Cesena Sulphur/Calcutta Jute Mills, supra note 46, at 437.
63 De Beers, supra note 53, at 458.
64 Ibid.
65 Ibid.
Wrenbury compared foreign corporate registration to foreign individual citizenship, observing that neither was determinative of a person’s liability to income tax in the United Kingdom’s residence-based system. There, as in *De Beers*, the court was dealing with a company incorporated abroad (the United States) but managed and controlled in the United Kingdom. Lord Wrenbury noted that the proposition that incorporation was not decisive had also been accepted in the converse case of a corporation that was registered in the United Kingdom but wholly managed abroad.

The English courts’ willingness to discount incorporation as a factor establishing residence was tested in the *Swedish Central Railway* decision. This case involved a corporation that was registered in England but was managed and controlled in Sweden, where it was constructing a railway. The majority of the House of Lords (Lord Atkinson dissenting) held that earlier decisions had not foreclosed the possibility of a corporation being resident in two places simultaneously. The majority concluded that the corporation’s registration in the United Kingdom, in conjunction with other factors identified by the commissioners, was sufficient to establish UK residence in addition to Swedish residence. The decision has been subject to academic criticism and was tightly circumscribed in the *Egyptian Delta* case. There, Viscount Sumner noted that the term “resident” is “exceedingly unsuited to describe” a legal entity and reasoned that the only “analogy that is really possible between a natural person and a company is that of carrying on business at a place, great or small.” On consideration of both the decided cases and desirable tax policy principles, the court concluded that the place of incorporation could not be determinative of residence.

The same conclusion was reached by the Privy Council, on appeal from the Supreme Court of Canada, in *British Columbia Electric Railway v. The King*, which

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66 *Bradbury v. English Sewing Cotton Co.*, [1923] AC 744, at 764-65 (HL); compare *American Thread Co. v. Joyce* (1912), 6 TC 1 (CA); aff’d. (1913), 6 TC 163 (HL). The English Sewing Cotton Company was the UK parent of the American Thread Company, a subsidiary incorporated and registered in New Jersey.

67 *Mitchell v. Egyptian Hotels Ltd.*, [1915] AC 1022 (HL). However, in this case counsel had admitted that the company resided in England. For some reason, Buckley LJ, as he then was, commences his judgment by saying, “This company is incorporated in the United Kingdom; it is therefore resident here.” Lord Atkinson later observed that “[t]here must be some mistake in the report of this statement, since incorporation does not necessarily imply residence”: *Swedish Central Railway Co. v. Thompson*, [1925] AC 495, at 516 (HL).

68 *Swedish Central Railway*, supra note 67.

69 Ibid., at 505. Unfortunately, the report does not shed light on what these other factors were.

70 Albert Farnsworth, “Union Corporation Ltd. v. IRC,” case note (1952) 68 Law Quarterly Review 307; *Dicey and Morris*, supra note 56, at 1103-4; and Couzin, supra note 2, at 79-82.

71 Supra note 42, at 16-18. Also see the text accompanying note 104.

72 Supra note 42, at 12-15.

involved a company incorporated and registered in England but entirely managed and controlled in Canada. Viscount Simon held that the company’s residence was “unquestionably Canadian.” To the extent that *Swedish Central Railway* remains relevant, it stands for the proposition that central management and control may be divided, rather than the more dubious proposition that incorporation alone can establish residence. That dubious proposition gained validity only by legislative amendment.

**Legislated Adoption of the Incorporation Test**

Viscount Sunner’s judgment in *Egyptian Delta* contains a thorough consideration of alternative residence formulations based on either a company’s activities or a company’s existence. In the course of his judgment, he made this observation:

> So far, my Lords, it does not seem to have occurred to any judge, that there might be two kinds of residence or two tests of its acquisition, one for the purpose of entangling foreign companies in British taxation and another for that of tying British companies down, so that they cannot wholly escape it. *I submit that such a doctrine is illogical in form and in substance unjust.*

The legislatures of the United Kingdom and Canada appear to disagree that such a doctrine is illogical or unjust. Canada moved first, amending its tax legislation in 1961 to deem a corporation to be resident in Canada if it was incorporated in Canada and if it carried on business in Canada at any time in the year. The requirement of carrying on business was largely removed in 1965, when the current rule was enacted; it deems a corporation to be resident in Canada if it is incorporated in Canada, whether under federal or provincial law, after April 26, 1965. Deemed residence is also provided in the case of certain “foreign business corporations,” and other corporations that were incorporated in Canada before April 27, 1965, if they thereafter became resident (on a common-law basis) or carried on business in Canada. In the United Kingdom, the Finance Act 1988 introduced the rule that a company is deemed to be resident in the United Kingdom if it is incorporated there, with certain companies incorporated in the United Kingdom before March 15, 1988
qualifying for an indefinite exception or a five-year transitional exception.\textsuperscript{78} Crucially, these deeming rules apply even if the corporation would be considered non-resident according to the location of its central management and control.

It is not readily apparent why the incorporation test was added to Canadian or UK law. It is unlikely that the respective legislatures became captivated by the legal entity/fiction theory and its reliance on the “franchise to be” as a justification for worldwide taxation. Part of the motivation for the Canadian 1961 amendment may have been the government’s desire for consistency with the incentives of the newly introduced branch tax: Canada was hoping for greater incorporation of subsidiaries in Canada and did not want these subsidiaries to be caught by the branch tax if they were managed abroad; thus, the subsidiaries would be deemed to be resident.\textsuperscript{79} It is also possible that the Canadian amendments were designed to bring Canadian law more in line with the US approach to corporate residence, particularly because the Canada-US tax treaty of the day defined a “Canadian enterprise” or “United States enterprise” as an enterprise carried on by an individual resident in the respective state or by a corporation, partnership, or other entity “created or organized” under the laws of the respective state.\textsuperscript{80} In my view, however, the most cogent explanation is that the government was concerned about tax avoidance through the manipulation of central management and control.\textsuperscript{81} Greater insight into this concern can be gained by looking at the motivations for the UK 1988 amendment. A key reason for adopting the incorporation test in the United Kingdom was the prevention of international tax avoidance, specifically double non-taxation. The \textit{International Manual} published by Her Majesty’s Revenue and Customs (HMRC) indicates that the incorporation rule was added to deal with so-called nowhere companies, being incorporated in the United Kingdom but managed and controlled in a state that does not use management and control as a residence test.\textsuperscript{82} The incorporation test thus can be seen as opportunistic legislation, imposing residence and residence-based taxation on a company that might otherwise not face comprehensive taxation anywhere.

\textsuperscript{78} Finance Act 1988 (UK), 1988, c. 39, section 66 and schedule 7, rewritten to CTA 2009 sections 14-15 and schedule 2. The exceptions related to the process of Treasury consent in respect of corporate migration. The Treasury consent rules were repealed effective July 2009.


\textsuperscript{80} Convention Between the United States of America and Canada Relating to the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes (1942) (as amended through 1966; terminated 1985), protocol paragraph 3. The 1942 treaty did not contemplate dual residence of corporations. The current treaty uses place of incorporation as the first preference criterion: see the text accompanying notes 158-59.

\textsuperscript{81} See also Pyrcz, supra note 79, at 386.

\textsuperscript{82} United Kingdom, HM Revenue & Customs, \textit{International Manual} (London: HMRC, 2014) (www.hmrc.gov.uk/manuals/intmanual/Index.htm), at sections 120040-50. As for Canada, in the 1960s there were various corporations incorporated in Canada and managed elsewhere (Brooks, supra note 79, at 416), rendering them “stateless.”
It is questionable why Canada or the United Kingdom should be concerned about taxing nowhere companies, because corporate income taxation is difficult or impossible to justify if there is no real economic interest in the taxing state. The policy foundations of the corporate tax were likely not given much consideration in the course of adopting the incorporation test, and perhaps the best explanation for its adoption in Canada and the United Kingdom was a desire for a clear, simple residence rule.\(^83\) Ironically, by choosing to supplement the test of central management and control with a test of incorporation, the respective governments augmented a connecting factor that is unclear, uncertain, and somewhat easy to manipulate with one that is clear, certain, and very easy to manipulate.

**Residence Based on Central Management and Control**

We have seen that the courts of the 19th and early 20th centuries thought it appropriate in the context of the income tax statute to determine residence on the basis of a corporation’s activities rather than its existence. This approach is, at least potentially, consistent with the thesis that residence should denote a substantial economic interest in the home state. How successful such an approach is in reflecting an economic interest depends on the precise activities that are selected as demonstrating residence. Unfortunately, a combination of 19th-century colonialism and 20th-century legal formalism has produced a “highest functions” paradigm that often fails to reflect economic interest, making this test little better than an incorporation test.

**De Beers: Central Management and Control as the Real Business**

*De Beers* is the decision that established most clearly that a company resides where its “real business is carried on,” which was said to be where its “central management and control actually abides.”\(^84\) Lord Loreburn went on to say that this is a question of fact to be determined by scrutinizing the corporation’s course of business and trading. The pertinent facts included the following: the company was incorporated and registered in South Africa, it carried on most of the functions of its diamond-mining business in South Africa, and its directors’ meetings were held in both Kimberley and London. However, a majority of its directors were resident in England, and, according to the facts as determined by the commissioners, it was at the directors’ meetings in London that “the real control” was always exercised in virtually all the important business of the company, except the mining operations themselves.\(^85\)

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84 *De Beers*, supra note 53, at 458.

85 The facts of the case are provided in the Court of Appeal judgment: [1905] 2 KB 612 (CA).
Lord Loreburn refused to disturb the commissioners’ finding of fact that “the head and seat and directing power of the affairs of the appellant company were at the office in London.”

This decision was applied without reservation throughout the 20th century, exhibiting a jurisprudential resilience that matches or exceeds that of *Salomon*. *De Beers* is considered the leading decision on corporate residence in Canada. Notable cases endorsing the decision include *Crossley Carpets*, *Bedford Overseas Freighters*, and *Birmount Holdings*, while many others explicitly or implicitly accept that the *De Beers* approach represents the law. It is regarded as the leading decision in various other Commonwealth jurisdictions as well. Judges and commentators frequently point to the statement of Lord Radcliffe in *Unit Construction* that Lord Loreburn’s formulation of corporate residence “was as precise and as unequivocal as a positive statutory injunction.”

There is nothing to be gained by canvassing all of the cases that influenced *De Beers* and those that followed from it because this has been done admirably elsewhere. It is sufficient for the purposes of this article to focus on the following key issues.

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86 Ibid., at 626.
87 *American Thread*, supra note 66; *Mitchell*, supra note 67; *New Zealand Shipping Co., Ltd. v. C.H. Thew* (1922), 8 TC 208 (HL); *Bradbury*, supra note 66; *Swedish Central Railway*, supra note 67; *Egyptian Delta Land*, supra note 42; *Union Corporation Ltd. v. IRC*, [1952] 1 All ER 646 (CA); aff’d on other grounds [1953] AC 482 (HL); *Unit Construction Co. Ltd. v. Bullock*, [1960] AC 351 (HL); *Re Little Olympian Each Ways Ltd.*, [1995] 1 WLR 560 (Ch.); and *Untelrab Ltd. v. McGregor*, [1996] STC (SCD) 1.
88 *MNR v. Crossley Carpets (Canada) Ltd.*, 69 DTC 5015, at 5016 (Ex. Ct.).
89 *Bedford Overseas Freighters Ltd. v. MNR*, 70 DTC 6072, at 6079 (Ex. Ct.).
90 *Birmount Holdings Ltd. v. The Queen*, 78 DTC 6254, at 6260 (FCA).
91 *British Columbia Electric Railway*, supra note 73 (although *De Beers* was not cited); *Zebnder & Co. v. MNR*, 70 DTC 6064 (Ex. Ct.); *Tara Exploration*, supra note 77; *Victoria Insurance Co. Ltd. v. MNR*, 77 DTC 320 (TRB); *Capital Life Insurance Co. v. The Queen*, 84 DTC 6087 (FCTD); *Gurd’s Products*, supra note 77; and *1143132 Ontario Ltd. v. The Queen*, 2009 TCC 477. For further discussion of the Canadian case history, see Couzin, supra note 2, or the following articles: Ward, supra note 83; Pyrcz, supra note 79; James S. Hausman and George T. Tamaki, “Canada,” in *The Fiscal Residence of Companies*, supra note 33, at 263-72; Edwin G. Kroft, “Jurisdiction To Tax: An Update,” in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 1:1-138, at 1:25-32; and Brooks, supra note 79, at 413-15.
92 See the reports from Australia, India, New Zealand, and Singapore in *Fiscal Residence of Companies*, supra note 33.
93 *Unit Construction*, supra note 87, at 366.
94 See especially Couzin, supra note 2, at chapter 2.
Central Management and Control as Highest Functions

Exercising central management and control is itself one aspect of carrying on business; indeed, it is what Lord Loreburn styled the “real business.” This was made plain in *San Paulo Railway*,95 was confirmed in *De Beers*, and is undoubtedly correct as a matter of tax policy. The courts have decided that such activities are not, however, equivalent to a company’s day-to-day trading operations or even to the practical management and oversight of these operations. The activities of central management and control have been variously described as the central point,96 the paramount authority,97 the head and brain,98 the pivot and axis,99 the superior and directing authority,100 and other similar metaphors. HMRC describes them as “the highest level of control” of the company’s business.101 These are the functions of corporate governance that, in accordance with British and Canadian corporate law, are usually found where a majority or totality of the board of directors meets to exercise its powers pursuant to the corporation’s constitution. In the United Kingdom, a very similar approach applies to partnerships.102 For corporations, the relevant “control” is not that which is wielded by a majority shareholder or by the shareholders at large through their voting power; it is the control exercised by directors through their oversight, management, and direction of the company’s affairs.103 It is possible, as discussed below, that management and control may actually be exercised by a party other than the board of directors, such as a dominant shareholder or the directors of a parent corporation, but in the normal course one looks to the corporation’s immediate directorial control.

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95 *San Paulo Railway*, supra note 46; compare *Malayan Shipping Co. Ltd. v. FCT* (1946), 71 CLR 156 (HCA).
96 *Cesena Sulphur/Calcutta Jute Mills*, supra note 46, at 454.
97 *American Thread*, supra note 66, at 164 (HL); and *Crossley Carpets*, supra note 88, at 5016.
98 *San Paulo Railway*, supra note 46, at 38.
99 *Koitaki Para Rubber Estates Ltd. v. FCT* (1941), 64 CLR 241, at 244 (HCA).
100 *Union Corporation*, supra note 87, at 658-62 (CA).
102 It can be significant whether the management and control of a partnership’s trade or business is located partly within the United Kingdom or wholly outside the United Kingdom. In the few cases in which this issue has arisen, the courts have accepted that the business of a partnership is managed and controlled in the place where the highest level of decision making occurs: see *Padmore v. IRC*, [1989] STC 493 (CA); and *Mark Higgins Rallying v. HMRC*, [2011] UKFTT 340 (TC).
103 *American Thread*, supra note 66, at 32-33 (CA); *Bedford Overseas Freighters*, supra note 89, at 6079-80; *Birmount Holdings*, supra note 90, at 6261-62; compare *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame*, [1906] 2 Ch. 34 (CA).
While terms like “central point” and “paramount authority” seem to suggest a single location for management and control, and thus a single corporate residence, several judgments, including *Swedish Central Railway* and *Unit Construction*, have allowed for the possibility that a corporation may have its management and control fragmented across jurisdictions. It is open to debate whether this position is sensible or not as a matter of international tax policy. The possibility of divided residence is consistent with the thesis that residence be understood as a special form of source, yet for the purposes of applying current tax treaties it would remain necessary to determine a “paramount” residence. What is more important for our purposes is the judicial focus on highest functions to the exclusion of other business functions. This choice of residence formulation means that a company is not resident where it carries on productive operations, even on a substantial scale, unless that is also the place where the supreme and directing authority is exercised. In *Calcutta Jute Mills*, a case in which the major productive operations occurred in India, Kelly CB stated the following in support of his conclusion that the company was a UK resident:

> Though the whole property and produce of the property is in India, and the whole capital is invested in India, and though the whole of the money which the company is ever entitled to receive, whether as profits or in any other shape, is earned in India, yet it all belongs to the company, who might at any moment virtually take possession of it. If, without their consent, anyone were to take possession of one of the jute mills, the company might immediately bring ejectment and recover it. It is the company located in England which can alone deal with, or authorize the dealing with, the property in any way.

Similarly, in *San Paulo Railway* Lord Halsbury asserted that although the company in question dealt entirely with land, goods, and passengers in Brazil, “the person who governs the whole commercial adventure . . . [and] makes the profits by his skill or industry, however distant may be the field of his adventure,” is the person who is trading. Lord Davey expressed that conclusion in more moderate terms: “The business is therefore in very truth carried on, in, and from the United Kingdom, although the actual operations of the company are in Brazil, and in that sense the business is also carried on in that country.”

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104 In *Unit Construction*, supra note 87, Lord Radcliffe analyzed the earlier cases contemplating dual residence, notably *Swedish Central Railway*, supra note 67; *Egyptian Delta Land*, supra note 42; and *Union Corporation*, supra note 87. He concluded, at 366, that divided management and control, and thus divided residence, was possible: “Though such instances must be rare, the management and control may be divided or even, at any rate in theory, peripatetic.” This position has been accepted in Canada: *Crossley Carpets*, supra note 88.

105 *Kaikoki Para Rubber Estates*, supra note 99, at 244 and 248-49.


108 Ibid., at 43.
One cannot read these passages, and similar passages appearing throughout the early jurisprudence, without sensing the colonialism or imperialism that underlies them. The presence of these attitudes is not surprising when one considers that the entire progress of joint stock companies was closely associated with the progress of British colonization and the extension of foreign trade.\textsuperscript{109} Modern observers might contend that the “real business” of an international enterprise consists in the productive endeavours of its employees in the foreign state, rather than in the management activities of its directors in the home state. Much depends on one’s ideological perspective. It should be borne in mind that the language of the income tax statutes did not permit the courts simply to equate residence with “trade” or “business” because that would have conflated residence-based and source-based taxation as understood at the time.\textsuperscript{110} Having decided to ascribe residence to a corporation on the basis of its activities rather than existence, it was necessary to select specific business activities for that purpose. Selecting the activities of the “head and brain” rather than the “hands and feet” was, if not theoretically ideal, at least logically defensible.

**Subsidiary Residence in Modern Multinational Enterprises**

*Exploitation of the Highest Functions Paradigm*

Many of the early cases on corporate residence concerned a single company, incorporated and registered in the foreign jurisdiction where the productive business was located, with a delegated or managing board in that foreign jurisdiction, but with the main or supervisory board making most of the decisions in England.\textsuperscript{111} It is apparent that this was a common method of engaging in multinational ventures. Alas, it was a method that resulted in the relevant corporations being subject to worldwide taxation in Britain at a time when foreign tax credits were rudimentary or non-existent. Various enterprises that had been based in Britain responded so as to avoid the burden of worldwide taxation, first by moving the functions of central management and control to the delegated or managing board in the foreign jurisdiction,\textsuperscript{112} and later by incorporating subsidiaries with ostensibly independent boards in the foreign jurisdictions.\textsuperscript{113} The latter part of this evolution can be seen in the Canadian cases as well, whether in the context of foreign corporations establishing subsidiaries in Canada or of Canadian corporations establishing subsidiaries abroad.\textsuperscript{114}

\begin{itemize}
\item \textsuperscript{110} Couzin, supra note 2, at 28-29.
\item \textsuperscript{111} For example, *De Beers*, supra note 53; *American Thread*, supra note 66; and *New Zealand Shipping*, supra note 87.
\item \textsuperscript{112} For example, *Mitchell*, supra note 67; *English Sewing Cotton*, supra note 66; and *Egyptian Delta Land*, supra note 42.
\item \textsuperscript{113} For example, *Unit Construction*, supra note 87; and *Untelrab*, supra note 87.
\item \textsuperscript{114} For example, *Bedford Overseas Freighters*, supra note 89; and *Victoria Insurance*, supra note 91.
\end{itemize}
It is well known that the dominant form of international business organization is now a globally integrated network of corporations, often with a single headquarters company and numerous foreign affiliates. Obviously, this evolution in the mode of international enterprise challenges the efficacy of any tax system that is based on the twin concepts of separate corporate personality and corporate residence. This is especially true when, as explained below, courts that are asked to determine the tax residence of “offshore” subsidiaries take a formal, entity-by-entity view of the matter. Thus, Arnold has argued that the test of corporate residence from De Beers has become a mere “tax-planning device,” while McIntyre has colourfully observed that the modern MNE can “exploit its androgynous nature to make corporate residence ineffective.”

At one time, the UK government recognized that corporate residence might be better measured by looking at functions other than the ceremonial functions of central management and control. In a 1981 consultation document, the Inland Revenue stated that the established criteria had “become artificial with the passage of time and technical innovation,” and they “enabled companies to arrange a residence for tax purposes which may bear little relation to the seat of the company’s operations.” It was suggested that the United Kingdom adopt a statutory test based on “practical day to day management,” “principal place of business,” or incorporation. The latter two options were subsequently discarded; the Inland Revenue instead proposed to define residence on the basis of where “the management of the company’s business as a whole is conducted,” which was considered to mean the place of “immediate day to day management.” In response to business pressure and a report by the Institute for Fiscal Studies, the government ultimately decided that modifying the concept of corporate residence would result in “upheaval,” so the idea was abandoned. The government instead elected to maintain the existing case law test and to enact specific rules aimed at international tax avoidance. Thus, the central management and control test endures.

115 Arnold, supra note 31, at 1564.
117 United Kingdom, Inland Revenue, Company Residence: A Consultative Document (London: Board of Inland Revenue, 1981), at paragraph 2. A consultation on CFC legislation was issued at the same time.
118 Ibid., at paragraphs 6-7.
121 United Kingdom, Inland Revenue, Taxation of International Business (London: Board of Inland Revenue, 1982), foreword by the minister of state, Treasury.
Judicial Affirmation of Separate Residence

The difficulties inherent in the central management and control test have been revealed in a number of cases, often involving a sole shareholder exerting influence over the decisions and actions of foreign subsidiaries.

The Unit Construction case is a notorious illustration of the possibility that the actual exercise of central management and control may not abide where it formally should abide. The case concerned certain subvention payments that had been made by the appellant company, a wholly owned Kenyan subsidiary of an English parent, to three other Kenyan subsidiaries. The deductibility of the subvention payments depended on whether the subsidiaries were resident in the United Kingdom.\textsuperscript{122} The evidence showed that although the subsidiaries were registered in Kenya and had boards that were distinct from the parent board, none of the boards ever made any decisions; instead, they “stood aside” in all matters of real importance.\textsuperscript{123} On this evidence, the court held that the management and control of the subsidiaries was actually exercised by the parent board. It was immaterial that this usurpation of power was contrary to the subsidiaries’ corporate constitutions: “The business is not the less managed in London because it ought to be managed in Kenya.”\textsuperscript{124}

Couzin correctly observes that Unit Construction was not a revolutionary decision; rather, it applied the aspect of De Beers that held that central management and control must be determined by scrutinizing the actual business conduct rather than the terms of the constating documents.\textsuperscript{125} Nonetheless, one regularly sees warnings from revenue authorities and tax practitioners that, in determining the residence of a company, the law requires an examination of the substance of the company’s activities and not merely the legal form, with the example provided of a parent company usurping the control of an offshore subsidiary.\textsuperscript{126} This is merely a recapitulation of the facts of Unit Construction. The case did not establish a rule of substance over form with respect to corporate residence—its scope is narrower. This narrow scope is demonstrated by a series of more recent decisions, culminating in the 2006 judgment of the Court of Appeal in Wood v. Holden.\textsuperscript{127}

Wood v. Holden involved a sophisticated scheme to mitigate capital gains tax on the sale of shares of a family company. The critical element was a transfer of certain

\textsuperscript{122} The case is unusual because the taxpayer, not the Revenue, was arguing that the companies were resident in the United Kingdom. It was essentially a loss importation arrangement.

\textsuperscript{123} Unit Construction, supra note 87, at 360 and 364.

\textsuperscript{124} Ibid., at 363.

\textsuperscript{125} Couzin, supra note 2, at 86.

\textsuperscript{126} For example, Statement of Practice 1/90, supra note 101, at paragraphs 12-17; Interpretation Bulletin IT-391R, “Status of Corporations,” September 14, 1992, at paragraph 15; and Hausman and Tamaki, supra note 91, at 265.

\textsuperscript{127} Wood v. Holden, supra note 13.
holding company shares from Copsewood Investments Ltd. (CIL), a company registered in the British Virgin Islands, to Eulalia Holding BV, a Dutch incorporated company wholly owned by CIL. The holding company shares were later resold to an unconnected purchaser. The taxpayers contended that both CIL and Eulalia were non-resident companies and members of the same corporate group, meaning that no gain accrued on the initial disposal. The primary focus in the case was the residence of the Dutch incorporated company, Eulalia. The taxpayers argued that Eulalia was non-resident at all material times, either because its central management and control was exercised in the Netherlands and not in the United Kingdom (the common-law test) or because its effective management was exercised in the Netherlands (relying on the treaty non-resident rule and the UK-Netherlands tax treaty). The Revenue argued that Eulalia was resident in the United Kingdom, either on the standard of central management and control or on the standard of effective management. Its position was that the managing director of Eulalia, ABN AMRO trust (AA trust), had merely held meetings and signed documents as instructed by the taxpayers’ advisers in the United Kingdom, following a pre-ordained plan. The special commissioners agreed with this position. The question on appeal was what degree of independence or initiative on the part of AA trust, as managing director of Eulalia, would constitute “central” or “effective” management of Eulalia?

Both Park J in the Chancery Division and the judges in the Court of Appeal stressed that there is an important difference between actually exercising management and control and being able to “influence” those who exercise management and control. On the one hand was Unit Construction, in which the parent board had unconstitutionally usurped the management of its subsidiaries. On the other hand were several cases—all involving persons incorporating a special-purpose entity in another (low-tax) jurisdiction—in which the local management “did not take initiatives” but responded to “proposals” or “instructions” that were presented to them. The cases referenced were from the United Kingdom, Australia, and New Zealand.

128 By reason of the Taxation of Chargeable Gains Act 1992 (UK), 1992, c. 12, sections 14(2) and 171.
129 CTA 2009 section 18.
132 Little Olympian, supra note 87 (entity held to be resident in Jersey); Untelrab, supra note 87 (entity held to be resident in Bermuda); Esquire Nominees Ltd. v. FCT (1971), 129 CLR 177 (HCA) (entity held to be resident in Norfolk Island); New Zealand Forest Products Finance NV v. CIR, [1995] 2 NZLR 357 (NZHC) (entity held to be resident in Netherlands Antilles). These cases are discussed in Wood v. Holden, supra note 13, at paragraphs 26-27 and 51-53 (Ch. D.).
Zealand; the taxpayers’ counsel could easily have added *Victoria Insurance* to the list, a decision of the Tax Review Board, in which a Bahamas subsidiary of a Canadian corporation engaged in the business of insurance and reinsurance was held to reside in the Bahamas on the basis of its local management and control. Returning to *Wood v. Holden*, Park J stated that in the four cases under consideration the respective courts had observed that the subsidiary’s local management may have been “complaisant” but it nevertheless retained its discretion to refuse to implement an “improper or unwise” request. Park J felt it important to make the following observation:

[I]t is possible (and is common in modern international finance and commerce) for a company to be established which may have limited functions to perform, sometimes being functions which do not require the company to remain in existence for long. Such companies are sometimes referred to as vehicle companies or SPVs (special purpose vehicles). “Vehicle” has a belittling sound to it, but such companies exist. They can and do fulfil important functions within international groups, and they are principals, not mere nominees or agents, in whatever roles they are established to undertake. They usually have board meetings in the jurisdictions in which they are believed to be resident, but the meetings may not be frequent or lengthy. The reason why not is that in many cases the things which such companies do, though important, tend not to involve much positive outward activity.

On the basis of the above, and the special commissioners’ finding that the directors of Eulalia “were not by-passed” and did not “stand aside” since their representatives “signed or executed the documents,” Park J held that the only conclusion open to them in law was that Eulalia was managed and controlled in the Netherlands. He offered the alternative conclusion that if there was any difference between the concepts of central management and effective management, Eulalia was effectively managed in the Netherlands and therefore non-resident pursuant to the treaty non-resident rule.

133 *Victoria Insurance*, supra note 91. Compare *Bedford Overseas Freighters*, supra note 89, which involved a company incorporated in Canada before April 1965. Although it was said that the non-resident majority shareholder “made the major decisions for the company” and that the Canadian directors “unquestioningly carried out his instructions,” the court held that the Canadian directors nonetheless “executed agreements and attended to the business and legal affairs of the company,” such that management and control was situated in Canada (see *Bedford Overseas Freighters*, supra note 89, at 6079-80).


135 Ibid., at paragraphs 37 and 64-72.

136 Ibid., at paragraphs 73-81. The Court of Appeal made no decision on this issue, although Chadwick LJ suggested that the two tests were equivalent: *Wood v. Holden*, supra note 13, at paragraphs 6 and 44 (CA).
While *Wood v. Holden* did not involve an active global enterprise, the same reasoning has been applied to special-purpose subsidiaries of active MNEs, both before and since that decision.137 Many legal commentators would contend that the decision in *Wood v. Holden* is unassailable on the basis of longstanding principles of company law and tax law, and various practitioners have commented on the correctness of the decision while disparaging the special commissioners’ contrary opinion.138 I have heard both British and Canadian tax practitioners remark that the special commissioners were unduly focused on the “reality” of the arrangement.139 The upper court decisions are applauded because they respect the separate legal existence of subsidiaries and fix the residence of a subsidiary on the basis of the directorial functions of that corporation’s board. Such an approach is said to favour certainty and predictability in tax planning.

I do not quarrel with these observations. As a matter of tax policy, however, one must question whether this formulation of corporate residence is consistent with the principles that animate residence-based taxation. Directors who manage some special-purpose vehicle, yet who do so without “initiative” because they are “complaisant” to the will of a guiding party, are exercising little of the intellectual endeavour that is essential to economic interest. To quote counsel for the minister in *Victoria Insurance*, there is little or no “independence of action” on the part of these directors. The purported residence of these entities may be described as “clockwork residence” because of the meticulous design involved.140 When offshore statehood can be purchased by hiring offshore advisers to manage offshore shelf companies, why is such a concept of residence thought to be meaningful?

To be fair, it is conceivable that in particular circumstances a sole shareholder or other dominant party might wield sufficient power over an ostensibly foreign entity to give him or her the actual management and control, with local directors acting

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137 In the United Kingdom, see *News Datacom Ltd. v. Atkinson*, [2006] STC 732 (SCD), which involved a global media group with affiliates based in Hong Kong and Israel; the commissioners held that the Hong Kong affiliate was resident outside the United Kingdom on the basis of its immediate directorial control. In Canada, see *1143132 Ontario Ltd.*, supra note 91, where a Barbados resale affiliate was held to be resident in Barbados on the basis of its immediate directorial control. As similarly argued in *Unit Construction*, supra note 87, the taxpayer in this case preferred to argue that the Barbados subsidiary was resident in Canada (in order to avoid a transfer-pricing adjustment).


139 Compare *Wood v. Holden*, supra note 13, at paragraph 50 (CA), where Sir Christopher Staughton warned against speaking about what happened “in real life” and what were the “real decisions.”

as “mindless” nominees. This possibility was expressly contemplated in *Wood v. Holden*,141 and was held to have occurred in *Laerstate BV v. Revenue & Customs*,142 a more recent decision of the First-Tier Tribunal. Laerstate was a holding company incorporated and registered in the Netherlands that originally had two directors, one of whom was the company’s sole shareholder (Mr. Bock). He resigned as a director before the disposition of certain shares by Laerstate. The issue was whether the capital gain from that transaction was taxable in the United Kingdom, which turned on the residence of Laerstate. Referring to *De Beers, Unit Construction*, and *Wood v. Holden*, the tribunal observed that central management and control was not necessarily to be found where the board of directors met or executed documents because this was a factual question to be answered by scrutinizing the whole “course of business and trading.”143 The tribunal considered very detailed evidence regarding the company’s affairs and concluded that Mr. Bock took a dominant role while in office and after resigning as director, making most of the key decisions regarding “policy, strategic, and management matters” within the United Kingdom, while the remaining director merely implemented decisions that had already been made. The company was held to be managed and controlled—and therefore resident—in the United Kingdom.144

Other recent decisions in the United Kingdom and Canada have demonstrated some judicial willingness, in the case of foreign trusts employed in a tax-avoidance arrangement, to look beyond the formalities of trustee administration to ascertain where the “realistic, positive management” of the trust was exercised. This approach was taken in *Smallwood Trust v. HMRC*,145 although this case involved a determination of trust residence for treaty purposes (having nothing to do with central management and control). *Smallwood* and related cases on trust residence under tax treaties are discussed in more detail in the next section of this article. A more relevant decision is *Fundy Settlement v. Canada*,146 where an approach comparable to *Smallwood* was taken. To briefly describe the facts in *Fundy Settlement*, a number of Canadian individuals were direct or indirect shareholders in a Canadian corporation known as “PMPL,” and a reorganization was undertaken to avoid capital gains tax on a future disposal of the PMPL shares. The structure involved the settlement by a non-resident individual of two Barbados trusts (Fundy and Summersby), each subscribing for shares in certain Canadian holding companies, which in turn subscribed for shares of PMPL. The sole trustee of each trust was a corporation resident in Barbados

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143 Ibid., at paragraphs 27-37.
144 *Laerstate*, ibid., was not appealed, apparently as a result of the death of Mr. Bock in 2010.
146 2012 SCC 14; aff’g. 2010 FCA 309 (sub nom. *St. Michael Trust Corp. v. Canada*); aff’g. 2009 TCC 450 (sub nom. *Garron Family Trust v. The Queen*).
(St. Michael). Later, the shares of the PMPL holding companies were sold by the trusts to a third party at a substantial gain, which was, so the taxpayers argued, exempt from Canadian taxation by virtue of the Canada-Barbados tax treaty.147 Although various arguments were made in the case, much emphasis was placed on the residence of the trusts. Woods J reasoned that it was appropriate to apply the central management and control test of corporate residence to a trust, rather than relying on the residence of the trustee.148 While that aspect of the decision was itself controversial, what is more interesting for the present purposes is Woods J’s interpretation and application of the central management and control concept. On the basis of the evidence before her, she decided that all of the “substantive decisions” in respect of the trusts were made in Canada by the Canadian beneficiaries and their advisers, with St. Michael making no decisions of its own but merely executing documents and providing incidental administrative services; accordingly, the trusts were resident in Canada at all times for both domestic law purposes and treaty purposes.149 In my view, this may represent a more expansive reading of central management and control than was applied to corporate subsidiaries in Victoria Insurance, Wood v. Holden, and similar cases. The decision was affirmed by the Federal Court of Appeal and, in a rather brief judgment, by the Supreme Court of Canada.

Given the forceful wording of the judgments in Wood v. Holden, and given the weight of authority both before and since Wood v. Holden, one can nonetheless expect that attempts to secure foreign residence for corporate entities will almost invariably succeed. The judgments in Unit Construction, Laerstate, and (indirectly) Fundy Settlement serve as warnings to taxpayers and their advisers that if they wish to achieve “clockwork residence” in a foreign jurisdiction, they must ensure that the clock is working. This does not mean that any substantial economic interest exists in the foreign state. Whereas in De Beers Lord Loreburn expressed concern about corporations avoiding UK taxation “by the simple expedient” of being registered abroad, MNEs can avoid home taxation by the simple expedient of being managed and controlled abroad, with the entrepreneurship, initiative, and influence remaining in the headquarters state. Some US authors have speculated that US international tax rules could be more resistant to profit shifting if the United States adopted a management and control test for corporate residence.150 In my view, they may have failed to appreciate how devitalized this concept is. If central management and control is

147 Agreement between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital (1980), article 14(4).
148 Fundy Settlement, supra note 146, at paragraphs 156-70 (TCC).
149 Ibid., at paragraphs 187-267.
as lacking in substance as I have argued, there is something to be said for using the incorporation test exclusively: while artificial, it has the benefit of simplicity and it avoids the environmental cost of board members travelling abroad to carry out equally artificial board meetings.

**CORPORATE RESIDENCE FOR TREATY PURPOSES**

**Background**

In the previous section, it was argued that neither incorporation nor central management and control (as currently understood) is a satisfying formulation of corporate residence. This leads one to ask whether residence should be determined on the basis of a different set of functions and activities. A useful source to consider is the range of definitions used for determining entity residence under the OECD model and various tax treaties. Tax treaties are worded so that they apply to persons who are residents of one or both of the contracting states. Indeed, this is one of the notable benefits associated with residence in a state. Determining who is a resident involves a consideration of the relationship between residence under domestic law, tax liability under domestic law, and residence for treaty purposes, followed by an examination of the treaty preference criteria for resolving dual residence conflicts.

**Domestic Liability and Treaty Residence**

The residence of a taxpayer for domestic law purposes is, of course, a matter left to each state to determine. As stated in the OECD commentary, tax treaties “do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as ‘resident.’” The laws of the United Kingdom and Canada consider corporate residence to follow from incorporation or central management and control, as already discussed, while other states use their own (possibly similar) rules. Other residence formulations, whether derived from case law or statute, apply to individuals, partnerships, and trusts.

The tax liability of a person under domestic law is relevant because of the way that residence is defined in most tax treaties. The first sentence of article 4(1) of the OECD model defines the term “resident of a Contracting State” as “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.” This is

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151 OECD model, supra note 37, at article 1.
152 Ibid., at paragraph 4 of the commentary on article 4.
153 Ibid., at article 4(1). The OECD model is silent on the temporal scope of this rule. If a person’s factual residence for part of a year results in deemed tax liability for the entire year, the person may be considered liable to tax “by reason of” residence and thus a “resident” for treaty purposes. For further discussion, see the contrasting judgments in Smallwood, supra note 145, and Geoffrey Loomer, “Smallwood Trust v HMRC: Diverging Opinions on the Offshore Residence of a Trust,” case comment [2010] no. 5 British Tax Review 468-75.
generally considered to mean that treaty residence requires comprehensive tax liability in a state based on a personal/subjective attachment to the jurisdiction. The second sentence of article 4(1) provides that a resident of a contracting state does not include a person “who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.” While serving several purposes, one effect of this sentence is to ensure that a permanent establishment of a foreign enterprise does not qualify as a resident for treaty purposes. Whether this restriction is good tax policy is a separate question.

Current Treaty Preference Criteria
Dual Residence for Treaty Purposes
Aside from defining who is a resident of a contracting state, the other purpose of article 4 of the OECD model is to resolve issues of dual residence through the application of preference criteria, also known as “residence tie-breaker rules.” The OECD model provides that where by reason of paragraph 1 a person other than an individual is a resident of both contracting states, the person is deemed to be a resident only of the state in which its place of effective management (POEM) is situated. Thus, for the purpose of treaties that adopt this feature of the OECD model, POEM takes precedence over other residence tests that may be used in domestic law.

Most tax treaties negotiated by the United Kingdom and Canada include a residence tie-breaker rule for legal entities. POEM is the usual preference criterion in UK tax treaties, and it appears as a possibly relevant criterion in many Canadian tax treaties; this is not surprising because both countries are longstanding members of the OECD. But POEM is not the only criterion in use. In Canada, the odd affinity for incorporation as a determinant of residence under domestic law finds its way into tax treaties as well. Of the 92 comprehensive tax treaties currently in force in Canada, 55 use place of incorporation or nationality (which is the same thing in the case of a legal entity) as the sole residence tie-breaker or as the primary tie-breaker, with the secondary factor in the event that the entity is not a national of either jurisdiction

154 OECD model, supra note 37, at paragraphs 3 and 8-8.8 of the commentary on article 4; Crown Forest Industries Limited v. Canada, [1995] 2 SCR 802; TD Securities (USA) LLC v. The Queen, 2010 TCC 186; and Vann, supra note 12, at 243-48.

155 See Vann, supra note 12, at 248-50.

156 OECD model, supra note 37, at article 4(3).

157 Some of the United Kingdom’s older tax treaties, for example, those with Belize (1947), Greece (1953), and Jersey (1952, as amended through 2009) have no tie-breaker rule. They simply provide that a company is treated as resident in one state or the other if its business is “managed and controlled” there. This was common in British tax treaties concluded before the first OECD model (1963), infra note 177: see John F. Avery Jones, “The Definition of Company Residence in Early UK Tax Treaties” [2008] no. 5 British Tax Review 556-86.
being either POEM or mutual agreement of the competent authorities.\textsuperscript{158} For example, under the current Canada-US tax treaty a company that is resident in both contracting states is deemed to be resident in the state under the laws of which it was created, and, if that cannot be determined, the resolution of residence is left to the competent authorities; in the absence of agreement, the company is not considered resident in either state for the purpose of claiming treaty benefits.\textsuperscript{159} Canada's remaining 37 treaties provide that in cases of dual residence of legal entities, the competent authorities of the two states shall endeavour to resolve the matter by mutual agreement. In some of these treaties, the residence article goes on to list the factors that should be considered by the competent authorities when making that determination, including place of incorporation and POEM.\textsuperscript{160} The United Kingdom historically used the POEM rule in its tax treaties and continues to do so in some recently concluded or amended treaties,\textsuperscript{161} while in other recent treaties “mutual agreement” appears as the sole preference criterion.\textsuperscript{162} Given that the POEM criterion is frequently used, either as the sole criterion or as an alternative to place of incorporation, it is worth considering what is meant by “effective management.”

\textit{Development of the Place of Effective Management Concept}\textsuperscript{163}

The issue of the “fiscal domicile” of companies for tax treaty purposes was analyzed by the technical experts to the League of Nations Financial Committee in their 1925 report.\textsuperscript{164} While the technical experts acknowledged that states were entitled to use their own definitions of fiscal domicile for domestic law purposes, they proposed that for tax treaty purposes the domicile of legal entities—specifically joint

\begin{itemize}
\item \textsuperscript{158} Fourteen treaties, including the recently amended treaty with Barbados (2012), rely on the place of incorporation or nationality only. Thirty-three treaties rely on (1) the place of incorporation or nationality or (2) POEM. Eight treaties, including the treaty with the United States, rely on (1) the place of incorporation or nationality or (2) mutual agreement of the competent authorities.
\item \textsuperscript{159} 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, article 4(3).
\item \textsuperscript{160} For example, Canada’s treaties with Ireland, the Netherlands, and the United Kingdom.
\item \textsuperscript{161} For example, the treaties with France (2008), Germany (2010), Hong Kong (2010), and Spain (2013).
\item \textsuperscript{162} For example, the treaties with the United States (2001), Japan (2006), the Netherlands (2008), Barbados (2012), and Norway (2013).
\end{itemize}
stock companies—should be the place “where the concern has its effective centre, i.e., the place where the ‘brain,’ management and control of the business are situated.”165 This was expressed in their draft resolutions as “the real centre of management and control of the undertaking,” echoing the allocation of taxing rights over international shipping income to the state where “the real centre of management and control of the undertaking” was situated.166 A key rationale given for adopting this residence definition was that it would prevent companies from “nominally transferring their headquarters to a place where the taxes are lower than in the country in which the effective centre of the business is situated.”167 Presumably, such a nominal transfer was believed to be possible under a more formal test, like place of incorporation. Thus, the focus was on “real” and “effective” residence as contrasted with “nominal” residence, suggesting some elevation of substance over form. This preference continued in the drafting of later model conventions, although subtle changes in wording attenuated the fixation on “reality.”

Subsequent reports through the 1930s shortened the formulation of fiscal domicile of legal entities to the “real centre of management,” no longer referring to “control.”168 This definition of fiscal domicile was adopted in the 1946 London draft model convention for companies, partnerships, and other legal entities.169 It is interesting that the authors of the 1943 Mexico draft model convention decided that the fiscal domicile of legal entities should be “the State under the laws of which they were constituted.”170 According to the League of Nations Fiscal Committee, the real centre of management test was used in “most” tax treaties between European countries, while the place of creation test was thought to be more consistent with American legal systems.171 As in various other areas, the wording in the London draft with respect to fiscal domicile prevailed.

Neither the Mexico draft nor the London draft revealed much concern with the possibility of legal entities being resident in both contracting states under the treaty definition of residence; the analysis of dual residence focused on individuals. The subsequent work of the Organisation for European Economic Co-operation (OEEC) considered this issue in depth. In 1958, the OEEC Fiscal Committee proposed that in the unlikely event that a legal entity was resident for treaty purposes in both
contracting states, then the conflict should be resolved by deeming the entity to be a resident of the state where the “place of effective management” was situated.\textsuperscript{172} This proposal was adopted from the final report of Working Party 2 of the OEEC Fiscal Committee.\textsuperscript{173} Interestingly, Working Party 2 had originally considered using “management and control” as the tie-breaker, on the basis of its belief that this was how the terms were used in existing UK tax treaties.\textsuperscript{174}

The decision to use POEM as the preference criterion for entity residence was stated to be based on three considerations.\textsuperscript{175} First, the Working Party and the OEEC Fiscal Committee noted that this criterion reproduced the treaty allocation rule with respect to income from international shipping and aircraft operations, used at the time in a number of existing tax treaties. Second, the concept of “effective management” was thought to be equivalent to “management and control,” the definition of corporate residence used in tax treaties concluded by the United Kingdom near that time, although in retrospect that thinking was probably wrong. Third, and perhaps most importantly, the OEEC observed that it “would not be natural to attach importance to a purely formal criterion like registration,” again demonstrating a preference for substance over form with respect to entity residence.\textsuperscript{176}

These observations were reiterated in the commentaries to subsequent versions of the OECD model\textsuperscript{177} and the UN model tax convention.\textsuperscript{178} While the specific reference to the residence formulation used in UK tax treaties was deleted in 1992, the current OECD commentary continues to highlight the replication of the allocation rule for income from international shipping and aircraft operations.\textsuperscript{179} The com-


\textsuperscript{174} In fact, as Avery Jones explains, the working party failed to understand what “central management and control” meant in UK domestic law, and thus failed to understand that the term was inserted in UK tax treaties not as a residence tie-breaker but to forestall arguments based on \textit{Swedish Central Railway}, supra note 67, that corporate residence followed from incorporation: Avery Jones, “2008 OECD Model: Place of Effective Management,” supra note 163, at 184-85.

\textsuperscript{175} OEEC report, supra note 172, annex C, at paragraphs 18-19; and working party final report, supra note 173, at 6.

\textsuperscript{176} OEEC report, supra note 172, annex C, at paragraph 18.


\textsuperscript{178} See United Nations, Department of Economic and Social Affairs, \textit{Model Double Taxation Convention Between Developed and Developing Countries} (Geneva: UN, 2001), at 66-67 (quoting the commentary on the OECD model, supra note 37).
mentary also states the following: “It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed.”

Although the word “real” has been excised from the residence preference criterion and commentary thereon, the word “actually” persists, echoing Lord Loreburn’s speech in *De Beers*. Canada and the United States have nonetheless entered reservations that they retain the right to use place of incorporation as the preference criterion and, failing that, to deny dual resident companies treaty benefits. By using incorporation as the tie-breaker, rather than POEM or some other concept, countries can neatly avoid the difficulty of determining what is “real” or “actual” in cases of dual residence.

**Meaning of Effective Management**

Even if the POEM concept suggests a more economically substantial nexus than registration or incorporation, the difficulty with using POEM as a residence preference criterion is that its meaning is far from certain. In the early OEEC reports, it seems that the authors were not clear about the meaning of POEM; it was an odd mixture of civil-law and English law concepts of fiscal domicile. This has led commentators from various countries to assume that POEM is synonymous with the definition of entity residence under their own domestic laws. One sees this in the United Kingdom and Canada, where commentators and judges have suggested that there is no difference between effective management and central management and control.

It does not help that the OECD commentary on the meaning of POEM has changed a number of times. The current OECD commentary defines POEM as follows:

> The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

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179 OECD model, supra note 37, at paragraph 23 of the commentary on article 4.
180 Ibid., at paragraph 22 of the commentary on article 4.
181 Ibid., at paragraphs 27 and 31 of the commentary on article 4. Canada’s reservation in this regard has now been deleted: see the OECD 2014 update, supra note 37, at paragraph 11.
182 Avery Jones et al., supra note 163, at 719-22.
185 *Wood v. Holden*, supra note 13, at paragraphs 6 and 44 (CA); and *Fundy Settlement*, supra note 146, at paragraph 265 (TCC).
186 OECD model, supra note 37, at paragraph 24 of the commentary on article 4.
Before the 2000 revision to the OECD commentary, there was no definition offered, other than the stated considerations for using POEM as a tie-breaker, mentioned above. In 2000, a different version of the above definition was introduced. The first sentence was largely the same, but the second sentence stated that POEM “will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions,” with the proviso that “no definitive rule can be given and all relevant facts and circumstances must be examined.” This wording suggested that effective management would “ordinarily” be the same as central management and control, as understood in UK and Canadian domestic law. However, the second sentence was changed to the above in the July 2008 revision, making it less clear that the two concepts should be considered equivalent. The words “as a whole” were also added to the first sentence. Although this amendment likely does not add much, it is notable that it echoes the Inland Revenue’s failed 1981 proposal to define corporate residence on the basis of where “the management of the company’s business as a whole is conducted.”

Where does this leave us? In one sense, we can interpret “effective” as meaning real, substantial, or primary, as opposed to nominal, formal, or subordinate. This appears to be the interpretation that HMRC pursued unsuccessfully in *Wood v. Holden* and successfully in *Smallwood*. In another sense, it can mean giving effect to, as opposed to planning or strategizing, which places the emphasis more on day-to-day management decisions. HMRC also seems to support this interpretation. It has stated that an entity’s POEM “will normally be located in the same country as central management and control but may be located at the company’s true centre of operations, where central management and control is exercised elsewhere.” The *Statement of Practice* on company residence suggests that POEM may be different from the place of management and control where, for example, a company is “run by executives based abroad” but the “final directing power” rests with non-executive directors in the United Kingdom. These interpretations may suggest that POEM lies closer to the productive operations of the business, while management and control involves ultimate directing power. There does not appear to be any commentary from the Canada Revenue Agency on the meaning of POEM and its possible difference from central management and control, which is not surprising, given that no Canadian tax treaties use POEM as the sole or primary preference criterion.

It remains important to determine whether POEM emphasizes substantive strategic decisions or day-to-day management decisions, particularly in the context of parent-subsidiary relationships within an MNE. Some tentative guidance is...
provided by a number of cases dealing with the treaty residence of trusts, where “effective management” was interpreted as “realistic, positive management,” and the court looked beyond the formal establishment of an offshore trust to the location where the real decisions were made.

The case of *Wensleydale’s Settlement Trustees v. IRC*\(^{192}\) involved the establishment of a purportedly foreign trust as part of an arrangement to avoid UK capital gains tax. The taxpayers’ goal was to have this trust considered resident in Ireland by operation of the POEM tie-breaker rule in the tax treaty between the United Kingdom and Ireland. Although the trustees had carried out certain formalities in Ireland, the special commissioner focused on where the proactive decision making really happened, which was held to be the United Kingdom.\(^{193}\)

That analysis was applied by the special commissioners and a majority of the Court of Appeal in *Smallwood*, which again (as in *Wood v. Holden*, *Wensleydale*, and various other cases) involved a capital gains tax-avoidance scheme. Here, the arrangement relied on a carefully orchestrated sequence of trusteeships exercised in different states at different times within the same fiscal year, from Jersey to Mauritius to the United Kingdom. The relevant shares were disposed of by the trustees during the period of formal Mauritian residence, in the hope that the UK-Mauritius tax treaty would shield the gain from taxation.\(^{194}\) The argument turned on the residence of the trust for treaty purposes during the period of formal Mauritian residence, which necessitated a determination of where the trust’s POEM was located: the United Kingdom or Mauritius.\(^{195}\) The special commissioners relied on the OECD commentary and the reasoning in *Wensleydale*, seeking to determine “in which state the real top level management (or the realistic, positive management) of the trustee qua trustee is found.”\(^{196}\) They applied that test to the facts and concluded that although the appropriate meetings were held and the appropriate resolutions were taken by the trustees in Mauritius, the design and influence that emanated from Mr. Smallwood and his advisers in the United Kingdom were such that POEM was at all times in the United Kingdom. Although that decision was overturned by the High Court, a majority of the Court of Appeal restored the decision. Unfortunately, the analysis of the meaning of POEM by the Court of Appeal does not provide much clarity.

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\(^{193}\) It is notable that the special commissioner relied on three corporate residence cases: *Calcutta Jute Mills*, supra note 46; *De Beers*, supra note 53; and *Unit Construction*, supra note 87.


\(^{195}\) *Smallwood*, supra note 145, at paragraphs 107-8 (SpC); and *Smallwood*, ibid., at paragraphs 46-47, 65, and 72 (CA). Mann J in the High Court held that the issue of dual residence did not arise: *Smallwood*, ibid., at paragraphs 44-47 (Ch.).

\(^{196}\) Ibid., at paragraphs 113-14 and 130 (SpC).
Hughes LJ, with whom Ward LJ agreed, chose to consider the trust’s POEM for the entire year, rather than just the period of formal residence in Mauritius, suggesting that if one focused just on the Mauritius period then the trust’s POEM would be in Mauritius. Patten LJ, dissenting, pointed to Wood v. Holden and the finding of fact that the trustees were not bound to act in a certain way; in his view, the only possible conclusion was that the trust was effectively managed in Mauritius.

A view of trust residence similar to that taken in Wensleydale and Smallwood was adopted at all levels of court in the Fundy Settlement decision. Woods J observed that Wensleydale and Smallwood were of no assistance in determining what the appropriate common-law test of trust residence should be, but nonetheless considered Smallwood to be relevant in terms of the interpretation and application of central management and control. As discussed previously, Woods J decided that all of the substantive decisions in respect of the trusts were made in Canada, with the Barbados trustee acting in a facilitative role only, and thus the trusts were resident in Canada for both domestic law and treaty purposes. This decision was affirmed by the Court of Appeal and the Supreme Court. It remains unclear whether the interpretation of central management and control in Fundy Settlement will have influence in the corporate context, whether for Canadian domestic law purposes or for interpreting POEM in the Canadian treaties where POEM is used.

Alternative Treaty Preference Criteria

Given the confusion regarding the meaning of POEM, there is much to be said for adopting a new residence preference criterion in the OECD model and in future tax treaty negotiations. When considering the normative basis for residence-based taxation of corporations, it seems desirable to determine residence for treaty purposes on the basis of where the “realistic, positive management” of the corporation is found, the interpretation of POEM that has been applied to trusts. But it is not even clear that judges have a uniform view of what that means. Moreover, it is unlikely, given the decision in Wood v. Holden and notwithstanding the decisions in Smallwood and Fundy Settlement, that such an interpretation of POEM will be applied with respect to corporations: talk of the “reality” of corporate residence is treated with derision. In my view, it is worth revisiting the “real centre of management” test proposed in the London draft, or something similar, in order to legislatively restore the focus on the place where decisions are actually made.

197 Ibid., at paragraphs 68-70 (CA).
198 Ibid., at paragraphs 61-63 (CA).
199 Fundy Settlement, supra note 146.
200 Ibid., at paragraphs 152-54, 181-86, and 264-66 (TCC).
201 Ibid., at paragraphs 252 and 267 (TCC).
This is not the only option. A more desperate option is exemplified in the new UK-Netherlands tax treaty,203 where the governments have broken away from using POEM as the preference criterion (it had been the criterion for 30 years). Dual residence of legal entities is now resolved by mutual agreement of the competent authorities; in the absence of agreement, the entity is not considered resident in either state for the purpose of claiming most treaty benefits.204 The 2008 explanatory memorandum to the treaty indicates that the factors to be considered by the competent authorities are (1) where senior management is carried on, (2) where board meetings are held, (3) where the headquarters are located, (4) the “extent and nature of the economic nexus” with each state, and (5) whether awarding residence to one state carries “the risk of an improper use” of the treaty or an “inappropriate application of the domestic law” of either state.205 This list of factors is consistent with the case-by-case approach to residence resolution suggested in the OECD commentary.206 Reliance on the mutual agreement of the competent authorities, with or without stating any objective preference criteria, has been the practice in various Canadian treaties as well.207

Obviously, this sort of tie-breaker is least favourable to taxpayers because it is discharged only by the exercise of mutual administrative discretion. I suspect that the amendment to the UK-Netherlands treaty was prompted in part by the decision in Wood v. Holden.208 The stated intention of considering the economic nexus to each state when determining residence is welcome. The stated concern about improper use of the treaty or domestic law is, in my view, less welcome. What this statement really means is that the respective governments (or at least the UK government) are not happy with the artificiality of current corporate residence formulations, the reliance on which is essential to various planning structures that the governments consider improper. This suggests that the governments should endeavour to change these formulations by legislation.

204 Ibid., article 4(4). There are special rules for public companies participating in a “dual listed company arrangement.”
206 OECD model, supra note 37, at paragraph 24.1 of the commentary on article 4.
207 See the text accompanying notes 158-60.
208 Note that the United Kingdom agreed to use POEM as the tie-breaker in the treaties recently concluded with France (2008), Germany (2010), Hong Kong (2010), and Spain (2013). Presumably the UK government is not as concerned about tax-avoidance arrangements exploiting residence in these states.
CONCLUSION

In my view, the justifications for residence-based corporate taxation have force only where corporate residence is understood as a special form of source—a sort of residual home source wherein the home state is given jurisdiction over income streams that are not easily sourced to another jurisdiction. Whether one agrees with this limited form of residence taxation, or instead believes that a corporation’s residence in a particular state should grant that state the unbridled right to tax the corporation’s global income (including foreign branch profits and foreign affiliate dividends), it is desirable to have a concept of corporate residence that is meaningful rather than meaningless. Formulating a meaningful concept of corporate residence demands some articulation of what is real, whether or not it is popular to speak of reality in the context of international tax planning. The reality seems to be the intellectual efforts of people in a particular place—that is, participation in the economic life of a nation. One could consider the efforts of personnel at any level of a corporation, but, given the traditional focus on a corporation’s strategic decision makers, we may wish to keep the focus there. The unreality is a box drawn on a piece of paper, perhaps connected to other boxes, with the name “Barbco” or “Luxco” written inside it, as though the act of drawing the box creates national attachment. It is unfortunate that the current meaning of corporate residence in the United Kingdom, Canada, and other Commonwealth jurisdictions, being based on the formality of incorporation or ceremonial acts of central management and control, appears to require little beyond this drafting exercise.

The incorporation test of residence is a de jure standard that bears little or no relation to economic activity. In my view, there was no convincing normative basis for its introduction in the United Kingdom or Canada: achieving consistency with US norms and opportunistically taxing foreign-managed entities were not good reasons. Having chosen to use such a test, how can the UK or Canadian governments be heard to complain that other states, including zero-tax states, employ the same residence test, or that MNEs rely on that test in their international structuring? Although it is unlikely to occur, there is much to be said for repealing the statutory incorporation test in the United Kingdom and Canada. The central management and control standard as currently understood is little better because it constitutes a “highest functions” paradigm that is easily manipulated, notwithstanding that this standard could have been interpreted as “real” and “actual” management emanating from a state. Although the treaty concept of POEM similarly could be interpreted as “real” and “positive” management, to date this interpretation has been neglected by courts, at least with respect to corporations.

This results in an international tax system where corporate residence is a critical determinant of home state tax obligations and treaty entitlements, while at the same time being a legal artifice that may not reflect economic reality. The flexibility of the corporate residence concept is thus central to much, if not most, international tax planning. Governments and revenue administrations respond by challenging alleged international tax law abuses that are made possible by their own corporate
residence definitions. This is a regrettable incongruity that could be addressed through legislative change, both in domestic law and tax treaties. As long as corporate residence remains a key feature in international tax rules, it is desirable to adopt a test or series of tests that focuses on where the practical, daily management or principal business operations exist (as suggested by the Inland Revenue over 30 years ago) or on where the “real centre of management” is situated (as suggested by the League of Nations Fiscal Committee over 60 years ago). Given the traditional focus in the case law on a corporation’s strategic decision makers—namely, the “head and brain” versus the “hands and feet”—perhaps the most feasible and incremental change would be to introduce, both in domestic law and tax treaties, a renewed “place of effective management” test that restores the focus on the location of autonomous decision making. It is useful to recall the comment from Cesena Sulphur/Calcutta Jute Mills that the residence of a corporation should be found in “the place not where the form or shadow of business, but where the real trade and business, is carried on.”209

209 Cesena Sulphur/Calcutta Jute Mills, supra note 46, at 452.
Policy Forum: Effective Tax Rates for Multinationals—The Role of Tax Incentives and Tax Planning

W. Steven Clark and Alexander Klemm*

PRÉCIS
On utilise fréquemment des taux d’impôt effectifs (tie) (marginaux et moyens) pour l’analyse et la conception de politiques fiscales touchant l’investissement; le présent article fournit divers exemples récents. Il aborde les questions soulevées lorsqu’on calcule les tie dans un contexte international, comme pour les investissements transfrontaliers. Il explique concrètement comment des incitatifs fiscaux et des stratégies de planification fiscale peuvent être inclus dans le calcul des tie. L’article fait ensuite état des difficultés habituelles liées à leur interprétation, dont bon nombre sont accentuées dans un contexte international. En particulier, la gamme de tie pour un pays donné augmente, et les niveaux et les classements du pays dépendent d’hypothèses relatives à des paramètres fiscaux et non fiscaux.

ABSTRACT
Effective (marginal and average) tax rates (ETRs) are frequently used in the analysis and design of tax policies affecting investment, and this article provides various recent examples. The article addresses issues that arise when ETRs are calculated in an international context, such as for cross-border investments. It explains concretely how tax incentives and tax-planning strategies can be included in the calculation of ETRs. It then discusses typical difficulties in their interpretation, many of which become more severe in an international context. In particular, the range of ETRs for a given country rises, and both levels and country rankings depend on assumptions about tax and non-tax parameters.

KEYWORDS: EFFECTIVE INCOME TAX RATES ■ CORPORATE INCOME TAXES ■ TAX PLANNING ■ TAX INCENTIVES

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INTRODUCTION

Effective tax rates (ETRs) have become a common way to summarize corporate tax systems with simple statistics and are often used by policy makers. The European Commission, for example, regularly commissions the calculation of such tax rates.\(^1\)

A main feature of ETRs is that they provide a summary indicator of the net effect of statutory tax provisions that have an impact on net returns on investment, factoring in complex interactions of tax and non-tax parameters. In addition, unlike backward-looking tax burden measures, ETRs are transparent, since the formulas used to measure them are explicit functions of tax provisions influencing the costs of and returns to investment.\(^2\) They can therefore be used to analyze incentives to invest in a country and are not affected by past decisions of taxpayers or legacies such as losses that are carried forward.

The term “effective tax rate” is not uniquely defined. For the purposes of this article, it is used only in reference to forward-looking measures of the tax rate that are built using the tax system and assumptions about profitability, investment, and financing choices. Concretely, the effective average tax rate (EATR) is defined as follows:

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EATR = \frac{PDV(\text{tax})}{PDV(\text{profit})}
\]

\(^1\) For the latest, see C. Spengel, Dieter Endres, Katharina Finke, and Jost Heckemeyer, Effective Tax Levels Using the Devereux/Griffith Methodology, Project for the EU Commission TaxUD/2013/CC/120 (Mannheim: Zentrum für Europäische Wirtschaftsforschung, Centre for European Economic Research, February 2014).

where PDV is the present discounted value and profit includes both the normal profit and any economic rent. The effective marginal tax rate (EMTR) is a special case, in which the post-tax profit covers exactly the cost of capital.

This broad definition is very general and allows ETRs to be adapted to almost any tax feature, including international tax issues, such as tax incentives or multinational tax planning. But for the definition to be operational, certain simplifying assumptions are needed. First, on the tax side, the most relevant tax laws need to be chosen, since it would be hopeless to consider the thousands of pages of tax code that depend on special circumstances. Similarly, on the investment side, certain profit rates, sources of finance, and assets need to be assumed. Devereux and Griffith\(^3\) have developed a specific proposal on how to calculate ETRs taking into account statutory tax rates, depreciation allowances, investment allowances, and interest deductibility. Their framework includes personal income taxes at the investor level, such as taxes on dividends, capital gains, and interest, which could be withholding taxes and home-country taxes in the case of international shareholders. Klemm\(^4\) has extended this framework to tax incentives, such as tax holidays and time-varying tax rates. Clark\(^5\) has introduced multinational tax-planning strategies.

This article presents an overview of how to calculate ETRs in an international context and how to interpret them, avoiding some common pitfalls. We begin by reviewing the basics of how to calculate ETRs in the presence of tax incentives, and then extend the discussion to cross-border issues and multinational tax planning. We provide examples of how ETRs have been used by government as an instrument of tax policy, review the analysis of the impact of ETRs in the academic literature, and point to some pitfalls in the interpretation of ETRs. A brief concluding section summarizes our views on the usefulness of ETRs in developing and analyzing tax policy.

**EFFECTIVE TAX RATES AND TAX INCENTIVES**

Tax incentives have become a major component of tax systems, especially in developing countries. Typical incentives include tax holidays, reduced tax rates, and special investment allowances and credits. Here we consider only incentives relating to corporate income taxes, although in practice they can also cover other taxes, such as value-added or personal income taxes.

The first article that discussed tax incentives in terms of their impact on ETRs was by Mintz,\(^6\) who found that tax holidays may have the unexpected effect of raising

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EMTRs in the last few years of the holiday. This is because under a tax holiday, depreciation allowances are worthless. If an investment takes place in the last few years of a tax holiday, the loss of the allowance—particularly if allowances are front loaded, as in the case of accelerated depreciation—can outweigh the short-term saving of the remaining holiday. Klemm's discussion of the main incentives and their costs and benefits, as indicated by ETRs, and shows how the relative attractiveness of tax holidays compared to investment allowances and reduced tax rates changes over time and depends on the expected profitability.

The appendix to this article shows how tax incentives can be formally incorporated into ETRs. Intuitively, the key is to consider a long-term horizon, though this requires an adjustment to the Devereux and Griffith framework,8 which is based on a one-period perturbation of the capital stock. Under many incentives, such as the typical tax holiday, the investor knows in advance that tax rates will change, and at the same time, the tax holiday is contingent on the investment. To take this into account, Klemm considers an increase in the capital stock that is permanent—except that it is undone over time by depreciation—and that yields a constant rate of pre-tax profit.10 With this assumption, it is possible to calculate the PDV of taxation, even for changing tax rates.

Figure 1 shows how different tax incentives affect ETRs by comparing two common incentives: a tax holiday and accelerated depreciation. For the tax holiday, a full tax exemption for eight years is assumed, but the figure also shows ETRs in the remaining years of the holiday. After two years, for example, only six years of the tax holiday remain, so the rate that applies to any further investment then is equivalent to a six-year holiday. When the holiday expires (when 0 years remain), the standard ETR applies to any new investment. On accelerated depreciation, the rate shown allows for full expensing in the year of investment, which is also known as a cash flow tax. (This is not the extreme case; some countries offer even more by combining depreciation with investment allowances, resulting in PDVs of depreciation that can exceed 100 percent of the investment.)

The ranking of tax incentives in terms of their effect on ETRs changes over time, as shown in figure 1. The ranking in terms of the EATR also depends on the expected level of profitability.

First consider the marginal case—a project that just breaks even. Under cash flow tax treatment, the EMTR is zero, as expected, because such a tax is theoretically neutral in its impact on investment; that is, any project that is worthwhile

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8 Devereux and Griffith, supra note 3.
9 Klemm, supra note 4.
10 This assumption is not required; the ETR could be calculated for any development of future rates of profitability. The greater the profitability in the early years, the greater is the advantage of incentives such as tax holidays, where the benefit is time limited.
before tax remains so after tax. The tax holiday does not achieve the same reduction in the EMTR. While no tax is paid for eight years, the PDV reflects tax payments after that period. Over time, as the tax holiday expires, the EMTR for any additional investment rises, as more of the tax-paying years enter the calculation. In the final year, the figure illustrates the Mintz11 result of the EMTR rising above its level in the absence of a tax holiday. This is because the loss of the depreciation deduction (which exceeds true economic depreciation by assumption) outweighs the benefit of not paying tax for one year.

- Then consider the case of a highly profitable investment. The cash flow tax also reduces the EATR, but by far less, because even after deducting the full investment, there remains a lot of economic rent that can be taxed. Under the tax holiday, however, the EATR is reduced significantly, because all of the rent will go untaxed for a long time.

Notes: Calculated for an investment in plant and machinery, financed by equity. Assumptions: statutory corporate income tax rate, 30 percent; depreciation allowance, 25 percent (declining balance); inflation, 3.5 percent; real rate of interest, 10 percent; economic depreciation, 12.25 percent; personal taxes excluded.


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11 Mintz, supra note 6.
To sum up, tax holidays are particularly attractive for highly profitable investments, especially if the profits accrue early. Over time, the incentive to invest falls, and for low-profitability investments, there may even be a disincentive. For other incentives, similar analysis is possible. A reduced tax rate, for example, will be very attractive for high-profitability investments, since it permanently reduces the tax take from rents.

**CROSS-BORDER ETRS AND INCORPORATING MNE TAX PLANNING**

ETRs for simple cross-border investment are conceptually relatively easy. Standard modelling practice assumes a direct holding structure, with conventional sources of finance. The structure involves a parent company (PCo) in a home country using retained earnings, borrowed funds, and new equity capital to invest in equity shares and debt securities of a foreign operating affiliate (OpCo) in a host country. OpCo uses capital injected by PCo, together with its retained earnings, to purchase physical capital used in production. The standard modelling approach assumes immediate payment of net earnings to the parent (that is, no deferral). Interest payments by OpCo are deductible (as are interaffiliate royalty payments and service fees), reducing host-country corporate tax, while receipts by PCo may be subject to home-country tax.

Even such a simple approach requires a lot of data collection. Information is needed on withholding taxes, home-country taxation (that is, exempt treatment of foreign dividends or a credit for foreign tax paid on foreign profit), and any special provision under a double taxation agreement. Examples of research that covers cross-border investment include studies by the Organisation for Economic Co-operation and Development (OECD), Chennells and Griffith, and Spengel et al. Tax planning in such a setting is limited to shifting profits from the high-tax to the low-tax country by using transfer pricing or leverage.

Multinational enterprises (MNEs), however, typically use more complicated structures than simple cross-border investment. Triangular structures involving an intermediate financing/holding affiliate in a no/low-tax country and the use of hybrid securities can fundamentally alter tax results. Triangular structures may significantly reduce host-country tax, while also enabling avoidance of home-country tax. Suppose that PCo injects equity to capitalize a wholly owned intermediate affiliate (IntCo) in a no/low-tax country. IntCo is capitalized with equity rather than debt, to avoid home-country tax on interest income. IntCo capitalizes OpCo with equity and debt, and OpCo uses the capital to purchase physical capital used in production. IntCo also licenses to OpCo intangible property...
(for example, patents), transferred to IntCo under a cost-sharing agreement with 
Pco under which the buy-in for IntCo’s rights to the intangible reflects only a frac-
tion of Pco’s research and development (R & D) expenditure used to create it.

Such a structure provides tax savings by enabling avoidance of home-country tax 
on foreign interest, royalty, and other payments deductible against the host country’s 
tax base. Compared with the direct structure, tax-planning incentives are increased 
to thinly capitalize OpCo with debt and strip out earnings as deductible interest.¹⁵

The incentive to overcharge (use non-arm’s-length prices) on interest and royalty 
payments to IntCo also rises.

A central tax-planning advantage offered by triangular structures is the avoidance 
of home-country corporate tax on interest income on an interaffiliate loan, assuming 
use of a conventional debt instrument. Another strategy is to use a hybrid instrument 
that is regarded as conventional debt, with deductible interest, by the host country 
but as equity, with exempt or lightly taxed dividends, by the home country.

Analysis by Clark¹⁶ signals the need to address MNE tax-planning strategies when 
measuring and interpreting the impact of ETRs on foreign direct investment (FDI). 
ETRs shown in figure 2 assume that Pco borrows in the home country to finance 
investment in OpCo in the host country. Pco deducts interest against domestic in-
come, taxed at a 30 percent statutory corporate rate. Business profit is subject to 
host-country corporate tax at a 15 percent statutory rate, with a 5 percent dividend 
withholding tax. Tax depreciation is assumed to match economic depreciation.

The first case (EATR_1, EMTR_1) assumes direct investment by Pco in equity 
shares of OpCo, with tax-exempt treatment of dividends received by the parent. 
EATR_1 is 4.1 percent, and EMTR_1 is −16 percent. The low EATR and negative 
EMTR (implying a tax subsidy) arise with FDI financed by debt, interest expense 
deducted at 30 percent, and earnings taxed at 18.8 percent. In the second case 
(EATR_2, EMTR_2), Pco capitalizes OpCo with equity and a hybrid instrument, with 
financing weights of 65 percent and 35 percent respectively. Payments on the hybrid 
are deductible as interest and received as tax-exempt dividends yielding lower ETRs.

¹⁵ Thinly capitalizing OpCo provides tax savings where the home country operates a dividend 
exemption or dividend credit system, regardless of the statutory corporate tax rates in the home 
and host countries. Avoidance of home-country tax on earnings retained by IntCo assumes the 
absence or avoidance of controlled foreign company (CFC) rules in the home country that would 
tax Pco on a current basis on interest and royalty income, paid out of active business income, 
received by IntCo. Many countries do not have CFC rules or do not apply them to such 
income (instead targeting income earned on portfolio securities and possibly other income, such 
as foreign-based company income). Even with CFC rules, hybrid entities or other structures or 
instrumerts may enable avoidance. Other provisions may be in place to safeguard host- and 
home-country tax bases. The host country may have thin capitalization rules that limit leveraging; 
the home country may have interest allocation rules that limit interest deductions against domestic 
taxable income (for example, on interest paid on funds borrowed to capitalize IntCo); or tracing 
rules may be used (though these are difficult to enforce, given the fungible nature of capital) to 
assign to foreign income interest costs on funds used to finance foreign direct investment.

¹⁶ Clark, supra note 5.
The third case assumes a triangular structure in which OpCo is capitalized with equity and conventional debt, and 50 percent of earnings are paid out as deductible interest and received tax-free by IntCo. ETRs fall even further then. These results illustrate how aggressive tax planning can significantly lower the corporate-level tax burden on investment.

The implication is that standard ETRs may not be particularly informative about incentives faced by MNEs that have access to advanced tax planning. And while the structures considered here go beyond the standard modelling of ETRs, they are still highly stylized, since MNEs may use even more complicated structures involving additional countries and intangibles.17

**POLICY APPLICATIONS OF ETR ANALYSIS**

**International Comparisons of Tax Systems**

ETRs are often used as indicators of the relative “competitiveness” of tax systems. The federal government of Canada, for example,18 presents EMTR analysis comparing the Canadian and US tax systems. Cross-country EMTR analysis took a prominent


18 Canada, Department of Finance, Tax Expenditures and Evaluations 2005 (Ottawa: Department of Finance, 2005).
role in Canada’s 2006 federal budget,\(^{19}\) where the federal government announced its goal of having the lowest EMTR among Group of Seven (G7) countries by 2010. This target initiated a tax reform agenda for successive budgets, including accelerated depreciation (capital cost allowance) for investments by manufacturing and processing firms. The measures were calculated to reduce Canada’s EMTR to 28.6 percent by 2011, as shown in figure 3. The analysis detailed further reforms that would be necessary to reduce Canada’s EMTR further to be the lowest among G7 countries.\(^{20}\)

The US President’s Framework for Business Tax Reform\(^{21}\) uses detailed ETR analysis to build a case for proposed tax reform measures to support the competitiveness of US businesses. The analysis shows that while the statutory corporate tax rate in the United States is relatively high, the EMTR on investment, at 29.2 percent, is competitive and below the average of other G7 countries. Bilicka and Devereux\(^{22}\) report a cross-country ranking analysis using ETRs for 2012, as well as for future years based on proposed tax reforms. The University of Calgary School of Public Policy\(^{23}\) provides an annual comparison of EMTRs.

ETRs have also been used to analyze comparative developments of tax systems over time. Devereux et al.,\(^{24}\) for example, find that the net impact of tax reforms in advanced countries has tended to raise EMTRs and lower EATRs, as tax bases have been broadened and tax rates narrowed. Loretz\(^{25}\) uses more recent data and finds that the downward trend in EATRs has continued, but that tax bases have stabilized. Abbas and Klemm\(^{26}\) consider developing and emerging economies and find that the general developments have mirrored those in advanced economies, but that the presence of tax incentives has created parallel tax systems, with ETRs close to zero,

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19 Canada, Department of Finance, 2006 Budget, Budget Plan, May 2, 2006, at 73-75.
20 The suggested harmonization of sales taxes (see figure 3) has still not been completed; three provinces—Manitoba, Saskatchewan, and British Columbia—continue to levy their own retail taxes.
22 Katarzyna Bilicka and Michael Devereux, CBT Corporate Tax Ranking 2012 (Oxford: Oxford University Centre for Business Taxation, 2012).
for qualifying investment. Abramovsky et al.\textsuperscript{27} also document trends among developing and emerging economies and find that those with the lowest incomes have particularly steep reductions in EMTrs, driven by narrowing tax bases.

**Identifying Tax Distortions to Investment**

Another use of ETrs is to identify non-uniform tax distortions to investment, where one type of investment has a different ETR from another. While this is sometimes intended (for example, in the case of an R & D incentive), it is often the accidental result of the interaction of many tax provisions. Tax systems may distort investment decisions regarding what assets to invest in, what sectors to invest in, whether to structure a business in corporate or non-corporate form, what location to invest in (which country or region), and how to finance an investment.

Figure 4, for example, shows EMTR variations in the United States by asset type, business form, and type of finance. The deduction for interest expense combined with accelerated depreciation for capital costs can even result in a negative EMTR,

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure3.png}
\caption{Predicted EMTRs in G7 Countries in 2011}
\end{figure}

CCA = capital cost allowance.
EMTR = effective marginal tax rate.
Notes: The 2011 EMTRs predicted in the 2007 budget included all legislated policy initiatives to be effective by 2011. They exclude resource and financial sectors, and research and development assets.
Source: Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, at 235, chart 5.3.

\textsuperscript{27} Laura Abramovsky, Alexander Klemm, and David Philips, “Corporate Tax in Developing Countries: Current Trends and Design Issues” (2014) 35:4 Fiscal Studies 559-88.
implying a tax subsidy. A negative EMTR indicates a tax distortion that favours investment relative to the no-tax case (that is, a larger capital stock than would be observed with no corporate tax on investment).

**Analyzing Effects on Investment of Detailed Tax Reform**

Tax reform often involves a number of tax-rate and base changes, some encouraging and others discouraging investment, while ETRs allow gauging of the net effect. A recent EMTR study by Ernst & Young, for example, analyzes the net effect of a reduction in the statutory corporate tax rate in the United States, financed by a limitation on corporate deductions for interest expense. The proposal reduces allowable interest expense deductions of corporations by 25 percent, by limiting interest deductions to the non-inflationary (real) component. The resulting revenue gain is estimated to cover the cost of reducing the statutory corporate tax rate by 1.5 percentage points. The net combined effect is an overall increase in the corporate

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EMTR of 2.1 percentage points (a 6.7 percent increase in the EMTR)—a result that is not surprising since depreciation allowances are particularly valuable for marginal investment.

Cost-Benefit Analysis of Tax Incentives

ETRs are also a key input to cost-benefit analysis of tax incentives, where they are used to estimate the investment response to tax relief. This then allows comparison of the cost to society of forgoing corporate tax revenue when providing tax relief with benefits linked to additional investment resulting from the incentive.

Estimating the investment response to a tax incentive requires, in broad terms, two measures.\textsuperscript{29} One is the percentage change in investment, resulting from a change in the ETR on investment. The other is the change in the ETR caused by the tax incentive. ETRs are used as explanatory variables in econometric work examining determinants of investment, with estimated coefficients on an ETR providing a measure of the sensitivity of investment to tax changes. Also, formulas used to measure ETRs allow calculation of the change in an ETR with the introduction of an incentive.

\textbf{INTERPRETATION OF ETRS}

Because ETRs are used in so many contexts, it is important that analysts and policymakers understand their meaning. This is complicated by various pitfalls in the interpretation of ETRs. The points are of a general nature, but they become particularly acute when taking into account tax holidays and MNEs, which increase the possible range of ETRs, as well as the likelihood of negative rates.

The EMTR is the simpler rate to interpret. It shows by how much the tax system affects the cost of capital. This is therefore the relevant rate determining tax effects on investment at the margin. A lower EMTR would mean greater incentives to invest and typically lead to a greater capital stock. The precise interpretation of an EMTR depends on whether it is calculated using in the denominator the tax-inclusive cost of capital\textsuperscript{30} or the tax-exclusive cost of capital. In case of the tax-inclusive denominator, the EMTR can become extremely high in absolute value, because the after-tax cost of capital can be close to zero. The EMTR may be negative, since the combination of interest deductibility and depreciation allowances can provide tax relief that more than offsets tax on the entire return on investment. Negative tax rates imply

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\textsuperscript{29} In addition to estimates of the sensitivity of investment to taxation (tax elasticity—the change in the ETR on investment caused by the tax change), cost-benefit analysis requires information on the marginal social cost of funds (taking into account efficiency losses incurred when higher taxes are levied to finance a tax incentive) and an assessment of spillover effects of the incentive (for example, on real wages/employment income) and possibly other effects (for example, effects on pre-tax rates of return resulting from technology spillovers), depending on the host country in question and whether investment is by domestic or foreign investors.

\textsuperscript{30} This is the case in Devereux and Griffith, supra note 3, and the appendix to this article.
that investment is subsidized, but they are meaningful only for firms that are able to claim tax losses (against profits from other or future activities). Otherwise, the tax rate cannot be less than zero, since (with very few exceptions) treasuries do not pay out tax refunds to loss-making firms.

The EATR is relevant for a firm expecting to earn an economic rent from a discrete investment—for example, because of a patented technology. Investors would be interested in the extent to which the pre-tax rent is reduced by the tax system. In practice, it is hard to think of a completely discrete investment project. Even if rents are earned from a given project, the scale of the project (in terms of size or quality of the investment goods) is determined by the EMTR. Because the EMTR differs across countries, the scale of a discrete investment project will also differ, and in turn the expected pre-tax rent will differ. Assuming a fixed pre-tax rate of profit in international comparisons is therefore a shortcut.\footnote{More generally, the pre-tax rate of profit would also differ depending on production costs, such as labour costs or access to infrastructure.}

All ETRs depend not only on tax but also non-tax parameters, such as inflation rates, which determine the real value of depreciation (since this is given in nominal terms). Whether non-tax parameters should be variable in an analysis depends on the purpose of a study. If the aim is to compare tax systems, imposing common non-tax factors may help in revealing differences in the tax code that would otherwise be mixed up with macroeconomic differences. An investor considering an international venture, however, would be interested in the actual ETRs as they apply given the macroeconomic environment in different markets.

Interpretation of ETRs can also become difficult when shareholder-level taxes are included. In the Devereux and Griffith framework,\footnote{Devereux and Griffith, supra note 3.} adding interest taxation typically reduces ETRs, because this has the effect of reducing the discount rate of investors, whose alternative is a financial investment in an interest-bearing instrument. The overall impact of shareholder-level taxes depends on the interplay of taxes on dividends, capital gains, and interest.

A particularly important point, however, is the multitude of ETRs. In making international comparisons, it is tempting to speak of the EMTR or the EATR of a particular country. But instead there is an infinite number of rates depending on the details of an investment, such as the choice of assets, the expected profitability, and the source of financing. And the ranking of countries is not stable across measures; some tax systems are particularly attractive at the margin, others at high rates of profitability. Most systems encourage debt finance, but some may have limiting rules. It is possible to come to an average rate by using an economy-wide average of the discount rate, the leverage ratio, asset allocation, etc. But such an average rate would not capture the incentives for any actual investment project, which depend on its particular characteristics.
CONCLUSION

In this article, we have discussed how ETRs can be calculated in the presence of tax incentives and tax planning by multinationals. Our main conclusion is that these additional considerations pose no theoretical problem, but that some of the general difficulties in interpreting ETRs become even more acute.

Specifically, while policy analysts may often wish to know the EATR or EMTR of a particular country, there is instead a multitude of ETRs. Not only the level of the ETR, but even the ranking of countries, depends on various assumptions about the assets invested in, rates of profitability, sources of finance, qualification for tax incentives, and access to tax-planning strategies. A high-tax country, for example, could have low ETRs when debt finance is used and no limitation on interest deductibility applies. Tax incentives can have dramatic effects and reduce tax rates to close to zero for qualifying investment.

Still, ETRs can play a very important role in policy analysis. In the cross-country context, they can be useful, provided that researchers do not look at single rates but at a broad range of tax rates. ETRs can provide insights into which types of investment are favoured in what countries, and to what extent tax incentives or tax planning undo the effect of the underlying tax system. Also, for the purposes of analyzing a particular reform—for example, the introduction of a tax incentive—ETRs conveniently put together the sometimes offsetting effects of various aspects.

APPENDIX DERIVATION OF EFFECTIVE TAX RATES

Following the Devereux and Griffith approach and notation, as extended by Klemm, we define the effective average tax rate (EATR) as follows:

\[
EATR = \frac{R^* - R}{p / (r + \delta)}
\]

where \(R^*\) is the present discounted value (PDV) of the economic rent earned in the absence of taxation, \(R\) is the same in the presence of taxation, \(p\) is the pre-tax net profit, \(r\) is the real interest rate, and \(\delta\) is true economic depreciation. The PDV of the economic rent must be equivalent to the change in the value \((V)\) of the firm, where \(d\) indicates the change:

\[
R = dV = \sum_{j=0}^{\infty} \frac{\gamma D_{j+1} - dN_{j+1}}{(1 + \rho)^j}
\]

where \(D\) are dividends; \(\gamma = (1 - m^d)/(1 - z)\) is a factor measuring the difference in treatment of new equity and distributions, with \(m^d\) representing the personal tax

33 Ibid.
34 Klemm, supra note 4.
on dividends and \( z \) the tax on capital gains; \( N \) is new equity issues; and \( \rho = i(1 - m')/(1 - z) \) is the investor’s discount rate, with \( m' \) representing the personal tax rate on interest and \( i \) the nominal interest rate. Dividends are determined by the flow of funds equation

\[
D_t = (\rho + \delta)(1 + \pi)K_{t-1}(1 - \tau) - I_t + B_t - (1 + i(1 - \tau))B_{t-1}
\]

\[+ \tau\phi(t, + K_{t-1}) + N_t \tag{3}\]

where \( \pi \) is the inflation rate, \( K \) is the capital stock, \( \tau \) is the corporate tax rate, \( I \) is the investment undertaken, \( B \) is new debt issued, \( \phi \) is the official depreciation allowance, and \( K^T \) is the tax-written-down value of capital.

Consider now the impact of a one-time permanent investment (that is, \( dl_t = 1, dl_{t+s} = 0, \) for any \( s > 0 \)). Using this and substituting (3) into (2), the tax-free PDV of profits can be easily derived by setting all taxes to zero:

\[
R^* = \frac{\rho - \tau}{\rho + \delta}. \tag{4}\]

In the presence of taxation, the derivation is more complicated. Assume initially that the investment is financed by retained earnings (that is, \( B = N = 0 \)),\(^{35}\) which yields

\[
R^{PE} = \gamma \left[ \sum_{s=1}^{\infty} \frac{(\rho + \delta)(1 - \tau)(1 + \pi)^s(1 - \delta)^{s-1}}{(1 + \rho)^s} - \sum_{s=0}^{\infty} dl_{t+s} + \tau\phi \sum_{s=0}^{\infty} dl_{t+s} + dK_{t-1+s}} \right] \tag{5}\]

\[
= \gamma \left( \frac{(\rho + \delta)(1 + \pi)(1 - \tau)}{\rho - \pi + \delta(1 + \pi)} - 1 + A \right)
\]

where \( A \) is the PDV of depreciation allowances.\(^{36}\)

Starting from equation (5), it is then possible to add special regimes. As an example, consider a reduced tax rate of \( \tau' \) (zero in case of a tax holiday), which applies for \( Y \) years:

\[
R = \gamma \left( \frac{(\rho + \delta)(1 + \pi)}{\rho - \pi + \delta(1 + \pi)} \left( 1 - \tau' \right) \left( \frac{(1 - \delta)(1 + \pi)}{1 + \rho} \right)^Y - 1 + A \right). \tag{6}\]

---

35 Additional financial effects apply if debt \( F_{DI} = \frac{\gamma(1 - \tau\phi)(\rho - i(1 - \tau))}{\rho + \delta(1 + \pi) - \pi} \) or new equity \( F_{NE} = (\gamma - 1)(1 - \tau\phi) \) is used to finance the investment.

36 This depends on the depreciation scheme: for example, for declining balance: \( A = \frac{\tau\phi 1 + \rho}{\rho + \phi} \); for straightline, \( A = \frac{\tau\phi (1 + \rho)}{\rho} \left( 1 - \left( \frac{1}{1 + \rho} \right)^{1/\phi} \right) \). More complicated schemes are also possible.
Similarly, the PDV of depreciation allowances and any financial effects need to reflect the change in the tax rate.37 Other special regimes can be added equivalently. An investment allowance, for example, would enter into the calculation of $A$. (Care needs to be taken to distinguish between investment allowances, which are in addition to depreciation, and first-year allowances, which reduce the tax-written-down value of an asset.)

To calculate the EMTR, the post-tax economic rent $R$ (equation (6) plus any financial effect $F$) is set equal to zero. Solving for the required level of pre-tax net profit ($\tilde{p}$),

$$\tilde{p} = \frac{(1 - A - F/\gamma)(\rho + \delta(1 + \pi) - \pi)}{(1 + \pi)\left(1 - \tau' - (\tau - \tau')\left(\frac{(1 - \delta)(1 + \pi)}{1 + \rho}\right)^\gamma\right)} - \delta. \tag{7}$$

The EMTR can then be calculated by obtaining $R^*$ for $\tilde{p}$ and substituting into (1), or equivalently as

$$EMTR = \frac{\tilde{p} - r}{\tilde{p}}. \tag{8}$$

\begin{footnotesize}
37 Declining balance depreciation, $A = \frac{1 + \rho}{\phi + \rho}\left(\tau' + (\tau - \tau')\left(\frac{1 - \phi}{1 + \rho}\right)^\gamma\right)$; straightline depreciation, $A = \frac{\phi(1 + \rho)}{\rho}\left(\tau' + (\tau - \tau')\left(\frac{1}{1 + \rho}\right)^\gamma - \tau\left(\frac{1}{1 + \rho}\right)^{1/\phi}\right)$, $F^{NE} = (\gamma - 1)(1 - \tau\phi)$, and $F^D = \frac{\gamma(1 - \tau\phi)}{\rho - \pi + \delta(1 + \pi)}\left(\rho - i(1 - \tau') + i(\tau - \tau')\right)\left(\frac{(1 - \delta)(1 + \pi)}{1 + \rho}\right)^\gamma$.
\end{footnotesize}
Douglas J. Sherbaniuk
Distinguished Writing Award

Catherine Brown and Arthur J. Cockfield

Catherine Brown and Arthur J. Cockfield are the 2014 recipients of the Canadian Tax Foundation’s Douglas J. Sherbaniuk Distinguished Writing Award. Their article, “Rectification of Tax Mistakes Versus Retroactive Tax Laws: Reconciling Competing Visions of the Rule of Law,” was published in (2013) 61:3 Canadian Tax Journal 563-98. The article was selected by a committee of experienced tax professionals as the best writing published by the Foundation in 2013-14. The award, which is conferred annually, is named for the Foundation’s late director emeritus.

Catherine Brown received her BA and LLB from the University of Windsor and her LLM from Dalhousie University. She is a professor in the Faculty of Law at the University of Calgary, where she has been teaching since 1981. Arthur Cockfield received his HBA from Western University Ivey Business School, his LLB from Queen’s University, and his JSM and JSD degrees from Stanford University. He is currently a professor with Queen’s University Faculty of Law.
Prix d’excellence en rédaction
Douglas J. Sherbaniuk

Catherine Brown et Arthur J. Cockfield


Catherine Brown a obtenu un baccalauréat ès arts et un baccalauréat en common law de l’Université de Windsor et une maîtrise en droit de l’Université Dalhousie. Depuis 1981, elle est professeure à la faculté de droit de l’Université de Calgary. Arthur Cockfield a obtenu un baccalauréat en administration de l'Ivey Business School de l’Université Western et a obtenu des diplômes JSM et JSD de l’Université Stanford. Il est présentement professeur à la Faculté de droit de l’Université Queen’s.
Canadian Tax Foundation Regional Student-Paper Awards

Each year, the Canadian Tax Foundation awards up to four regional student-paper prizes. Depending on the merit of the papers received, one prize may be awarded for each of four regions of the country: Atlantic Canada (the Canadian Tax Foundation-McInnes Cooper Award); Quebec (the Canadian Tax Foundation-Osler Hoskin Harcourt Award); Ontario (the Canadian Tax Foundation-Fasken Martineau DuMoulin Award); and western Canada (the Canadian Tax Foundation-Bert Wolfe Nitikman Foundation Award). Papers must be written as a requirement of a tax-related course, including directed research courses, and can address any aspect of the Canadian tax system, including comparative analyses, tax policy, tax compliance, tax planning, and tax system design. Papers may be written in either English or French and must be recommended for award consideration by the professor or instructor of the course.

Papers will be reviewed by three independent reviewers, and abstracts (of 400 words or less) of the award-winning papers will be published in the Canadian Tax Journal. The authors of the winning papers will also receive a cash prize from the firms or institutions sponsoring the awards and a one-year membership in the Foundation, entitling them to receive complimentary copies of many of the currently issued Foundation publications, including the Canadian Tax Journal, Canadian Tax Highlights, Tax for the Owner-Manager, and the annual tax conference report, along with one year of complimentary access to TaxFind, the Foundation’s online research database. As members of the Foundation, winners can also take advantage of generous discounts on other publications as well as discounted registration fees for Foundation conferences and courses.

Submissions to the student-paper competition should be addressed to the Canadian Tax Foundation, Student-Paper Competition, 595 Bay Street, Suite 1200, Toronto, ON M5G 2N5, or e-mailed to CTF_Awards@ctf.ca. Entries must be accompanied by a letter of recommendation from the professor or instructor of the tax course for which the paper was written and must include the student’s name and e-mail address if known. The submission deadline for the 2014-15 academic year is June 30, 2015.
The Canadian Tax Foundation-Fasken Martineau DuMoulin Award for Ontario

Jason T. Kujath (2013-14 recipient)

The Canadian Tax Foundation is pleased to announce that Jason T. Kujath is the winner of the Canadian Tax Foundation-Fasken Martineau DuMoulin Award for the best Ontario paper of 2013-14 dealing with an aspect of Canadian taxation.

Mr. Kujath’s paper, “Client-Privilege in the Context of Tax Advice” was written for the LLM program at Osgoode Hall Law School. Mr. Kujath holds a Juris Doctor from the University of Windsor, Faculty of Law, and a bachelor of commerce degree. He is an associate at Felesky Flynn LLP in Calgary.

Abstract

Privilege is fundamental to the rule of law. Confidential communication between a client and lawyer is pivotal for the proper administration of justice. If afforded privilege, tax memoranda, notes of tax advice, or other documents that set out or show the advice and reasoning or analysis provided to a client are protected from disclosure. The paper sets out the essential principles of privilege and highlights why privilege, as a fundamental concept to the proper administration of justice, does not apply to communications other than those made with a lawyer for a legal purpose.
The Canadian Tax Foundation is pleased to announce that Adam Drori is the winner of the Canadian Tax Foundation-Osler Hoskin Harcourt Award for the best Quebec student paper of 2013-14 dealing with an aspect of Canadian taxation.

Mr. Drori’s paper, “Price Related Terms in Agreements for the Purchase and Sale of a Business,” was written for the Masters of Law program at HEC Montreal. Mr. Drori obtained a bachelor of arts degree from McGill University in 2007 and civil and common-law degrees from McGill University in 2010, all with honours. While completing his law degrees at McGill, he was the recipient of the Mackay Award in Corporate Taxation as well as the Speigel Sohmer Taxation Scholarship. He has practised tax law at Stikeman Elliott LLP since his admission to the Quebec bar in 2013.

Abstract

This paper discusses the tax consequences that can arise from certain commercial terms relating to purchase price that are commonly found in purchase and sale agreements.

The first section addresses the allocation of purchase price in an asset deal, and specifically the risk of a reallocation by the Canada Revenue Agency under section 68 of the Income Tax Act. It analyzes the leading case law on reallocations, the Federal Court of Appeal decision in Transalta Corporation v. R (2012 FCA 20), and focuses on reallocations between goodwill and other assets.

The second section addresses the tax consequences of holdback and escrow clauses that secure a vendor’s indemnification obligations under the agreement and focuses on the availability of reserves and issues relating to interest.

The last section addresses the tax consequences (certain and less so) relating to conventional and reverse earnouts and focuses on how the outcome may vary depending on whether the deal is an asset or share deal and whether the vendor is a Canadian resident or non-resident.
Prix régionaux du meilleur article par un étudiant de la Fondation canadienne de fiscalité

Chaque année, la Fondation canadienne de fiscalité (FCF) décerne jusqu’à quatre prix régionaux pour des articles rédigés par des étudiants. Selon la qualité des articles qui ont été soumis, un prix peut être décerné pour chacune des quatre régions du pays: le Canada atlantique (le Prix FCF — McInnes Cooper); le Québec (le Prix FCF — Osler Hoskin Harcourt); l’Ontario (le Prix FCF — Fasken Martineau DuMoulin); et l’Ouest canadien (le Prix FCF — Bert Wolfe Nitikman Foundation). Les articles doivent avoir été rédigés dans le cadre d’un cours lié à la fiscalité, comprenant les cours de travaux dirigés, et ils peuvent porter sur tout aspect du régime fiscal canadien, y compris les analyses comparatives, la politique fiscale, l’observation des règles fiscales, la planification fiscale et la conception du régime fiscal. Les articles peuvent être rédigés en anglais ou en français et une lettre de recommandation du professeur ou du chargé d’enseignement du cours doit être au dossier.

Les articles sont évalués par trois examinateurs indépendants, et des précis (de 400 mots ou moins) des articles primés seront publiés dans la Revue fiscale canadienne. Les auteurs des articles primés recevront aussi une récompense en argent des organismes ou des sociétés qui commanditent le prix ainsi qu’une adhésion d’une année à la FCF, leur donnant le droit de recevoir des exemplaires gratuits d’un grand nombre d’ouvrages publiés par la FCF, dont la Revue fiscale canadienne, les Faits saillants en fiscalité canadienne, Actualités fiscales pour les propriétaires exploitants, ainsi que le Rapport de la conférence annuelle en fiscalité, avec un accès annuel à TaxFind en ligne, l’outil de recherche électronique de données de la FCF. À titre de membre de la FCF, les lauréats bénéficient également de réductions appréciables sur le prix d’autres publications ainsi que de frais d’inscription réduits pour les conférences et les cours offerts par la FCF.

Les dossiers de participation au concours du meilleur article rédigé par un étudiant doivent être transmis par la poste à la FCF, Concours du meilleur article rédigé par un étudiant, 595 Bay Street, bureau 1200, Toronto, ON M5G 2N5, ou par courriel à CTF_Awards@ctf.ca. Les dossiers doivent être accompagnés d’une lettre de recommandation du professeur ou du chargé d’enseignement du cours en fiscalité dans le cadre duquel l’article a été rédigé ainsi que des nom et adresse courriel de l’étudiant si connue. La date d’échéance de présentation des dossiers pour l’année universitaire 2014-15 est le 30 juin 2015.
PRIX DE LA FONDATION CANADIENNE DE FISCALITÉ-FASKEN MARTINEAU DUMOULIN POUR L’ONTARIO

Jason T. Kujath (Récipiendaire 2013-14)

La Fondation canadienne de fiscalité a le plaisir d’annoncer que monsieur Jason T. Kujath est le lauréat du Prix FCF-Fasken Martineau DuMoulin pour le meilleur article d’un étudiant 2013-14 de l’Ontario qui traite d’un aspect de la fiscalité canadienne.

L’article de M. Kujath « Client-Privilege in the Context of Tax Advice » a été rédigé dans le cadre du programme de maîtrise en droit d’Osgoode Hall Law School. M. Kujath détient un Juris Doctor de la faculté de droit de l’Université de Windsor ainsi qu’un baccalauréat en commerce. Il travaille à Calgary chez Felesky Flynn LLP.

PRÉCIS

Le privilège est fondamental à la règle de droit. La communication confidentielle entre le client et l’avocat est un pivot à une bonne administration de la justice. Un mémorandum fiscal, les notes d’une opinion fiscale ou tout autre document qui fait état de l’opinion, du conseil ou de l’analyse et qui est couvert du privilège, assure une non-divulgation au client. Cet article énonce les principaux principes du privilège et il souligne pourquoi le privilège, à titre de concept fondamental à une bonne administration de la justice, ne s’applique pas aux communications autres que celles faites avec un avocat dans un but légal.
PRIX FCF-OSLER HOSKIN HARCOURT
POUR LE QUÉBEC

Adam Drori (Récipiendaire 2013-14)

La Fondation canadienne de fiscalité a le plaisir d’annoncer que monsieur Adam Drori est le lauréat du Prix FCF-Osler Hoskin Harcourt pour le meilleur article d’un étudiant 2013-14 du Québec qui traite d’un aspect de la fiscalité canadienne.


PRÉCIS

Cet article discute des conséquences fiscales qui découlent de certains termes commerciaux relatifs au prix de vente et qui se retrouvent fréquemment dans les contrats d’achat-vente.


La seconde partie porte sur les clauses de retenues et clauses d’entiercement qui garantissent les obligations d’indemnisation du vendeur en vertu de l’entente et elle porte plus particulièrement sur la disponibilité des réserves et les problématiques relatives à l’intérêt.

La dernière partie porte sur les conséquences fiscales (plus ou moins) relatives aux clauses d’indexation sur les bénéfices futurs et clauses d’indexation inversées. Elle porte plus particulièrement sur les résultats qui peuvent varier selon que la vente est une vente d’actifs ou d’une vente d’actions et selon que le vendeur est ou non résident au Canada.
FINANCES OF THE NATION

Vivien Morgan*

SURVEY OF PROVINCIAL AND TERRITORIAL BUDGETS, 2014-15

For almost 60 years, the Canadian Tax Foundation published an annual monograph, Finances of the Nation, and its predecessor, The National Finances. In a change of format, the 2014 Canadian Tax Journal introduced a new “Finances of the Nation” feature, which will present a series of articles on topical matters related to taxation and public expenditures in Canada. The first article, published in the third issue for 2014, provided a survey of the 2013-14 provincial and territorial budgets; this article provides a survey of the 2014-15 provincial and territorial budgets.

KEYWORDS: BUDGETS ■ PROVINCIAL ■ TERRITORIAL ■ GOVERNMENT FINANCE ■ REVENUE ■ EXPENDITURES

* Of the Canadian Tax Foundation, Toronto. I would like to thank Alan Davis of PricewaterhouseCoopers LLP, Toronto, for preparing the figures. I would also like to thank Larry Chapman of the Canadian Tax Foundation, Kevin Milligan of the University of British Columbia, Michael Smart of the University of Toronto, and Ken McKenzie of the University of Calgary for their insightful comments.
The upstream loan rules announced on August 19, 2011 and enacted on June 26, 2013 require an analysis of all loans or indebtedness owing to foreign affiliates of a Canadian taxpayer. Taxpayers have now had sufficient opportunity to apply the new provisions to their specific situations, and many have found that there is significant interpretive uncertainty regarding the application of the rules. While some areas of uncertainty have been addressed through administrative announcements by the Canada Revenue Agency, there remain situations where the application of the rules yields results that seem inconsistent with the underlying policy.

This article focuses on two aspects of the rules that in our view require amendment: the repayment requirement in paragraph 90(8)(a) and subsection 90(14) of the Income Tax Act, and the reserve mechanism in subsections 90(9), (11), and (12). After reviewing the policy objectives of the rules, certain technical issues with the aspects of the rules identified above, and the limited planning opportunities currently available to mitigate the negative impact of these provisions, we suggest potential amendments that should be considered.

**KEYWORDS:** LOANS ■ FOREIGN AFFILIATES ■ POLICY ■ MULTINATIONALS ■ SURPLUS ■ RESERVES
In the 2014 federal budget, the government proposed tax measures that eliminate significant tax benefits associated with testamentary trusts. In this article, the author examines the changes to the tax treatment of testamentary trusts included in the budget and the applicable legislation contained in Bill C-43, which was tabled on October 23, 2014. She describes the implications of the 2014 budget, including the ways in which the current use of testamentary trusts will change once the new legislation is implemented in 2016, the resulting changes in estate-planning strategies, the continued uses of testamentary trusts, and possible methods of dealing with established testamentary trusts.

**KEYWORDS:** TESTAMENTARY TRUSTS ▪ ESTATE PLANNING ▪ BUDGETS ▪ GRADUATED RATE ESTATES ▪ QUALIFIED DISABILITY TRUSTS

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Planification fiscale personnelle
Co-rédactrices de chronique : Pearl E. Schusheim* et Gena Katz**

Fiducie testamentaire : les nouvelles règles

Natalie Woodbury***

Dans le budget fédéral de 2014, le gouvernement a proposé des mesures fiscales qui ont pour effet d’éliminer d’importants avantages fiscaux associés aux fiducies testamentaires. Dans le présent article, l’auteure examine les changements apportés au traitement fiscal des fiducies testamentaires dans le budget ainsi que les mesures législatives applicables contenues dans le projet de loi C-43, qui a été déposé le 23 octobre 2014. Elle décrit les répercussions du budget de 2014, incluant les façons dont l’utilisation actuelle des fiducies testamentaires sera modifiée lors de l’entrée en vigueur des nouvelles mesures législatives en 2016, les changements dans les stratégies de planification fiscale qui en découlent, l’utilisation continue des fiducies testamentaires et les traitements possibles des fiducies testamentaires déjà établies.

Mots-clés : Fiducie testamentaire • Planification successorale • Budget • Succession assujettie à l’imposition à taux progressifs • Fiducie admissible pour personne handicapée

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Corporate Tax Planning
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Paid-Up Capital Planning
Ronald E. Nobrega****

Paid-up capital is a key tax attribute relevant to corporations and their shareholders, particularly in the context of distributions and reorganizations. Distributions of paid-up capital are generally received by shareholders on a tax-free basis. The author of this article considers the meaning of stated capital and paid-up capital, and adjustments to paid-up capital stipulated under several provisions of the Income Tax Act. Planning opportunities and pitfalls relating to paid-up capital are reviewed. The application of specific anti-avoidance provisions and the general anti-avoidance rule to transactions involving paid-up capital are also discussed.

Keywords: Capital • Shares • Dividends • Capital Gains • Canada Business Corporations Act • GAAR

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Few practitioners will be surprised to learn of this study’s conclusion, which is that the correspondence emanating from the Canada Revenue Agency (CRA) can be substantially improved. Still, it is surprising to hear this conclusion from the CRA, and many of the details are interesting. For example, many taxpayers and tax practitioners believe that what they are reading is a form letter, and they are right: of every 1,000 letters sent out by the CRA, 959 are automated, 40 are employee-customized, and just 1 is employee-authored.\(^1\)

Siegelvision, a company that specializes in the clarity of communications, made the following main criticisms of CRA correspondence: the information was not well organized, the presentation of this information did not inspire confidence, and the tone used to convey this information lacked empathy. In particular, Siegelvision reviewed the Canada child tax benefit (CCTB) notice of redetermination. The top-most message in the notice is not the urgent issue (you owe money; your CCTB entitlement will be reduced by 50 percent) but instead “keep for your records.” Further, the notice contains four calculations across two pages, making it difficult to understand the relationship among the original benefit, subsequent credits, payments, and the current amount owed. Therefore, it was not surprising that only half of the respondents found that the letter was intended to require them to make a payment; the remaining respondents answered questions concerning the letter’s purpose incorrectly or did not know the letter’s purpose.\(^2\)

Difficulty in understanding the correspondence increases the volume of telephone calls. A survey of CRA enquiries agents posed the following question: “Of the calls answered over the last 12 months, approximately what percentage related to letters or notices sent by the CRA?” The most common answer was 25 to 50 percent.
Further, most agents estimated that 25 percent or more of the calls that related to correspondence involved the public’s inability to understand the correspondence.3

The authors of the study also concluded that the CRA could learn from what tax administrations in the United States, Australia, and Quebec have done to improve correspondence. One page of the study compares the notice of reassessment used by the CRA with that issued by the Internal Revenue Service (IRS). Near the top of the IRS form in bold letters is the amount due. In contrast, the CRA buries this information at the bottom of the page, and it appears in the same font as the main text of the letter (in contrast with the boldface type used for headings).4

Many of the flaws in CRA correspondence can be traced back to the limited usefulness of CRA computer systems for automated correspondence (many of which are described as “legacy” systems, which seems to be the polite term meaning “out of date”). Design and graphics in all CRA correspondence examined by Siegelvision were rated as poor. Blame is placed on the CRA’s electronic letter creation system, which one-quarter of CRA surveyed users found to be hard or extremely hard to use when looking for suitable “verses” to include in letters. A new enterprise correspondence system is much better rated, but it is used in only some regions.5

The CRA notes that beginning from February 2015 to early 2016 its top-volume letters and notices will be available online in simplified formats. This response conceals more than it reveals: does it mean that the better version will be available only through the “my account” and “my business account” services, while the inferior version will continue to be mailed out?

A.M.

David W. Chodikoff, ed., Transfer Pricing & Tax Avoidance
(London: Sweet & Maxwell, 2014), 585 pages

This volume is a collection of articles contributed by practitioners in 32 countries, including Canada. Each article follows the same template and discusses transfer pricing and tax avoidance in a specific country. Transfer-pricing subjects include legislative frameworks, national policy issues, case law, penalties, and dispute resolution mechanisms. Tax avoidance topics include acceptable tax-planning areas and subjects, definitions of abusive tax avoidance, legislative frameworks, key areas of interest, penalties, and current trends. Rothstein J of the Supreme Court of Canada wrote the foreword. He noted the recent phenomenon of “international taxation unexpectedly becoming the subject of popular media attention and discussion” and remarked on the complexities of international rules in one country and the “exponentially greater” level of complexity “when a tax issue arises that involves more

3 At 21–22.
4 At 26.
5 At 32–33.
than one tax system.” He also stated that this volume is an “invaluable resource for assisting readers.”

As a resource book, it provides readers with materials and insights about law that are both theoretical and practical. Even though the arm’s-length principle is adopted by countries in their domestic law and tax treaties, the implementation of the principle seems to differ from country to country, depending on the local process, institutions, and the seriousness of the transfer-pricing issues. For example, Albania and China have no court decisions on transfer pricing, while the courts are becoming involved in resolving transfer-pricing disputes in both common-law countries (such as Canada, Australia, and India) and civil-law countries (such as Finland, France, Germany, Italy, and Malaysia); case law adds nuanced perspectives to the meaning of the arm’s-length principle.

The articles reveal some common patterns and trends across countries. Examples include the following: the Organisation for Economic Co-operation and Development’s (OECD’s) transfer-pricing guidelines6 and its recent base erosion and profit shifting (BEPS) initiative7 are noted by many authors as being relevant to their country’s transfer-pricing system, advance pricing agreements are commonly used to minimize transfer-pricing disputes, penalties are commonly imposed under transfer-pricing regimes, and countries’ approaches to tax avoidance and general anti-avoidance rules are more divergent than their approaches to transfer pricing.

This book is a valuable contribution to tax literature. International tax practitioners and researchers often find it difficult to obtain creditable information in English on the international tax law of non-English-speaking countries. This book addresses that difficulty by including chapters on Albania, Austria, Belgium, Brazil, China, Finland, France, Germany, Greece, Indonesia, Israel, Italy, Japan, Luxembourg, Malaysia, Mexico, the Netherlands, Norway, Russia, Serbia, Spain, Switzerland, and Turkey. Not all chapters contain the same level of depth and substance, but each contains helpful information for some readers.

J.L.


The Congressional Budget Office (CBO) released its annual report on the distribution of household income and federal taxes for 2011. In addition to looking at market income, the authors of the report estimate the amounts and distributional

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effects of government transfers and federal taxes. The CBO examines the distribution of income using the Gini index, which can vary from 1 to 0, with 1 indicating total inequality and 0 meaning complete uniformity. According to the authors of the report, federal taxes and transfers have a meaningful effect in reducing income inequality in the United States. According to the Gini index, income inequality after transfers and taxes was lower in 2011 than it was in 2000.

In the CBO’s terminology, market income refers to labour, capital, and other income earned in markets. Before-tax income is market income plus federal, state, and local transfers (including benefits from programs such as Social Security, Medicare, and unemployment insurance). After-tax income is before-tax income minus federal taxes. In 2011, average household market income was approximately $81,000. Government transfers averaged approximately $13,000 per household. Federal taxes averaged $17,000 per household.

The distribution of before-tax income was uneven: approximately $25,000 for the lowest income quintile, $66,000 for the middle quintile, and $246,000 for the highest quintile. The average federal taxes were $500 (with an average federal tax rate of 2 percent) for households in the lowest income quintile, $7,000 (with an average federal tax rate of 11 percent) for households in the middle quintile, and $58,000 (with an average federal tax rate of 23 percent) for the highest quintile. As a result of the progressive rates, households in the highest quintile paid a greater share of federal taxes in 2011 than they received in before-tax income, while households in each of the other quintiles paid a smaller share of federal taxes than they received in before-tax income. Households in the highest quintile received more than half of total before-tax income and paid more than two-thirds of all federal taxes in 2011. In contrast, households in the lowest quintile received 5 percent of total before-tax income and paid less than 1 percent of all federal taxes.

Thanks to government transfers and taxes, households in the lowest income quintile received about 6 percent of total after-tax income, compared with 5 percent of before-tax income, whereas households in the highest income quintile received about 48 percent of after-tax income, compared with 52 percent of before-tax income. In other words, in percentage terms government transfers and taxes on average raised household income by 55 percent in the bottom quintile and reduced it by 20 percent in the top quintile.

With regard to trends in the distribution of household income and federal taxes between 1979 and 2011, the CBO calculates that inflation-adjusted market income rose by 16 percent for the bottom quintile, 56 percent for the top quintile, and 174 percent for the top 1 percent of households. After taking taxes and transfer payments into account, the inflation-adjusted incomes grew by 48 percent for the bottom quintile, 40 percent for the middle quintile, 67 percent for the top quintile, and 200 percent for the top 1 percent. The rich have got richer very fast since 1979. Overall, though, the CBO found that inequality is 26 percent lower than it would have been if the United States had left the 1979 tax code and income support programs unchanged.

J.L.
In tax law, tax deferred is the same as tax saved. Tax deferral is used as a principal policy instrument to encourage savings for retirement. However, the role of tax deferral is often misunderstood. For example, it is sometimes said that putting capital gains property in a qualified retirement savings account creates a tax disadvantage because the gain will be subject to taxation at full ordinary rates on withdrawal. In this forthcoming article, Professors Halperin and Warren show why the statement is erroneous. They seek to clarify the role of deferral in income taxation by introducing a distinction between “pure deferral” and “counterparty deferral.”

The authors define “pure deferral” to mean any legal rule (whether in the Internal Revenue Code, regulatory materials, or judicial decisions) that defers inclusion of an item of income, relative to economic accrual of the item or acceleration of a deduction. An example of the latter is the expensing of a capital investment. They define “counterparty deferral” as a transaction that permits a taxpayer to defer the inclusion of an item of income relative to economic accrual by shifting taxation of the item in the interim to another party or to an account with different tax characteristics. An example is a qualified retirement savings account.

Through several examples, the authors demonstrate that a pure deferral is equivalent to the exemption of capital income (or a component of it) from tax. The following example is illustrative:

Example 1: In year 0, taxpayer T, whose tax rate is 20 percent, receives wages of $125. T invests the entire amount in unimproved land. With expensing, T owes no taxes in year 0. The land triples in value to $375 by year 3, when it is sold. T owes taxes of $75 in year 3 as his basis is zero, leaving $300 after taxes. The same result could be obtained without expensing by taxing the wages immediately and then exempting the return on the investment. Under this alternative, T owes $25 in taxes in year 0 and purchases $100 of land with his remaining funds. The land appreciates to $300 in year 3, when it is sold. T again has $300 after taxes, because the investment return is exempt. If neither expensing nor exemption were available, T would pay taxes of $25 in year 0 and $40 in year 3 (20% of a gain of $200), leaving $260 after taxes.  

The additional $40 retained by T in the above example can be thought of as the forgone 20 percent tax on the investment return of $200 that would have been earned in the absence of expensing. Other examples are used to illustrate that the benefit of pure deferral is an interest-free loan from the government.

The authors demonstrate in example 4 and other examples that the benefit of counterparty deferral is determined by the tax status of the counterparty:
Example 4: Taxpayer T, whose tax rate is 20 percent, receives wages in year 0. If T contributes $100 of those wages to a tax-exempt qualified account, no taxes are due until an amount is withdrawn during retirement. Assuming that the contribution compounds at 10 percent annually for 20 years and that T’s tax rate does not change, T will withdraw $673 (100 × 1.120), pay $135 in taxes, and retain $538. Alternatively, T could have paid $20 in taxes in year 0 and invested the remaining $80 in a tax-exempt account, which would again produce $538 (80 × 1.120) in 20 years if compounded at 10 percent.9

If the qualified account itself is tax-exempt, the above example shows that a counterparty deferral is equivalent to exemption of investment income. Further, the investment income would be exempt from taxation as long as the qualified account itself is tax-exempt and the tax rate is constant, regardless of whether the contributions are deducted and the withdrawals are included. In effect, the current exclusion/later inclusion system of treating qualified retirement savings has the same effect as full taxation of the original wage or salary to the employee and exemption of the subsequent investment income.

According to the authors, the key role of the tax-exempt status of the account means that qualified accounts are advantageous even for tax-preferred investments that would be taxed at a rate higher than zero outside the accounts. The extent of tax advantage for placing investments in a qualified account depends on how the income would be treated outside these accounts. The statement that capital gains property should not be placed in a qualified account is erroneous because it fails to take into account the tax benefit of deducting (at ordinary income rates) contributions to these accounts. If the tax rate does not change, the benefit will be equal in present value to the burden of ordinary income tax on withdrawal. The point is that the benefit of counterparty deferral is taxation of capital income earned in the interim at the counterparty’s tax rate.

The distinction between pure deferral and counterparty deferral is helpful to appreciating the Canadian deferral rules because they are similar to those in the United States.

J.L.


The distinction between debt and equity is one of the challenging issues in income taxation, especially in the areas of corporate tax and international tax. The recent OECD-G20 BEPS project targets this issue in action 2, “Neutralise the Effects of Hybrid Mismatch Arrangements,” and action 4, “Limit Base Erosion via Interest Deductions and Other Financial Payments.”10 There is no shortage of literature on

9 Ibid., at 9.
10 See Action Plan on Base Erosion and Profit Shifting, supra note 7.
this topic. For example, the debt-equity conundrum was one of the main subjects at the International Fiscal Association’s 2012 annual congress in Boston. This article adds to the rich body of literature by analyzing the demarcation between debt and equity from a comparative perspective and drawing on private laws (corporate law, contract law, and the law of obligations) in suggesting new approaches to domestic and international tax law.

The article consists of three main parts in which the authors discuss equity and debt in private law, domestic tax law, and international tax law. Under the private law of the countries analyzed in the article (Brazil, Germany, France, Greece, the Netherlands, Austria, Switzerland, the United Kingdom, and the United States), the scope of proprietary participation rights available to equity holders, but not debt holders, seems to be an important feature. At its core, equity represents the financial contributions made by a member of a legally binding association of persons under corporate or partnership law for a common commercial purpose. Equity holders have joint control of the assets and the operation of the enterprise, and they share in the profits and losses of the business. Debt holders enjoy the right to the repayment of the capital and the right to the payment of a rate of return. In general, though, the authors note that private law recognizes a continuum of financial instruments that contain various (almost random) collections of property and procedural rights for investors; no distinguishing feature clearly stands out.

In stark contrast to private law, tax law generally adopts a binary classification between debt and equity and prescribes different consequences for debt financing and equity financing of entrepreneurial activity. Under general income tax law, the partners in a partnership are taxed on their share of business profits earned through the partnership, whereas the creditors are taxed on their return on capital—that is, investment income. Under national corporate tax law, dividends are not deductible, giving rise to double taxation of corporate profits that requires special relief mechanisms for dividends at the shareholder level to minimize double taxation. Under international tax law, dividends are generally taxed in the country of residence, whereas interest is generally not subject to withholding tax at source (this is true in the European Union, the United Kingdom, and the United States). However, deduction limits apply to shareholder loans, resulting in a treatment that is not dissimilar to the treatment of dividends at the corporate level.

The authors make some interesting observations about the concepts of income, corporate income tax, and international tax. They state that the basic concept of income—net increase in wealth—does not require that a distinction be drawn between equity or dividend and debt or interest. The fact that a profit share distinguishes itself from fixed interest as a result of its risk profile and volatility is not relevant because income is measured by quantity, and the quality of that income as dividend or interest plays no role in the measurement.

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The authors note that it is necessary to have corporate income tax to capture the retained income of corporations. The corporate tax is a kind of pre-payment of tax by shareholders on their share of the profits, and the existence of a corporate tax raises the issue of double taxation of profits earned through corporations. The pragmatic reason for taxing corporate income is that the double taxation “should only have to be borne in clear cases” of equity holdings. “Equity’s ‘core area’ is comprised of the classic membership holdings (shares in public and private corporate entities).” Hybrid instruments that offer contractual participation rights should not be treated as equity only because there are comparable membership participation rights. In practice, however, as the authors note, countries have different approaches to classifying hybrid instruments as either debt or equity. The authors suggest that the distinction between debt and equity “should fundamentally take into account whether the company (or its organs) makes the decision about the distribution of profits or whether this decision lies in the hands of individual capital investors.”

The authors offer some insights into the treatment of debt and equity under the current international tax rules. In general, these rules treat returns on equity and returns on debt differently: dividends are in principle subject to tax in the state of source of the entrepreneurial activity whereas interest is in principle taxed in the state of residence of the capital investor. The authors explain that the source state has the right to tax profits from entrepreneurial activity in three ways:

1. if the activity is conducted by the non-resident investor through a permanent establishment or partnership, the profit is taxable in the source state;
2. if the activity is conducted through a subsidiary corporation in the source state, profit from the activity is subject to corporate income tax, which functions as a withholding tax on undistributed earnings on equity; and
3. if the earnings are distributed to the non-resident investor, the source state levies a withholding tax on the dividends.

In contrast, the source state often does not tax returns on debt: interest payments are deductible to the corporate borrower, and withholding tax on interest is waived unilaterally (for example, in Germany, the United Kingdom, the United States, and France) or bilaterally via tax treaties. Only developing and emerging countries still insist on levying withholding tax on interest. The domestic laws of many countries have special anti-avoidance rules about shareholder loans (for example, the “interest barrier” and other debt caps rules) to limit the deductions of interest. The treatment of hybrid instruments under domestic law varies from country to country. For example, participation debts are treated as debt in France, but not in the United

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12 At 198.
13 At 198.
14 At 216-17.
15 At 203.
Kingdom, triggering the application of different treaty rules: article 10 or article 11 of the OECD model convention.\textsuperscript{16}

The authors suggest a “new approach”: source taxation should be extensively waived for debt holdings, whereas higher taxation for equity holdings could be enforced. Equity holdings should include not only equity shares under corporate law but also profit-participation loans or shareholder loans. The main justification for the suggestion is that source taxation of equity is anchored in the economic allegiance theory and is not susceptible to tax competition for mobile capital. According to the authors, returns on equity clearly differ from returns on debt in their risk profile and volatility, as well as in the possibility of generating economic rents:

Whereas the usual return on debt depends on no other substantial parameter than the average market interest rate, the prospects of the underlying currency and the risk of insolvency of the debtor concerned, returns on equity depend on the economic prospects of success of the company involved, its geographical situation, the quality of the products, the domestic and international customer markets and further specifics. This means that the investment of equity in a certain enterprise cannot easily be replaced by an investment in a different enterprise in a different state of source. He who acquires shares in a German or US American chemical enterprise in the hope of inframarginal returns or increases in value from this investment will justify this decision with the particular qualities of this particular investment. . . .

The shareholder in a specific corporation simply does not have the possibility of acquiring exactly the same kind of investment in another jurisdiction and is thus less able to benefit from the pressure of tax competition.\textsuperscript{17}

Another rationale for the suggested new approach is consistency in classifying debt and equity to avoid double taxation and double non-taxation in the case of shareholder loans and hybrid instruments.

Overall, the authors shed light on the debt-versus-equity question by going to the core of equity and examining whether the investor is motivated by earning a market-dictated rate of return on capital or sharing the commercial profits of the corporation. Because equity investments are generally location-specific and enterprise-specific and the profits arising from the corporate activities (whether distributed or retained by the corporation) are closely linked to the source state, source taxation is justified. Debt capital is internationally mobile and thus easier for the residence country to tax. The recommendations in this article may not solve the problems of debt bias or base erosion that arise as a result of interest deductions; however, they do offer some insights about addressing BEPS associated with mismatch arrangements.

J.L.


\textsuperscript{17} At 212-13.

Intangibles of multinational corporations (MNCs) present difficulties when applying the arm’s-length standard, largely because they are unique and generate integration value that have no comparables in an arm’s-length situation. They are also mobile and difficult to value. Profits attributable to the integration value, or synergistic gains, cannot be allocated under the existing transfer-pricing methodologies, which respect the separateness of entities under common control and allocate profits by reference to a baseline of uncontrolled, but comparable, situations. The OECD transfer-pricing guidelines are being revised to expand the notion of “intangibles” in the hope of capturing synergistic gains. A question has been raised whether a distinct “synergy intangible” should be introduced to take account of these gains.

In this article, the author argues that it is undesirable to introduce a new category of synergy intangible because it would not reduce the risk of double taxation while achieving a reasonable allocation of tax base across countries. In support of this argument, he introduces a three-part categorization of intangible value arising from the integration of assets: common control value, bilateral integration value, and unilateral integration value. The author also introduces a novel “fractional” interpretation of article 9 of the OECD model, under which the value from common control is not covered by this article. His conclusion is that the value from common control should be left to the discretion of the taxpayer.

Classification of the synergistic gains as three types of value of integration is interesting. The author provides the following illustration of the three values:

1. A Co holds, among other property, two valuable intangible assets: a customer database and a proprietary computer algorithm that is tailored to work with the particular information in the database to produce a ranking of sales leads. Each of these assets is separately legally transferrable. However, if transferred together, they are worth more than the sum of their individual values. This value is described as “unilateral integration value.”

2. If A Co transfers its database to B Co, an unrelated company holding its own customer database (not overlapping with A Co’s database), the two databases are worth something more than the total sum of the independent value of each database. The extra value is “bilateral integration value.”

3. Instead of transferring the database to B Co by means of a contract, the two databases come together because A Co and B Co come under common control or ownership. It is possible that the two databases are worth more than the bilateral integration value mentioned above. This additional value created,

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18 Supra note 6.
19 Supra note 16.
for example, by savings from not having to police contractual abuse, is “value from common control.”

The author explains that unilateral and bilateral integration create very different sorts of value in the sense that the former arises by virtue of ownership (of multiple assets) and the latter arises by virtue of contract (between unrelated owners of assets). Common control value and unilateral integration value are more closely aligned in the sense that the value in each case derives from the ownership of multiple assets. The difference is that one represents gains from ownership and integration within a corporate entity, and the other represents gains from ownership and integration across separate corporate entities that have been brought under common control.

The arm’s-length standard under article 9 cannot accommodate the common control value because “[n]o amount of searching, whether in competitive equilibrium or not, could ever hope to identify a comparable for the value associated with common control.” Bilateral integration value can be allocated, however, because it is possible to find comparables. There may be a range of defensible transfer prices.

The author develops a consensus approach to the arm’s-length standard anchored in a fractional reading of article 9. He suggests that article 9 should not be read as employing the arm’s-length standard to allocate the full amount of profit realized by commonly controlled taxpayers across contracting states. Instead, article 9 should be read as employing the standard to allocate a fraction of the profits—namely, those profits that could have been earned at arm’s length. The author asserts that this approach is consistent with the OECD transfer-pricing guidelines. Article 9 is in fact silent about the allocation of any common control value. Further, article 9 functions as a limitation on transfer-pricing adjustments made by one treaty country in relation to profits reported by the taxpayer. The paramount concern of article 9 is to avoid excessive taxation, not to provide a substantive rule for allocation. This concern differs from the concerns in applying the arm’s-length standard in a domestic context. In the domestic context, tax authorities make adjustments to taxpayers’ reported profits on the basis that the reported profits would otherwise distort the tax liabilities of the associated enterprise.

The author rejects the idea of introducing a novel category of intangible because it would not be based on consensus and would therefore increase the risk of double taxation. He maintains that transfer-pricing analysis should focus on legal ownership of recognized asset categories, whose assets are separately transferrable. Further, gains from common control would be allocated by means of taxpayer discretion following legal ownership. Any attempt to define and allocate this value through a formulary mechanism would result in an outcome that is worse than the status quo. To the extent that the value is reported in a state that is not a treaty country, other anti-avoidance rules, such as the controlled foreign corporation rules, should be followed.

20 At 291.
This article is provocative in its analysis of the synergy gains and its defence of the status quo under its novel fractional reading of article 9. The consensus approach that is defended by the author contradicts the approach taken in the recently revised OECD discussion draft on intangibles, which tends to diminish the weight placed on legal ownership.

J.L.

John F. Avery Jones and Jürgen Lüdicke, “The Origins of Article 5(5) and 5(6) of the OECD Model” (2014) 6:3 World Tax Journal 203-41

Article 5 of the OECD model tax convention defines permanent establishment (PE), a concept that determines if a source country has the right to tax business profits earned by an enterprise resident in the other treaty country. Article 5(5) deems an agent (other than an agent falling within article 5(6)) to be a PE if the agent is acting on behalf of the enterprise and “has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise.” Article 5(6) states that an enterprise is not deemed to have a PE in a contracting state merely because it carries on business there through a broker, general commission agent, or any other agent of an independent status, provided that the agent is acting in the ordinary course of its business. These provisions are well known to international tax practitioners and scholars. They are also known to be manipulated by taxpayers through the use of a commissionaire arrangement under civil law. BEPS action 7 is intended to tackle the issue of “artificial avoidance of PE status.” However, the origins of these two provisions have not been much examined in literature.

In this article, John Avery Jones from the United Kingdom and Jürgen Lüdicke from Germany investigate the origins of articles 5(5) and (6). The original PE article was drafted by the Organisation for European Economic Co-operation (OEEC) working party, consisting of delegates from Germany and the United Kingdom. Avery Jones and Lüdicke consider the history of the agency PE from their particular legal perspectives (common law and civil law, respectively) in order to understand what was in the minds of the working party members. They also draw on material in the UK and German archives concerning the negotiation of the Germany-UK treaty, which was concluded two years before the work for the OEEC working party. One of their important conclusions is the following:

[They] members of the working party] never appreciated the differences in their respective laws of agency which has led to an unsatisfactory result caused by the two legal systems approaching article 5(5) of the current OECD Model in different ways and the exceptions in article 5(6) having different effects in each system.


23 At 203.
The authors first explain the differences between the civil and common law of agency. In civil law, the term “agency” has two very different meanings. As a technical term agency refers to a way of contracting—that is, contracting with a legally binding effect on a third party. In a broader sense, agency describes the relationship between a principal and a person who acts on the account of the principal. In the technical legal sense, in order to conclude a contract that is binding on the principal, the person endowed with a Vollmacht must disclose the principal’s existence to the third party in the process of contracting. In German law, the principle of disclosure is expressed in English as “acting in the name of the principal.” Because a commissionaire buys and sells goods in his or her own name for the account of the principal, the commissionaire does not act as an agent in the technical sense.

Agency has two meanings in common law as well. The term “agent” in its legal sense denotes a person who can represent the principal and in doing so affect the principal’s legal position. The non-legal meaning of the term is wider. Common law is more flexible and recognizes freedom of contract; the contract binds the principal whether or not the principal is disclosed to the third party. The civil law notion of contracting “in the name of” the principal has no meaning in common law. Since virtually all agents’ contracts bind the principal in common law, “on behalf of” and “in the name of” are essentially equivalent terms. Common law does not recognize the distinction between contracts made in the name of the principal (which bind the principal) and contracts made in the name of the agent (which, as in the case of the commissionaire, do not bind the principal). Relying on the historical material, the authors state:

[T]here was little or no common ground between the Englishman, Mr. Leach, who was not a lawyer, and the German, Mr. Mersmann, who was a lawyer, on the law of agency. What is even more important is that the available documents demonstrate that they were unaware of the existence of such a difference.  

The authors provide a detailed discussion of the origin of articles 5(5) and (6), including the UK agency profits treaties in the 1930s; the League of Nations drafts in 1929, 1943, and 1946; the Germany-UK treaties before the OEEC; and the Germany-UK income and capital tax treaty (1954). Article 5(5) originated from a treaty provision and was not designed to be accompanied by an equivalent of article 5(6). Article 5(6) originated from a domestic law provision that had no equivalent to article

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24 At 209.

5(5). The OEEC commentary on what was not a PE was written by Mr. Mersmann, the German representative on the working party, who did not appreciate the differences between common law and civil law. Apparently, the commentary was not read by the English representative, who would have challenged it on the basis that it disqualified a whole class of agents from being able to create a PE.

The authors conclude that articles 5(5) and (6) “do not fit together well”26 because they produce different results in civil law and common law:

While article 5(5) is fairly useless from the common law point of view, and article 5(6) is fairly useless from the civil law point of view, together they manage to give a reasonably similar result under both systems—at least so long as we read only the version in our own language and system of law without asking what it means in another language and system of law.27

J.L.


The author reviews the evolution of article 5 on PEs in approximately 100 bilateral tax treaties concluded by China from 1983 to 2013 in terms of the economic context for cross-border businesses and the administrative interpretation of article 5 by the Chinese State Administration of Taxation (SAT). She draws on a rich body of material published in both Chinese and English and offers some predications about the future development of the PE concept in China’s tax treaties on the basis of the past trends. She takes note of China’s unique position: as a non-OECD member country, it is not bound to follow the OECD model tax convention or the OECD commentaries on article 5. She also notes that China may become a “new force” in the international tax area because of its rising economic position in the global community and its ability to adapt the international tax norms to suit its needs.

The bulk of the article is devoted to a systematic review of article 5. The author discusses the trends in respect of seven key concepts: physical PEs, construction PEs, service PEs, agency PEs, the exceptions clause, insurance PEs, and PEs arising from the exploitation of natural resources. She makes several interesting findings: the text of the relevant article in the treaties and SAT’s interpretation of it draw heavily on the OECD model and commentaries; China’s transition from being a net capital-importing country (a source country) to a net capital-exporting country (a residence country) has been accompanied by movements toward the OECD approach; and SAT’s interpretation of article 5 has become sophisticated, especially in respect of international secondment of personnel, representative offices, and commissionaire structures.

26 At 240.
27 At 241.
This article does not specifically discuss the treaty between Canada and the PRC (1986). However, the general treaty interpretation issues canvassed by the author should be relevant to Canadian businesses operating in the PRC.

J.L.


The authors use Statistics Canada’s tax and transfer model—the social policy simulation database and model—to estimate the revenue impacts of changes in the federal personal income tax, including both rate changes and the abolition of special tax deductions and credits (tax expenditures). The description of the methodology is quite short (less than a page), but in most cases it is not difficult to infer what has been done. Essentially, the authors calculate tax payable with and without a tax change in a sampling of approximately 200,000 tax returns; they then make projections in relation to all taxpayers.

The authors consider three options for federal rate structure changes. Revenue cost amounts are determined on a static basis, without allowing for behavioural changes in response to the new rate structure. Option 1 proposes the elimination of the two middle rates of 22 percent and 26 percent, and extends the present 15 percent rate to the level of taxable income where the 29 percent bracket now starts (at approximately $136,000 of taxable income for 2014); this option provides the cover graphic for the monograph. Option 1 would cost (in forgone revenue) $21 billion. Option 2 raises the threshold at which the 29 percent bracket now starts to $250,000. This option would cost $26 billion. Option 3 builds on option 2 by reducing the top marginal rate from 29 to 25 percent, which increases the cost to $29 billion.

All three options provide substantial rate cuts, amounting to 16 percent, 20 percent, and 22 percent (respectively) of the $130 billion of personal income tax revenue for 2013-14.

Clearly, implementing a rate cut of this magnitude is not politically or economically feasible without offsetting revenue increases. The authors find these increases by proposing the elimination of 68 tax expenditures in the personal income tax; these are listed in table 5. The 57 tax expenditures that are not eliminated are those that move the personal income tax toward a consumption base (such as registered retirement savings plans, registered pension plans, and the non-taxation

28 At 30.
29 At 31.
30 At 20.
31 At 25.
32 At 24, table 4.
of capital gains on principal residences) and those that the authors consider to be benchmark or broad-based features of the system (such as the basic personal exemption and the spousal credit).

The virtue of this article is that it makes a simple point in quantitative terms: rate decreases can be purchased by base broadening—that is, by eliminating some of the major tax credits (and a few deductions). The rate cuts in options 1 to 3 cost between $21 and $29 billion; although this seems unaffordable, abolishing the tax credits listed in table 4 would raise $23 billion. Unfortunately, income distribution is analyzed only in relation to a combination of a rate cut and an abolition of tax expenditures; the impacts of these two phenomena are not shown separately.

Of course, it is easy to question the authors’ choice of credits to eliminate. The authors propose to keep any tax expenditure that moves the system toward a consumption base, even if it benefits a narrow group of people for questionable reasons (for example, farmers who use cash basis accounting). However, some of the tax expenditures proposed for elimination appear to be required to recognize legitimate differences in taxpayers’ ability to pay; despite the authors claims, these expenditures do not appear to be inconsistent with a consumption tax base (for example, disability tax credits and child care expense deductions). The expression “the devil is in the details” applies well to the choice of which tax expenditures should be eliminated. The authors devote only about a page to addressing why the 68 tax credits in table 5 should be eliminated; perhaps a future paper will examine the credits one by one.

A.M.


This is a commendable effort in using broadly similar survey instruments across four countries to compare the cost to small businesses (defined primarily as businesses with 50 or fewer employees) of complying with the goods and services tax (GST), the income tax, and source withholding rules. However, the reliability of the results is disappointing for Canada and the United Kingdom, each of which had a response rate to the invitations to participate of only 1 percent, and each of which produced only 40 or fewer usable responses. One interesting finding was the low level of knowledge about small business tax concessions: in Canada, despite the fact that 100 percent of the respondents were eligible, only 35 percent thought that they were eligible, and 39 percent thought that they were ineligible (the rest were unsure). Another finding was that the tax work that was not outsourced was mostly

33 At 37-39.
34 At 462.
35 At 473.
(60 percent) income tax work in Canada, whereas in the other countries it was mostly (69 percent or above) GST (value-added tax) and source withholding.\(^\text{36}\) In all four countries, only about one-third of tax work (or less) was outsourced.\(^\text{37}\)

Marisa Beck, Nicholas Rivers, Randall Wigle, and Hidemichi Yonezawa,


British Columbia is the first jurisdiction in North America to implement a meaningful carbon tax. Although carbon taxes are criticized as being regressive because low-income people spend a higher proportion of their income on energy, this conclusion is reversed by the present study, which uses a computable general equilibrium model. The BC carbon tax is found to be progressive because it causes a drop in real wages, which affects high income households more dramatically because they are more dependent on labour (and less dependent on government transfers) as an income source. This conclusion is arrived at without considering the use of the money from the carbon tax; when this factor is considered, the BC carbon tax becomes “highly progressive.”\(^\text{38}\)

Jane G. Gravelle,

*Dynamic Scoring for Tax Legislation: A Review of Models*

(Washington, DC: Congressional Research Service, 2014), 35 pages

Estimates of the revenue impact of major tax changes typically allow for some type of behavioural response; for example, investment may increase if taxes on capital are reduced. However, the modelling of behavioural response typically assumes that the gross domestic product (GDP) of the economy stays constant. In contrast, dynamic scoring of the impact of tax changes allows for macroeconomic effects. For example, major tax cuts may increase the GDP, which reduces the revenue cost of the tax cut since it increases the tax base.

Gravelle compares alternative macroeconomic models that can be used for this purpose, without clearly taking a position about which is superior or whether the addition of the GDP change to the model increases or decreases the accuracy of the forecast. However, one point is clear: “No reasonable estimate of the responses of labor supply or savings to tax changes can produce”\(^\text{39}\) a large enough offsetting effect to cause a tax cut to actually increase revenue.

\(^{36}\) At 463.

\(^{37}\) At 466.

\(^{38}\) At 1.

\(^{39}\) “Summary.”

Given the amount of mathematics involved, this is a textbook about taxation and public expenditure economics that is intended primarily for masters and PhD students, rather than undergraduates. It differs from other graduate textbooks in that it covers horizontal and vertical equity in some detail,\(^{40}\) and includes a discussion of the Haig-Simons criterion. As suggested in the title, the emphasis is more on theory than on empirical work. The third edition of this text introduces new chapters on behavioural public sector economics\(^ {41}\) and international public finance.\(^ {42}\)

A.M.

Vincent Chandler, “The Effectiveness and Distributional Effects of the Tax Credit for Public Transit” (2014) 40:3 *Canadian Public Policy* 259-69

The author examines data on transit ridership in six major Canadian cities and finds that the introduction of the transit credit in 2006 appears to have had no effect on ridership, although there is some evidence in four cities that the policy encouraged commuters to purchase a monthly pass instead of tickets (only purchasers of monthly passes are eligible for the credit). Of course, it is not clear whether the measure was intended to change behaviour or just to provide tax relief for those who incur public transit costs.

A.M.


This new US textbook, for use in the first federal income tax course in law schools, is completely free in its PDF version, although it is not to be used for commercial purposes. The publisher, eLangdell Press, a division of Computer-Assisted Legal Instruction of the United States, has produced a number of other free texts in other areas of law. Deborah Geier is a respected US legal academic who is the author of one previous for-profit book and many tax articles.

The preface to the book provides a description of the contents and the author’s purpose in using this unconventional distribution procedure. Problems, without solutions, are provided at the end of each chapter.

The 2015 edition, to be released in the winter, is also to be available in EPUB format for iPads and MOBI format for Kindles. The only charge is for the hard copy version, which is to be made available at cost.

A.M.

\(^{40}\) Chapter 11.

\(^{41}\) Chapter 25.

\(^{42}\) Chapter 29.
Beginning in 2011 in the United States, banks processing credit card transactions and owners of third-party payment systems (such as PayPal) have been required to report to the IRS on form 1099-K the total receipts of businesses from these payment forms. The purpose of this new requirement was to prevent businesses from understating their sales revenue, since this revenue could not now fall short of reported receipts. Third-party reporting had worked very well for employment income, and the expectation was that this new measure could increase compliance in reporting business income.

The authors of this study focus on businesses whose income is reported on schedule C of the individual tax return, form 1040, which are essentially sole proprietorships. Of the 23 million schedule C filers, about 1 million, or 5.1 percent, received at least one form 1099-K; presumably the rest of these sole proprietors received payment mainly in cash or by cheque. Thus, it is not surprising that aggregate trends in schedule C filings do not show any sharp break in 2011. However, a subgroup of taxpayers who report receipts at or slightly above the amount reported on form 1099-K were found to increase their reported receipts by up to 24 percent over previous periods. Nevertheless, the impact in revenue is modest, even for this group of taxpayers, because they largely offset this increased revenue with increased reported expenses, which are not subject to information reporting.

It appears that policy makers in Ottawa who read this report will not be in a rush to adopt this new compliance strategy.

A.M.


In 2004, Canadian-controlled private corporations (CCPCs) with prior year taxable income of between $200,000 and $500,000 became eligible for an additional 15 percentage points of tax credit, for a total tax credit rate of 35 percent on research and development (R & D) expenditures up to the expenditure limit. The additional credit was fully refundable.

This study uses CRA tax records for all CCPCs that operated in only one province and claimed scientific research and experimental development (SR & ED) credits at least once between 2000 and 2003. The sample period is 2000 to 2007. Thus, by examining behaviour before and after the 2004 change, the responsiveness of these firms to incentives can be estimated.

Previous studies on R & D incentives across various countries have tended to show an elasticity with respect to the after-tax cost of R & D of about minus 1—that
is, a 1 percent decrease in the after-tax cost increases R & D expenditure by 1 percent. In contrast, these small Canadian firms were found to be quite sensitive to the after-tax price of R & D, showing an elasticity of minus 1.5. Other findings showed evidence of fixed adjustment costs in the response of these firms to the increase in the incentive.

A.M.