The Treaty Network Theory: Accessing Foreign Tax Information Networks Under the OECD Model Convention

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ABSTRACT

Globalization and the current economic climate have forced states to work toward improving access to foreign and domestic tax information with a view to better protecting their own tax base. At the forefront of these efforts are the exchange-of-information provisions found in virtually all bilateral tax treaties, many of which are based on the model double taxation convention of the Organisation for Economic Co-operation and Development (OECD). Curiously, existing departures from the OECD model suggest that certain states may have the obligation to assist one treaty partner by requesting and providing tax-related information from another treaty partner. This article analyzes the viability of this “treaty network theory”

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in the context of the OECD model and Canada’s existing tax treaties. The author concludes that the text of many of Canada’s treaties appears to allow for such a result, suggesting that tax authorities and treaty negotiators should carefully consider, in their future work, whether this was intended, or whether they should protect against this possibility.

**KEYWORDS:** Tax Treaties ■ Information Exchange ■ Confidentiality ■ Disclosure ■ OECD ■ Canada

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**CONTENTS**

Exchange of Information Under Canada’s Bilateral Tax Treaties—Potential Extension to Third-Party States 876
Analysis of Article 26 of the OECD Model 878
Application to Canada’s Tax Treaties 887
Appendix: Article 26 of the OECD Model 891

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**EXCHANGE OF INFORMATION UNDER CANADA’S BILATERAL TAX TREATIES—POTENTIAL EXTENSION TO THIRD-PARTY STATES**

Canada’s international tax treaties provide for the collection and exchange of information relevant to the administration and enforcement of Canadian tax laws and those of Canada’s treaty partners. Curiously, a plain reading of many of these treaties suggests that Canada may have obligations to assist one treaty partner by requesting and providing tax-related information obtained from another treaty partner (“the treaty network theory”). This interpretation of Canada’s information exchange obligations could allow countries that have been disinclined to broaden their own treaty systems—or have been unsuccessful in attempting to do so—to gain access to Canada’s vast tax treaty network. In turn, this could have significant

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1 For a current listing of Canada’s tax treaties, see Canada, Department of Finance, “Notices of Tax Treaty Developments” (www.fin.gc.ca/treaties-conventions/treatystatus_-_eng.asp).

2 Of course, the text of any particular treaty cannot be read in isolation. The paramount goal in interpreting Canada’s tax treaties is to give the text meaning based upon the language used and the intentions of the parties (see, for example, Crown Forest Industries Ltd. v. Canada, [1995] 2 SCR 802, at paragraph 29). This interpretive approach involves looking to the text of the treaty, academic literature, and other extrinsic materials that form part of the treaty’s legal context, including accepted model conventions and official commentaries thereon (see Crown Forest, ibid., at paragraph 30 et seq.). The approach recognizes that states draft tax conventions in general language, as compared with the level of detail and precision that tends to characterize the preparation of domestic tax legislation (Pacific Network Services Ltd. v. Canada (Minister of National Revenue), 2002 FCT 1158, at paragraph 35).

3 There are numerous factors at play that help to explain why certain countries have entered into relatively few double taxation treaties. For example, tax haven states, which impose little or no tax or are highly secretive with respect to tax-related information, may be disinclined to exchange tax information on the international stage because it hurts their bottom line. Nearer to the other end of the spectrum, the United States’ commitment to certain principled treaty policies and
consequences with respect to associated administrative costs and the dissemination of confidential taxpayer information. It may also negatively affect Canada’s international relations to the extent that certain international partners consider the treaty network theory to go beyond the intended scope of their double taxation conventions with Canada.4

It is unclear whether any of Canada’s treaty partners have adopted such an interpretation of Canada’s treaty obligations, or whether they would actually expect to obtain tax information through Canada’s network of treaties in this manner. Nevertheless, gaining a better understanding of the scope of Canada’s information exchange obligations will assist in predicting future directions in this field and may help to protect against undesired effects flowing from Canada’s existing tax treaties. The viability of the treaty network theory is particularly important in today’s economic climate, where countries are making greater efforts to obtain foreign and domestic tax information, often in innovative ways, so as to better protect their own tax bases.5

Against this background, the analysis in this article considers whether the treaty network theory may operate under the information exchange provisions contained in article 26 of the model double taxation convention developed by the Organisation for Economic Co-operation and Development (OECD).6 This is significant because

4 See, for example, Organisation for Economic Co-operation and Development, Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Canada 2011: Combined: Phase 1 + Phase 2 (Paris: OECD, April 2011) (herein referred to as “Peer Review: Canada”) (http://dx.doi.org/10.1787/9789264110458-en), at paragraph 185. In particular, the global forum’s report expresses the common view that “[g]overnments would not engage in information exchange without the assurance that the information provided would only be used for the purposes permitted under the exchange mechanism and that its confidentiality would be preserved.”

5 Take, for example, the high-profile success of the US Internal Revenue Service (IRS) in obtaining the disclosure of records on approximately 4,450 Swiss bank accounts in the UBS AG case. By first pressing judicial action in US District Court against the Swiss bank UBS AG, the IRS was able to negotiate an out-of-court settlement with the bank and with Swiss tax authorities that covered the interpretation of the information exchange obligations in the US-Switzerland tax treaty. See, for example, Scavron, supra note 3, at 162-63 and 176-77; and Anand Sithian, “‘But the Americans Made Me Do It!’: How United States v. UBS Makes the Case for Executive Exhaustion” (2011) 25:1 Emory International Law Review 681-729, at 688-93 and 727.

many nations—including Canada—use the OECD model as the template for their bilateral tax treaties. A detailed analysis of article 26 of the OECD model reveals that the standard information exchange article implicitly protects against disclosure of treaty-based information to third-party states. However, almost a third of Canada’s 90 existing tax treaties depart from the very text in the model that normally protects against such disclosure. Although the intentions underlying those departures should be determined on the basis of individual analyses of the treaties in question, the departures themselves suggest a potential basis for applying the treaty network theory to relations with a large number of Canada’s treaty partners. Canadian tax authorities and treaty negotiators should therefore specifically consider the desirability of adopting (or protecting against the effects of) the treaty network theory when negotiating and renegotiating terms for Canada’s future double taxation conventions.

**ANALYSIS OF ARTICLE 26 OF THE OECD MODEL**

The OECD model is the most widely accepted model double taxation convention. More than 3,000 current bilateral tax treaties are based on it, and it is also often used as the basis for other model tax conventions. Similarly, its information exchange provisions are the most widely accepted framework for bilateral tax information exchange agreements.

Article 26 of the OECD model contains a broad code for the exchange of tax information between treaty partners. Among other things, it provides what is commonly referred to as a “major information clause,” which obligates the contracting states to exchange information relating to any domestic tax laws—not merely information that is necessary for carrying out the terms of a particular tax treaty. Paragraph 1 of article 26 contains the model tax information exchange commitment:

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7 See, for example, Pacific Network Services, supra note 2, at paragraph 36.

8 Although only a third of Canada’s tax treaties depart from the OECD model in a way that would permit the disclosure of information obtained under those treaties to third-party states, the other two-thirds of Canada’s treaty partners may also be able to request information via Canada’s treaty network. This may be so even if those requesting countries would not permit Canada to pass on their own information to third-party states under their respective treaties with Canada (but see the discussion above on the reciprocity principle and limits on information-gathering measures in paragraph 3 of the OECD model).


10 This latter, narrower obligation is commonly referred to as a “minor information clause.” See, for example, Lang, supra note 9, at paragraphs 511-17. See also paragraph 10.1 of the July 2012 commentary on article 26 of the OECD model, supra note 6.
1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.

The imperative text ("shall") suggests a mandatory obligation to exchange certain types of taxpayer information between the contracting states. The "foreseeably relevant" threshold qualifies this obligation, which is intended to provide for the widest possible exchange of information between treaty partners. The threshold requires only that there be a "reasonable possibility" when a request is made that the requested information will be relevant to the tax matters specified in the request. In the same vein, while the requested information cannot relate to taxation prohibited by the treaty, it is not restricted to either information relating to persons protected under the treaty or the taxes covered by the particular treaty. Similarly, the OECD model's information exchange article is not limited to information contained in the contracting states’ tax files. Instead, where the requested information is not available in the supplying state’s files, the supplying state must use its information-gathering measures to seek to obtain the requested information for the requesting state.

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12 See paragraphs 1 through 9 of the July 2012 commentary on article 26 of the OECD model, supra note 6 (especially at paragraph 5).

13 Ibid.

14 For example, residents of the contracting states under article 1 of the OECD model.

15 That is, taxes described under article 2 of the OECD model.

16 See, for example, the OECD EOI manual, supra note 11, General Module, at paragraph 29; and paragraph 2 of the July 2012 commentary on article 26 of the OECD model, supra note 6.

17 See paragraph 4 of article 26 of the OECD model (reproduced in the appendix to this article and discussed in the text below, at notes 21-23). See also paragraph 19.7 of the July 2012 commentary on article 26 of the OECD model, supra note 6; the OECD EOI manual, supra note 11, General Module, at paragraphs 32 and 49; and *Pacific Network Services*, supra note 2, at paragraphs 25-26 and 29-34 (which considers an earlier version of the information exchange commitment then found in the tax treaty between Canada and France). Notably, it appears perfectly reasonable to view Canada’s reciprocal right to receive information through its bilateral tax treaty network as an extension of its domestic information-gathering measures. This suggests that Canada would have an obligation to use its broader treaty network to obtain information requested by any individual treaty partner.
As a result, article 26 creates a relatively sophisticated and extensive information exchange obligation. The article’s text suggests the operative question for the purposes of the present analysis—namely, can taxpayer information requested under a treaty to assist a third-party state be “foreseeably relevant . . . to the administration or enforcement of the domestic laws concerning taxes . . . imposed on behalf of” the parties to that particular treaty? Two issues should be addressed when answering this question:

1. the meaning of the specification relating to the “domestic laws concerning taxes . . . imposed on behalf of” the contracting states, and
2. how the specification regarding the administration or enforcement of one of the contracting state’s domestic tax laws applies in the circumstances of Canada’s international treaty practices.

First, it is almost trite to note that the requirement that requested information be foreseeably relevant to “domestic laws concerning taxes . . . imposed on behalf of” the contracting states is not limited to situations where one tax is imposed by both contracting states. The simple reason for this is that the power to impose taxation is seen as a sovereign state’s right; multiple sovereign states will not (generally) impose a single tax. Indeed, there is no single tax that is jointly imposed by Canada and any other country, although Canada and many of its treaty partners each impose the same type of tax (such as a tax on income earned by residents). As well, even though multiple states may impose the same type of tax, paragraph 4 of article 26 of the OECD model suggests that the information exchange obligation is not restricted

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18 Since this article is concerned with the effect of a particular contracting state’s information exchange obligations under a bilateral treaty on that state’s relations with a third (non-party) state, the criterion that the information requested be foreseeably relevant “for carrying out the provisions of this Convention” is only of tangential significance. For example, where (1) country A has bilateral tax treaties with both country B and country C, and (2) country C requests taxpayer information from country A that country A does not possess but that country B possesses, the requested information will not normally be “foreseeably relevant” for carrying out the purposes of the treaty between countries A and B since those countries are only indirectly interested in the information. However, this criterion could conceivably be satisfied if, by way of further example, the underlying information related to an international tax plan in which each of the countries was interested for audit and assessment purposes.

19 See, for example, J.C. Sharman, Havens in a Storm: The Struggle for Global Tax Regulation (Ithaca, NY: Cornell University Press, 2006), at 81: “the power to tax and make fiscal policy is a quintessential prerogative of sovereign states.”

20 Exceptions to this rule exist where a state cedes some of its sovereign power over taxation to another body. For example, the members of the European Union have ceded certain of their taxation powers to the union (particularly in the context of indirect taxes: see, for example, Council Directive 2006/112/EC, “On the Common System of Value Added Tax,” November 28, 2006). It is not suggested that Canada or any of its political subdivisions have ceded any of their taxing powers to any non-Canadian body.
to information relevant to a common type of tax imposed by each of the contracting states. That paragraph indicates that the information exchange duty applies “even though [the] other State may not need such information for its own tax purposes,” and even though the supplying state may have “no domestic interest in such information.” Furthermore, the OECD model’s official commentary emphasizes that the supplying state is not excused from its obligations where it is itself unable to use the requested information owing to domestic procedural rules or limitation periods. Thus, to come within the OECD model’s information exchange provision, the requested information need only be relevant to the administration of the domestic tax laws of one of the parties to a particular tax treaty, not to the laws of both contracting states.

Second, as a result of the OECD model’s reference to “domestic laws concerning taxes,” the intended boundaries of the information exchange obligation are not entirely clear in circumstances where a country’s tax treaties are enacted into domestic legislation. For this reason, it is important to understand Canada’s laws with regard to the entering into and the implementation of international conventions. In brief, although the executive branch of government formally enters into Canada’s tax treaties, those international conventions must be enacted through statute before they can affect domestic tax laws. As a matter of practice, Canada’s double taxation treaties are generally enacted into domestic law in their entirety through federal statute, such as the Canada-United States Tax Convention Act, 1984. This is significant since it suggests that activities conducted in respect of the administration or enforcement of any enacted Canadian tax treaty will be activities “foreseeably relevant . . . to the administration or enforcement of [Canada’s] domestic laws concerning taxes.” While one could advocate a narrower reading of this treaty provision, the breadth

21 See also paragraph 1 of article 26, which expressly indicates that information exchange is not restricted to taxes referred to in article 2 of the OECD model.

22 For the full text of paragraph 4, see the appendix to this article.

23 See paragraphs 19.6 through 19.9 of the July 2012 commentary on article 26 of the OECD model, supra note 6.

24 See, for example, Hugh Kindred et al., International Law: Chiefly as Interpreted and Applied in Canada, 7th ed. (Toronto: Emond Montgomery, 2007), at 206-8.

25 SC 1984, c. 20. See, generally, Pacific Network Services, supra note 2, at paragraph 27.

26 For example, by taking the position that the laws in respect of which the information exchange commitment applies are only those that actually impose taxes, rather than those that protect against double taxation or those that merely provide a regulatory scheme for collecting taxes owed. However, it is reasonable to maintain that the drafters would have referred to “domestic laws imposing taxes,” rather than “domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States,” had they intended such a narrower meaning. The same type of response may be given to the argument that an enacted Canada-country B tax treaty constitutes Canadian domestic law concerning taxes for the purposes of a Canada-country C tax treaty only insofar as it relates to Canada’s taxes, not to country B’s taxes.
of the term “concerning” suggests that doing so would be inappropriate.27 Reading the model information exchange article in the Canadian context thus suggests28 that tax information requested by another state under one of Canada’s enacted tax treaties could legitimately form the basis of an information request made by Canada under another of its tax treaties.

It therefore appears that paragraph 1 of model article 26 permits the operation of the treaty network theory. It thus becomes necessary to consider further qualifications and restrictions on the model information exchange obligation before proceeding to analyze its incorporation into Canada’s tax treaties. Paragraph 3 of model article 2629 introduces the principle of reciprocity to limit contracting states’ information-gathering obligations to the mechanisms that exist under those states’ domestic laws, administrative practices, or public policies. A supplying state is only obligated to obtain information through the information-gathering measures that would be open to the requesting state in similar circumstances. This prevents a requesting state from taking advantage of the other state’s information-gathering system to the extent that the other system is wider than its own.30 Notably, however, there is no indication in the OECD model that a contracting state’s right to obtain information from its treaty partners is excluded from the class of information-gathering measures that it is obligated to use to fulfill a request under article 26.31

27 Merriam-Webster Online defines “concerning” as “relating to” and “regarding” (www.merriam-webster.com/dictionary). By way of comparison, the Supreme Court of Canada has explained that the words “in respect of” are “words of the widest possible scope [which] import such meanings as ‘in relation to,’ ‘with reference to’ or ‘in connection with.’ The phrase ‘in respect of’ is probably the widest of any expression intended to convey some connection between two related subject matters.” Nowegijick v. The Queen, [1983] 1 SCR 29, at 39.

28 To be clear, there may be room for further academic debate on this issue, particularly given that official commentaries on a number of other model provisions explicitly or implicitly indicate that certain references to domestic laws in the OECD model are intended to exclude tax treaties (see, for example, paragraph 10 of the July 2012 commentary on article 26 of the OECD model, supra note 6). On the other hand, the absence of such a specification in the context of the model information exchange article may itself be telling.

29 See the appendix to this article.

30 See, for example, the OECD EOI manual, supra note 11, General Module, at paragraphs 37, 38, and 49; and paragraph 15 of the July 2012 commentary on article 26 of the OECD model, supra note 6.

31 Furthermore, paragraph 16 of the July 2012 commentary on article 26 of the OECD model, supra note 6, indicates that information is “deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examinations for their own purposes.” This excerpt from the official commentary deals only with the availability of particular information through “the normal course of the administration” of the contracting state, as opposed to information obtainable through other domestic information-gathering laws (see paragraph 3(b) of article 26). In any event, the operative question for determining what steps a supplying state
The reciprocity principle also creates a curious conceptual hurdle for countries that enact their tax treaties into domestic legislation when they enter into tax treaties with countries that do not. For example, let us say that one of Canada’s treaty partners—hypothetical country B—bases its tax treaties on the OECD model but follows a legal system in which international treaties have direct legal effect (that is, without the need for implementation through domestic statute). Country B’s tax treaties might thus not be considered to be part of that country’s “domestic laws concerning taxes” under a provision based on paragraph 1 of model article 26. If they are not, country B’s information exchange obligations would not require the exchange of information under one treaty for the purposes of a request under another.\footnote{This is so even if some of country B’s tax treaties depart from the OECD model provisions in a way that would otherwise allow for the application of the treaty network theory.} Thus, under the reciprocity principle in paragraph 3 of the information exchange article, Canada would arguably have no obligation to obtain information through its larger treaty network further to a request from country B because, were the circumstances reversed, the requested information would not be obtainable under country B’s laws.\footnote{See, for example, supra note 30 and the related text.} This suggests a potentially awkward need for each contracting party to analyze its treaty partner’s tax information-gathering laws and practices before responding to an information exchange request. Although this is a somewhat odd result, it flows from the structure of the model information exchange provision, not from the treaty network theory. What is more significant for present purposes is that, apart from this conceptual point, paragraph 3 of the model article does not prevent the application of the treaty network theory in the Canadian context.

In contrast, paragraph 2 of model article 26 presents a more substantial hurdle to the treaty network theory. It reads:

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.

The requesting state is therefore generally obligated to treat information received from a treaty partner as “secret in the same manner as information obtained under the domestic laws of that State.” This reflects the view that the confidentiality of...
taxpayer information is largely a domestic legal matter; decisions as to how such “secret” information should be treated generally ought to be left to the receiving state.\textsuperscript{34} If the model provision stopped there, the treaty network theory could operate in the context of many bilateral tax conventions. For example, although Canadian tax statutes include extensive protections against the disclosure of taxpayer information,\textsuperscript{35} disclosure is generally allowed for the purposes of “a provision contained in a tax treaty with another country or in a comprehensive tax information exchange agreement between Canada and another country or jurisdiction.”\textsuperscript{36} Thus, quite apart from interpretive provisions or common-law rules elevating tax treaties over other domestic laws,\textsuperscript{37} Canadian federal laws do not themselves protect against the dissemination of information received from one treaty partner to another partner under a second treaty. Instead, paragraph 2 of model article 26 stands as an impediment to the treaty network theory because it goes on to circumscribe to whom disclosure may be made, irrespective of whether domestic laws would allow for disclosure to a wider range of parties.

Specifically, paragraph 2 provides that information received under the model article “shall be disclosed only to persons or authorities . . . concerned with the assessment or collection of, the enforcement or prosecution in respect of, [or] the determination of appeals in relation to the taxes referred to in paragraph 1”\textsuperscript{38} (collectively referred to herein as “assessment activities”). The paragraph similarly obligates any such receiving entities to use the information received only for purposes of those same assessment activities. The issue arising in the context of the treaty network theory is that, at first blush, the uses to which tax information can be put under paragraph 2 (absent express permission from the supplying state)\textsuperscript{39} appear to be narrower than the scope of the information exchange obligation in paragraph 1.\textsuperscript{40} The following example illustrates this.

\textsuperscript{34} See also paragraph 11 of the July 2012 commentary on article 26 of the OECD model, supra note 6.
\textsuperscript{35} See, for example, the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended, section 241.
\textsuperscript{36} Ibid., subparagraph 241(4)(e)(xii).
\textsuperscript{37} See, for example, the Canada-United States Income Tax Convention Act, supra note 25, section 3(2).
\textsuperscript{38} See, generally, the OECD EOI manual, supra note 11, General Module, at paragraph 57. Although paragraph 2 also effectively permits disclosure to persons overseeing the contracting states’ assessment activities, this appears to have little significance for the treaty network theory.
\textsuperscript{39} As seen above, the final sentence of the OECD model’s paragraph 2 allows information to be used for purposes other than those specified in the paragraph if (1) such uses are permitted under the laws of both contracting states and (2) the supplying state authorizes those uses. Therefore, the treaty network theory will always be available as an optional measure where contracting states adopt the language of the OECD model, their domestic laws allow for the exchange of treaty-based tax information with third-party jurisdictions, and the supplying state expressly permits the exchange to the third-party state.
\textsuperscript{40} But see infra note 43.
Generally, if the treaty network theory applies, Canada may be requested (under a bilateral tax treaty with country C) to act as a conduit for obtaining tax information under Canada’s treaty with country B and providing that information to country C.

The requested information may be “foreseeably relevant” to the administration or enforcement of country C’s tax laws, and would thus satisfy the paragraph 1 requirement vis-à-vis country C’s treaty with Canada.

Similarly, given that the requested information is foreseeably relevant to the “administration or enforcement” of Canada’s domestic tax laws (that is, those enacting the Canada-country C tax treaty), Canada’s request for information from country B also satisfies the paragraph 1 requirement as regards its treaty with country B.

However, by virtue of the paragraph 2 restriction, Canada may disclose information obtained from country B only to entities concerned with assessment activities “in relation to the taxes referred to in paragraph 1” of the information exchange article in the Canada-country B tax treaty. That is, Canada may disclose information supplied by country B only to entities concerned with assessment activities relating to any tax imposed by either Canada or country B. Thus, unless country C’s tax authorities are pursuing assessment activities concerning taxes imposed by Canada or by country B, Canada is prohibited from providing any information that it receives under its treaty with country B to country C.

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41 Without taking into account particular legal restrictions on the disclosure of such information. See infra note 43 for further discussion of this point.

42 While in practice this may be unlikely, such enforcement activities could perhaps be grounded in the obligation to provide assistance in the collection of taxes under article 27 of the OECD model. However, that possibility is irrelevant to the present analysis since the main question being considered is how the treaty network theory might apply in the case of “conduit” countries that have no direct interest in the requested information.

43 One may suggest that this analysis is flawed because Canada seems to have an obligation/right to obtain information from country B for the purposes of a request for information from country C, and yet may at the same time be unable to transmit the requested information to country C by virtue of the model disclosure restriction. This potential circularity disappears when one considers that it will be difficult to maintain (for the purposes of satisfying the paragraph 1 requirement under the Canada-country B treaty) that the requested information is “foreseeably relevant” to Canada’s laws enacting the Canada-country C treaty if the information can never be disclosed to country C by virtue of paragraph 2. That is, if the disclosure prohibition in the Canada-country B treaty prevents Canada from disclosing information obtained from country B to country C, then Canada arguably has no obligation in the first place to obtain that information from country B further to a request from country C. Thus, treaties directly incorporating these aspects of the OECD model also prevent the application of the treaty network theory at this earlier stage of the analysis.
This example suggests that the treaty network theory cannot apply in the context of treaties that directly incorporate the disclosure restriction in paragraph 2 of model article 26.44

Official commentaries and extrinsic evidence regarding the object and purpose of the model information exchange provisions support the preceding interpretation.45 The available OECD information exchange guidance documents generally explain that the OECD model “does not permit disclosure to any other person, entity, authority or jurisdiction.”46 Furthermore, since 2005, the OECD model’s official commentary has explained that “information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.”47 Similarly, the current edition of the commentary indicates that the last sentence of paragraph 2 “allows the sharing of tax information by the tax authorities of the receiving State with other law enforcement agencies and judicial authorities in that State on certain high priority matters (e.g., to combat money laundering, corruption, [or] terrorism

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44 Unless that country receives permission to use tax information in this manner from the supplying state as provided in the final sentence of model paragraph 2 (see supra note 39). See also supra note 43.

45 Model commentaries are a “widely-accepted guide to the interpretation and application of the provisions of existing bilateral [tax] conventions”: Canada v. Prévost Car Inc., 2009 FCA 57, at paragraph 10. Although judicial precedent interpreting the information exchange provisions of particular tax treaties or model conventions would be binding or persuasive in regard to future interpretations, it has only rarely been necessary for Canadian courts to analyze such treaty provisions. By way of example, as of 2011, the Canada Revenue Agency has had occasion to obtain only a single judicial compliance order in respect of treaty-based exchange of information requests (see Peer Review: Canada, supra note 4, at paragraph 143). As a result, the present analysis is effectively restricted to considering the text of the provisions themselves and the available secondary commentary, rather than reviewing an established body of Canadian jurisprudence on the underlying issues.

46 OECD EOI manual, supra note 11, General Module, at paragraph 57 (emphasis added). See also ibid., at paragraph 56. Notably, the prohibition against disclosure to any other jurisdiction is included by way of reference to the OECD’s April 2002 model Agreement on Exchange of Information on Tax Matters (www.oecd.org/ctp/harmful/2082215.pdf), which specifically permits disclosure of tax information only to persons or authorities in the jurisdiction of the receiving state (see especially article 8).

financing). Unfortunately, these guidance documents do not identify the source of the apparent prohibition on the provision of information to entities in third-party jurisdictions. Nevertheless, the inclusion of these references suggests that the drafters of the OECD model intended such a prohibition—indeed, no OECD member state has issued an official reservation or observation relating to these aspects of the guidance documents. In view of the preceding textual analysis, the foundation for prohibiting disclosure to third-party jurisdictions appears to be the paragraph 2 specification that allows disclosure only in respect of assessment activities in relation to taxes imposed by one of the contracting states. While there is thus significant doubt as to the availability of the treaty network theory under bilateral treaties that explicitly incorporate the model disclosure prohibition, the provision of information to third-party jurisdictions may well be available where treaties depart from this aspect of the OECD model.

APPLICATION TO CANADA’S TAX TREATIES

Canada has one of the world’s most extensive tax treaty networks, comprising 90 double taxation conventions currently in force. As noted earlier, Canada generally uses the OECD model as the basis for its tax treaties. The OECD has expressed the view that each of Canada’s existing treaties meets the OECD model’s standard limits

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48 Paragraph 12.3 of the July 2012 commentary on article 26 of the OECD model, supra note 6 (emphasis added). While this “prior authorization clause” was first introduced as a provision of the OECD model in 2012, it had previously been set out as an optional provision in paragraph 12.3 of the commentary on article 26 of the OECD model (see paragraph 4.3 of the July 2012 commentary on article 26 of the OECD model, supra note 6). However, the reference to the ability of the tax authorities of the receiving state to share tax information obtained under a treaty with other agencies “in that state” was only included in the 2012 revision.

49 See, for example, the July 2012 update to the OECD model, supra note 6, at 17.

50 Particularly in the context of those treaties that incorporated the OECD model exchange-of-information provisions subsequent to the initial appearance of these types of statements in the official commentary and OECD guidance documents.

51 See the Department of Finance treaty website, supra note 1. Canada also has an additional 16 tax information exchange agreements (TIEAs) currently in force: see Canada, Department of Finance, “Tax Information Exchange Agreements: Notices of Developments” (www.fin.gc.ca/treaties-conventions/tieaerf-eng.asp). However, the significance of Canada’s TIEAs to the interpretation of its formal tax treaty information exchange obligations is not clear. Distinguishing characteristics include the following: TIEAs (1) may be pursued with a view to achieving different goals than formal tax treaties, (2) are not enacted into domestic laws, and (3) often incorporate express prohibitions on the disclosure of information to third-party states (see, for example, article 8 of the Agreement Between the Government of Canada and the Government of the Cayman Islands Under Entrustment from the Government of the United Kingdom of Great Britain and Northern Ireland for the Exchange of Information on Tax Matters, signed at George Town on June 24, 2010). In any event, in-depth consideration of particular Canadian TIEAs and corresponding model TIEAs falls outside the scope of this article.
on disclosure of treaty-based tax information. Notably, every version of the OECD model issued in the past 40 years has specified that information obtained under the convention shall be treated as secret and shall be disclosed only for the purpose of assessment activities relating to the taxes covered by the OECD model. That is, since its inception, the OECD model has continuously and explicitly restricted treaty information disclosure to entities concerned with the assessment of taxes imposed by one of the two parties to a particular bilateral tax treaty. Considering this long history, one might expect that any significant departure from the OECD model’s relatively narrow disclosure specification would constitute an intentional shift toward a broader right to disclose information received under a tax treaty.

Surprisingly, 29 of Canada’s 90 tax treaties depart from the OECD model’s disclosure specification in a significant way. Twenty-six of those treaties provide that any information received by a contracting state shall be treated as secret according to domestic laws, and, at a minimum, “shall be disclosed only to persons or authorities . . . concerned with [assessment activities] in relation to taxes.” In other words, the text of almost one-third of Canada’s tax treaties merely restricts the disclosure of treaty-based information to assessment activities relating to “taxes” generally, rather than to the particular taxes covered by those treaties or, more broadly, to taxes imposed by one of the two contracting states. In addition, Canada’s treaty with Switzerland allows disclosure only to entities involved in assessment activities in relation to the somewhat less general “income or capital taxes,” but without expressly identifying which income or capital taxes the parties had in mind. Further along on

52 Peer Review: Canada, supra note 4, at paragraph 186.

53 See the history of article 26 contained in the full version of the OECD model, supra note 6, at M-62 to M-65. Since 1963, the relevant text of paragraph 2 of article 26 has varied in certain (immaterial) respects, but as regards the present analysis, it has remained substantively identical in successive revisions. In particular, it has provided that information received under the treaty shall be disclosed only to entities concerned with assessment activities in relation to “the taxes covered by the Convention,” “the taxes which are the subject of the Convention,” or “taxes of every kind and description imposed on behalf of the Contracting States.”

54 Specifically, Canada’s current treaties with Algeria, Austria, Azerbaijan, Belgium, Bulgaria, Chile, Colombia, Croatia, Estonia, Gabon, Greece, Iceland, Jordan, Kyrgyzstan, Latvia, Lithuania, Moldova, the Netherlands, Oman, Portugal, Senegal, Singapore, Slovenia, South Korea, Ukraine, and the United Arab Emirates. See the Department of Finance treaty website, supra note 1.

55 Emphasis added. This is a standardized version of the provision; some of the 26 treaties contain minor differences not relevant to this analysis, such as substituting “involved in” for “concerned with” assessment activities.

56 See article 25(2) of the Convention Between Canada and Switzerland for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, signed at Berne on May 5, 1997, as amended by the protocol signed on October 22, 2010.
this end of the spectrum is the current Canada-Peru treaty, which restricts disclosure to assessment activities in relation to “any tax.”\(^{57}\) Finally, Canada’s treaty with South Africa contains perhaps the loosest disclosure restriction of any of Canada’s double taxation conventions: it requires nothing more than that the information be treated as “secret in the same manner as information obtained under the [receiving state’s] domestic laws.”\(^{58}\) On their face, these departures suggest that the treaty network theory may be available in the context of Canada’s relations with these 29 states.\(^{59}\)

There may be reasons for departing from the OECD model in each of these instances that implicitly demonstrate a continued intention between the contracting states to prevent disclosure to third-party jurisdictions. For example, because the vast majority of these 29 treaties were agreed to in the years since 1995, the relevant phrasing may simply reflect some unrelated policy consideration prevalent during this period. However, it is notable that Canada completed a significant number of other tax treaties during the same period without departing from the more explicitly defined scope of the OECD model’s disclosure prohibition.\(^{60}\) On the other hand, perhaps the departures constitute an attempt at simplifying the OECD model by removing unnecessary text but without changing the intentions expressed in the OECD guidance documents. Indeed, one may argue that any reference to “taxes” in the disclosure prohibition must necessarily relate to the taxes referred to in the first paragraph of the information exchange article, or in the initial treaty article specifying that a treaty applies (only) to taxes imposed on behalf of the contracting states (that is, article 2). However, this would also be unusual because the departure in question is relatively precise, and the remaining text of the information exchange article in many of these 29 treaties closely follows the OECD model. What is clear is that no explanation for these departures is apparent from the text of the treaties themselves. Thus, it will be important to consider further evidence of each contracting state’s intentions in order to determine whether one state could reasonably expect the other to obtain and provide information under the treaty network theory. The need to consider external interpretive aids also flows from Canadian case law,

\(^{57}\) See article 26(1) of the Convention Between the Government of Canada and the Government of the Republic of Peru for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Lima on July 20, 2001 (emphasis added).


\(^{59}\) See also supra note 8.

\(^{60}\) By way of example, and despite the fact that the phrasing may depart from the model provisions in other ways, see Canada’s treaties with the Czech Republic (2001), Finland (2006), Germany (2001), India (1996), Luxembourg (1999), Mexico (2006), and the United Kingdom (2003).
which holds that the omission of a particular model provision in a tax treaty does not necessarily indicate an intention to deviate from the model on that particular issue.61

The broad scope of the preceding analysis makes it impossible to conclude whether the treaty network theory will apply in the context of any of Canada’s 29 deviating tax treaties. However, it is significant that the particular departure from the model text found in each of these treaties appears to be precisely the type that would permit the use of one treaty’s information exchange provisions to assist in responding to another treaty partner’s information request. It is also notable that this is not merely a Canadian issue. Any similar departure from the OECD model (or the model convention developed by the United Nations)62 in other states’ bilateral tax treaties may provide additional support for information requests based on the application of the treaty network theory. Furthermore, such departures may have a broad impact on spontaneous or automatic exchange of taxpayer information between treaty partners where relevant information obtained from one partner is subject to a modified version of the model disclosure prohibition.63 It is therefore important for treaty negotiators to expressly consider these issues in their work. Doing so will help to ensure that the resulting treaties are consistent with the contracting states’ true intentions and will protect against negative effects on international relations with treaty partners that do not subscribe to the treaty network theory. Similarly, the

61 See, for example, Pacific Network Services, supra note 2, at paragraph 39; and Crown Forest, supra note 2, at paragraphs 63-76. However, the courts’ views appear to have been significantly affected by the existence of other extrinsic evidence suggesting an intention not to depart from the model treaty on the issues in question. It is not clear that the same result would follow in the complete absence of extrinsic evidence explaining the departure from the model provisions or the contracting states’ intentions on such a fine point.

62 United Nations, Model Double Taxation Convention Between Developed and Developing Countries (New York: UN, 2011). The UN model contains essentially the same information exchange obligation as the OECD model; see, for example, Lang, supra note 9, at paragraph 513. In particular, the paragraph 2 disclosure prohibition in the UN model is substantively identical to the OECD model’s prohibition against disclosure to entities other than those concerned with assessment activities in relation to taxes imposed by the contracting states. Thus, it is likely that the treaty network theory would apply equally to bilateral treaties based on the UN model and those based on the OECD model.

63 Article 26 of the OECD model is one legal basis for the automatic exchange of taxpayer information. The principle that exchanged information should be used only for the purposes allowed under the applicable information exchange instrument, such as a bilateral treaty based on the OECD model, supports the view that spontaneous or automatic exchange could include providing information received from one treaty partner to another under the treaty network theory. See, generally, Organisation for Economic Co-operation and Development, Automatic Exchange of Information: What It Is, How It Works, Benefits, What Remains To Be Done (Paris: OECD, 2012) (www.oecd.orgctp/exchange-of-tax-information/AEOI_FINAL_with%20cover_WEB.pdf), at 13 and 25; and Keeping It Safe, supra note 47 (which generally discusses the framework for information exchange and various practices, policies, and recommendations for appropriately maintaining the confidentiality of information exchanged for tax purposes).
Canada Revenue Agency may wish to consider (if it has not yet done so) the viability of the treaty network theory both in responding to future information requests and in considering whether to make such requests of Canada’s treaty partners for domestic tax administration purposes. In an age of growing international pressures and increases in international tax information exchanges, the treaty network theory may prove to be an innovative tool for better securing domestic tax bases.

APPENDIX: ARTICLE 26 OF THE OECD MODEL

The following is the current version of article 26 of the OECD model as approved by the OECD Council on July 17, 2012.64

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

   a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

   b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

   c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject

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64 See supra note 6.
to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.
Suing Canadian Tax Officials for Negligence: An Assessment of Recent Developments

John Bevacqua*

P R É C I S
Dans Leroux v. Canada, la Cour d’appel de la Colombie-Britannique a refusé une demande de l’Agence du revenu du Canada (ARC) de radier l’action d’un contribuable pour négligence contre l’ARC. Ce faisant, la Cour a confirmé la possibilité que l’ARC puisse avoir un devoir de diligence délictuel envers un contribuable.

Leroux est la plus récente d’une série d’actions pour négligence contre des agents canadiens du fisc. Le présent article examine le raisonnement dans ces causes et analyse ce qui distingue l’arrêt Leroux de ses prédécesseurs infructueux. L’analyse s’étend à l’examen des principes canadiens de droit de la responsabilité délictuelle qui pourraient être appliqués dans un procès sur le fond entourant les questions de négligence dans Leroux.

A B S T R A C T
In Leroux v. Canada, the British Columbia Court of Appeal refused a Canada Revenue Agency (CRA) application to strike out a taxpayer plaintiff negligence action against the CRA. In so doing, the court confirmed the possibility that the CRA could owe a tortious duty of care in negligence to a taxpayer.

Leroux is the latest in a line of recent negligence actions against Canadian tax officials. This article examines the reasoning in those cases and assesses what distinguishes the Leroux case from its unsuccessful predecessors. The analysis extends to discussion of the Canadian tort-law principles that might be applied in a full trial of the negligence issues in Leroux.

KEYWORDS: NEGLIGENCE ■ TAX LITIGATION ■ TORTS ■ PUBLIC POLICY

C O N T E N T S
Introduction 894
Recent Negligence Claims Against Canadian Tax Officials 894
Taxpayer Claims and Proximity 895
The CRA’s Exclusive Duties to the Crown 897

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INTRODUCTION

There has recently been a spate of Canadian cases in which taxpayers have raised causes of action alleging negligence by Canada Revenue Agency (CRA) officials. To date, none of these negligence actions has been successful. Most of the claims have been summarily dismissed. However, a recent exception arose in Leroux v. Canada.1 In this case, the British Columbia Court of Appeal refused to strike out the plaintiff’s claim in negligence. While the decision in Leroux falls short of recognizing a CRA tortious duty of care to taxpayers, this is not the first time that Canadian courts have recognized the potential for a tortious claim against the CRA.2 It does, though, give renewed cause for a detailed assessment of the prospects of such a duty being recognized, either in any eventual trial of Leroux or otherwise.

The first part of this article examines the reasoning in the recent negligence cases against the CRA. The aim is to extrapolate common threads of judicial reasoning in the treatment of negligence claims against the CRA and its officers. In the second part of the article, the analysis extends to a consideration of the developing tort of negligent investigation and its application in a tax context. The third part discusses how Canadian tort-law principles might be applied in a full trial of the negligence claims in Leroux.

RECENT NEGLIGENCE CLAIMS AGAINST CANADIAN TAX OFFICIALS

It has been observed that “there are very limited remedies available to a taxpayer where . . . negligent conduct on the part of Revenue Canada officials has caused him or her expenses.”3 As far as damages claims via the tort of negligence are concerned, recent negligence claims against Canadian tax officials appear to bear out this observation. As noted above, in almost every case, these claims have been summarily

1 Leroux v. Canada Revenue Agency, 2012 BCCA 63.
2 See, for example, Canada Revenue Agency v. Tele-Mobile Company Partnership, 2011 FCA 89, at paragraph 6, where the Federal Court of Appeal acknowledged the possibility that a taxpayer plaintiff could bring an action in tort to obtain compensation for damages caused by the CRA.
dismissed. No case has recognized any CRA tortious duty of care in negligence to taxpayers.⁴

In order to determine whether a duty of care in negligence exists, the Canadian tax cases apply the two-stage “Anns-Cooper” test.⁵ Fisher J in Leighton v. Canada (Attorney General) described the test as follows:

The Anns-Cooper test has two stages: (1) whether the relationship between the parties justifies the imposition of a duty of care on the defendant; and (2) whether there are residual policy considerations that militate against recognizing a novel duty of care.⁶

To date, all Canadian negligence claims by taxpayers against the CRA have failed at the first stage of the Anns-Cooper test. Specifically, the biggest stumbling block for taxpayer plaintiffs has been the task of establishing the existence of a sufficiently proximate relationship to support a common-law duty of care.⁷

**Taxpayer Claims and Proximity**

The decision in Leighton illustrates the difficulties posed by the proximity requirement. The plaintiff was the shareholder of a taxpayer company. He alleged that he had suffered loss attributable to negligent delay by the CRA in correcting “obvious accounting errors” in assessing the taxpayer company.⁸ In rejecting the plaintiff’s application to amend his claim to include a claim in negligence, Fisher J explained that

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⁴ Although, referring to the determination in Leroux, supra note 1, the Federal Court of Appeal in Ereiser v. Canada, 2013 FCA 20, at paragraph 36, has subsequently acknowledged the possibility of an action in tort for damages for wrongful conduct of an income tax official. As noted in note 2, supra, the Federal Court of Appeal also made similar observations in Tele-Mobile Company Partnership, a case decided prior to the determination in Leroux.

⁵ This test reflects the Supreme Court of Canada’s interpretation in Cooper v. Hobart, 2001 SCC 79, of the UK House of Lords approach to determining when a novel duty of care can be established, as set out in Anns v. London Borough of Merton, [1977] 2 All ER 492.

⁶ 2012 BCSC 961, at paragraph 50. According to the Supreme Court of Canada in Cooper v. Hobart, supra note 5, at paragraph 30, the first stage of the analysis requires consideration of two questions: (1) was the harm that occurred the reasonably foreseeable consequence of the defendant’s act; and (2) are there reasons, notwithstanding the proximity between the parties established in the first part of the test, why tort liability should not be recognized in the case before the court? At the second stage, as noted by the court, “the question still remains whether there are residual policy considerations outside the relationship of the parties that may negative the imposition of a duty of care.” Ibid.

⁷ According to the reasoning in Cooper, supra note 5, at paragraph 30, “[t]he proximity analysis involved at the first stage of the Anns test focuses on factors arising from the relationship between the plaintiff and the defendant. These factors include questions of policy, in the broad sense of that word. If foreseeability and proximity are established at the first stage, a prima facie duty of care arises.”

⁸ The plaintiff had sought to amend his pleadings (which already included claims of defamation, estoppel, and abuse of process) to include a claim in negligence against the CRA. Fisher J refused leave for the plaintiff to amend his claim.
a duty of care by CRA in respect of its statutory audit function to the shareholder of a corporate taxpayer has not been established within a category that has been recognized at law, nor is it a duty of care that can be given legal recognition.9

He concluded:

[T]here is simply no basis to establish any proximity of relationship in these circumstances.10

The reasoning in Leighton is similar to that of the Alberta Court of Appeal in 783783 Alberta Ltd. v. Canada (Attorney General).11 This complaint concerned an error by the CRA in allowing a non-resident business competitor of the plaintiff to claim deductions that were only available to Canadian residents. The plaintiff alleged that this error resulted in the loss of its competitive advantage as a Canadian resident.

In striking out the plaintiff’s claim, the court reasoned that proximity could not be established in these circumstances. The court observed:

There is no prior case establishing liability on the part of tax collectors to one group of taxpayers based on the taxes imposed on another group of taxpayers. . . . It is significant that nothing in the Income Tax Act suggests that one taxpayer has any remedy with respect to the assessment of another taxpayer.12

Similarly, in McCreight v. The Attorney General,13 the Ontario Superior Court of Justice rejected the plaintiffs’ negligence claim on proximity grounds.14 The plaintiff’s accountants alleged that CRA auditors owed them a tortious duty of care in carrying out audit investigations that resulted in lengthy (and ultimately discontinued) fraud and conspiracy prosecutions against the accountants for tax advice provided to some of their clients.15 Patterson J accepted the Crown’s submission that

CRA and its prosecutors were in an inherently adversarial relationship with the subjects of the investigation . . . and therefore, this would be contrary to there being a proximity such that would create a duty of care.16

9 Leighton, supra note 6, at paragraph 57.
10 Ibid., at paragraph 44.
11 2010 ABCA 226.
12 Ibid., at paragraph 44.
14 Nevertheless, the court agreed with a range of residual policy concerns raised by the CRA. These are discussed below under the heading “Parliamentary Sovereignty, Floodgates, and Chill Factor Policy Concerns.”
15 The facts in McCreight are discussed further in the second part of this article.
16 McCreight, supra note 13, at paragraph 62.
Broadly similar reasoning was applied in *Canus v. Canada Customs*. In this case, the plaintiff taxpayer alleged that the CRA had been negligent in conducting an audit of the taxpayer. The audit resulted initially in a reassessment of the taxpayer for substantial additional income taxes. The audit was vacated three years later, but not before the plaintiff had suffered significant business losses as a result of the increased contingent tax liability resulting from the initial erroneous audit. Hood J held that there is no sufficiently proximate relationship between taxpayers and CRA auditors capable of sustaining a duty of care. According to Hood J, taxpayers and CRA auditors have “inherently opposing interests,” with the former being motivated to minimize their taxes and the latter being charged with the responsibility of ensuring that all taxes legally owing are collected.

In advancing this argument, Hood J referred to the statutory framework regulating the relationship between taxpayers and the CRA. She pointed out that

> [t]here are no directions in the *Act* about how the Minister and his employees should carry out the duties under the *Act*.

According to Hood J, this statutory silence evinces a parliamentary intent to preclude any relationship of tortious proximity between CRA auditors and taxpayers in the CRA’s performance of its audit function.

Hood J drew a broader conclusion, however, surmising that

> [A]ny duty owed by [the CRA auditor] was to the Minister of National Revenue whose duty is owed in turn to Parliament and to all taxpayers generally. Therefore, there is no duty of care owed to an individual taxpayer under the *Income Tax Act*.

**The CRA’s Exclusive Duties to the Crown**

The reasoning of Hood J in *Canus* is consistent with that of a number of other judges who have also confined the statutory duties of the CRA exclusively to the Crown and have reasoned that, accordingly, there is no room to impose any tortious duty of care to taxpayers. These arguments have been raised not just in determining

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17 2005 NSSC 283.

18 Ibid., at paragraph 73. It should be noted that Hood J also found against the plaintiff on negation of duty of care, standard of care/breach, causation and damages, and the awarding of general damages. In fact, the only successful argument for the plaintiff was on the question of reasonable foreseeability of the harm caused.

19 *Canus*, supra note 17, at paragraph 74. Citing comments in *Western Minerals Ltd. v. Minister of National Revenue*, [1962] SCR 592, Hood J went on to note that there is no standard set out anywhere, either implicitly or explicitly, to fix essential requirements of an assessment or the intensity of any examination of a taxpayer.

20 *Canus*, supra note 17, at paragraph 87. Fisher J made similar comments in *Leighton*, and was also blunt in his conclusion that “[t]hese cases demonstrate that proximity is not established where statutory duties are owed to the public.” *Leighton*, supra note 6, at paragraph 54.
the issue of proximity, but also as residual policy considerations negating any duty of care in accordance with the second stage of the Anns-Cooper analysis.

For example, in Leighton, Fisher J dealt with the matter both as a question of proximity and as a residual policy consideration, observing in respect of the latter that

there are residual policy considerations that would militate against recognizing a duty of care in this case, one example being that the effect of recognizing a duty of care would conflict with CRA’s broad duties under the Income Tax Act to ensure that all taxes lawfully owing are correctly assessed and collected.21

Similarly, in the decision of the Supreme Court of British Columbia in Foote v. Canada (Attorney General), Dley J struck out the plaintiff’s negligence claim, concluding that the duties of the CRA are owed exclusively to the Crown:

The duty of care owed by the Revenue Agency is to the Crown—not to the taxpayer. As long as the auditor is reasonably competent, any flaws in the investigation are not subject to liability under the tort of negligent investigation.22

In 783783 Alberta, the court also characterized the duties owed by CRA tax assessors as fundamentally public duties, although the observations of the Alberta Court of Appeal are more nuanced than those of Hood J in Canus, Fisher J in Leighton, and Dley J in Foote:

The relationship between the tax assessors and any taxpayer is primarily to ensure that the taxpayer is fairly assessed. The tax assessors also have a general duty to the government they work for, and indirectly to the general public. But overall, the relationship is not one where the tax assessors should be responsible for protecting taxpayers from losses arising from competitive disadvantages of the type pleaded. The assessors’ duty is directed elsewhere.23

In City Centre Properties Inc. v. Canada,24 MacKay J also asserted that the duty of CRA employees is to protect the Crown’s interest, characterizing the relationship between taxpayers and the CRA as a debtor-creditor relationship. Accordingly, while

21 Leighton, supra note 6, at paragraph 58.
22 2011 BCSC 1062, at paragraph 41 (citing Canus, supra note 17, at paragraphs 50-51, 61-65, and 86-87; 783783 Alberta, supra note 11, at paragraph 48; and Hill v. Hamilton-Wentworth Regional Police Services Board, 2007 SCC 41). In Foote, the plaintiffs alleged negligence, misfeasance in public office, breach of privacy, false imprisonment, and trespass arising out of CRA tax-evasion investigation activities.
23 783783 Alberta, supra note 11, at paragraph 45.
24 (1994), 70 FTR 222.
expressly conceding that the relevant official in this case had been careless in allowing a letter guaranteeing tax debts to lapse, this carelessness was insufficient to support a duty of care to any taxpayer. MacKay J observed:

In my view he [the tax official] was at fault in performance of his duties in relation to the letter of guarantee by letting it lapse. But carelessness in performance of his duty in ensuring protection of the Crown’s interest does not constitute negligence at common law for he owed no duty to [the taxpayer] to call for payment under the bank guarantee.25

**Parliamentary Sovereignty, Floodgates, and Chill Factor Policy Concerns**

In addition to the concern not to impose private-law duties on tax officials that might conflict with CRA duties to the Crown, a number of other residual policy concerns have been raised in the tax cases. One such concern is the fear of subjecting the CRA to large and indeterminate liability. For example, in 783783 Alberta, the court held that

[recognizing a duty of care in tort in such circumstances would expose Canada to liability to an unidentifiable group for an indeterminate amount.26

In *Canadian Taxpayers Federation v. Ontario (Minister of Finance)*, the same issue was raised in rejecting the plaintiffs’ claim of negligent misrepresentation, with Rouleau J expressing a fear that imposing a duty of care “would raise the spectre of unlimited liability to an indeterminate class.”27 This case concerned a written election promise by Ontario Premier Dalton McGuinty that a re-elected Liberal government would not introduce any new taxes. Upon re-election, the Liberal government introduced the Ontario health premium. The plaintiffs alleged that this constituted either a breach of contract and/or a negligent misrepresentation.

Rouleau J, in dismissing the negligent misrepresentation claim, also referred to a number of other policy concerns, including a concern that

[imposing a duty of care in circumstances such as exist in the present case would have a chilling effect. . . . Once elected, members would be concerned about the representations they made during their election campaigns and would not consider themselves at liberty to act and vote in the public interest on each bill as it came before the legislature.28

25 Ibid., at 239-40.
26 783783 Alberta, supra note 11, at paragraph 48.
27 (2004), 73 OR (3d) 621, at paragraph 70 (SC).
28 Ibid., at paragraph 71.
In McCreight, Patterson J summarized a number of additional policy arguments centred on justiciability and underlying separation-of-powers concerns often raised by the Crown to negate any possible duty of care to individual taxpayers:

The government in this case argued that there were other remedies available to the plaintiffs; that the issue of misfeasance and malicious prosecution are available for the plaintiff in this case against the Attorney General of Canada; that it should not be permissible for the public to second guess every aspect of the investigatory work with the benefit of hindsight; and, that a duty of care to the public at large is contrary to the self-assessing tax system and the government’s need to raise revenue through the Income Tax Act.29

Collateral Attack/Availability of Alternative Remedies

The reasoning of Patterson J in McCreight refers to the availability of alternative remedies as negating any possible CRA duty of care to taxpayers. This issue features prominently in the reasoning in a number of cases. Typically, the argument is justified by reference to the comprehensive measures contained in the Income Tax Act (ITA)30 that allow taxpayers to challenge tax assessments. An argument to this effect was accepted by Hood J in Canus. She observed that

the Act provides a complete remedy by way of notices of objection and appeals. As well, s. 152(8) of the Act provides that assessments are deemed to be valid and binding.31

This argument is particularly prominent in cases where negligence by the CRA in carrying out its tax-assessment duties is alleged. For example, in Canada v. Roitman,32 the appellants raised a range of tortious claims arising out of a reassessment of their tax liabilities in accordance with terms of settlement struck with the CRA. The Federal Court of Appeal dealt summarily with these allegations, concluding that it had no jurisdiction to hear such claims.

The court in Roitman characterized the appellants’ claim as, in reality, a challenge to tax assessments, and held that such challenges must be dealt with utilizing the mechanisms contained in Canadian tax legislation.33 This argument is often referred

29 McCreight, supra note 13, at paragraph 63.
30 RSC 1985, c. 1 (5th Supp.), as amended.
31 Canus, supra note 17, at paragraph 104.
32 2006 FCA 266. The appellants also pleaded breach of fiduciary duty, unjust enrichment, breach of trust, and abuse of public office.
33 Similarly, in Smith et al. v. Canada (Attorney General) et al., 2006 BCCA 237, at paragraph 11, the British Columbia Court of Appeal concluded, “The causes of action all have a common element: they allege that the respondents acted wrongfully toward the appellants in the rule-making and administration of the tax scheme regarding their meal expenses. This is, in reality, a challenge to the assessments by the Canada Revenue Agency. Since the Income Tax Act provides administrative remedies for disputes regarding income tax assessments, the issues lie outside the jurisdiction of the Supreme Court.”
to as the “collateral attack” doctrine. The substance of the collateral attack doctrine is that “a plaintiff is not allowed to frame his action, with a degree of artificiality, in the tort of negligence to circumvent the application of a statute.”

Some limitations have been placed on the collateral attack doctrine. For example, in *Gardner v. Canada (Attorney General)*, an interesting distinction was drawn by the Ontario Superior Court of Justice between tortious actions challenging CRA processes as distinct from assessments of tax:

Ms. Gardner’s claim for tort damages depended on the alleged improper process and improper purpose for which the CRA officials acted in reassessing her tax return. The issue in her tort claim was not whether or not the taxes were owing but rather her allegation that the process followed by CRA officials constituted tortious conduct which caused her to suffer damage. . . . The issue of whether the taxes were really owing is a different issue from whether the CRA officials’ actions were tortious, namely that they followed an improper process and acted for an improper purpose and thereby caused Ms. Gardner to suffer damage.

Accordingly, if a case involves no challenge to any tax assessment and comprises allegations of negligence only peripherally associated with an assessment, the collateral attack argument loses its force.

**CANADIAN TAX OFFICIALS AND THE TORT OF NEGLIGENT INVESTIGATION**

Concurrently with the developments outlined above, Canadian courts have also recognized a tort of negligent investigation that has significant scope for application in a tax context. The tort was first recognized in 1997 in *Beckstead v. Ottawa (City of)*. In that case, the Ontario Court of Appeal recognized the tort in the context of criminal prosecutions. The case involved an action for damages for negligence on the part of a police officer in laying a criminal charge against the plaintiff. Subsequently, in *Hill v. Hamilton-Wentworth Regional Police Services Board*, the Supreme Court of Canada in a 6-3 decision reaffirmed the existence of the tort, with the majority concluding

that police are not immune from liability under the Canadian law of negligence, that the police owe a duty of care in negligence to suspects being investigated, and that their

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35 2012 ONSC 1837, at paragraphs 54-55.

36 As discussed below, the British Columbia Court of Appeal had cause to give comprehensive consideration to the scope of the collateral attack argument in *Leroux*, supra note 1.

37 1997 CanLII 1583 (ONCA).
conduct during the course of an investigation should be measured against the standard of how a reasonable officer in like circumstances would have acted. The tort of negligent investigation exists in Canada.\textsuperscript{38}

The scope of the tort has subsequently been extended in a number of cases. For example, in 2008 in \textit{Correia v. Canac Kitchens},\textsuperscript{39} the Ontario Court of Appeal extended the tort to cover the case of negligent investigation by a firm of private investigators retained to investigate employees. Most pertinently, however, in 2011, in \textit{Neumann v. Canada (Attorney General)},\textsuperscript{40} the British Columbia Court of Appeal appeared to accept that the tort of negligent investigation applied in the case of the execution of a warrant under the ITA, but held that the plaintiff had not made out a case of negligence. \textit{Neumann} involved an allegation that the CRA had negligently obtained and executed a search warrant to search the plaintiff’s home as part of a tax-evasion investigation of a business associate of the plaintiff. In effect, therefore, the plaintiff was a third party to the investigation of the suspect. Despite this fact and the fact that, in contrast, both \textit{Hill} and \textit{Beckstead} involved a direct relationship between investigator and suspect, the court was prepared to proceed on the basis that the CRA still owed a duty of care to the plaintiff third party, only finding against the plaintiff on the basis of absence of a breach of that duty.

It is interesting to contrast this finding with the determinations in cases such as \textit{Leighton} and \textit{783783 Alberta}, which also involved allegations of negligence by third parties (a shareholder of the corporate taxpayer in \textit{Leighton} and a business competitor of the taxpayer in \textit{783783 Alberta}). It will be recalled from the earlier discussion of these cases that the proximity hurdle proved insurmountable for the third-party plaintiffs in seeking to establish the existence of a CRA duty of care. Accordingly, in cases where third parties allege that they are owed a tortious duty of care, the tort of negligent investigation potentially holds better prospects for success. The matter, however, is far from resolved. The question of whether a duty could be owed to a third party was not raised by the CRA in \textit{Neumann} until both parties had concluded their cases, allowing no scope for judicial consideration.

The question of the applicability of the tort of negligent investigation in the tax context was most recently re-examined in \textit{Gordon v. Canada}.

\textsuperscript{41} In this case, the plaintiff chartered accountants and their accounting firm were accused of fraud by the CRA for the methodology that they employed in claiming research and development tax credits for their clients. As a result, the Crown pursued criminal charges against

\textsuperscript{38} \textit{Hill}, supra note 22, at paragraph 3. The Ontario Court of Appeal had revisited the issue in 2005 (\textit{Hill v. Hamilton Wentworth Regional Police Services Board}, 76 OR (3d) 481) and reaffirmed the existence of the tort by a 3-2 decision (although concluding that a case for liability had not been made out).

\textsuperscript{39} 2008 ONCA 506.

\textsuperscript{40} 2011 BCCA 313.

\textsuperscript{41} 2013 FC 597.
the plaintiffs, which were ultimately dropped after almost seven years. Hughes J rejected an application by the Crown to strike out the negligent investigation claim by the plaintiffs, accepting the prothonotary’s characterization of the plaintiffs’ situation as analogous to the situation involving police and a suspect. Specifically, Hughes J observed that in both instances, the subjects of the investigation have a critical personal interest in the conduct of the investigation, with their personal freedom and reputations being at stake. Accordingly, although describing the allegations of negligence as “tenuous,” Hughes J concluded that

[i]t can hardly be said that the Claims are bereft of any likelihood that there is no proximate relationship giving rise to a duty of care.42

However, he further qualified his conclusion by noting that

[t]he case law is clearly evolving in this area, and the last word has yet to be written by an appellate court.43

It is interesting to contrast the approach of Hughes J in Gordon with the approach of Patterson J in McCreight as outlined in the earlier discussion. The CRA sought to rely on McCreight in Gordon on the basis of the factual similarity between the two cases. McCreight also involved ultimately discontinued prosecutions of tax advisers for fraud and conspiracy arising out of research and development credit claims by a number of their clients. It will be recalled that the plaintiffs in McCreight failed both stages of the Anns-Cooper test. Despite the factual similarity, Patterson J made little reference in McCreight to the tort of negligent investigation; he simply referred to Neumann as confirming “that there is no legal authority for establishing a duty of care between CRA officers and the subject of an investigation”44 and confined Hill to its facts.45 Hughes J in Gordon noted that McCreight is currently on appeal.46 It will be interesting to see whether the Ontario Court of Appeal affords greater weight to the tort of negligent investigation argument.

One hopes that the Court of Appeal in its decision on McCreight will resolve the uncertainties with respect to proximity and foreseeability—stage one of the Anns-Cooper analysis—concerning the potential application of the tort of negligent investigation in the tax context. Ideally, the court will also give detailed consideration to the possible policy concerns at stage two of the Anns-Cooper analysis, which could be raised in seeking to apply the tort of negligent investigation in the tax

42 Ibid., at paragraph 28.
43 Ibid., at paragraph 39.
44 McCreight, supra note 13, at paragraph 54.
45 This cursory treatment of the tort is typical of the tax cases. See, for example, the comments of Dley J in Foote, supra note 22, at paragraph 41 (quoted in the text above at note 22).
46 Gordon, supra note 41, at paragraph 33.
context. This detailed consideration is lacking in the cases to date, despite the significant judicial attention given to a range of policy concerns in Hill. The majority of the Supreme Court in Hill considered policy issues such as the quasi-judicial nature of police duties, the potential effect that imposing liability could have on prosecutorial discretion, the potential for confusion with the standard of care for arrest, potential chilling effects and floodgate effects, and the risk that guilty persons who are acquitted may unjustly recover in tort.

It is difficult to predict how consideration of such concerns might play out in the tax context. For example, on the one hand it could be argued that criminal law touches upon fundamental issues of liberty and security of the person, demanding tortious protection not applicable in the context of simple revenue statutes. But it could also be argued that if the Supreme Court was able (in Hill) to extend tortious protection in an area as fundamental as criminal law (notwithstanding arguable risk to the integrity of the criminal justice system), extending that same protection to less serious forms of investigation should pose little difficulty. Certainly this was the type of reasoning applied in Correia to extend liability to private investigators, where the Ontario Court of Appeal observed that “on a policy level, the case for recognizing a duty of care in respect of private investigation firms may be stronger than for police.”47 It is unclear, however, whether a similarly expansive approach will be taken in the tax investigation context.

The question may ultimately come down to the extent to which the tax functions being challenged are characteristic of fact-based investigative functions, similar to the functions carried out by police. The answer is likely to differ for different tax administration activities. For example, investigations in connection with alleged offences under the ITA and the Excise Tax Act (ETA)48 are closely related to the police investigations described in Hill. However, tax audits under those statutes may not be as directly comparable. It is unclear whether this would make them more or less susceptible to the imposition of a duty of care to taxpayers.

In either event, the standard for assessing how much weight various policy concerns should be afforded to determine whether a duty of care should be imposed was explained by McLachlin CJ in Hill as follows:

In approaching these arguments, I proceed on the basis that policy concerns raised against imposing a duty of care must be more than speculative; a real potential for negative consequences must be apparent.49

There is little guidance to date in the tax cases involving the tort of negligent investigation as to how judges might approach the application of this test and which policy concerns might prevail. Accordingly, at present, the treatment of the policy

47 Correia, supra note 39, at paragraph 38.
49 Hill, supra note 22, at paragraph 48.
issues in the negligence cases discussed above provides the greatest insight into how judges might approach these issues. These cases indicate that there are a number of policy concerns that will be afforded significant weight in the tax context. For example, while McLachlin CJ in Hill was dismissive of floodgate\textsuperscript{50} and chill factor\textsuperscript{51} concerns in the police context, such concerns have been taken much more seriously in tax cases such as 783783 Alberta and Canadian Taxpayers Federation. It will be recalled from the earlier discussion that in 783783 Alberta, the court held that “[r]ecognizing a duty of care in tort . . . would expose Canada to liability to an unidentifiable group for an indeterminate amount.”\textsuperscript{52} Similar comments were made by Rouleau J in Canadian Taxpayers Federation.\textsuperscript{53}

Perhaps the most significant policy hurdle that might be encountered in the tax context is the argument that the ITA does not create any duties to taxpayers and that the duties of the CRA are owed exclusively to the Crown. This argument was advanced by the CRA in Gordon. Hughes J agreed that the ITA itself creates no tortious duties to taxpayers. This is broadly consistent with the reasoning in Foote, Canus, 783783 Alberta, and Leighton, as discussed above. Hughes J also reproduced the reasoning in Leighton, to the effect that “recognizing a duty of care would conflict with CRA’s broad duties under the Income Tax Act to ensure that all taxes lawfully owing are correctly assessed and collected.”\textsuperscript{54} However, for reasons including an acknowledgment of the evolving and unresolved nature of the law in this area, Hughes J was not prepared to dismiss the possibility that a tortious duty of care might be capable of coexisting with the CRA’s statutory duties to the Crown. Accordingly, the question has been left open. Undoubtedly it is a policy question that will arise for consideration in Leroux.

**LEROUX AND THE PROSPECT OF A SUCCESSFUL NEGLIGENCE CLAIM AGAINST THE CRA**

In all of the cases discussed thus far, the plaintiffs’ tortious actions against the CRA were unsuccessful. However, a glimmer of hope that a taxpayer negligence claim against the CRA might succeed arose recently in Leroux. In this case, the plaintiff alleged misfeasance in public office, negligence, and breach of the Canadian Charter of Rights and Freedoms\textsuperscript{55} and the Canadian Bill of Rights.\textsuperscript{56} While the Charter and

\textsuperscript{50} See ibid., at paragraph 61.

\textsuperscript{51} Ibid., at paragraphs 56-59.

\textsuperscript{52} 783783 Alberta, supra note 11, at paragraph 48.

\textsuperscript{53} Canadian Taxpayers Federation, supra note 27, at paragraph 70.

\textsuperscript{54} Leighton, supra note 6, at paragraph 58, cited in Gordon, supra note 41, at paragraph 31.

\textsuperscript{55} Canadian Charter of Rights and Freedoms, part I of the Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK), 1982, c. 11 (herein referred to as “the Charter”).

\textsuperscript{56} Canadian Bill of Rights, SC 1960, c. 44 (herein referred to as “the Bill of Rights”).
Bill of Rights claims were struck out,\(^\text{57}\) the British Columbia Court of Appeal refused to strike out the tortious claims. In reaching this conclusion, the court reasoned as follows:

The question on this appeal is whether negligent supervision or a negligent act in the course of the administration or enforcement of either of the taxing acts in issue, can give rise to a private law remedy. The answer to that question depends on whether a duty of care should be imposed on the CRA or any of its employees toward a taxpayer. Neither party has provided any authority or analogous cases in which any court has previously identified proximity between a taxing authority and a taxpayer.\(^\text{58}\)

While the decision falls short of confirming a taxpayer’s capacity to successfully sue the CRA for negligence, the issue is now unequivocally open to debate.\(^\text{59}\) It is therefore pertinent to consider how the facts in \textit{Leroux} might play out if the case ultimately proceeds to a full hearing of the negligence issues. A necessary starting point for this consideration is an understanding of the basic facts of the case.

\textbf{The Facts in Leroux}

The facts in \textit{Leroux} were described by Preston J in the hearing of the matter by the British Columbia Supreme Court as “a series of Kafkaesque events that spanned approximately 13 years.”\(^\text{60}\) The plaintiff’s problems started in 1996 with an audit of business records related to the recreational vehicle park that he operated in the province. As part of the audit process, the CRA auditors took possession of the taxpayer’s business receipts and other records. Before those records could be copied, a significant proportion of them were shredded or simply lost by the CRA. Nevertheless, the audit was completed, and since the taxpayer was unable to substantiate significant business expense deductions, his liability for both income tax and goods and services tax (GST) was reassessed (after numerous audits over a number of years) at a combined total of approximately $1 million.

The CRA issued seizure and sale orders against the plaintiff’s property to recover the assessed tax debt. The plaintiff unsuccessfully sought to put up cash deposits with the CRA while he sought refinancing to secure the tax debt. As a result, he lost his properties and was ruined financially.

\(^{57}\) The British Columbia Court of Appeal affirmed the Supreme Court’s decision to strike out the Charter and Bill of Rights claims: see \textit{Leroux} (BCCA), supra note 1, at paragraphs 47, 55, and 57; and \textit{Leroux v. Revenue Canada Agency}, 2010 BCSC 865, at paragraph 75.

\(^{58}\) \textit{Leroux}, supra note 1, at paragraph 38.

\(^{59}\) Although in some cases the findings of the Court of Appeal in \textit{Leroux} have been overstated. For example, in \textit{McCreight}, supra note 13, at paragraph 57, Patterson J observed that “the \textit{Leroux} case found for the first time, in Canada, that a duty of care was owed by CRA agents for negligent conduct.”

\(^{60}\) \textit{Leroux} (BCSC), supra note 57, at paragraph 2.
The plaintiff’s appeal against the reassessments was heard by the Tax Court of Canada in 2005. Those proceedings were ultimately resolved by consent orders, pursuant to which the CRA agreed to reduce the plaintiff’s income tax liability to zero and his GST liability to $20,000. The latter amount was offset against a similarly-sized refund owing to the plaintiff. The plaintiff subsequently commenced the current tortious proceedings, seeking millions of dollars in damages for the loss of his property and business.61

The Supreme Court and Court of Appeal Proceedings

At the Supreme Court of British Columbia, the CRA sought to strike out the plaintiff’s statement of claim as a collateral attack on the tax assessments62 and/or as an abuse of process. Preston J rejected the collateral attack argument, characterizing the plaintiff’s claim in the following terms:

This action . . . raises issues distinct from those that would have been addressed in the statutory review process which concerned itself with the validity of the assessments. Further, the statutory review process under the ITA would not have provided the plaintiff with the remedy he seeks. On the information before this Court at this stage, the plaintiff’s action does not raise a collateral attack on the validity of the earlier proceedings.63

Preston J also considered and rejected the argument that the doctrine against collateral attack requires plaintiffs to first exhaust avenues of administrative law relief prior to resorting to damages claims in provincial superior courts. He concluded that

where the plaintiff’s claim does not challenge the validity of the decision, where the review process will not address the issues the plaintiff seeks to litigate and where the review process will not grant the plaintiff the remedy sought, requiring judicial review

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61 The Supreme Court of British Columbia described the plaintiff’s claims in the following terms: “His basic allegations are that the defendant CRA conducted a prolonged sequence of audits, assessments, reassessments, and collection procedures relating to both Income Tax and Goods and Services Tax that caused his substantial business empire to collapse and impoverished him.” Ibid., at paragraph 1.

62 Preston J described the collateral attack principle as follows: “On an application to strike out the statement of claim based on abuse of process, the court must look beyond the cause of action alleged and the remedy sought, and determine whether the statement of claim is in pith and substance an action questioning the validity of the tax assessments. If the action does not question the lawfulness of the assessment or if questioning the lawfulness of the decision is not a pre-requisite to the damages sought, because the Tax Court does not have the jurisdiction to determine tort liability, then bringing an action in the provincial superior courts is not a collateral attack on the tax assessment.” Ibid., at paragraph 36.

63 Ibid., at paragraph 54.
as a pre-requisite does not serve the policy interests that underlie the rule against collateral attack.64

On the question of whether a reasonable cause of action in tort might lie, Preston J was brief and to the point, concluding that

> [t]he facts pleaded in the amended statement of claim are sufficient to support those claims. The existence of a duty in tort on the part of CRA is an arguable issue.65

At the Court of Appeal, the CRA unsuccessfully appealed the Supreme Court’s refusal to strike out the plaintiff’s tort claims.66 The court rejected the CRA’s suggestion that the plaintiff’s claim would necessarily involve revisiting particulars of the assessments that were the subject of the earlier Tax Court proceedings. The court observed that while

> Crown liability in tort and the validity of an underlying administrative decision may generate some overlapping considerations . . . they present distinct and separate justiciable issues. They are conceptually distinct.67

On the question of whether the pleading revealed a sustainable cause of action in negligence, the court was less conclusive:

> The CRA’s primary duty, as the agent of the Minister, is to fulfill its statutory mandate to administer and enforce the ITA . . . as well as other taxing statutes. . . . The question on this appeal is whether negligent supervision or a negligent act in the course of the administration or enforcement of either of the taxing acts in issue, can give rise to a private law remedy. The answer to that question depends on whether a duty of care should be imposed on the CRA or any of its employees toward a taxpayer. Neither party has provided any authority or analogous cases in which any court has previously identified proximity between a taxing authority and a taxpayer. Without such an established or analogous category, Mr. Leroux must plead and ultimately prove that the CRA or one of its employees was in a close and direct relationship to him or her such that it is just to impose a duty of care in the circumstances.68

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64 Ibid., at paragraph 49. The reasoning is similar to the reasoning of the Alberta Court of Appeal in 783783 Alberta, supra note 11. In that case, at paragraph 42, the court rejected an interpretation of Holland v. Saskatchewan, [2008] 2 SCR 551, that would have incorporated “into the law of tort the administrative law concept of exhaustion of remedies. The law of tort is a free-standing, primary basis for civil liability, not merely a residual cause of action which only exists when no other remedy can be identified.”

65 Leroux (BCSC), supra note 57, at paragraph 56.

66 The plaintiff cross-appealed against the dismissal of his Charter and Bill of Rights claims. As noted above, both the appeal and the cross-appeal were unsuccessful: see supra note 57.

67 Leroux, supra note 1, at paragraph 22.

68 Ibid., at paragraphs 37-38.
The Leroux Negligence Claims and Stage One of the Anns-Cooper Approach

As intimated by the Court of Appeal, the greatest—and preliminary—hurdle for Mr. Leroux in any eventual trial of his tortious claims will be establishing a duty of care. The court will apply the Anns-Cooper analysis to determine this question. As noted earlier, stage one of the Anns-Cooper analysis addresses questions of reasonable foreseeability and proximity. The question of foreseeability is likely to be uncontroversial in the Leroux case. As noted by the Court of Appeal, the CRA “accepts [that] the circumstances pleaded disclose the reasonable foreseeability of harm.”69

However, as in the cases examined in the first part of this article, proximity will also be a significant hurdle for Mr. Leroux. Some of those cases can easily be distinguished from Leroux. For example, in Leighton and 783783 Alberta, the plaintiffs sought to extend proximity respectively to situations involving shareholders of taxpayers and to taxpayers for assessments of third parties. Leroux is confined purely to a discrete individual taxpayer-CRA relationship and involves no allegations of a CRA duty of care to any third party.

A greater challenge arises in dealing with the reasoning in cases such as Canus and McCreight, in which the plaintiffs also sought to confine a duty of care to discrete taxpayer-CRA relationships. It will be recalled that in McCreight Patterson J accepted as given the Crown’s submission that

the CRA and its prosecutors were in an inherently adversarial relationship with the subjects of the investigation . . . and therefore, this would be contrary to there being a proximity such that would create a duty of care.70

This argument is peculiar at best. Extending this reasoning to its logical conclusion would lead to the questionable result that persons in an adversarial relationship do not owe each other a duty of care. Patterson J cites no authority for such an approach in any tax case or in tort more generally. His acceptance of the Crown’s submission on this point is also inconsistent with cases such as Gordon and Neumann, in which, in the context of the tort of negligent investigation, judges have been prepared to concede that despite the adversarial nature of the relationship between the taxpayer and the CRA investigator, a duty of care can arise. Accordingly, a strong case could be advanced in Leroux that such an argument should not hold sway on the question of duty of care.71

However, it may be that Patterson J had in mind the less controversial (and more difficult to overcome) “inherently opposing interests” argument advanced by Hood J

69 Ibid., at paragraph 40.
70  McCreight, supra note 13, at paragraph 62.
71 Alternatively, the McCreight argument could be confined to situations involving criminal prosecutions of taxpayers.
in Canus.72 The nub of the argument is that opposing interests are created by the statutory scheme under the ITA. Accordingly, to impose a duty of care in these circumstances would be to contradict the statutory intent implied by that scheme. Hood J in Canus went further, arguing that this argument is strengthened by legislative silence as to how the minister and his employees should carry out their audit functions.

At its heart, the inherently opposing interests argument advanced by Hood J simply reflects the fact that taxation is fundamentally a state-sanctioned harm imposed on citizens in the form of an “enforced contribution exacted pursuant to legislative authority.”73 Necessarily, therefore, the ITA, and the CRA in administering its provisions, will adversely affect the interests of individual taxpayers, and opposing interests will arise. However, this fact, even when coupled with legislative silence as to how CRA officials are to carry out their duties, cannot be taken to preclude the possibility of the existence of any CRA tortious duty of care to taxpayers.

As noted by Lord Wilberforce in Anns v. London Borough of Merton,74 such situations do not absolve public officials from all tortious responsibility. In such situations, the common-law duty is simply modified to “a duty to avoid causing extra or additional damage beyond what must be expected to arise from the exercise of the [statutory] power or duty.”75 It is difficult, therefore, to sustain an argument that the inherently opposing interests of taxpayers and CRA officials, or the absence of specific legislative directives as to how CRA officials are to carry out their duties, necessarily negates any common-law duty of care to taxpayers. To sustain this argument, there must be something more specific in the legislative scheme.

Really, then, the question is whether any express tax provision or provisions can be interpreted as evincing a statutory intent to preclude a duty of care in negligence. Such an argument was considered in British Columbia Ferry Corp. v. Canada (Minister of National Revenue).76 In this unjust enrichment case, the Federal Court held that the relevant provision of the ETA—section 71—was a “comprehensive code” sufficient to preclude “the common law or any equitable remedy.”77 However, ETA section 71 is unequivocal, providing that

71. Except as provided in this or any other Act of Parliament, no person has a right of action against Her Majesty for the recovery of any moneys paid to Her Majesty that are taken into account by Her Majesty as taxes, penalties, interest or other sums under this Act.

72 See supra notes 18-19 and the related text.
74 Anns, supra note 5.
75 Ibid., at 500.
76 2000 CanLII 14950 (FC).
77 Ibid., at paragraph 10.
Pertinently, ETA section 71 is similar to one of the provisions under consideration in the landmark tort case of Cooper v. Hobart, namely, section 20 of the British Columbia Mortgage Brokers Act. This provision expressly prohibits action against the mortgage brokers registrar “unless it was done in bad faith.” In the face of such unequivocal statutory limitations on suit, it is understandable that both the Supreme Court in Cooper and the Federal Court in British Columbia Ferry Corp. reasoned that there was no room for any common-law duty of care to coexist alongside the statutory duties of the defendant public officials.

What distinguishes provisions such as these from a more general suggestion that common-law causes of action are always precluded in the tax context is that these provisions are prescriptive and expressly create specific immunities from suit. Arguably, the closest equivalent general income tax provision is the privative clause contained in ITA subsection 152(8). This provision provides limited immunity from suit with respect to assessments of tax, and reads as follows:

(8) An assessment shall, subject to being varied or vacated on an objection or appeal under this Part and subject to a reassessment, be deemed to be valid and binding notwithstanding any error, defect or omission in the assessment or in any proceeding under this Act relating thereto.

Consequently, a submission could be made in Leroux that Parliament turned its mind to questions of immunity from suit in the income tax context and chose not to extend immunity more broadly. The provisions considered in Cooper and in British Columbia Ferry Corp. provide examples of the Canadian legislature creating broader immunity from suit—the latter in a revenue context. Hence, if Parliament had intended to include a similar restriction on the right to sue the CRA, it could have done so. Instead, the privative provision in ITA subsection 152(8) applies only to tax assessments.

The more appropriate question, therefore, is whether the Leroux case falls within the scope of the express restriction on common-law suit contemplated by the current legislative scheme for dealing with tax complaints. This concern is captured by the

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78 Cooper, supra note 5.
79 RSBC 1996, c. 313.
80 Section 20 in its entirety provides, “An action may not be brought or continued against the registrar or a person acting under the authority of the registrar for anything done by the registrar or the person in the performance of duties under this Act or in pursuance or intended or supposed pursuance of this Act or the regulations, unless it was done in bad faith.”
81 Such provisions are common in the international tax context. International examples include sections 175 and 177 of the Australia Income Tax Assessment Act 1936 (Cth).
82 This argument is consistent with basic principles of statutory interpretation such as the well-known maxim expressio unius est exclusio alterius. For a generic discussion of this longstanding principle, see Clifton Williams, “Expressio Unius Est Exclusio Alterius” (1931) 15:4 Marquette Law Review 191-96.
residual public policy “collateral attack” argument. If the argument can be confined to the collateral attack doctrine in Leroux, the plaintiff is on solid ground. As noted above, both the British Columbia Supreme Court and the Court of Appeal in Leroux dealt with and dismissed the collateral attack argument (and the affiliated argument of exhaustion of alternative avenues of relief). The Court of Appeal described questions surrounding the assessment of the plaintiff’s tax liabilities and his tortious claims as “distinct and separate justiciable issues.” Accordingly, while the answer to the proximity question for the purposes of stage one of the Anns-Cooper analysis is far from straightforward, the preceding discussion suggests that Leroux is capable of falling within a narrow band of cases in which proximity could be established.

This is particularly true if the tort of negligent investigation is pleaded because, as discussed in the second part of the article, courts appear to have been more receptive of arguments that the relationship between tax officials and the subjects of CRA investigations is sufficiently proximate to support a tortious duty of care. It is significant, however, that to date the tort of negligent investigation has been raised in the tax context only in cases involving criminal conduct investigations. It would therefore be a significant extension of the current body of case law to seek to apply the tort in the Leroux context.

The Leroux Negligence Claims and Stage Two of the Anns-Cooper Approach

At stage two of the Anns-Cooper analysis, involving residual policy considerations, the plaintiff will also encounter significant difficulties, whether or not the tort of negligent investigation is also pleaded. The primary issue (which has also intruded in the stage one proximity analysis) is the general judicial view that the imposition of a tortious duty of care would conflict with the CRA’s duties to the Crown. However, on closer analysis, most judges have been equivocal when advancing this view. For example, as discussed above in Foote Dley J qualified his comments on this point, observing that such an argument would apply “as long as the auditor is reasonably competent.” Similarly, in 783783 Alberta the court implicitly accepted that “[t]he relationship between the tax assessors and any taxpayer is primarily to ensure that the taxpayer is fairly assessed.” Such obiter comments indicate that there is room for a common-law duty to taxpayers for torts falling short of deliberate misconduct to coexist with the CRA’s duties to the Crown. Tort of negligent investigation cases such as Gordon and Neumann appear to bear this out.

83 Leroux, supra note 1, at paragraph 22.
84 Foote, supra note 22, at paragraph 41. (For additional context, see note 22 and the related text.) Unfortunately, Dley J did not elaborate on what he meant by “reasonably competent.”
85 783783 Alberta, supra note 11, at paragraph 45. (For additional context, see supra note 23 and the related text.)
86 Given the peculiar facts in 783783 Alberta, in which a duty to third parties in carrying out tax-assessment functions was advanced by the plaintiff, the court was able to easily dispose of the question that any such duty is implicit in the Canadian legislative framework.
Nevertheless, not all judges have conceded this possibility. A prime example is the approach of MacKay J in *City Centre Properties*. It will be recalled that this case concerned a failure of a CRA official to enforce a bank guarantee securing tax debts of a predecessor of the plaintiff before the bank guarantee expired. Although MacKay J conceded that the CRA official had been careless, he reasoned that the official’s duties were owed to the Crown, not the taxpayer.87

The facts in *City Centre Properties* justify the approach of MacKay J and can be readily distinguished from the situation in *Leroux*. Had MacKay J concluded otherwise in that case, the effective result would have been the forgiveness of a tax debt owed by the plaintiff, creating inequality in the tax treatment of the plaintiff and other taxpayers. It is easy to see why residual rule-of-law and parliamentary sovereignty policy concerns would be permitted to intrude in these situations. No such situation exists in *Leroux* since the plaintiff no longer has an outstanding tax debt. There is no relationship of taxpayer debtor and CRA creditor in this case.

The unusual facts in *Leroux* are also likely to assist the plaintiff in dispelling the policy challenge that permitting his claim to succeed would open the floodgates to suit and potentially expose the CRA to large and indeterminate liability, and the allied concern that exposing the CRA to an extension of liability to taxpayers might result in overly defensive behaviour by tax officials or chilling effects. It is unlikely that there would be a flood of claims arising from taxpayer success in *Leroux*. This is because any precedent would be confined to factual situations in which

1. no challenge is posed to a CRA assessment decision;
2. the plaintiff does not owe any tax debt;
3. the actions complained of raise no challenge to the CRA’s decision-making or policy discretion; and
4. the factual matters and remedies sought cannot be dealt with under the review and objection mechanisms contained in the ITA.

Consequently, properly understood, a determination in favour of the plaintiff in *Leroux* should not elicit an overly defensive or wary response among reasonable and responsible tax officials, or usher in a flood of similar claims. Such potential negative consequences are more likely to be speculative than real.88 Nevertheless, if the CRA persists in advancing such arguments, those arguments should be weighed against any possible countervailing positive policy effects (for example, improvements in taxpayer trust and confidence and the encouragement of greater care) that might flow from imposing liability on the CRA in circumstances such as those that arose in

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87 See supra notes 24-25 and the related text.
88 It will be recalled that in *Hill*, supra note 22, at paragraph 48, the Supreme Court of Canada approached such policy concerns (in the context of the tort of negligent investigation) on the basis that to be sustainable, the negative effects of imposing liability must be more than speculative—a real potential for negative consequences must be apparent.
Leroux. In this respect, it is relevant to note that the CRA’s treatment of Mr. Leroux has been widely and publicly denounced as unfair and unacceptable.89

CONCLUSIONS

The analysis in this article has demonstrated that the prospects of a successful negligence claim against the CRA are far from certain. Canadian judges have consistently expressed a reluctance to impose tortious duties of care in negligence on CRA officers. However, prior to Leroux, Canadian judges had not been faced with a realistic challenge to the sustainability of this reluctance. The cases to date have all asked judges to stretch concepts such as proximity beyond incremental encroachments on the CRA’s duties to the Crown in assessing and collecting Canadian taxes.

While it is difficult to speculate on the basis of pleadings alone how the appeal in Leroux might play out, this case is different. It raises no challenge to tax assessments and arises out of facts in which the taxpayer is not indebted to the CRA. It raises no challenge to the discretion of CRA officials in their interpretation of Canadian tax laws. It raises clear and seemingly uncontroverted evidence of purely operational CRA failures—especially in the negligent destruction/misplacement of the plaintiff’s original documentation—which were the catalyst for the calamitous and protracted continuing dispute between the CRA and Mr. Leroux. These factors may all enhance the plaintiff’s prospects of success.

Nevertheless, it remains to be seen whether Canadian judges will take up the challenge to deal with cases such as Leroux in a manner that resists the allure of rejecting the existence of a CRA duty of care on the basis of largely untested residual policy concerns—particularly any unstated but presumed legislative intent to deny taxpayer recovery in tort. This article has sought to provide an analysis of the existing case law to assist judges in this process.

Policy makers too could use this analysis as a primer for legislative clarification, particularly on the questions of to whom CRA duties are owed, and in what circumstances (if any) common-law duties are owed to taxpayers. Ultimately, this would be preferable to relying on piecemeal and incremental judicial innovation.

Even if the result of this legislative attention is the express negation of any common-law duties of care to taxpayers, the certainty that this development would produce for all taxation stakeholders and their advisers would be a welcome improvement. At the very least, it would eliminate any possibility that taxpayer rights may be needlessly sacrificed in the name of a presumed, but potentially non-existent, legislative intent.

89 For a typical example of the media’s response to Mr. Leroux’s plight, see Kevin Gaudet, “Audit Nightmare,” Canada Free Press, January 13, 2010 (www.canadafreepress.com/index.php/article/18927).
The Negotiation and Drafting of the First Australia-Canada Taxation Treaty (1957)

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PRÉCIS

La convention fiscale de 1957 entre l'Australie et le Canada était la troisième convention fiscale exhaustive conclue par l'Australie et la 11e par le Canada. La négociation et la rédaction de la convention, pas plus que son importance pour comprendre le développement de la pratique et de la politique en matière de convention de chaque pays, n'ont déjà fait l'objet de travaux de recherche publiés. Cet article se base sur des documents d'archives de la National Archives of Australia et de Bibliothèque et Archives Canada.

L'idée d'une convention est venue du Canada à la suite de demandes d'entreprises canadiennes (au départ, des sociétés de transport, et par la suite, Ford et Massey-Harris-Ferguson), qui, après la signature des conventions fiscales entre l'Australie et le Royaume-Uni en 1946 et l'Australie et les États-Unis en 1953, se sont senties en position de désavantage concurrentiel par rapport aux entreprises britanniques ou américaines investissant en Australie ou faisant affaire avec ce pays. Le lobbying actif des entreprises canadiennes visait à corriger les niveaux élevés d'imposition à la source en Australie et la position d'exportation déficitaire du moment du Canada par rapport à l'Australie. Au départ, l'Australie était peu disposée à conclure d'autres conventions fiscales; mais en 1953, ayant pris conscience des avantages directs qui pouvaient découler des conventions pour les investisseurs étrangers, en plus du désir de ne pas offenser le Canada et d'être solidaire du Commonwealth, l'Australie a donné son accord à une convention avec le Canada basée sur des modalités semblables à celles de la convention de 1953 entre l'Australie et les États-Unis.

Fait remarquable, après des négociations en personne en 1953, les fonctionnaires ont continué à négocier par correspondance jusqu'en 1957, même si le seul désaccord technique important entre les deux pays touchait l'impôt australien sur les bénéfices non distribués. Les fonctionnaires du ministère des Finances canadien craignaient peut-être une réaction défavorable des États-Unis si le Canada concédait davantage à l'Australie en matière d'impôt sur les bénéfices non distribués qu'il l'avait fait pour les États-Unis dans sa convention fiscale avec ce pays en 1946. Une fois les questions d'ordre technique résolues, à la suite d'une concession du Canada concernant l'impôt sur les bénéfices non distribués, les parties ont signé la convention de 1957. En conclusion, l'auteur plaide pour que l'on prenne en compte la nature unique de cette convention, qui est à la fois le troisième traité conclu par l'Australie et le 11e traité pour le Canada.
non distribués, le Trésor australien a ravivé son opposition générale aux conventions fiscales en réponse à la réaction publique défavorable aux niveaux élevés des paiements de dividendes par la filiale australienne de General Motors à sa société mère américaine. Dans les deux pays, les ministères des Affaires extérieures et les ministres concernés ont mis davantage d’efforts à promouvoir la solidarité avec le Commonwealth et les investissements directs entre les deux pays qu’à régler les questions d’ordre technique. Finalement, le point de vue pragmatique et axé sur la politique étrangère a prévalu, ce qui a mené à la signature de la convention en 1957.

La convention signée était semblable aux conventions canadiennes précédentes, mais avec quelques modifications résultant du désir de l’Australie de protéger certaines caractéristiques spécifiques de sa loi nationale. Certaines de ces caractéristiques distinctives sont toujours présentes de nos jours dans la pratique australienne en matière de convention. L’impression tirée des négociations est que, à cette époque, le Canada était prêt à accepter des particularités peu communes dans certaines conventions à condition qu’elles n’entrent pas en conflit avec les éléments clés que le Canada considérait comme essentiels à toutes ses conventions fiscales.

ABSTRACT
The 1957 Australia-Canada taxation treaty was the third comprehensive taxation treaty entered into by Australia and the 11th entered into by Canada. Neither the negotiation and drafting of the treaty nor its relevance for understanding the development of the treaty practice and policy of each country has previously been the subject of published research. This article is based on archival sources located in the National Archives of Australia and in Library and Archives Canada.

The impetus for the treaty came from Canada following submissions by Canadian businesses (initially shipping companies and subsequently Ford and Massey-Harris-Ferguson), which, after the signing of the 1946 Australia-Uk taxation treaty and the 1953 Australia-US taxation treaty, regarded themselves as being at a competitive disadvantage as compared with UK or US businesses investing in or doing business with Australia. The active lobbying by Canadian business reflected the high levels of source taxation in Australia and Canada’s then net capital export position in relation to Australia. Australia was initially reluctant to enter into further taxation treaties; but in 1953, awareness of the direct benefit that could flow to foreign investors through treaties, coupled with a desire not to offend Canada and notions of Commonwealth solidarity, meant that Australia was then willing to enter into a treaty with Canada on similar terms to those in the 1953 Australia-US treaty.

Remarkably, following face-to-face negotiations in 1953, officials continued to negotiate via correspondence until 1957, even though the only technical issue of substantial disagreement between them concerned Australian undistributed profits tax. Canadian Department of Finance officials may have been concerned about a possible adverse US reaction if Canada conceded more to Australia on undistributed profits tax than it had to the United States in the 1946 Canada-US treaty. Once the technical issues had been resolved, following a concession by Canada on undistributed profits tax, the Australian Treasury reignited its general opposition to taxation treaties in response to adverse public reaction to high levels of dividend remittances by the Australian subsidiary of General Motors to its US parent. In both countries, the departments of External Affairs and relevant ministers were more concerned with promoting Commonwealth solidarity and
direct investment between the two countries than with technical issues. Ultimately, this pragmatic and foreign-policy-oriented perspective prevailed, leading to the signing of the treaty in 1957.

The treaty entered into was similar to earlier Canadian treaties but with variations resulting from Australia’s desire to protect the operation of specific features of its domestic law. Some of those distinctive features continue in Australian treaty practice to this day. The impression gained from the negotiations is that, in this period, Canada was prepared to agree to unusual features in some treaties provided that they did not conflict with key features that Canada considered essential to all its taxation treaties.

**KEYWORDS:** TREATIES ■ AUSTRALIA ■ CANADA ■ NEGOTIATIONS ■ HISTORY

**CONTENTS**

Introduction 918

Canada’s Initial Attempt To Obtain a Taxation Treaty with Australia, 1947-1948 922

The Renewed Request for Negotiations, 1952 928

The Negotiations in Ottawa in May 1953 933

  - Industrial or Commercial Profits 935
  - Permanent Establishment — Substantial Equipment 938
  - Calculation of Undistributed Profits Tax 938
  - Undistributed Profits Tax on Private Companies 940
  - The Conclusion of the Negotiations and the Agreement To Continue Correspondence 943

The Resumption of Correspondence, 1954-1956 944

  - Dividends 946
  - Undistributed Profits Tax 946

Canada Concedes on Undistributed Profits Tax 958

Australia Delays in Sending Draft Treaty 959

The 1957 Australian Draft 967

The Signing of the Treaty and Its Significance for Each Country 974

Concluding Observations 985
INTRODUCTION

The 1957 Australia-Canada taxation treaty\(^1\) was the third comprehensive taxation treaty entered into by Australia\(^2\) and the 11th entered into by Canada.\(^3\) The treaty is briefly mentioned in some previous literature on Canadian and Australian taxation treaties,\(^4\) but neither its negotiation and drafting nor its relevance for understanding the development of the treaty policy and practice of each country has previously been the subject of published research.

The impetus for a taxation treaty between Canada and Australia came from Canadian businesses, which, following the ratification of the 1946 Australia-UK taxation treaty and the 1953 Australia-US taxation treaty, believed themselves to be at a competitive disadvantage as compared with UK or US businesses investing in or doing business with Australia. From a Canadian perspective, the main advantages to be

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1 Agreement Between the Government of the Commonwealth of Australia and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Mont Tremblant on October 1, 1957. References herein to “the Australia-Canada treaty” are to the agreement signed in 1957. In 1957, taxation treaties entered into by Australia and Canada were referred to as “agreements,” except in the case of their respective treaties with the United States, which were referred to as “conventions.” This terminology has continued in subsequent Australian practice, whereas current Canadian practice is generally to refer to Canada’s taxation treaties as “conventions.” The majority of Australian and Canadian taxation treaties have been agreed between governments and not between heads of state. There are exceptions to this general rule; for example, the Australia-Taipei treaty is an agreement between the Australian Commerce and Industry Office and the Taipei Economic and Cultural Office. Although the term “treaty” is technically confined to agreements between heads of state, it has been chosen as the preferred term in this article because it is an appropriate neutral descriptor that avoids terminology currently favoured by one country and not the other. “Taxation treaty” generally refers to a treaty that deals with the taxation of income and capital and the prevention of fiscal evasion.

2 The previous Australian taxation treaties were the 1946 Australia-UK treaty and the 1953 Australia-US treaty.

3 Canada had previously entered into taxation treaties with the following countries: the United States, 1942 (modified by a supplementary agreement signed in 1950); the United Kingdom, 1946; New Zealand, 1948; France, 1951; Sweden, 1951; Ireland, 1954; Denmark, 1955; Germany, 1956; the Union of South Africa, 1956; and the Netherlands, April 2, 1957. As will be apparent from the subsequent discussion in this article, but for Australian attitudes toward taxation treaties in the period 1946 to 1952 and Canadian attitudes toward undistributed profits tax, an Australia-Canada taxation treaty could easily have been the third comprehensive taxation treaty entered into by Canada.

4 For Canadian commentary, see, for example, Ernest H. Smith, “Making Canada’s Tax Treaties” (1962) 10:4 Canadian Tax Journal 289-97, which merely discusses (at 293) the entry-into-force provision of the Australia-Canada treaty and (at 295) includes the treaty in a list of taxation treaties entered into by Canada up to that time. Similarly, A.J. Easson, “The Evolution of Canada’s Tax Treaty Policy Since the Royal Commission on Taxation” (1988) 26:3 Osgoode Hall Law Journal 495-536, at 497, merely lists the Australia-Canada treaty among other taxation treaties entered into by Canada by 1966.
gained at this time from a taxation treaty with Australia were lower rates of Australian source-country tax on dividends paid by Australian subsidiaries to their Canadian parent companies, and taxation of shipping and aircraft profits on a residence basis. Previous literature indicates that, during this period, it was unusual for Canada to initiate taxation treaty negotiations, and commentators have suggested that Canada's negotiating position was generally weak, given that Canada typically gave little away in its bilateral taxation treaties. That Canadian businesses actively lobbied for a taxation treaty with Australia reflects the high levels of source taxation in Australia at the time and Canada's net capital export position in relation to Australia.

Prior to the negotiation of the 1953 Australia-US taxation treaty, the Australian attitude was that where unilateral provisions preventing double taxation existed in both countries, entry into bilateral taxation treaties only had the effect of reducing Australian revenue from foreign investment in Australia. The driving force behind Australia's decision to enter into a taxation treaty with the United Kingdom in 1946 had been the perceived inadequacy of the unilateral measures for relieving double taxation that the United Kingdom had adopted prior to 1946. Australia in this period was concerned that other countries wishing to enter into taxation treaties with it would require terms similar to those that it had agreed with the United Kingdom. Those terms included a zero rate of source-country taxation on dividends paid to a parent by a wholly owned subsidiary. Australia realized that, when coupled with a foreign tax credit system in the home country, the zero rate of source-country taxation meant that the benefit of reductions in source-country tax ensued to the foreign treasury rather than to the foreign investor (the so-called treasury effect).

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5 See, for example, Smith, supra note 4, at 290. Smith suggests a number of reasons for Canada's reluctance to initiate treaty discussions, including the generous (in his view) Canadian provisions granting unilateral relief from international double taxation, the relatively low rates of withholding tax in Canadian domestic law, and a shortage of senior government staff with experience in international tax work. (Smith notes that, at the time, the federal government had no permanent staff engaged full-time in this area.) Easson, supra note 4, at 501, also notes that most of Canada's early treaty negotiations appeared to have been initiated by the other country. In addition, Easson suggests that Canadians receiving foreign-source income benefited from a generous foreign tax credit system and were not overly concerned about negotiating reductions in foreign tax rates unless those rates were especially high.


The Spooner and Hughes report to the Australian treasurer in 1950 argued that adverse effects on US direct investment in Australia flowed from limitations in the US foreign tax credit system and from the absence of a taxation treaty between Australia and the United States. Nevertheless, the Australian Treasury appears to have remained skeptical about the relationship between a taxation treaty with the United States and increased US investment in Australia. The treasurer’s Cabinet submission requesting authorization to commence negotiations with the United States expressed the view that it was likely that increased US investment in Australia would occur in the absence of a taxation treaty, and that any such investment was likely to be of a transitory nature and of restricted value to the Australian economy. The treasurer’s submission was that negotiating a taxation treaty with the United States could not be justified on taxation principles, but that it was necessary to consider “political considerations arising out of the relationships between the two countries in the then current circumstances.” It is possible that the treasurer’s reference to political considerations alludes to negotiations, commencing in February 1951, for the ANZUS treaty (a military alliance between the United States, Australia, and New Zealand). In negotiating the 1953 Australia-US taxation treaty, Australia persuaded the United States to agree to a 15 percent source-country tax on all dividends. This concession, coupled with the relative rates of corporate tax in both countries, enabled the Australian commissioner of taxation to advise the Australian treasurer that the reduction in Australian source-country tax on dividends under the treaty provided real benefits to US investors rather than to the US treasury.

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8 E.S. Spooner and J.W. Hughes report to A.W. Fadden, Commonwealth Treasurer, August 30, 1950 (herein referred to as “the Spooner and Hughes report”), in “United States of America—Double Taxation Agreement Between Australia and the United States of America,” National Archives of Australia, series no. A1838, control symbol 827/1/5, part 1, barcode 555197.


10 Ibid.

11 The ANZUS treaty was concluded on September 1, 1951 and came into force on April 29, 1952. There is an extensive literature, much of it partisan, on the Australia-US alliance. For a critical review of the literature, see David McLean, “Australia in the Cold War: A Historiographical Review” (2001) 23:2 International History Review 299-321.

As it happened, the 15 percent dividend tax rate in the Australia-US taxation treaty coincided with the rate of withholding tax on dividends in Canadian domestic law and with what was then, and for some years later, the sacred cow of Canadian tax treaty policy. As a believer itself in high rates of source taxation on dividends, Australia was, initially at least, happy to enter into a treaty in which source-country taxation of dividends was only reduced to 15 percent rather than to zero, as had been the case under the 1946 Australia-UK taxation treaty in respect of dividends paid by Australian wholly owned subsidiaries of UK companies.

Awareness that a taxation treaty could be negotiated in a manner that produced benefits for direct investors in Australia, coupled with notions of Commonwealth solidarity and a desire not to offend Canada, led to the Australian government's willingness, from 1953 to 1956, to enter into a taxation treaty with Canada on terms similar to those in the recently concluded Australia-US taxation treaty.

Remarkably, following face-to-face negotiations in 1953, Australian and Canadian officials continued to negotiate via correspondence until 1957, even though the only technical issue of substantial disagreement between them throughout this period concerned undistributed profits tax. The correspondence was, at times, desultory and evidences a somewhat intransigent commitment to principle by taxation and finance officials on both sides.

It appears that Canadian Department of Finance officials may have been concerned about a possible adverse US reaction if Canada adopted a more liberal approach on undistributed profits tax in a treaty with Australia than it had taken in negotiating the 1942 Canada-US treaty. By 1956, when agreement on technical aspects of the treaty was finally reached (in part through the persistence of the Australian commissioner of taxation, as discussed in detail below), the Australian Treasury reignited its general opposition to taxation treaties in response to adverse public sentiment concerning the levels of low-taxed dividend remittances by General Motors Holden to its US parent. At this point, there was clearly a conflict of views between the Australian commissioner of taxation (who favoured a taxation treaty with Canada) and senior officials in the Australian Department of the Treasury (who opposed it).

13 See the discussion in Easson, supra note 4, at 500-1. James S. Peterson, “Canada’s New Tax Treaties” (1975) 23:4 Canadian Tax Journal 315-32, at 320, refers to the 15 percent treaty rate as “the sacred cow.” A rate of 5 percent had applied on subsidiary-to-parent dividends in the 1942 Canada-US taxation treaty. It is likely that the rate was reduced at the request of the United States. The initial US negotiating position on dividends in the 1953 Australia-US taxation treaty had been for a 5 percent source-country tax rate on subsidiary-to-parent dividends. See the memorandum, McGovern to Fadden, supra note 12, at 10-12, and particularly paragraphs 77 and 90. Under the 1946 Canada-UK taxation treaty, dividends paid by a wholly owned Canadian subsidiary of a UK parent company were exempt from Canadian tax where less than 25 percent of the gross income of the Canadian company was derived from interest and dividends (other than interest and dividends from any wholly owned subsidiary company). This reflected the United Kingdom’s negotiating position at the time and was consistent with proposals that the United Kingdom put to other Commonwealth dominions following the conclusion of the 1945 UK-US taxation treaty. See the discussion in Taylor, 2009 BTR and “Dreary Subject,” supra note 7.
The Australian and Canadian departments of External Affairs, and the relevant ministers in both countries, appear to have been more concerned with promoting Commonwealth solidarity and (particularly in Canada’s case) direct investment between the two countries, given that the undistributed profits tax issue had no immediate revenue consequences for either country. As will be seen below, ultimately the more pragmatic and foreign-policy oriented approaches of the respective departments of External Affairs prevailed.

This article is based on archival sources that I have been able to locate in the National Archives of Australia and in Library and Archives, Canada. These include Department of External Affairs files for each country, Canadian Department of Finance and Australian Treasury files, and Australian Cabinet submissions and minutes. I have not been able to locate an Australian Taxation Office file relating to the negotiation of the 1957 Australia-Canada treaty, nor have I been able to locate a Canadian Department of National Revenue, Taxation Division file relating to the treaty.

**CANADA’S INITIAL ATTEMPT TO OBTAIN A TAXATION TREATY WITH AUSTRALIA, 1947-1948**

The initial request for a taxation treaty between Australia and Canada came in 1947 from representatives of Canadian ship owners who, following the entry into force of the United Kingdom’s taxation treaty with Australia in 1946, regarded themselves as being at a competitive disadvantage, as compared with UK ship owners, in


15 “International Taxation—Canadian Tax Agreements with Other Countries—Australia Policy Development,” LAC RG 12, file 5425/A938-2, vol. 1 (herein cited as “Canadian Department of Finance file, 1957 treaty, vol. 1”); and National Archives of Australia, series no. A571, control symbol 1968/6374, part 1 (herein referred to as “Australian Treasury file, 1957 treaty”). Although the Australian Treasury file, 1957 treaty, discloses that a part 2 was created, officers of the National Archives of Australia have advised me that to date they have been unable to locate part 2 of this file in the National Archives.


17 The National Archives of Australia index to “J” files (which are Australian Taxation Office files relating to the negotiation of taxation treaties and other policy matters) records the existence of a file J 245/22, part 1, “Double Taxation—Australia-Canada,” but notes that it is “missing.”

18 Library and Archives Canada in Ottawa does not appear to contain any Department of National Revenue files relating to the negotiation of taxation treaties.
shipping to Australia.\textsuperscript{19} Although the initial request related only to the treatment of shipping profits, Canadian officials decided by September 1947 to suggest to Australia that a general taxation treaty be entered into between the two countries.\textsuperscript{20}

\textsuperscript{19} Letter from Robert Kidd, Resident Partner, Cooper Brothers Ltd., to Maxwell H.W. Mackenzie Esq., Deputy Minister of Trade and Commerce, West Block, Parliament Buildings, Ottawa, Ontario, May 28, 1947. Copies of the letter are contained in the Canadian Department of Finance file, 1957 treaty, vol. 1, and the Canadian Department of External Affairs file, 1957 treaty, part 1. Cooper Brothers Ltd. were the auditors for an international shipping line with Canadian subsidiaries that were engaged in trade with Australia and New Zealand and that had several charters for British interests for cargo from Australia. Kidd commented that the charters were extremely profitable and formed a considerable part of the Canadian companies' earnings. Prior to 1949, Canadian corporate tax was levied at a flat rate of 30 percent. A progressive rate scale for companies was introduced in 1949, with the first $10,000 being taxed at a 10 percent rate and a rate of 33 percent applying to income above $10,000. Between 1946 and 1951, provincial corporate tax at a rate of 5 percent was collected by the dominion government for all provinces other than Quebec and Ontario, which collected their own provincial tax. Companies were entitled to a credit (generally at a rate of 5 percent) for tax paid to provincial governments. Thus, up to 1949, the credit usually resulted in an effective corporate income tax rate (after allowing for the credit for provincial tax) that was equal to the dominion corporate tax rate. Also, until 1947, an excess profits tax at a rate of 15 percent applied to profits in excess of the company's average profits for the four years prior to 1939 of Canadian-resident companies, and to profits of non-resident companies carrying on business in Canada. Canadian budget resolutions introduced in 1947 provided that the tax would not be imposed on profits earned after December 31 of that year. Canadian excess profits tax is discussed in Herbert A.W. Plaxton, \textit{The Law Relating to Income Tax and Excessive Profits Tax of the Dominion of Canada}, 2d ed. (Toronto: Carswell, 1947), at 430-94. Canadian-resident taxpayers were entitled to a foreign tax credit up to the proportion of the tax otherwise payable that was equal to the proportion of the company's foreign-source income to the company's income from all sources. In 1947, Canadian parent companies were entitled to a credit for foreign underlying corporate tax paid by their wholly owned subsidiaries. Income that was exempt from tax in the source country was not eligible for a foreign tax credit. In 1947, the relevant provisions dealing with the foreign tax credit were sections 8(1) through (4) of the Income War Tax Act, RSC 1927, c. 97, as amended. These provisions are discussed in Plaxton, supra, at 180-91. The scope of the credit for underlying corporate tax was extended to dividends paid to Canadian parents by 50-percent-owned subsidiaries, by an amendment to the Income War Tax Act, section 8(2A) (SC 1947, c. 63, section 6). The amendment is discussed in Herbert A.W. Plaxton, Carl H. Morawetz, and J.S. Wright, \textit{Canadian Income Tax Law and Excess Profits Tax Law: 1949 Second Supplement (Cumulative) to Plaxton, 2nd Edition} (Toronto: Carswell, 1949), at 38. The Income War Tax Act continued to apply to the end of the 1948 Canadian tax year, at which time it was replaced by the Income Tax Act, SC 1948, c. 52. Section 37 of the 1948 Income Tax Act allowed a resident company a credit for underlying foreign corporate tax, and section 38 (subject to the limitations stated above) allowed all resident taxpayers a foreign tax credit for tax paid to the government of a country other than Canada. Sections 37 and 38 of the 1948 Income Tax Act are discussed in Plaxton et al., supra, at 174-76. Canadian corporate tax, corporate tax rates, and foreign tax credits for the period to 1955 are discussed in Francis Eugene La Brie, \textit{Introduction to Income Tax Law: Canada} (Toronto: CCH Canadian, 1955), at 199-206.

In Australia, the rate of corporate tax in 1947 was 30 percent, but a supertax was payable by non-private companies at a rate of 5 percent on taxable income in excess of £5,000. During the war, Australia had also introduced a wartime (company) tax, which applied to the amount (Footnotes 19 and 20 are continued on the next page.)
The official Australian response to the request for a treaty dealing with shipping and aircraft profits was that

- there was little prospect of privately owned aircraft operating between Canada and Australia, and therefore the question of taxation of profits from aircraft was not likely to arise;

by which the company’s taxable profit exceeded 5 percent of its capital employed. The rate of wartime (company) tax was 24 percent on the portion of a company’s taxable profit that represented more than 5 percent of its capital employed up to a maximum of 12 percent, and 48 percent on the balance of its taxable profit. Companies were subject to the higher of the supertax and the wartime (company) tax. The War-Time Company Tax Act 1947 (Cth) terminated the tax effective June 30, 1947.

Following the discontinuation of Canadian excess profits tax on December 31, 1947, between 1948 and 1949, a Canadian shipping company that carried on business in Australia and was subject to the Australian supertax on profits would not be entitled to a foreign tax credit for the excess of its Australian tax liability over its Canadian tax liability. In 1947, this would also have been true for a Canadian shipping company that was not subject to Canadian excess profits tax (for example, because it did not have excess profits as defined in the Canadian Excess Profits Tax Act, 1940, SC 1939-40, c. 32) but was subject to superprofits tax in Australia. By contrast, the Australian-source income of a British shipping company was exempt from Australian tax under the 1946 UK-Australia taxation treaty. If an equivalent provision had applied to the Australian-source income of Canadian shipping companies, prior to 1949 the global tax liability on a shipping company’s Australian-source income would have been limited to the Canadian tax of 30 percent, as distinct from the Australian tax of 30 percent and supertax of 5 percent on the excess of the company’s taxable income over £5,000.

20 The constitutional position of both countries at the time was that an international agreement between governments could be entered into and ratified as an executive act by ministers pursuant to an authorization by the governor general of the country. In both countries, however, implementation of a treaty as part of federal domestic law required an act of that country’s federal parliament. For a discussion of the constitutional position in relation to treaties at the time in both countries, see Ronald L. Cheffins, “The Negotiation, Ratification, and Implementation of Treaties in Canada and Australia: Part I” (1955-1961) 1:4 Alberta Law Review 312-24 and “. . . Part II” (1955-1961) 1:5 Alberta Law Review 410-30. The Canadian high commissioner in Canberra initially requested a limited treaty dealing with shipping profits. This is clear from an aide-mémoire dated October 16, 1947 from the High Commissioner for Canada, Canberra to the Secretary of State for External Affairs, Ottawa, Canada. The aide-mémoire from the Australian Department of External Affairs to the High Commissioner for Canada in Australia dated October 13, 1947 indicates that the original aide-mémoire from the High Commissioner for Canada to the Australian Department of External Affairs was dated July 18, 1947. The October 16, 1947 document and the October 13, 1947 document are in Canadian Department of External Affairs file, 1957 treaty, part 1. The instructions from the minister for external affairs to the Canadian high commissioner in Australia are set out in L.S. Pearson, for Secretary of State for External Affairs to High Commissioner for Canada in Australia, despatch no. 253, July 2, 1947, in Canadian Department of External Affairs file, 1957 treaty, part 1. It is possible that the instruction from the deputy minister of finance to the undersecretary of state for external affairs to raise the possibility of a taxation treaty with Australia may have been interpreted more narrowly (as a request for a treaty dealing only with taxes on shipping and air transport) than was originally intended. The letter from W.C. Clark, Deputy Minister, Finance, East Block, Ottawa to L.S. Pearson, Esq., Undersecretary of State for External Affairs (Footnotes 20 and 21 are continued on the next page.)
at that time, there were no shipping lines owned by Australian residents engaged in trade between Australia and Canada, and therefore Canada was not obtaining any revenue from Australian ship owners; and

the suggested agreement would mean that Australia would lose the revenue that it currently collected from Canadian ship owners, whereas Canada would benefit in that it would not have to give the ship owners credit for Australian tax they paid.

Hence, in the Australian view, the proposed agreement would provide advantages to Canada but would impose a revenue cost on Australia and would not provide any corresponding advantages to Australia.22

Australia reiterated the view that it had expressed in negotiating its 1946 taxation treaty with the United Kingdom, that profits from the carriage of passengers and freight from Australian ports were Australian, that the source country had the primary right to tax such profits, and that any double taxation should be relieved by the residence country. Australia adhered to this view despite the inclusion in the Australia-Uk treaty of a reciprocal exemption for shipping and aircraft profits, and stated that Australia would agree to a reciprocal exemption only if there was a reasonable balance in the number of the ships registered in each country, or if the agreement contained other factors that would compensate for the existing lack of balance.23 The Australian view was that the reciprocal exemption for shipping and aircraft profits in the 1946 Australia-Uk treaty should not be divorced from the overall context of the treaty and be seen as representing the Australian position.24
While noting the view expressed in an aide-mémoire by the Canadian high commissioner that the 1946 Australia-UK taxation treaty put Canadian ship owners at a competitive disadvantage as compared with UK ship owners, Australia indicated that it could not see how this could be so, given that Canadian ship owners would obtain a credit for Australian tax they paid.25

The Australian government’s view was that any taxation agreement with Canada should be comprehensive and should confer mutual advantages on the respective countries. Australia pointed out, however, that Australian law protected Australian residents from international double taxation on Canadian-source income. Australia did not tax its residents on income (other than dividends) derived in Canada that had been subject to tax in Canada. Canadian-source dividends were subject to Australian tax, but Australian residents were entitled to a credit for the lesser of the Canadian and the Australian tax on the dividend. Australia also understood that Canadian law, through a foreign tax credit, protected Canadian residents from international double taxation on Australian-source income.26 The conclusion in the Australian aide-mémoire to the Canadian high commissioner was that, in view of the unilateral relief against international double taxation provided by each country, there did “not appear to be any great need for such an agreement.”27

The Canadian response to Australia was that, while Canada also in its taxation treaty negotiations “strongly maintained” the prior right of source taxation, it viewed taxation of shipping and aircraft profits as an exception, owing to the difficulties associated with determining the source of the relevant profits.28 In addition, the Canadian view was that it was not easy to defend any system that required residents of one country to provide tax returns to another country. For these reasons, Canada had, without regard to the relative volumes of shipping or air transport involved, entered into treaties in which it gave up its right to tax shipping and air transport at source.

While Canada recognized that unilateral measures in both countries probably meant that international double taxation was “adequately taken care of” and that both countries were probably using reasonable methods to determine industrial and commercial profits of agencies, branches of foreign companies, and foreign-controlled

25 Ibid., at 1-2.
26 Ibid., at 2-3.
27 Ibid., at 3. See also the Fadden Cabinet submission, supra note 16.
28 W.C. Clark, Deputy Minister, Finance to Undersecretary of State for External Affairs, November 17, 1947, in Canadian Department of Finance file, 1957 treaty, vol. 1, outlining a suggested response to the Australian aide-mémoire dated October 13, 1947 (supra note 21). The instructions from the secretary of state for external affairs to the Canadian high commissioner in Australia are in substance virtually identical to Clark’s suggested response, but they adopt a slightly more diplomatic tone: rather than expressing disappointment at the Australian response, the high commissioner was asked to convey to Australia the principles that Canada had in mind when suggesting a taxation treaty. The instructions to the high commissioner are contained in despatch 472 dated November 10, 1947, in Canadian Department of External Affairs file, 1957 treaty, part 1.
enterprises, nonetheless Canada regarded it as desirable that “sound tax rules and practices should, wherever possible, be codified in Conventions with a view to securing widespread recognition of certain basic tax principles.”

Australia then replied on March 4, 1948. The Australian reply began by not denying that, owing to difficulties associated with determining the extent to which profits from shipping or air transport had their source in a particular jurisdiction, arguments could be advanced for placing these profits in a different category from ordinary trading profits. The Australian response noted, however, that most, if not all, of the conventions dealing with shipping or aircraft profits were between countries that taxed on both a residence and a source basis, and that the similarity between taxing systems would naturally facilitate entry by these countries into conventions dealing with shipping and air transport notwithstanding their revenue effects.

The response went on to point out that Australia departed from a purely source basis of taxation in only very limited circumstances and for this reason was reluctant to enter into a treaty that would involve it in waiving “its admitted right to tax” profits from shipping and air transport and incurring the associated revenue loss without there being a compensating revenue gain, simply because of difficulties associated with determining the source of those profits.

While Australia endorsed the Canadian view that, where possible, it was desirable to have sound tax rules and practices codified in conventions, with a view to achieving widespread acceptance of those rules and principles, the Australian view was that such conventions should be as comprehensive as possible so that mutual benefits would flow from them. If Australia were to enter into a treaty that exempted Canadian ship owners from Australian tax, then Australia would soon face similar requests from other countries and would eventually lose all the tax that it was currently obtaining from overseas ship and aircraft owners.

After acknowledging receipt of Australia’s response, and stating that the views of the Australian government had been noted, Canadian officials decided to discontinue the discussions. The Australian view as disclosed in this correspondence was consistent with the general Australian view expressed to other potential treaty partners, that bilateral taxation treaties were unnecessary where each country’s domestic law contained adequate provisions for unilateral relief from international juridical

29 Ibid.


31 Ibid.

double taxation. Australia also realized that agreeing again to a zero rate of source-country tax on dividends paid by wholly owned Australian subsidiaries to their foreign parents, as had been agreed in the 1946 Australia-Uk taxation treaty, would only benefit the foreign treasury and not the foreign direct investor.

This attitude prevailed among Australian taxation and treasury officials until 1951, when, following persistent lobbying by US businesses and possibly in a desire to obtain US-dollar loans, the Australian treasurer (A.W. Fadden) commissioned E.S. Spooner (the chair of the Commonwealth Committee on Taxation) and J.W. Hughes (a deputy commissioner of taxation) to report on whether Australia should enter into a double taxation treaty with the United States. The Spooner and Hughes report\(^3\) observed that limitations on the credit granted under the US foreign tax credit system meant that some international juridical double taxation still existed for US investors in Australia. The Spooner and Hughes report concluded that Australia should enter into a taxation treaty with the United States to stimulate US direct investment in Australia, and considered that the loss of revenue and the treasury effect would be mitigated if the United States adhered to its then treaty practice of agreeing to 5 percent source taxation of non-portfolio dividends and 15 percent source taxation of other dividends. Although Australian Treasury and taxation officials were less sanguine about the expected consequences of a taxation treaty with the United States, the actual treaty as agreed to in 1953 allowed 15 percent source taxation of all dividends, thus minimizing Australian revenue loss and virtually eliminating the treasury effect.\(^4\)

**THE RENEWED REQUEST FOR NEGOTIATIONS, 1952**

Until 1952, no further tax treaty negotiations or requests for negotiations took place between Canada and Australia. During the period from 1948 to 1952, the Canadian government continued to receive complaints from the shipping industry to the effect that the payment of taxes in both Australia and Canada was a heavy burden.\(^5\) It also received a submission from a Canadian aluminum manufacturer with a non-portfolio shareholding in an Australian aluminum manufacturing company, requesting Canada’s entry into a taxation treaty with Australia that would accord Australian dividends paid to Canadian residents tax treatment similar to the treatment given to Australian

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33 Supra note 8.

34 For a discussion of Australian attitudes to treaty negotiations in this period and the influence of the Spooner and Hughes report, see Taylor, 2012 *ATF*, supra note 12.

35 Note for file 3920-B-40, July 26, 1949, Double Taxation Agreement with Australia (noting discussion with Mr. Fisher of Canadian Maritime Commission), in Canadian Department of External Affairs file, 1957 treaty, part 1; and G.S. Hall, Director, Transportation and Communications Division to Undersecretary of State for External Affairs, March 24, 1952, in Canadian Department of External Affairs file, 1957 treaty, part 1, and Canadian Department of Finance file, 1957 treaty, vol. 1.
dividends paid to UK residents under the 1946 UK-Australia taxation treaty. Eaton, the assistant deputy minister of finance, pointed out that the 1947-48 discussions with Australia had not been very encouraging, but that years had passed since then and the Australian view might have changed. Eaton noted that he understood that Australia had recently concluded a taxation agreement with the United States (which had not yet been published) and that Eldon King of the US Treasury had advised him by letter that while he was in Canberra, he had had “many pleasant visits” with the Canadian high commissioner to Australia (C. Fraser Elliott). At Eaton’s suggestion, Canada’s secretary of state for external affairs wrote to the high commissioner, asking him to comment on the recent discussions between the Australians and US Treasury officials relating to the Australia-US double taxation treaty. The high commissioner was also asked to approach the Australians to see if they were receptive at that time to a comprehensive treaty that would include the usual

36 A.F.W. Plumptre (Undersecretary of State for External Affairs) to Assistant Deputy Minister of Finance (A.K. Eaton), May 29, 1952 (enclosing submission by Aluminium Limited dated March 29, 1952), in Canadian Department of External Affairs file, 1957 treaty, part 1, and Canadian Department of Finance file, 1957 treaty, vol. 1. Dividends paid by a wholly owned subsidiary to a non-resident parent company were exempt from source-country tax under the 1946 Australia-Uk taxation treaty. In March 1952, Australian corporate tax was payable by companies other than private companies and life insurance companies at a rate of 35 percent, with an additional tax of 10 percent also being payable, and dividends paid to non-resident companies were taxed on an assessment basis at the relevant corporate rate. The additional tax of 10 percent did not apply to the dividend income of non-resident companies. Hence, the Australian tax on the Australian-source income of an Australian wholly owned subsidiary of a Canadian public company would have been 45 percent and any dividends paid to the Canadian parent would have been taxed on an assessment basis at a rate of 35 percent. Relevant rates are set out in Australia’s Income Tax and Social Services Contribution Act 1951 (Cth).

In Canada in 1952, federal corporate tax was payable at a rate of 22 percent on the first $10,000 of taxable income and at a rate of 52 percent on taxable income in excess of $10,000. From January 1, 1953, the Canadian federal rates of corporate tax were 20 percent on the first $20,000 of taxable income and 49 percent on taxable income in excess of $20,000. Corporate rates in this period are discussed in Arthur W. Gilmour, *Income Tax Handbook 1953-1954* (Toronto: De Boo, 1953), at 351. A Canadian company holding more than 25 percent of the shares of a foreign company was entitled to a deduction for the amount of any foreign dividends received from that company, thus effectively rendering the foreign dividend exempt from Canadian tax. These provisions are discussed in Gilmour, supra, at 252, and in La Brie, supra note 19, at 273. A company that held less than 25 percent of the shares of a foreign company paying a dividend was entitled to a foreign tax credit, subject to the limits set out in note 13, supra. After allowing for credits for provincial corporate tax, the effective corporate tax rate for a Canadian company was 30.5 percent on taxable income of $15,000, 38.1 percent on taxable income of $25,000, and 49.7 percent on taxable income of $1 million. A table setting out effective rates of federal corporate income tax after allowing credit for provincial tax is set out in J. Harvey Perry, *A Fiscal History of Canada—The Postwar Years*, Canadian Tax Paper no. 85 (Toronto: Canadian Tax Foundation, 1989), at 397.

article on shipping and aircraft profits. The high commissioner advised the secretary of state that on the basis of discussions he had had with Eldon King and with R.G. Casey, the Australian minister for external affairs,

the former attitude toward double taxation agreements outlined in your despatch has changed and it now appears that the Government of Australia is now ready and willing to enter upon such agreements even though it may result, due to their particular position, in the reduction of revenue, but it enhances the possibility of further capital investments in their country and this latter thought now prevails.

The high commissioner also reported that King had told him that the Australia-US taxation treaty was broadly along the lines of the US-UK treaty and was very similar, in general, to existing comprehensive double taxation treaties. The high commissioner commented that “those skilled in these matters, such as Dr Eaton” would know “substantially what is in the agreements” in the light of King’s comments.

On June 26, 1952, the high commissioner wrote to Casey formally inquiring whether the Australian government would be receptive to entering into negotiations for a comprehensive tax treaty containing “the usual clauses relating to income from shipping and aircraft activities and other commercial profits, dividends and so forth.” Casey sent a formal reply, dated July 3, 1952, indicating that “[c]onsideration will be given at this end to the matters that you raise.” The Australian Department of External Affairs referred the request to the Australian Treasury for advice. Australian Treasury officials discussed the request with the Australian Taxation Office, where it was referred to the assistant deputy commissioner, M.J. Belcher,

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38 A.E. Richie, for Secretary of State for External Affairs to Canadian High Commissioner to Australia, Canberra, June 3, 1952, in Canadian Department of External Affairs file, 1957 treaty, part 1.

39 High Commissioner for Canada in Australia, Canberra to Secretary of State for External Affairs, June 26, 1952, in Canadian Department of External Affairs file, 1957 treaty, part 1.

40 The use of the plural appears to be a reference to the fact that Australia and the United States had concluded a treaty in relation to income tax and a separate treaty in relation to estate and gift duties.

41 Supra note 39.

42 C. Fraser Elliott, High Commissioner to Rt. Hon. R.G. Casey, MP, Minister for External Affairs, Canberra, June 26, 1952, in Canadian Department of External Affairs file, 1957 treaty, part 1. The high commissioner also asked Casey whether the negotiations might include a treaty on death duties (although the June 3 despatch from the secretary of state had not specifically asked him to do so). It appears that, prior to writing to Casey, the high commissioner had had informal discussions with P.S. McGovern, the Australian commissioner of taxation: memorandum from Canadian High Commissioner in Australia, Canberra to Secretary of State for External Affairs, March 13, 1953, in Canadian Department of External Affairs file, 1957 treaty, part 1.

43 R.G. Casey, Canberra, ACT to His Excellency Mr. C. Fraser Elliott, High Commissioner for Canada, Canberra, ACT, July 3, 1952, Australian Treasury file, 1957 treaty.
who had been involved in the negotiation of the treaties that Australia had previously concluded with the United Kingdom and the United States. The Australian treasurer, Fadden, advised Casey on September 30, 1952 that he would be agreeable to negotiations taking place with Canada for double taxation treaties in relation to both income tax and estate duty. Fadden suggested that negotiations first take place at the official level, indicating that he would make officials from his department available, with the understanding that no commitments would be entered into until the result of the officials’ discussions had been considered by both governments. Fadden also suggested that, before a reply was sent to the high commissioner, the matter might be submitted to Cabinet and, if Casey concurred, that Treasury officials might draft the Cabinet submission. Casey agreed that the request should be referred to Cabinet, and officials in the Treasury and the Taxation Office, in consultation with External Affairs officials, were asked to prepare the submission for Cabinet.

After summarizing the previous Canadian request for a treaty dealing with shipping and air transport and the Australian response to that request, the Cabinet

44 Correspondence from L.R. McIntyre (for secretary) Department of External Affairs, Canberra to the Secretary, Department of the Treasury, Canberra, September 17, 1952, indicates that the high commissioner’s letter of June 26, 1952 was forwarded by External Affairs to Treasury on July 3, 1952. Although the covering letter forwarding the high commissioner’s letter is not currently contained in either the Australian Treasury file, 1957 treaty, or the Australian Department of External Affairs file, 1957 Canada treaty, part 1, a note typed on the letter of July 3 from Casey to Elliott (supra note 43) indicates that both the high commissioner’s letter and the letter from Casey to the high commissioner were forwarded to the Australian Treasury on July 3, 1952. A copy of the high commissioner’s letter dated June 26, 1952 is contained in the Australian Treasury file, 1957 treaty. Handwritten notes dated 3/10 on the correspondence from McIntyre to the secretary of the treasury indicate that Treasury had discussed the request with Australian Taxation Office officials and that the matter was before the deputy commissioner. Although these notes refer to the deputy commissioner, an internal Australian Treasury file note dated 12/9/52 indicates that the treasurer referred the matter to “Taxation direct,” that Belcher (the assistant deputy commissioner) was handling the matter, and that an Australian External Affairs official understood that Belcher now had “something to put to the Treasurer on the matter.” The internal Australian Treasury file note is contained in the Australian Treasury file, 1957 treaty.


47 Correspondence between the Australian Treasury, Taxation Office, and External Affairs department exchanging drafts of the submission is contained in the Australian Treasury file, 1957 treaty. It is evident that while the initial draft of the submission was prepared by Treasury, subsequent drafts were developed in response to input from the Australian Taxation Office. The Department of External Affairs simply agreed to the draft, developed by Treasury and the Taxation Office, that had been forwarded to it.
submission\textsuperscript{48} pointed out that Canada was now seeking a comprehensive treaty but had not indicated the terms that might be acceptable to it. The submission noted, however, that Canada had entered into several taxation treaties and that there were “substantial grounds” for concluding that a treaty could be negotiated “on a basis which, in broad outline, followed the proposals contained in the proposed agreement with the United States.”\textsuperscript{49} The submission then went on to summarize the content of the articles envisaged in the treaty and estimated the revenue effects for Australia of each article. Based on June 30, 1951 figures, the total revenue loss to Australia from the treaty was estimated to be AU£320,000; however, given the tendency for incomes to increase, the revenue loss for the year ending June 30, 1952 was estimated to be AU£400,000. The submission observed that a very large portion of the revenue loss resulted from dividends paid to one Canadian company that was associated with “United States interests.”\textsuperscript{50} The submission speculated that if Australia were to conclude a taxation treaty with the United States but not with Canada, the shareholdings of that company might be transferred from Canada to the United States in order to gain the concessional rate on dividends that Cabinet had already agreed to provide under the proposed agreement with the United States. In such event, the revenue cost to Australia of a taxation treaty with Canada was estimated to fall to AU£100,000.

The submission considered that the arguments in favour of entering into a taxation treaty with Canada were the promotion of closer relations with Canada and possible encouragement of Canadian investment in Australia. The arguments against a treaty were a loss of revenue and some loss of dollars; however, it was not considered practical, at that time, to estimate either the extent to which the treaty would encourage Canadian investment in Australia or the loss of dollars associated with increased remittances to Canada that would result from a lowering of Australian source tax under the treaty. From a political perspective, the submission observed that it would be difficult, and perhaps embarrassing, in any treaty with Canada to deny the inclusion of terms that were broadly comparable to those proposed to be agreed with the United States.

The drafting of the submission appears to have been completed on November 26, 1952, and the submission was considered by the Australian Cabinet Administrative Committee on January 16, 1953. The committee agreed that discussions with the Canadian government should be opened at the official level and that the Canadian

\textsuperscript{48} A copy of the final version of the submission to the Australian Cabinet Administrative Committee is contained in the Australian Treasury file, 1957 treaty.

\textsuperscript{49} Ibid.

\textsuperscript{50} Ibid. It is likely that the reference is to the Ford Motor Company of Canada, which was the parent of the Ford Motor Company of Australia. Ford Canada subsequently made submissions to both the Canadian and the Australian governments in favour of a taxation treaty between the two countries. At the time, Ford Canada was 49 percent Canadian-owned and was relatively independent of the Ford Motor Company of the United States. See infra note 134 for additional details.
government should be advised that Australia was prepared to send officials to Ottawa for discussions during the first half of 1953.\textsuperscript{51}

On March 13, 1953, the Australian Department of External Affairs formally replied to the Canadian high commissioner’s inquiry, stating that the Australian government was prepared to enter into negotiations with Canada for taxation treat- ies relating to income tax and estate and gift duties.\textsuperscript{52} The reply indicated that P.S. McGovern, the commissioner of taxation, would be in Washington in the latter part of April that year and inquired whether it would be convenient for him and a small party of officials to commence treaty negotiations with Canada in either late April or early May. The reply also suggested that a joint announcement be made and included a draft announcement. After the addition of personnel and dates by Canada, the joint announcement was released on April 23, 1953 in Ottawa and on April 24, 1953 in Canberra.\textsuperscript{53}

\section*{THE NEGOTIATIONS IN OTTAWA IN MAY 1953}

Negotiations for a taxation treaty began in Ottawa on May 19, 1953. Australia was represented by P.S. McGovern, commissioner of taxation, and M.J. Belcher, assistant deputy commissioner of taxation. Canada was represented by A.K. Eaton, assistant deputy minister of finance; E.H. Smith, finance officer; J.G. McEntyre, assistant deputy minister, Department of National Revenue, Taxation Division; E.F. O’Brien, supervisor, Manufacturing and Miscellaneous Assessments, Department of National Revenue, Taxation Division; T.E. Boles, Legal Division, Department of National Revenue, Taxation Division; and W.I. Linton, Succession Duty Office, Department of National Revenue.\textsuperscript{54}

\begin{itemize}
\item \textsuperscript{51} A copy of the relevant portion of the minutes of the Australian Cabinet Administrative Committee meeting (GA D15) of January 16, 1953 is contained in the Australian Treasury file, 1957 treaty.
\item \textsuperscript{52} A copy of the reply is contained in the Australian Treasury file, 1957 treaty. The reply is quoted in Canadian High Commissioner in Australia, Canberra to Secretary of State for External Affairs, March 13, 1953, in Canadian Department of External Affairs file, 1957 treaty, part 1. To date, I have been unable to locate the relevant Australian Department of External Affairs file dealing with this period of negotiations on the Australia-Canada treaty.
\item \textsuperscript{53} A copy of the joint announcement is contained in the Australian Treasury file, 1957 treaty.
\item \textsuperscript{54} “Australia-Canada Discussion for Agreement for the Avoidance of Double Taxation,” May 19, 1953, in Canadian Department of External Affairs file, 1957 treaty, part 1; and “Memorandum, the Commonwealth Treasurer, Canberra, ACT,” November 12, 1953 from P.S. McGovern, Commissioner of Taxation, copy in Australian Treasury file, 1957 treaty. There are relatively minor differences in the records of attendance at the discussions contained in these two documents. The document in the Canadian Department of External Affairs file, 1957 treaty, refers to Belcher as “Assistant Commissioner of Taxation” whereas McGovern’s memorandum refers to him as “Assistant Deputy Commissioner of Taxation.” (McGovern’s version is likely correct on this point.) McGovern’s memorandum also includes W.I. Linton (from the Department of National Revenue) in the list of attendees, but Linton’s name is omitted from the memorandum in the Canadian file.
\end{itemize}
The Canadian Department of Finance file relating to the negotiations contains a carbon copy of a draft treaty that appears to have been examined by Canadian Finance officials prior to the commencement of the negotiations. The draft closely resembles the Australia-US income tax treaty of 1953. Subsequent correspondence confirms that Australia sent a draft treaty, based on the 1953 Australia-US treaty, to Canada, and internal evidence suggests that the copy contained in the Canadian Department of Finance file is of that draft. Handwritten comments have been made in the margins of the draft treaty, evidently by Canadian officials. The nature of the handwritten comments supports the conclusion that the copy in the Finance file is of the draft that Australia sent to Canada. If so, then this document is the earliest example of a draft taxation treaty prepared by Australia that I have been able to locate in archival records to date.

Neither the Canadian Department of Finance file nor the Canadian Department of External Affairs file contains a record of the negotiations that commenced on May 19, 1953. The Finance file does contain a memo by Eaton recording details of a telephone conversation that he had with McGovern shortly after the conclusion of the negotiations. The Australian Treasury file contains a copy of a report on the negotiations, dated November 12, 1953, from McGovern to the Australian treasurer. The account of the negotiations appearing below is based on Eaton’s file note and McGovern’s report.

55 Convention Between the Government of Canada and the Government of the Commonwealth of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (herein referred to as “the 1953 draft treaty”), in Canadian Department of Finance file, 1957 treaty, vol. 1. In the copy in the Canadian Department of Finance file, the word “Convention” has been struck out and replaced in handwriting with the word “Agreement.”

56 Despatch from High Commissioner for Canada in Australia, Canberra to Secretary of State for External Affairs, Ottawa, March 18, 1954, in Canadian Department of Finance file, 1957 treaty, vol. 1. The inference that the 1953 draft treaty is based on the Australia-US treaty of 1953 is supported by the close similarity in the wording of the two documents. In addition, in some parts of the draft, the word “Convention” (the term used in the Australia-US treaty) is used in reference to the title of the treaty, while elsewhere the word “Agreement” is used (consistent with the terminology in the Australia-UK taxation treaty of 1946 and in previous Canadian treaties with Commonwealth countries). Also, tellingly, sometimes the United States is referred to as one of the contracting states where the reference should obviously be to Canada.

57 The handwritten notes change “Convention” to “Agreement” and also change “United States” to “Canada” wherever appearing. Other changes made by the handwritten notes exhibit disagreement with or questioning of the content of the draft, and are consistent with other evidence of the Canadian position in the negotiations.

58 “Note for file. Re: Canada-Australia Tax Agreement,” May 28, 1953, in Canadian Department of Finance file, 1957 treaty, vol. 1; and A.K. Eaton to G.F. McEntyre, Esq., Assistant Deputy Minister (Taxation), Department of National Revenue, Ottawa, May 28, 1953, in Canadian Department of Finance file, 1957 treaty, vol. 1, indicating that the file note was made by Eaton and that the conversation referred to is between Eaton and McGovern.

59 Memorandum from McGovern, supra note 54.
**Industrial or Commercial Profits**

Eaton records that, in his telephone conversation with the taxation commissioner, McGovern indicated that Australia would concede the Canadian point on article III, the industrial or commercial profits article, such that Australia “would not tax more than profits earned in Australia attributable to a permanent establishment.”60 As will be seen below, it is not entirely clear whether Eaton’s concern here was that the industrial or commercial profits article in the Australian draft would have permitted Australia to tax foreign-source profits of an Australian permanent establishment of a Canadian enterprise, or that the draft article would have permitted Australian taxation of all Australian profits of a Canadian enterprise once it was found to have a permanent establishment in Australia. McGovern’s report to the Australian treasurer indicates that the former was Eaton’s concern, but subsequent correspondence and the form of the article in the final treaty are more consistent with the latter concern. The two explanations, however, are not mutually exclusive.

Article III of the draft treaty, like the equivalent provision in the 1953 Australia-US treaty,61 taxed industrial or commercial profits on a force-of-attraction basis once a permanent establishment was found to exist in a contracting state. Relevant portions of article III in the draft treaty were as follows:

1. The industrial or commercial profits of a Canadian enterprise shall not be subject to Australian tax unless the enterprise is engaged in trade or business in Australia through a permanent establishment in Australia. If so engaged Australian tax may be imposed upon the entire income of that enterprise from sources within Australia.

2. The industrial or commercial profits of an Australian enterprise shall not be subject to Canadian tax unless the enterprise is engaged in trade or business in Canada through a permanent establishment in Canada. If so engaged Canadian tax may be imposed upon the entire income of that enterprise from sources within Canada.62

The copy of the draft treaty in the Canadian file contains a handwritten question mark in the margin beside the second sentence of paragraph 1, and the phrase “to the extent that income is” is inserted in handwriting after “enterprise” and before “from sources.”63 Corresponding annotations were not made to paragraph 2 of article III.

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60 “Note for file,” supra note 58.

61 Articles III(1) and (2) of the Convention Between the Government of the United States and the Government of the Commonwealth of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington, DC on May 14, 1953. Australian Taxation Office files on the negotiation of the 1953 Australia-US taxation treaty indicate that the proposal for use of the force-of-attraction principle in determining the profits of a permanent establishment came from the United States. Memorandum from McGovern, supra note 54, at 8, paragraph 55.

62 Article III of the 1953 draft treaty, supra note 55.

63 Ibid.
These annotations, together with concessions (discussed below) made by McGovern in subsequent correspondence, and the fact that the final treaty taxed industrial or commercial profits on an attribution rather than a force-of-attraction basis, suggest that McGovern had indicated to Eaton that Australia would agree to such a change in the basis of taxation in article III.

From McGovern’s report to the Australian treasurer and from a subsequent despatch from the Canadian high commissioner to the Canadian secretary of state for external affairs, it appears that at the initial discussions Canadian officials were prepared for the industrial or commercial profits article in the proposed treaty to be identical to the equivalent article in the 1953 Australia-US treaty, but sought to add a provision that would have explicitly prohibited the country in which the permanent establishment was situated from taxing profits of the permanent establishment from sources outside that country. At least, it appears that this is how the Australian delegation understood the Canadian request. There is, however, no explicit reference to such a request in either the Canadian Finance file or the Canadian External Affairs file. The handwritten notes on the draft treaty in the Canadian Finance file

64 See articles III(1) and (2) of the final treaty, supra note 1.
65 This analysis is consistent with P.S. McGovern to A.K. Eaton, March 7, 1956, in Canadian Department of Finance file, 1957 treaty, vol. 1. In that correspondence, McGovern summarized three concessions, additional to those made in the Australia-UK and Australia-US taxation treaties, that Canada had asked Australia to make at the conclusion of the discussions in Ottawa. The third concession, according to McGovern, was “that Article III be so drawn so as to enable only the industrial or commercial profits attributable to a permanent establishment to be taxed outside the country of residence.” The analysis conflicts with the account of the Australian position set out in the March 18, 1954 despatch from the Canadian high commissioner to Australia’s secretary of state for external affairs, supra note 56, following discussions with unnamed Australian taxation officials. As discussed in more detail below, the despatch suggests that the Australian position was that it should have the right under the treaty to tax foreign-source profits of an Australian permanent establishment of a Canadian enterprise; however, that position is not reflected in the terms of the 1953 draft treaty. The deemed-source rule in article III(3) of the draft treaty deemed profits of a permanent establishment determined on the basis of an arm’s-length dealing fiction to be from sources in the host state, but that source rule was consistent with earlier treaties (see, for example, article III(3) of the Agreement Between the Government of New Zealand and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Ottawa on March 12, 1948) and is not expressly mentioned in any of the correspondence between Eaton and McGovern. Moreover, the same deemed source rule contained in the 1953 draft treaty is also found in the final version of the treaty, notwithstanding that (as will be discussed below) Australia subsequently conceded the point on the extent to which profits of a permanent establishment could be taxed by the source state. It may be that the Canadian high commissioner had a conversation with Australian taxation officials about the rationale behind the deemed-source rule, as a result of which either the high commissioner or the unnamed Australian taxation officials mistakenly believed that the deemed-source rule was a point of contention during the Ottawa negotiations.
66 Despatch, supra note 56.
67 Memorandum from McGovern, supra note 54, at paragraph 12.
do suggest a concern that the article in the draft, in referring to “the entire income of that enterprise,” could otherwise be interpreted as permitting Australia to tax foreign-source income of a Canadian permanent establishment in Australia. Against that reading is the fact that the reference to “the entire income of that enterprise” is qualified in the draft itself by the words “from sources within Australia,” and the fact that ultimately the handwritten annotations were not incorporated into the final version of the treaty, which (as noted above) taxed industrial or commercial profits on an attribution rather than a force-of-attraction basis. It is also possible that the Canadian view was that article III(3) in the draft treaty, which applied an arm’s-length fiction in determining the industrial or commercial profits that were attributable to a permanent establishment in a source country, would, where an attribution basis was used in articles III(1) and (2), restrict source taxation of industrial or commercial profits to those so determined.

In any case, it is clear that McGovern regarded the Canadians as requesting the inclusion of an additional provision that would have prevented the country in which a permanent establishment was situated from taxing income of the enterprise other than income from sources within that country. McGovern explained to the Australian treasurer that, although Australia did not then tax non-resident enterprises on foreign-source profits, he had given no indication that Australia would concede to the Canadian proposal since he felt that it went beyond the terms of the approval that he had obtained.68 McGovern indicated to the Australian treasurer that he had in mind, for example, a Canadian company setting up a branch in Australia that controlled the whole of the company’s activities in the southwest Pacific area. McGovern considered that in such a case there might be “room for the view” that Australia should tax not only the profit having an Australian source in the legal sense, but also the foreign profit that arose from activities managed and controlled by the Australian branch.69 McGovern also considered that if in the future Australia were to change its jurisdictional claim from predominantly a source basis to a residence and source basis, then, subject to double taxation relief, Australia might want to tax the worldwide profits of an Australian permanent establishment of a Canadian enterprise.70

Both comments reflect a view that would equate an Australian permanent establishment of a foreign enterprise with an Australian-resident company that was a wholly owned subsidiary of a foreign company. McGovern went on to advise, however, that it would not be worthwhile to resist agreement solely on the basis of the hypothetical circumstances he had described, and he envisaged that an alternative method of achieving the desired result might be to widen the definition of “resident of Australia.” Accordingly, McGovern recommended conceding the point if Canada persisted with the request.71

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68 Ibid., at paragraph 13.
69 Ibid., at paragraph 14.
70 Ibid., at paragraph 15.
71 Ibid., at paragraph 16.
Permanent Establishment—Substantial Equipment

There is no evidence in either the Canadian Department of Finance file or the Canadian Department of External Affairs file of any Canadian concerns being raised in the negotiations about the definition of “permanent establishment” in article II of the 1953 draft. A notable feature of the definition was that, like the definition in the 1953 Australia-US taxation treaty, it contained a “substantial equipment” provision similar to that which had been included in the draft that the United States had sent to Australia in the course of the negotiation of their treaty. It appears that inclusion of a substantial equipment provision might not have been part of the United States’ usual taxation treaty practice at the time, but such provisions do appear in several other Canadian taxation treaties in the 1950s.72

Calculation of Undistributed Profits Tax

Eaton records that McGovern had indicated that he would be willing to delete article VIII of the 1953 draft treaty, which “had the effect of making tougher the basis for their undistributed profits tax on private companies.”73 Article VIII of the draft treaty read as follows:

The additional tax assessable in respect of the undistributed amount of the undistributed income of a company which is a private company for purposes of Australian tax, shall be the amount which would have been assessable if Articles VI(1) and VII(1) had not been included in this Agreement.74

The original version of article VI(1) in the draft treaty provided that a dividend paid by a Canadian company to a Canadian resident would be exempt from Australian tax.75 Article VII(1) in the draft treaty limited the Australian tax on dividends paid by an Australian resident to a Canadian resident that was not engaged in trade or business in Australia through a permanent establishment to 15 percent of the gross amount of the dividend.76 The effect of removing article VIII from the draft treaty would presumably have been that the limitations in articles VI(1) and VII(1)

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72 Specific reference to “substantial equipment” was included in several other Canadian treaties of the 1950s, beginning with the June 12, 1950 supplementary convention to the 1942 Canada-US treaty. Prior to the entry into the Australian treaty, “substantial equipment” had also been specifically referred to in the Canada-South Africa taxation treaty, 1956 (in article II(1)(j)). In addition to the 1957 Canada-Australia treaty, two other Canadian taxation treaties concluded in the 1950s contained substantial equipment provisions: the Belgium-Canada treaty, 1958, article II(1)(i)(bb), and the Finland-Canada treaty, 1959, article II(1)(j). Substantial equipment provisions do not appear in US taxation treaties in the 1950s other than the 1950 supplementary convention to the 1942 treaty with Canada and the 1953 Australia-US treaty.

73 “Note for file,” supra note 58.

74 1953 draft treaty, supra note 55.

75 Ibid.

76 Ibid.
would apply to Australian undistributed profits tax on the amount of the undistributed 
Australian-source profits of a Canadian-resident private company that was attribut-
able to Australian-source dividends. Article VIII had been based on the equivalent 
article in the 1953 Australia-US taxation treaty. At the time that negotiation of that 
treaty commenced, Australian undistributed profits tax on private companies was 
based on the tax that would have been paid by the shareholders in the company if a 
distribution had been made.

In commenting to the Australian treasurer on the draft of article VIII produced 
as a result of 1952 negotiations with the United States, McGovern pointed out that, 
although Australian undistributed profits tax was calculated as the tax that would 
have been paid by shareholders if a distribution had been made, article VIII meant 
that the reductions in source taxation of dividends in articles VI and VII did not oper-
ate to reduce the undistributed profits tax payable at source. Although Australia 
had changed the basis on which it calculated undistributed profits tax on private 
companies later in 1952, article VIII of the 1952 draft remained in the final version 
of the Australia-US taxation treaty. The final draft of the Australia-US treaty had been 
prepared by Australia, and, while recognizing that the unchanged article VIII was 
now redundant, the drafter commented that retention of the article could only be 
justified as protection in case of a possible return to the previous method of assessing 
undistributed profits tax.

With regard to the 1953 draft of the Australia-Canada treaty, McGovern's report 
to the Australian treasurer on this point reiterated the background to draft article 
VIII, tracing its history to the 1946 Australia-UK taxation treaty. McGovern noted

77 Memorandum, McGovern to Fadden, supra note 12, at 12, paragraphs 94-96.
78 The undistributed profits tax provisions were amended by the Income Tax and Social Services 
Contribution Assessment Act (No. 3) 1952, the bill for which was introduced in Parliament on 
September 18, 1952. The effect of the amendments was that from the year ending June 30, 
1952, part III, division 7 of the Income Tax and Social Services Contribution Assessment Act 
1936 imposed tax on the amount of undistributed profits of private companies remaining after 
the deduction of a retention allowance. For the 1951-52 taxation year, undistributed profits tax 
was levied at a flat rate of 10 shillings to the pound, or 50 percent. Undistributed profits tax as 
it applied in the 1951-52 taxation year is discussed in N.E. Challoner and C.M. Collins, Income 
Tax Law and Practice (Commonwealth) (Sydney: Law Book of Australasia, 1953), at 725-79. 
Undistributed profits tax on private companies as it applied prior to the 1951-52 year is 
79 “Double Taxation—USA—Australia 7/1/50—13/7/62, Comments on Draft Treaty,” in 
National Archives of Australia, series no. A7073/21, control symbol J245/45/21, part 4. The 
actual text of the comment (after pointing out that the article was now redundant, given the flat 
rate of undistributed profits tax) spoke of retention being justified as protection “against” a 
possible return to the former method of assessing undistributed profits tax. Since the effect of 
the article would have been to enable Australia to return to its former method of levying 
undistributed profits tax without being constrained by the limits on dividend taxation in articles 
V(1) and VII(1), it is submitted that the word “against” was used in error and that the comment 
makes more sense if “against” is replaced with “in case of.”
that the Australian system of taxing undistributed profits had changed, so that the current function of the draft article was to protect Australia’s position should it revert to its former system of taxing undistributed profits. McGovern’s report does not indicate that he had agreed to delete the draft article, although he did suggest that if Australia’s position could be as effectively protected by legislation as by a treaty, then it would be appropriate to omit the draft article provided that the omission was not regarded as limiting Australia’s right to legislate on the issue.80 McGovern noted that the Canadian officials had indicated that they were disinclined to recommend the draft article to their government and that their opposition was not lessened when it was pointed out to them that “under present Australian law, the provision would not prejudice either Canada or its taxpayers, but would merely ensure that the Commonwealth Parliament could exercise its right to tax company profits on a basis of its own choice.”81 McGovern regarded the Canadian attitude as, in effect, a denial of the widely recognized right of a country, where industrial or commercial profits were derived through a permanent establishment, to tax those profits without restriction as to the basis of taxation.82

Undistributed Profits Tax on Private Companies

The major point of disagreement in the 1953 negotiations concerned the imposition of Australian undistributed profits tax on private companies.83 Eaton noted that, in his conversation with McGovern, the taxation commissioner

80 Memorandum from McGovern, supra note 54, at paragraph 29.
81 Ibid., at paragraphs 24-27.
82 Ibid., at paragraph 28.
83 A subsequent memorandum dated December 2, 1955, and apparently written by the Canadian high commissioner, indicates that McGovern had told the author of the memorandum that, during the 1953 negotiations, Canada would agree to a uniform rate of withholding tax of 15 percent on all dividends only if Australia agreed to not levy its undistributed profits tax (Canadian Department of Finance file, 1957 treaty, vol. 1). A 15 percent gross basis withholding tax on dividends was consistent with the general rule in Canadian domestic law. Section 106(1)(a) of the 1948 Income Tax Act, supra note 19, imposed a 15 percent withholding tax on dividends paid to non-residents by Canadian-resident companies; however, the withholding rate on dividends paid to non-resident parent companies by wholly owned subsidiaries was only 5 percent (see infra note 95). Under the 1946 Canada-UK taxation treaty, dividends paid by a wholly owned Canadian subsidiary of a UK parent company were exempt from Canadian tax where less than 25 percent of the gross income of the Canadian company was derived from interest and dividends (other than interest and dividends received from any wholly owned subsidiary company); article VI(2) of the Agreement Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at London on June 5, 1946. The Canadian tax treatment of dividends paid to non-residents in 1954-55 is discussed in La Brie, supra note 19, at 312-16, and in Gilmour, supra note 36, at 556-60.
expressed the view that his government would not concede any abatement from the full operation of their undistributed profits tax on private companies even though such a company were owned entirely by persons not resident in Australia.84

McGovern’s report to the Australian treasurer on this issue notes that Canadian officials sought the inclusion of a provision that would prohibit Australia from levying undistributed profits tax on any profits of a Canadian company even though the profits arose from the activities of a permanent establishment in Australia.85 McGovern pointed out that, during the negotiations with the United Kingdom in 1946, Australia had rejected a similar proposal by the United Kingdom on the ground that Australia’s right to tax profits derived through a permanent establishment in Australia should be unrestricted.86 McGovern considered that this principle, acknowledged by the Canadians, was paramount and should not be impinged upon merely because Australia chose to impose its tax in part in the form of a levy on undistributed profits. To cede to the Canadian proposal would be to impose a restriction on Australia’s right to select its own method of taxation and, in McGovern’s view, would leave the way open for other countries to “press for basis changes in Australia’s taxing laws.”87 For these reasons, McGovern’s advice was that the Canadian proposal should be rejected.88

The final issue of disagreement at the Ottawa discussions concerned the taxation of dividends paid by Canadian companies to non-Australian shareholders. Eaton noted, on this aspect of his conversation with McGovern, that

[McGovern] thinks they must retain the right to tax all non-Canadian shareholders of Canadian companies carrying on business in Australia. He stated that the British tried to pry them off this but they could not.89

McGovern’s report to the Australian treasurer also makes it clear that Canada requested that the article in the draft treaty that provided that dividends paid by a

84 “Note for file,” supra note 58.
85 Memorandum from McGovern, supra note 54, at paragraph 31.
86 Ibid., at paragraph 32.
87 Ibid., at paragraph 34.
88 Ibid., at paragraphs 34-35.
company resident in one country to a shareholder resident in that country should not be taxed in the other country be extended to all shareholders of Canadian companies (that is, including shareholders resident in third countries) other than those resident in Australia.\textsuperscript{90} McGovern indicated that the Canadian proposal would have little revenue cost to Australia, owing to practical difficulties typically associated with collecting tax from non-residents.\textsuperscript{91} McGovern was concerned that if Australia were subsequently to resume taxation treaty negotiations with New Zealand, Australia’s position might be undermined by the fact that this concession would have, in effect, already been granted to New Zealand.\textsuperscript{92} McGovern conceded, however, that Australia’s position in its previous negotiations with the United Kingdom and the United States would not have been prejudiced if it had previously made a similar concession to a third country.\textsuperscript{93} McGovern’s preference was for the draft article to remain unchanged, but he considered that, if Canada were to press the point, it should be yielded as part of an overall package of concessions in order to obtain signature.\textsuperscript{94}

Eaton had advised McGovern that, although Australia’s refusal to yield on these points might not have any great practical effect, the question of principle was important for Canada.\textsuperscript{95}

\textsuperscript{90} Memorandum from McGovern, supra note 54, at paragraph 19.
\textsuperscript{91} Ibid., at paragraph 20.
\textsuperscript{92} Ibid., at paragraph 21.
\textsuperscript{93} Ibid., at paragraph 22.
\textsuperscript{94} Ibid., at paragraph 23.
\textsuperscript{95} “Note for file,” supra note 58. In 1953, Canada did not impose an undistributed profits tax as such. Income received by a “personal corporation,” as defined in the 1948 Income Tax Act, was exempt from normal corporation tax but was deemed to have been distributed to shareholders on the last day of the fiscal year whether or not such income had actually been distributed. Where a shareholder in a personal corporation was a non-resident, a withholding tax of 15 percent on the deemed distribution was payable by the personal corporation. In general, dividends actually paid by a personal corporation to a shareholder were free of tax to the recipient. The Canadian treatment of personal corporations in 1953-54 is discussed in Gilmour, supra note 36, at 393-401. Canadian-resident individuals who held shares in other Canadian companies included dividends received in determining their taxable income. In certain circumstances, the inclusion could also give rise to an additional investment income tax of 4 percent. Canadian-resident shareholders were entitled to a credit of 20 percent of the net amount of the dividend received (after deductions for allowances for depletion and carrying charges) from the tax otherwise payable on the net dividend received. Generally, dividends received by one Canadian-resident company from another were effectively exempt from tax to the recipient company through the allowance of a dividends-received deduction, and were classified as exempt income for the purpose of denying deductions for expenses associated with those dividends. The Canadian tax treatment of dividends paid to Canadian-resident individuals by Canadian-resident companies is discussed in Gilmour, ibid., at 414-17. The dividends-received deduction did not apply to dividends paid by a controlled corporation, as defined in the 1948 Income Tax Act, to the controlling Canadian company where the dividend was funded from preacquisition surplus. The controlled corporation could elect to pay a special tax of 15 percent on its preacquisition surplus. Any dividend funded from preacquisition surplus on which the 15 percent tax had been paid was effectively exempt from tax to the shareholders.
The Conclusion of the Negotiations and the Agreement To Continue Correspondence

Eaton noted that he and McGovern were both of the view that it would be good to have an agreement, particularly if Australia signed its proposed treaty with the United States.96 They agreed that the matter could be handled by correspondence from that point, with Eaton to write to McGovern after two or three months to state the Canadian position at that time. Eaton was not, however, optimistic about the prospects for coming to an agreement with Australia, commenting to McEntyre that the Australian negotiators “are not anxious to give very much by way of having us come together.”97

Canadian taxation of controlled corporations at the time is discussed in Gilmour, ibid., at 418-29. Dividends paid to non-residents were subject to a 15 percent withholding tax, but this was reduced to 5 percent for dividends paid by wholly owned subsidiaries of a foreign parent. Withholding tax on dividends paid by a wholly owned subsidiary to a foreign parent was zero under the Canada-UK taxation treaty. Canadian taxation of dividends paid to non-residents at the time is discussed in Gilmour, ibid., at 417. Subject to conditions, Canadian companies could elect to pay a special 15 percent tax on their undistributed income, and certain distributions funded from undistributed income on which the 15 percent tax had been paid were not included in the shareholder's assessable income. (Such distributions included certain distributions on winding up or on reorganization; certain redemptions of shares, reductions of capital, or share buybacks; conversions of ordinary shares into another class of shares; and payments of stock dividends or bonus issues.) The calculation of undistributed income, the special 15 percent optional tax on undistributed income, and the effects of distributions from tax-paid undistributed income, are discussed in Gilmour, ibid., at 462-92. Canadian tax law also had a series of provisions dealing with disguised distributions to shareholders through the payment of excessive salaries, distributions in the course of a winding up or reorganization, reductions of capital, redemptions or buybacks of shares, conversions of ordinary shares into another class or obligation, capitalizations or the issuances of bonus shares or stock dividends, payments to shareholders outside genuine business transactions, appropriations of funds or property for the benefit of shareholders, the conferring of benefits by the company on its shareholders, and loans to shareholders. Sales and appropriations of property to shareholders in a non-arm's-length transaction could be readjusted to fair market value, with the effect of increasing the company's income. From the shareholder's perspective, disguised distributions were deemed to be dividends. Provisions dealing with disguised distributions are discussed in Gilmour, ibid., at 429-48 and 455-62. Some of the archival evidence strongly suggests that, prior to negotiating the 1942 treaty with the United States, Canada had been concerned about US taxes on the undistributed profits of Canadian companies: see Elliott to Robertson, supra note 89. Elliott's letter, ibid., at 2, proposed that the US law be amended so that undistributed profits tax did not apply to distributions by a Canadian company to another Canadian company or individual. Ultimately, the 1942 Canada-US treaty only contained a provision (article XIII) limiting the application of US undistributed profits tax to Canadian companies in which 50 percent or more of the voting stock was owned directly or indirectly by Canadian residents. Canadian officials may have been concerned that, if they were to allow Australia to apply its undistributed profits tax to Canadian companies, they might face pressure from the United States to relax the restrictions on the application of its undistributed profits tax in any subsequent treaty negotiations.

96 “Note for file,” supra note 58.
97 Ibid.
THE RESUMPTION OF CORRESPONDENCE,
1954-1956

As noted above, McGovern provided a detailed written report on the negotiations to the Australian treasurer on November 12, 1953. Although that report included recommendations to concede, if pressed, to Canadian requests other than those relating to undistributed profits tax, there is no evidence in the available files of any response by the Australian treasurer to those recommendations at this stage of the negotiations. Neither side took the initiative, at either the official or the political level, until the following year.

The next item in the Canadian files is a despatch dated March 18, 1954, from the Canadian high commissioner in Australia to Canada’s secretary of state for external affairs. Casey (the Australian minister for external affairs) had asked the Canadian high commissioner for an indication of the Canadian attitude toward the proposed taxation treaty between Australia and Canada. The high commissioner, who had not received a report of the negotiations in Ottawa in May 1953, had made inquiries of unnamed Australian taxation officials, who had advised him that during the negotiations differences of opinion had arisen in three areas:

1. the taxation of profits of permanent establishments,
2. the taxation of dividends, and
3. the imposition of tax on undistributed profits.

The high commissioner’s account of the issues in relation to items 2 and 3 is consistent with the description in Eaton’s file note of May 28, 1953, discussed above. The high commissioner’s account of the issues in relation to item 1 is inconsistent with Eaton’s file note, with the terms of the draft treaty, and with subsequent correspondence from McGovern to Eaton. It is, however, consistent with McGovern’s November 12, 1952 report to the Australian treasurer on the negotiations, also discussed above.

The high commissioner’s account of the issues in relation to the taxation of profits of a permanent establishment is that Australia wanted the right to tax non-Australian-source profits attributable to a permanent establishment in Australia, and that it was not concerned with taxing Australian-source profits that were not attributable to the permanent establishment. By contrast, analysis of Eaton’s file note, relevant articles in the draft treaty, and a subsequent letter from McGovern

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98 Despatch, supra note 56.
99 Ibid.
100 “Note for file,” supra note 58.
101 Articles III(1), (2), and (3) of the 1953 draft treaty. Articles III(1) and (2) adopted a force-of-attraction approach to source taxation of industrial or commercial profits once a permanent establishment was found to exist in the source country. Article III(3) provided for the calculation of profits attributable to the permanent establishment in the source country using an arm’s-length transaction fiction and deemed those profits to have a source in the source country. The
to Eaton102 suggests that Australia wanted to apply a force-of-attraction principle to the taxation of the Australian profits of permanent establishments situated in Australia. The high commissioner’s explanation of the Australian view was that although Australia largely adopted a source basis of taxation, it wanted to be able to tax non-Australian-source income of an Australian permanent establishment if it subsequently chose to tax on a source and residence basis.103 To do so would involve treating a permanent establishment of a foreign enterprise as if it were an Australian resident even though it was not, according to the definition of Australian resident at that time (and subsequently).104

On the other hand, the high commissioner’s account of the issues in relation to the taxation of industrial or commercial profits is consistent with McGovern’s advice to the Australian treasurer discussed earlier.105 In his report to the Australian treasurer, however, McGovern had already recommended conceding the point if the Canadians persisted.106 Hence, as will be seen below, there is little subsequent discussion, and no further explanation, of the point in subsequent correspondence between McGovern and Eaton. A subsequent report by McGovern to the treasurer, dated June 7, 1956,107 is more consistent with the concern being that Australia

only changes to the wording of draft article III made in the preparation of the final version of the treaty occur in paragraphs (1) and (2). In the draft article, the source country was given the right, once a permanent establishment was found to exist in the country, to tax the entire income of the enterprise from sources within that country. In the final version of the treaty, source-country taxation of industrial or commercial profits was limited to “so much of them as is attributable to that permanent establishment” (see supra note 1, article III(2)). This restriction was not inconsistent with source-country taxation of foreign-source industrial or commercial profits attributable to a permanent establishment in the source country.

102 McGovern to Eaton, supra note 65, wherein McGovern set out his understanding that Canada required the inclusion of an additional provision in article III specifying that only the industrial or commercial profits attributable to a permanent establishment could be taxed outside the country of residence.

103 Despatch, supra note 56. Eaton’s file note, supra note 58, somewhat obliquely refers to discussion of this issue with McGovern, but at no point does it appear to have really been a point that Australia was not prepared to concede.

104 Despatch, supra note 56. The comment may reflect a misunderstanding of what a permanent establishment was, on the part of either the high commissioner or the unnamed Australian tax officials to whom he spoke. The high commissioner also referred to Australian concern about artificial manipulation of the source of income of Australian permanent establishments to avoid Australian taxation. This may reflect an early example of the desire of Australian tax officials to extend Australian source in taxation treaties via deemed source rules. If so, this desire would be consistent with later Australian treaty practice: see C. John Taylor, “Some Distinctive Features of Australian Tax Treaty Practice: An Examination of Their Origins and Interpretation” (2011) 9:3 eJournal of Tax Research 294-338.

105 See supra notes 67-71 and the accompanying text.

106 See supra note 71 and the accompanying text.

wanted to apply a force-of-attraction principle to the Australian profits of permanent establishments in Australia. It is possible that McGovern’s understanding of the nature of the Canadian request changed in the meantime.

**Dividends**

On dividends, Canada had proposed that a dividend paid by a Canadian-resident company, funded from Australian sources, be exempt from Australian tax when paid to a non-resident of Australia. The 1953 draft treaty exempted such dividends only if they were paid to a Canadian resident. The high commissioner had been advised that Canada’s request went beyond the authority given to the Australian negotiators and had been reserved for government decision. He commented that the proposed extension, if adopted, would affect persons who were not residents of either country.

**Undistributed Profits Tax**

On undistributed profits, the high commissioner reported that Australia had requested a provision (article VIII of the draft treaty) that would have meant that the concessional rate of tax on dividends would not apply to the amount of tax payable as undistributed profits tax, and he pointed out that corresponding provisions had been included in Australia’s treaties with the United Kingdom and the United States. This provision would, the high commissioner reported, have no practical application at the present time, owing to the new basis for taxing undistributed profits of private companies, but Australia wanted article VIII to be retained as a protective measure in the event that Australia subsequently revised its position on undistributed profits tax. The high commissioner noted that Canada did not favour this provision. He also reported that he had been advised that Canada had also requested a provision prohibiting Australia from levying undistributed profits tax on the Australian-source undistributed profits of Canadian companies.

The high commissioner’s impression was that the Australian negotiators did not regard the permanent establishment and dividend points as being important, that they would be prepared to recommend that their government accept the Canadian request on dividends, and that their only objection on the permanent establishment point was that they thought that it was not an appropriate request for Canada to make. The high commissioner also had the impression that there was a possibility for compromise on draft article VIII but that the Canadian request to prohibit Australia from levying undistributed profits tax would be unacceptable. He had the definite

108 Despatch, supra note 56. Handwritten annotations to article VI of the 1953 draft treaty, supra note 55, support the high commissioner’s account of the Canadian request.

109 Article VI of the 1953 draft treaty, supra note 55.

110 Despatch, supra note 56.

111 Ibid.
impression that the difference of opinion on this issue was the only serious obstacle to securing a treaty.\textsuperscript{112}

The high commissioner understood that, in submitting a draft treaty based on the 1953 Australia-US taxation treaty, Australia thought that it was making several concessions that would have a revenue benefit to Canada for the purpose of attracting Canadian investment to Australia. He stated that Casey, the Australian minister for external affairs, was “very anxious” to develop closer relations with Canada and would welcome a taxation treaty between the two countries.\textsuperscript{113} He requested advice on whether it would be desirable to reopen negotiations for a taxation treaty and instructions as to the advice that he should give to Casey.\textsuperscript{114}

Presumably in response to the high commissioner’s despatch, Eaton wrote to McGovern on March 18, 1954.\textsuperscript{115} Eaton explained that since the negotiations in Ottawa in 1953, Canadian officials had reviewed the issues that had proved difficult in the negotiations and had discussed them with ministers. As a result of this review, Canadian officials did not consider that they could recommend to ministers a treaty that did not include a provision similar to the following, found in Canada’s agreements with the United Kingdom, New Zealand, and Sweden:

\begin{quote}
Where a company which is a resident of one of the territories derives profits or income from sources within the other territory, the government of that other territory shall not impose any form of taxation on dividends paid by the company to persons not resident in that other territory, or any tax in the nature of an undistributed profits tax on undistributed profits of the company, by reason of the fact that those dividends or undistributed profits represent, in whole or part, profits or income so derived.\textsuperscript{116}
\end{quote}

Eaton pointed out that, as McGovern was aware, this provision was extremely important to Canada, and while it was unfortunate that it cut across a “somewhat fundamental doctrine in [Australia’s] basic law,” it would be pointless for Eaton to attempt to minimize the importance of the issue to Canada.\textsuperscript{117} Eaton asked McGovern to “think the matter over” and to consider whether there would be any useful purpose in renewing discussions.\textsuperscript{118}

McGovern’s reply to Eaton on May 6, 1954 began by stating that “most useful purposes would be served” by the renewal of discussions on a taxation treaty between

\textsuperscript{112} Ibid.
\textsuperscript{113} Ibid.
\textsuperscript{114} Ibid.
\textsuperscript{116} Ibid. It is notable that the 1942 Canada-US taxation treaty contained a less restrictive provision (article XIII). See supra note 95.
\textsuperscript{117} Ibid.
\textsuperscript{118} Ibid.
the two countries.\textsuperscript{119} McGovern had reviewed the three requests that Canada had made that went beyond what Australia had to offer at the 1953 Ottawa discussions and had concluded that the only real obstacle to a treaty was the Canadian request that Australia not impose an undistributed profits tax on the undistributed Australian-source profits of a Canadian company.

McGovern could not see how Australia could ever agree to a request that curtailed its right to impose tax on Australian-source profits, and whether the tax was a basic tax or was imposed because profits were retained would not alter that view. McGovern maintained that Australia’s position was consistent with the principle that a source country should have the prior right to its full quantum of tax on profits sourced in its jurisdiction, and he was “at a loss” to understand why Canada should try to achieve a result that seemed to derogate from that principle.\textsuperscript{120} Perhaps there was some point that McGovern did not see and, if so, he considered that further talks might “bring enlightenment.”\textsuperscript{121}

McGovern asked Eaton to consider what effect Australia would be creating if it conceded the point. Where a Canadian company met the Australian definition of a private company and all or a large proportion of its shareholders were Australian residents, the company would only be subject to Australian corporate tax at a rate of 30 percent on those profits, and Australia would not be able to impose undistributed profits tax. This, in McGovern’s view, would amount to an overgenerous treatment of the Canadian company and would give it an unjustified trading and capitalization advantage over Australian private companies that it was competing with.

Shortly after receiving McGovern’s letter, Eaton wrote to C. Gavsie, deputy minister (taxation) in Canada’s Department of National Revenue, enclosing a copy of the letter and observing that “quite clearly [McGovern] does not want to terminate discussions.”\textsuperscript{122} Eaton suggested that Australia and South Africa might be willing to “go along with the 50\% rule with respect to undistributed profits tax on Canadian companies” and that “we might draft something and try it on both [the Australians] and the South Africans.”\textsuperscript{123} While Eaton appeared to have decided on this course of action in May 1954, he did not reply to McGovern’s letter until the following September.

In the interim, the Canadian Shipowners Association raised the question of progress on a taxation treaty with Australia with the Canadian undersecretary of state for external affairs, in correspondence that again pointed out the disadvantaged

\textsuperscript{120} Ibid.
\textsuperscript{121} Ibid.
\textsuperscript{122} A.K. Eaton to C. Gavsie, Deputy Minister (Taxation), Department of National Revenue, Ottawa, May 12, 1954, in Canadian Department of Finance file, 1957 treaty, vol. 1.
\textsuperscript{123} Ibid.
position of Canadians shipping to Australia as compared with their competitors.\footnote{W.J. Fisher, General Manager, Canadian Shipowners Association to Under-Secretary of State for External Affairs, Ottawa, May 21, 1954, in Canadian Department of Finance file, 1957 treaty, vol. 1.}

This letter was referred to Eaton for comment.\footnote{Eaton's reply is found in A.K. Eaton, Assistant Deputy Minister, Finance, to the Under-Secretary of State for External Affairs, Ottawa, June 9, 1954, in Canadian Department of Finance file, 1957 treaty, vol. 1.}

When Eaton replied to McGovern's letter of May 6, on September 8, 1954,\footnote{A.K. Eaton to P.S. McGovern, September 8, 1954, in Canadian Department of Finance file, 1957 treaty, vol. 1.} he raised the possibility of exempting Canadian companies from Australian tax on their Australian-source profits only where more than 50 percent of the shares were held by Canadians, and he enclosed a draft proposal to this effect. While sympathetic to Australia's desire to protect its revenue from the use of Canadian companies as a device to accumulate Australian-source income, Eaton considered that the proposed compromise was reasonable and pointed out that it was based on an article in the Canada-US taxation treaty, where the same issue had arisen.\footnote{The relevant provision in the 1942 Canada-US treaty was article XIII. See supra note 95.} Eaton, in words that are naïve from a 21st-century perspective, considered that “it is a bit far-fetched to think that a small group of persons composed of Australians and Canadians would get together to connive against your personal income tax law.”\footnote{Eaton to McGovern, supra note 126.} Eaton pointed out that Canada had “always professed to be strongly behind the source principle of taxation”\footnote{Ibid. Eaton’s statement is consistent with archival evidence of early Canadian policy. See C.D. Skelton, for Secretary of State for External Affairs to W.A. Riddell, Canadian Advisory Officer, League of Nations, Geneva, Switzerland, April 22, 1937, in LAC, RG19-F-2, vol. 5218, part 1, file no. (creator) 5425-02, “Canadian Tax Agreements with Other Countries—Policy Development.”} but did not think that that principle could be carried through to the point of regarding a shareholder of a Canadian company as deriving Australian-source income merely because the paying company earned its profits in Australia.

McGovern did not reply to Eaton until May 5, 1955,\footnote{See infra note 136 and the accompanying text.} but in the meantime a memorandum regarding Australia’s taxation of dividends to Canada\footnote{“Australian Taxation of Dividends to Canada,” March 29, 1955, in Canadian Department of Finance file, 1957 treaty, vol. 1. The memorandum compared the effective rates of Australian and home-country tax paid by Canadian companies with Australian subsidiaries and UK companies with Australian subsidiaries.} had been given to Fred Bull, the Canadian deputy minister for trade and commerce, by James Duncan of Massey-Harris-Ferguson Ltd. and had been forwarded to Eaton for
Eaton’s comment on the memorandum is evidence of Canada’s negotiating strategy, the reasons why Canada wanted a taxation treaty with Australia, and Eaton’s assessment of the Australian negotiating position. Eaton suggested that it would be “all right” if either C.D. Howe, the minister of trade and commerce, or Fred Bull, the deputy minister, inquired as to how the negotiations were coming along, indicating that they understood that it was “Australia’s next move on the question,” but he did not want the Australians to get the impression that Canada was too worried about the situation. That this was part of the Canadian negotiating strategy is clear from the following extract from Eaton’s letter, as is Canada’s motivation in pursuing a treaty with Australia:

Actually we would like to see an agreement for the sake of both Ford [the Ford Motor Company of Canada] and Massey-Harris-Ferguson but I would not like to have our bargaining position weakened by an indication that we are weakening in the rather tough but sound position that we took with [the Australians]. They, I think, are the ones that are mostly worried. They have agreements with both the U.S. and the U.K. under which their 35% withholding tax has been lowered, or in some cases, removed. I do not think they want the situation to continue under which they do not give Canada as good terms as they have given to these other countries.

McGovern’s reply of May 5, 1955 does not exhibit signs of worry on his part, although it does contain somewhat melodramatic prose. McGovern states that Eaton’s letter had “caused me to search my soul to ascertain whether or not I could recommend the basic principle for acceptance by the Commonwealth Government.” McGovern disagreed with Eaton’s assessment of the unlikelihood of Australians and Canadians combining to defeat the intention of the treaty, commenting:


135 Eaton to Isbister, supra note 133.


137 Ibid.
I may have become cynical but there is so much daily evidence that our Australian residents leave no stone unturned in their endeavour to reduce their taxation liability, contrary to the spirit of the law, but without actual wrongdoing, that I think it would be naïve to conclude that this would not happen. I have also seen more than enough of the willingness of overseas enterprises to follow a similar trail. A combination of Australian and Canadian interests might be no less ingenious.138

More important, from McGovern’s perspective, were the implications flowing from the “somewhat singular” Australian form of tax on companies,139 which made an approach that did not recognize that form of tax impossible. Australia, in McGovern’s view, imposed a low rate of tax on companies—a minimum of 20 percent and a maximum of 30 percent for private companies—and was able to do this because it taxed dividends paid by private companies or a substantial proportion of their undistributed profits. If Australia chose to impose a higher rate of tax on companies, including tax on the Australian profits of a permanent establishment of a Canadian company, McGovern felt sure that Canada would allow the usual credit for the Australian tax. After pointing out that neither the United States nor the United Kingdom had been concerned that Australia levied tax on private companies by two differing procedures rather than in one assessment, McGovern considered that Canada could adopt a similar view by appreciating that the total Australian tax was only equivalent to the tax that would be payable if Australia adopted the Canadian approach to corporate-shareholder taxation. Continuing his focus on the substantive effect, as opposed to the formal characteristics of the Australian system, McGovern pointed out that at one time Australia had only taxed undistributed profits of companies and that if Australia imposed a higher tax on companies but allowed them a deduction for dividends paid, then nothing in Eaton’s draft proposal would prevent this or prevent credit being given for the higher Australian corporate tax.140

McGovern wondered whether the Canadian objection was as much to the Australian proposal for a reference to the term “undistributed profits” as to the actual imposition of the tax. If so, then it might be possible to arrive at a solution that left Australia unimpeded but removed terminology that was objectionable to Canada.

While appreciating Eaton’s efforts to break the deadlock, McGovern indicated that even the modified proposal relating to undistributed profits ran counter to a principle that Australia, McGovern believed, would find it essential to maintain in any taxation treaty that it might conclude.

McGovern’s letter concluded by pointing out that Australia had offered substantial concessions, particularly in relation to dividends and shipping profits, and that

138 Ibid.
139 Ibid.
140 McGovern’s letter appears to assume that Canada still granted a foreign tax credit for all dividends on which foreign income tax had been paid. By this stage, however, as discussed earlier, Canada exempted foreign-source dividends received by a Canadian company from a subsidiary in which it held a 25 percent or greater shareholding; see supra note 95.
those concessions would not involve Canada in yielding either revenue or principle. McGovern hoped that the issue of undistributed profits would not prevent ultimate agreement and was confident that, if that issue could be settled, further talks would lead to an early settlement of other matters of detail.

On receipt of McGovern’s letter, Eaton wrote to McEntyre observing, “I have not studied it very closely but it does not look like we would make much headway with these fellows.”141

There is no record in the Canadian Department of Finance file of further action in relation to the treaty until December 12, 1955, when a letter from the Canadian high commissioner in Australia, dated November 30, 1955, and other associated documents were forwarded to the Canadian deputy finance minister.142 Canadian companies had continued to make submissions indicating that the absence of a taxation treaty between Australia and Canada was impeding Canadian direct investment in Australia or causing it to be routed through US-resident companies.143 In addition, Fred Bull, the Canadian minister and deputy minister for trade and commerce, had visited Australia in April 1955 and had had discussions with McGovern on the taxation treaty issue.144

The high commissioner had also recently asked McGovern whether there had been any developments on the issue at his end, and McGovern had told him that he believed that an Australia-Canada treaty was desirable both on the grounds of Commonwealth solidarity and to make it more attractive for Canadians to invest in Australia. McGovern had reiterated that the one serious point of difference was that Canada wanted an article preventing Australia from levying undistributed profits tax on the Australian-source profits of Canadian companies and that Australia was unwilling to concede this point since it cut across a fundamental doctrine in Australia’s basic tax law.145

The deputy minister for trade and commerce had stated to the high commissioner that Canada should not press the Australians on undistributed profits and should try to get a treaty through as quickly as possible, because in the meantime Canadian companies were losing money.146

142 Under-Secretary of State for External Affairs, Ottawa to Deputy Minister of Finance, Ottawa, December 12, 1955, enclosing a copy of a letter dated November 30, 1955 from High Commissioner for Canada in Australia, Canberra to Under-Secretary of State for External Affairs, in Canadian Department of Finance file, 1957 treaty, vol. 1.
143 The high commissioner’s letter, supra note 142, records discussions with and representations by C.B. Neal, president of the Outboard Marine and Manufacturing Company of Canada, and by a representative of a Canadian minerals exploration company.
144 Ibid.
145 Ibid.
146 Ibid.
Having visited Australia in April 1955 and having advised McGovern to correspond with Eaton to “iron out the difficulties,” the deputy minister for trade and commerce wrote to the deputy minister, finance, stating that he had been surprised to receive a letter from the high commissioner, dated November 24, 1955, indicating that McGovern had advised the high commissioner that Australia was still “waiting for some action on the Canadian side.”

The deputy minister for trade and commerce had told the high commissioner that he thought that Canada had been mistaken in trying to get Australia to accept the Canadian view on undistributed profits, and that he intended to take the matter up with Finance when he returned to Ottawa. The high commissioner noted that the Australia-US taxation treaty did not contain a provision equivalent to the one that Canada was seeking on undistributed profits tax.

The Canadian Department of Finance file contains a memorandum dated December 2, 1955 recording a discussion on that day with McGovern following a meeting on sales tax. Neither the author of the memorandum nor the employer of the author is identified. The memorandum is not contained in the Canadian Department of External Affairs file. For that reason, it is unlikely that the memorandum was written by either the high commissioner or by staff attached to the High Commission. Rather, it seems likely that the memorandum was written either by a Canadian Department of Finance official, other than Eaton, in relation to a meeting that occurred in Canberra on December 2, 1955, or perhaps by the deputy minister for trade and commerce in relation to a meeting in April 1955. The former appears to be more likely since the memorandum refers to the meeting “following today’s meeting on sales tax,” strongly suggesting that the date of the meeting was December 2, 1955 not April 1955. In addition, the record of the meeting contains a reasonably detailed explanation of the then current Australian position on undistributed profits tax. It is unlikely that the deputy minister for trade and commerce would have provided such detail on Australian undistributed profits tax, since in his letter to the deputy minister, finance, on December 2, 1955, he commented in relation to his meeting with McGovern in April 1955, “I realized immediately that I started into this discussion . . . that I was outside my field and asked him (McGovern) to write to Ken Eaton.” Whatever the provenance of the memorandum, it appears to have

147 Wm. Frederick Bull, Deputy Minister of Trade and Commerce, Ottawa to A.W. Taylor, Deputy Minister, Finance, December 5, 1955; and High Commissioner for Canada in Australia, Canberra to Under-Secretary of State for External Affairs, November 30, 1955, Canadian Department of Finance file, 1957 treaty, vol. 1.

148 High Commissioner to Under-Secretary of State for External Affairs, supra note 142.

149 Ibid.


151 The memorandum refers to Eaton in the third person.

152 Bull to Taylor, supra note 147.
influenced Eaton’s next letter to McGovern and a softening of the Canadian position in relation to undistributed profits tax.

The memorandum contained details of McGovern’s explanation of the current Australian undistributed profits tax. The tax was imposed at a rate of 50 percent on the amount by which a private company’s distributions fell short of 75 percent of its earnings. No equivalent tax applied to public companies. The memorandum also outlined the Australian definition of a private company and pointed out that wholly owned subsidiaries of public companies were deemed to be public companies. This meant that undistributed profits tax would not apply to the Australian subsidiaries of Ford, General Motors, and Massey-Harris-Ferguson. The author of the memorandum had suggested to McGovern that 75 percent was an unusually high requirement given that most companies distributed 50 percent of their earnings. McGovern had replied that the 75 percent requirement had been established as a matter of high government policy and that he did not believe that it was appropriate for Canada to ask for better treatment than that which had been decided upon generally for Australia. When the author of the memorandum drew McGovern’s attention to the Australia-US taxation treaty, McGovern pointed out that under that treaty both Australia and the United States had reserved their right to tax undistributed profits, and he suggested that the proposed Australia-Canada treaty remain silent on the issue. The memorandum then records that a Mr. MacGillivray had pointed out that a restriction on the taxation of undistributed profits might easily be circumvented by either party.153

Following receipt of the memorandum of December 2, 1955 and correspondence from the high commissioner and the deputy minister for trade and commerce, Eaton wrote to McGovern on December 12, 1955.154 Curiously, given the previous correspondence, Eaton began by raising the issue of Australian taxation of dividends paid by Canadian companies to non-Australian shareholders, even though McGovern had indicated as early as April 1953 that he was prepared to concede to Canada’s request on this point. Eaton alluded to the impracticality of collecting tax in these circumstances and then indicated that Canada’s concern was primarily with public companies. Canada, he said, had “no desire to protect Australian interests who by means of a succession of companies set up in various countries might attempt to avoid your taxes.”155

Similarly in relation to undistributed profits tax, Canada’s main concern was with public companies. Eaton asked for confirmation that Australia’s undistributed profits tax only applied to private companies, and also asked whether McGovern would be prepared to include an undertaking in the agreement that Australia would not apply undistributed profits tax to a Canadian company that was not a private company.

153 Supra note 150.
155 Ibid.
negotiation and drafting of the first Australia-Canada taxation treaty

This request suggests that Australia’s position on this point had not been communicated to Canada prior to the memorandum recording the discussion with McGovern in December 1955. Eaton noted that Canadian law did not have a definition of “private company” for tax purposes but that the Australian definition conformed to Canada’s understanding of what a private company was, and that it would be possible to include a definition in the treaty. Alternatively, Eaton asked McGovern to consider adopting a provision similar to one included in South Africa’s undistributed profits tax, which applied only where more than 50 percent of the profits of a company had a South African source.

Eaton’s letter indicated that he was hopeful that Canadian ministers would accept undertakings on either of these bases, and that if such undertakings were made, Australia and Canada would have the basis for a treaty. Eaton suggested that if either of these ideas appealed to McGovern, he might work it into a redraft of the whole treaty and send it back for consideration by Canada.

McGovern replied to Eaton on March 7, 1956, pointing out that when he went to Ottawa in 1953, he was authorized to negotiate a taxation treaty with Canada on the same terms as had been acceptable to the United States in 1953. The latter, he noted, differed in only minor respects from the terms of the Australia-UK taxation treaty and the terms of treaties that the United States had entered into with other countries, merely reflecting such changes as were necessary to reconcile small variations in different taxing systems. Australia, in its treaties with the United Kingdom and the United States, had given up more than its treaty partners because in these relationships Australia was a net capital importer. Australia had done this to encourage the investment of UK and US capital in Australia, in the belief that, over the long term, when Australia ceased to be a capital-importing country, a balance would be achieved in the tax concessions for each treaty partner. In the case of Canada, all the concessions would be made by Australia and there would even be a net revenue gain to Canada, owing to the reduction in foreign tax credits that Canada would allow as a result of the proposals on dividends and shipping profits. Nevertheless, McGovern was authorized to negotiate an agreement on terms similar to those in Australia’s treaty with the United States.

McGovern then reiterated the three additional concessions that Canada had asked of Australia at the Ottawa negotiations. With respect to dividends and the attribution of profits to a permanent establishment, McGovern indicated that, while he did not regard Canada’s requests as appropriate in the circumstances, he did not

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156 McGovern to Eaton, supra note 65.

157 There were, in fact, several significant differences between the 1946 Australia-UK taxation treaty and the 1953 Australia-US taxation treaty. The most significant difference related to the treatment of dividends. In the 1946 Australia-UK treaty, dividends paid by a wholly owned subsidiary to its parent were exempt from tax in the source country, while source-country tax on other dividends was reduced by 50 percent. In the 1953 Australia-US treaty, source-country taxation of all dividends was limited to a standard rate of 15 percent. For a discussion of other differences between these two treaties, see Taylor, “National Report,” supra note 12.
think that these points were sufficiently important for them to “wreck the negotiations.” Accordingly, as previously advised, he was prepared to recommend that Australia should concede these points.158

McGovern regarded undistributed profits tax as vital from Australia’s viewpoint and stated that he could see no prospect of his being able to recommend the Canadian request, either in whole or in part. The fact that Canada had “held out” despite McGovern’s advice to this effect indicated to McGovern that Canada regarded the request as vital.159 Normally this would have meant that there could be no treaty, but McGovern indicated that he had persisted with discussions because he was unable to recognize the rationale of Canada’s proposition or the position that Canada was seeking to protect.

McGovern went on to outline, again, the Australian system of corporate-shareholder taxation, pointing out that Australia levied low rates of tax on private companies and that, as a consequence, undistributed tax on private companies was a vital part of the system. Importantly, McGovern explained that Australia at that time did not levy undistributed profits tax on public companies, and that a private company was defined broadly as one that was not listed and was controlled by seven or fewer individuals. Subsidiaries of public companies were not private companies.

McGovern noted that Canadian enterprises operating in Australia were generally and almost invariably subsidiaries of public companies. This would mean that little or no Australian undistributed profits tax would be imposed on Canadian companies and that the concession that Canada sought from Australia would not affect current Australian tax law but would merely bind Australia for posterity, so that it could never impose undistributed profits tax on Canadian companies.

Although McGovern did not say so explicitly at this point, viewed from this perspective, the “concession” offered by Eaton in his letter to McGovern of December 12, 1955 was effectively no concession at all, since the only Canadian companies that could be affected by a subsequent change in Australian undistributed profits tax would be subsidiaries of public companies.

McGovern noted that a provision preventing the application of undistributed profits tax to Canadian companies had been included in Canada’s taxation treaties with the United Kingdom and the United States,160 but considered that perhaps this did not matter so much to those countries since “they take what they want from the company’s profits in company tax and they don’t have to worry overmuch about the weight of tax borne by retained profits ploughed back into capital.”161

158 McGovern to Eaton, supra note 65.
159 Ibid.
160 This was not strictly true of the 1942 Canada-US taxation treaty, which (as noted earlier) prevented the United States from levying undistributed profits tax in relation to Canadian-resident companies only where more than 50 percent of the voting shares were owned by Canadians. See supra note 95.
161 McGovern to Eaton, supra note 65.
For Australia, by contrast, the low rate of company tax made it necessary to regulate the amount of tax payable on retained profits through the use of an undistributed profits tax. This did not give undistributed profits tax the same character as any tax imposed on dividends payable to the shareholder, and exposed what McGovern saw as the fallacy in Canada’s argument. Any undistributed profits tax that might in the future be imposed on public companies would be there to ensure that those profits bore their full weight of tax as company profits. McGovern saw no difference in substance between the Australian approach and the Canadian approach, which imposed a high rate of company tax on all company profits and then rebated some of that tax when the profits were distributed to shareholders.

McGovern noted that, even if Australia granted the concession, it could easily be circumvented by doing exactly what Canada had done, and this made McGovern wonder what could be the worth of the concession to Canada.

McGovern conceded that he had “written at some length” and had “recapitulated quite a bit,” but that this was in a “final effort” to see if the countries could not “get together on this matter because I think our countries ought to have a tax agreement,” even if it only dealt with the items on which they agreed and left other items for subsequent negotiation. McGovern indicated, however, that he was “just about the only Australian who has any enthusiasm for further negotiation.” This was despite the fact that McGovern indicated that he was “called upon at regular intervals to defend the loss of revenue involved in the agreements between Australia and the United Kingdom and the United States of America.” McGovern concluded by suggesting, “Perhaps all that is necessary is for you to take the opportunity to come out here and fix it up. A visit by you to Australia is surely overdue.”

At about this time, there were further submissions from Canadian industry about the desirability of a taxation treaty between Australia and Canada, pointing out that Canadian industry was being disadvantaged by the absence of a treaty. Both the Canadian Department of External Affairs and the Department of Trade and Commerce clearly wanted a treaty concluded as quickly as possible, and there may have been high-level interdepartmental discussions on the issue, but there is only indirect evidence of this in the relevant Department of Finance and Department of External Affairs files. Clearly, correspondence was forwarded between relevant departments on the issue at this time.

The Department of Finance file contains a copy of a letter, dated March 22, 1956, from the Canadian high commissioner in Australia to the undersecretary of

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162 Ibid.
163 Ibid.
164 Ibid.
165 Ibid.
state for external affairs,\textsuperscript{166} in which, after reiterating his understanding of the Australian position on undistributed profits tax, the high commissioner reported on a meeting he had had with the president of the Ford Motor Company of Canada. The president had indicated that, although Ford had decided to make a large capital investment in Australia to contest the market more effectively through General Motors Holden, the absence of a taxation treaty between Australia and Canada meant that Ford was in a disadvantaged position as compared with General Motors, which enjoyed the benefit of reduced rates of tax on dividends paid to US residents under the US-Australia taxation treaty.

The high commissioner considered that the impasse was the same as that which had arisen a year before, when the Canadian deputy minister of trade and commerce had had discussions with McGovern. He noted that, although McGovern personally felt very strongly that there should be an agreement, he was unable to concede the undistributed profits tax point and considered that Canada was being unreasonable, given that Australia had conceded all other points raised by Canada. The high commissioner’s distinct impression was that Australian taxation officials had now reached the point where they would prefer to “wreck the whole agreement” rather than concede the undistributed profits tax point.\textsuperscript{167} The high commissioner acknowledged that he did not know “how far up the line” discussions had progressed but suggested that if interdepartmental or even ministerial discussions had not taken place on the issue as yet, then they might be desirable.\textsuperscript{168}

**Canada Concedes on Undistributed Profits Tax**

It is unclear whether Canadian interdepartmental discussions on the issue did take place at this point. The high commissioner’s letter was not forwarded to the Department of Finance until April 5, 1956.\textsuperscript{169} In the interim, following the receipt of

\textsuperscript{166} W. Arthur Irwin, High Commissioner for Canada, Canberra to Under-Secretary of State for External Affairs, Ottawa, March 22, 1956, in Canadian Department of Finance file, 1957 treaty, vol. 1, and Canadian Department of External Affairs file, 1957 treaty, part 1.

\textsuperscript{167} Ibid.

\textsuperscript{168} Ibid.

\textsuperscript{169} A.E. Richie, Under-Secretary of State for External Affairs, Ottawa to A.K. Eaton, Deputy Minister, Department of Finance, Ottawa, April 5, 1956, in Canadian Department of Finance file, 1957 treaty, vol. 1, and Canadian Department of External Affairs file, 1957 treaty, part 1. Richie’s letter encloses the high commissioner’s letter and summarizes the high commissioner’s and the Australian views. The penultimate paragraph of Richie’s letter indicates a significant degree of concern in the Canadian Department of External Affairs on the issue: “Our High Commissioner is most anxious that we reach an agreement on this issue with the Australians in the near future. He considers that Australia represents a fruitful area for capital investment, in which Canada would be well advised to participate. Canadian inaction may well be construed as an unfriendly gesture affecting the general relations between the two countries. He notes that the lack of agreement has seriously concerned Rhys Sale of the Ford Motor Company who is anxious to establish a branch industry in Australia.”
McGovern’s letter of March 7, 1956, Eaton met with the Canadian finance minister, and as a result of that meeting, Canada conceded Australia’s point on undistributed profits tax.170 It may be that McGovern’s letter was enough to produce a change in the Canadian viewpoint, but in the light of the high commissioner’s letter of March 22, 1956, the possibility that there had been informal higher-level interdepartmental or ministerial discussions cannot be entirely dismissed.

In any event, Eaton wrote to McGovern on March 26, 1956171 indicating that he had had another talk with the minister of finance, who had agreed to drop Canada’s insistence on the undistributed profits tax point if Australia would concede the points on dividends and attribution of profits to permanent establishments. Although Eaton thought that it would have been useful for him to have visited Australia to work on the draft with McGovern, he could not possibly get away before the Canadian summer, and his minister had suggested that they might be able to settle the draft by correspondence, noting, “We are not usually fussy on matters of form.”172 Eaton suggested that McGovern send a draft to him, and indicated that Canada might be able to sign it without alteration in the next few months and have it approved by Parliament, which would be in session until the end of June.

AUSTRALIA DELAYS IN SENDING DRAFT TREATY

Somewhat ironically, given McGovern’s relatively strong support for a taxation treaty with Canada, delays now occurred on the Australian side.

McGovern advised the Australian treasurer of the change in the Canadian position in relation to Australia’s undistributed profits tax on June 7, 1956.173 McGovern reiterated that he had been, in effect, authorized by the Australian Cabinet decision of January 16, 1953 to prepare a draft for the Canadian government’s consideration containing provisions similar to those in the 1953 Australia-US taxation treaty, and that, during discussions in Ottawa in April 1953, Canada had requested a number of variations from the terms of that treaty on which McGovern considered he had no authority to reach a compromise. Hence, a draft agreement had not been prepared following those discussions, but the understanding was that Canadian officials would “study these questions and indicate when further progress might be practicable.”174

McGovern then summarized the three issues on which the delegations had failed to reach agreement. His summary of the issue in relation to source taxation of industrial or commercial profits is worth quoting at length, since it contrasts with his


171 Eaton to McGovern, supra note 170.

172 Ibid.

173 McGovern to the Commonwealth Treasurer, supra note 107.

174 Ibid., at paragraphs 4-5.
earlier report to the treasurer and with the Canadian high commissioner’s comments on this issue.\footnote{175}

Under the Australia-United States convention, Australia may tax a United States enterprise upon its entire Australian income if the enterprise is engaged in trade or business through a permanent establishment in Australia. Canadian officials desired that the corresponding provision in the Australia-Canada agreement should permit Australia to tax industrial or commercial profits of a Canadian enterprise only to the extent that the profits are attributable to a permanent establishment in Australia. Adoption of this course might lead to Australia exempting so much of the industrial or commercial profits of a Canadian enterprise as are derived through certain classes of agents, even though the enterprise has an established business in Australia. Canada would grant a corresponding exemption to Australian enterprises deriving profits through agents in Canada.\footnote{176}

McGovern noted that this issue was one of principle rather than one of revenue. He was not aware of any case where acceptance of the Canadian request would involve a significant loss of Australian revenue; moreover, in the 1946 taxation treaty with the United Kingdom, Australia had accepted a provision identical in effect to the one requested by Canada.\footnote{177}

The second point at issue concerned dividends paid by Canadian companies from Australian-source profits. The issue was whether the exemption from source taxation should extend to dividends paid to residents of third countries. Since the exemption from Australian-source taxation in the Australia-US taxation treaty applied only to dividends paid to US residents, McGovern had not considered himself authorized to accept the Canadian proposal. McGovern pointed out that, except in rare circumstances, Australia was unable to enforce payment of tax on dividends paid by a non-resident company to a non-resident shareholder. Since it was unlikely that any loss of Australian revenue would result from the Canadian proposal, the treasurer, McGovern suggested, might consider that that proposal could appropriately be adopted.\footnote{178}

On the key issue of Australian undistributed profits tax, McGovern for the first time indicated that the Canadian request to exempt all Canadian companies from the tax was a counter to article VIII in the draft treaty.\footnote{179} McGovern explained that article VIII was sought so that Australia would be unfettered in any proposals that it might consider in the future in respect of the basis of its undistributed profits tax, and he noted that the point had been conceded by the United States and, after strong
opposition, by the United Kingdom. In providing background to the Canadian request, McGovern pointed out that during the Second World War, Australia had imposed undistributed profits tax on all companies (including public companies) resident in Australia or trading through a principal office or branch in Australia.

What McGovern did not point out in this advice, but had in his previous report to the treasurer, is that Australia no longer imposed undistributed profits tax on public companies and had changed the basis for calculating undistributed profits tax. McGovern did report in this subsequent communication that the Australian negotiators had advised Canadian officials that it was not considered appropriate for Australia to be asked to surrender its right to impose, in any manner it saw fit, tax on Australian profits. As is indicated by his correspondence with Eaton, McGovern clearly saw this as a key point of principle underpinning Australia’s continuing emphasis on source-basis taxation. McGovern also did not point out that, in discussions and previous correspondence with Eaton, he had already indicated that he would be prepared to omit article VIII of the draft treaty, although it is evident from his report to the Australian treasurer in November 1953 that this would have to be on the understanding that the omission would not limit Australia’s right to determine the basis or amount of undistributed profits tax.

McGovern reported that Eaton had now advised him that the Canadian government would not press its proposal that Canadian companies be exempted from Australian undistributed profits tax if Australia accepted the Canadian proposals on the other two issues. In McGovern’s view, the undistributed profits tax point was much more vital than the other two, and accordingly he recommended that the compromise be accepted.

On July 4, 1956, the Canadian high commissioner reported to Canada’s under-secretary of state for external affairs that he had had a private and unofficial discussion with McGovern in which McGovern had told him that the proposed taxation agreement was now with the treasurer, who had given no indication of whether or not he favoured it. The high commissioner commented that with the worsening economic situation in Australia and recent political criticism of large dividend remittances by General Motors Holden, it might be more difficult to persuade the Australian Cabinet of the advantages of a taxation treaty with Canada than it would have been at any time in the past three years. The high commissioner

180 Ibid., at paragraph 14.
181 Ibid., at paragraph 15.
182 Memorandum from McGovern, supra note 54, at paragraph 30.
183 Ibid., at paragraph 25.
184 McGovern to the Commonwealth Treasurer, supra note 107, at paragraph 16.
185 Ibid., at paragraphs 8, 9, and 16.
recommended that Canada not press the matter at present but allow McGovern to argue his case, noting that some of the Australians were still sensitive about Canada’s delay in reaching agreement at the technical level. The high commissioner hoped that Canada would receive some indication of the Australian Treasury’s attitude within a matter of weeks, but indicated that a final decision might have to await the return of the Australian prime minister (R.G. Menzies).

Canada had still not received a draft treaty from Australia by September 24, 1956, when the high commissioner’s office reported to the undersecretary of state for external affairs187 that the matter had recently been raised with the Australian minister for external affairs (Casey) and the Australian prime minister.

According to the report of the conversation by the high commissioner’s office, Casey had indicated that he understood that a draft had been prepared, but, as far as he knew, it had not yet been discussed in Cabinet. He undertook to raise the matter and to do everything he could to push it through—notwithstanding the short-term loss of revenue—having regard to the long-term benefits to Australia of increased Canadian capital investment. The high commissioner’s office also reported that Prime Minister Menzies had commented that the Ford Motor Company had raised the matter with him when he was in Canada, and that it was at the top of the list of topics that he was going to discuss with the Australian treasurer. Menzies had indicated that he would pursue the matter and, without committing himself, had given the impression that he wanted to see the treaty go through.

According to Casey’s file note of the meeting,188 the high commissioner had indicated that he had heard a rumour that a submission was ready for Cabinet. Casey had raised the question of the cost to Australia, and the high commissioner had referred to the long-term benefits to Australia arising from increased Canadian investment. According to Casey, the high commissioner had mentioned the possibility that the Ford Motor Company might expand its interests in Australia and had pointed out that Menzies’s visit to Toronto (where Casey thought he had met with Henry Ford III) might reflect an interest on Menzies’s part in attracting Canadian capital investment. Casey’s file note states that he had said that he knew nothing about recent developments but understood that the matter was currently in discussion between the Australian treasurer and the commissioner of taxation. Casey had said that he would endeavour to find out more about it.

Documents in the Australian Treasury file on the 1957 treaty are consistent with the high commissioner’s reports. The treasurer had prepared a submission to Cabinet (drafted by the commissioner of taxation) for approval to enter into the treaty

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in August 1956.\textsuperscript{189} At this point, owing to public dissatisfaction in Australia with the high level of remittances to the United States by General Motors Holden following the entry into force of the 1953 Australia-US taxation treaty, the Australian Treasury took the view that it would be better not to enter into further treaties until Australia had a better understanding of the policy that North American companies were likely to follow in relation to reinvestment of their profits in Australia. On August 27, 1956, the day before the submission was due for consideration by the Australian Cabinet, R.J. Randall, the first assistant secretary of the Australian treasury, wrote to the treasurer\textsuperscript{190} making this point and also suggesting that, although in the absence of a taxation treaty Australia would not be obliged to tax dividend remittances by Canadian companies at a rate greater than 15 percent, the absence of a guaranteed rate might mean that those companies would exercise more caution both in making profits in Australia and in remitting them to Canada.

As a consequence of the letter from Randall, the treasurer withdrew the August 1956 submission and asked Randall and the commissioner of taxation to prepare advice giving the pros and cons in relation to entering into a taxation treaty with Canada.\textsuperscript{191} Understandably, in the resulting memorandum (dated October 25, 1956),\textsuperscript{192} Randall wrote the cons and McGovern wrote the pros. In submitting the memorandum to the Treasury secretary (Sir Frederick Wheeler) for review, Randall commented that he considered it likely that Cabinet would agree to a treaty with Canada, if only because Australia could hardly refuse to give Canada treatment as good as that which it had granted to the United States—a view with which Wheeler concurred in a handwritten note.\textsuperscript{193}

The statement of pros and cons\textsuperscript{194} began by noting that the balance of argument was probably in favour of proceeding with the treaty, but then went on to state that

\textsuperscript{189} For Cabinet, Income Tax, Proposal for Relief of Double Taxation by Australia and Canada, A.W. Fadden, Treasurer, August 20, 1956, in Australian Treasury file, 1957 treaty. A copy of the submission, dated August 20, 1956, is contained in the Australian Treasury file, 1957 treaty. A note from R.J. Randall, First Assistant Secretary of the Australian Treasury to the Secretary (of the Treasury, Sir Frederick Wheeler) dated October 19, 1956, in Australian Treasury file, 1957 treaty, makes it clear that the submission was drafted by the commissioner of taxation and withdrawn from the Cabinet list by the treasurer following a note from Randall dated August 27, 1956, infra note 190.

\textsuperscript{190} R.J. Randall, First Assistant Secretary (Australian Treasury) to the Treasurer, August 27, 1956, in Australian Treasury file, 1957 treaty.

\textsuperscript{191} Randall to Wheeler, supra note 189, and P.S. McGovern, Commissioner of Taxation to R.J. Randall, Acting Secretary of the Treasury, Canberra, ACT, October 15, 1956, in Australian Treasury file, 1957 treaty.

\textsuperscript{192} Infra note 194.

\textsuperscript{193} Randall to Wheeler, supra note 189. Wheeler wrote on the note “So do I” with an arrow pointing to the paragraph taking this view.

\textsuperscript{194} Statement to the Commonwealth Treasurer, October 25, 1956 (herein referred to as “the statement of pros and cons”), in Australian Treasury file, 1957 treaty.
before looking at the arguments in support of the treaty, it was worth considering whether it was advisable for Australia to reduce its right to tax dividends paid by Australian-resident companies to Canadian shareholders to 15 percent for as long as the proposed double taxation treaty with Canada was operative. The Australian Treasury at this point was skeptical of the value of much foreign investment into Australia, as can be seen from the following passage in the statement:

There has been active discussion recently as to whether overseas investment is always the unqualified boon to this country that it has sometimes been held up to be. Examples of very large dividend remittances by foreign companies where investment of capital here is relatively small have suggested that, at least from the balance of payments standpoint, we may in the long run lose considerably more than we gain from overseas investment in Australia. Often, no doubt, there may be intangible advantages to set against any such loss—the acquisition of know-how, the establishment of efficient manufacturing capacity, the strengthening of economic ties between ourselves and major powers abroad are examples. In other cases, however, there may be no such offsetting advantages and the activities of foreign investors here may amount to little more than exploitation of our natural resources with no permanent gain to set against that loss of resources.195

Other arguments were raised in the statement of pros and cons against having a taxation treaty with Canada.196 One was that while some foreign investors set up enterprises of great value to Australia, reinvested the greater part of their profits, and kept remittances to a minimum, others were merely “speculative types” who aimed to “bring as little as they can into the country and take as much as they can out.”197 Treasury saw no case for encouraging the latter type of investor, or for granting such investors guarantees against future tax increases on their remittances.

A further argument raised was that, since the Australian government was perceived as having very limited powers to regulate the operations of foreign investors in Australia, it was questionable that it should limit the power of control that it had through taxation. Although that power might not be used, if it remained unfettered, foreign investors might be more cautious about the size of their remittances so as to avoid possible retaliation through tax measures. In addition, the statement questioned whether tax incentives were necessary to attract foreign investment into Australia.

Treasury found it difficult to identify any other countries in the world that offered a better combination of advantages than Australia. As a consequence, it was argued, Australia should not have undue fears about failing to get a share of foreign investment, or go to undue lengths to induce such investment.

The final point made in the case against a treaty was that although broader considerations had weighed in favour of having taxation treaties with the United

195 Ibid., at 1.
196 Ibid., at 2-3.
197 Ibid., at 2.
Kingdom and the United States, it was not logical to thus conclude that Australia should have a taxation treaty with Canada. The statement asserted that if there were sound arguments against the treaty, they remained sound irrespective of what may have been done in the past.

The case in favour of the treaty (which, as noted, was written by McGovern) was considerably longer than the case against it. In brief, the points made in favour of the treaty were as follows.\(^\text{198}\)

First, Australia had responded to an invitation from Canada to negotiate a treaty by offering a treaty virtually the same as the Australia-US treaty, but now was considering not bringing the offer to fruition because of the increase in dividends flowing to Canadian parent companies, which had the consequence of an increase in the cost of the treaty. To do so would be to deny to Canada a treaty virtually identical with the US treaty and more favourable to Australia than the Australia-UK treaty.

Second, the restriction on tax on dividends paid by Australian companies to Canadian shareholders (most of which were parent companies of Australian subsidiaries) was not as serious a surrender of economic control as might first appear. In contrast to the desire to avoid the treasury effect that had underpinned Australia’s approach to the 1953 US treaty, a case was now being made in support of a treaty with Canada on the ground that, owing to what McGovern mistakenly understood\(^\text{199}\) to be the general Canadian approach to unilateral relief from international economic double taxation,\(^\text{200}\) the reduction in source taxation was more a matter between governments than between Australia and Canadian-resident shareholders.

The statement of pros and cons then pointed out that to put the issue in perspective, it was necessary to keep in mind the following considerations:

- Australia retained full source-country taxing rights in respect of the profits of Australian subsidiaries of Canadian companies and could, if it wished, tax those profits more heavily than the profits of other companies.
- Canadian companies could easily avoid the Australian tax on dividends by using an Australian branch instead of a subsidiary. Australia did not tax branch profits remitted to an overseas head office.
- In practice, foreign-resident shareholders of Canadian companies with Australian-source profits could avoid Australian tax on dividends funded from

\(^{198}\) Ibid., at 3-6.

\(^{199}\) The charitable view is that McGovern was mistaken. It is possible that he was being disingenuous and was providing the treasurer with information that was partially true but misleading.

\(^{200}\) In 1956, under the 1948 Income Tax Act, section 28(1)(d) dividends received by a Canadian company from a non-resident company in which the Canadian company owned 25 percent of the issued share capital with voting rights were deductible from the Canadian company’s income in computing the company’s taxable income. This meant that the full benefit of reductions in source-country tax on dividends was enjoyed by such Canadian companies, not by the Canadian treasury. For a discussion of this provision, see La Brie, supra note 19, at 272-73, and Arthur W. Gilmour, Income Tax Handbook 1956-1957 (Toronto: De Boo, 1956), at 291.
those profits simply by not retaining any assets in Australia against which recurrence could be had for payment of tax on the dividends.

- If excessive source taxation forced foreign investors to operate through Australian branches rather than through subsidiaries, Canadian companies would likely reduce the amount of profits retained in Australia for further expansion. The profit retention record of subsidiaries was thought to be better than that of branches.
- Provision was ordinarily made for the termination of taxation treaties at short notice.

The third argument in favour of a treaty was that the 15 percent limit on Australian-source taxation of dividends was not generous. The statement of pros and cons summarized the effect of the combined application of the Australian corporate rate and domestic rates on dividends paid to non-resident parent companies and noted that they represented rates higher than those paid by the vast majority of Australian-resident shareholders of Australian companies. Under the treaty, as proposed, there would still be Australian tax of 8s 8d on the pound (a rate of 43.33 percent) if the subsidiary company distributed 50 percent of its profits. The statement of pros and cons then argued that, since non-resident shareholders, while benefiting from Australian institutions, did not share in social services, in principle they should be taxed at a lower rate than residents, rather than at a higher rate as was the non-treaty position.

Finally, the Australian practice of taxing dividends flowing to non-resident companies at the normal company rate originated in 1939 and to some extent represented a theory of the past, according to which it was thought that non-resident shareholders who exploited Australian resources should be taxed at a higher rate than residents. This was inconsistent with the current practice of capital-importing countries, which, if not offering outright encouragement to foreign investors, at least did not discriminate against them. At the time that the practice originated, taxes on company profits were relatively low and made little contribution toward social services. In adhering to past practice, Australian rates were out of step with current international practice. In particular, Canada itself imposed a rate of only 15 percent on outbound dividends; the United States imposed a rate of 30 percent (reduced to 15 percent under the Australia-US taxation treaty); and the United Kingdom included dividends in income only for the purposes of the UK surtax, which was waived under the Australia-UK taxation treaty.

The statement of pros and cons and McGovern’s reports of June 7, 1956 and November 12, 1953, together with an estimate of the likely revenue cost of the treaty, the submission to Cabinet dated August 20, 1956, and a copy of the draft treaty (prepared by the Australian Taxation Office), were included as attachments in a further submission to Cabinet by the treasurer on October 25, 1956.201 The submission to

Cabinet presented in August had observed that it was not practicable to give an estimate of the increase in Canadian capital flows to Australia that was likely to result from the treaty.\(^{202}\) The submission had then pointed out that the “on the political side it may be accepted that the conclusion of the agreement would be desirable” and went on to note that refusal to have a treaty with Canada would “involve withholding from Canada terms granted to the United States.”\(^{203}\) On December 14, 1956, the Australian Cabinet decided that a taxation agreement should be concluded with Canada in accordance with the terms of the draft that had been prepared by the Australian Taxation Office.\(^{204}\)

**THE 1957 AUSTRALIAN DRAFT**

Following Cabinet approval, on January 17, 1957 the Australian Taxation Office sent a draft treaty and explanatory notes\(^{205}\) to the Australian Department of External Affairs,\(^{206}\) which were duly forwarded to the Canadian high commissioner in Australia,\(^{207}\) then to the Canadian Department of External Affairs,\(^{208}\) and finally to the Canadian Department of Finance.\(^{209}\)

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\(^{202}\) Cabinet submission, August 20, 1956, supra note 189, at paragraph 14.

\(^{203}\) Ibid., at paragraphs 14 and 16.

\(^{204}\) Cabinet Minute, Canberra, December 14, 1956, decision no. 584, copy contained in the Australian Treasury file, 1957 treaty. Correspondence from McGovern to the secretary of Australia’s Department of External Affairs also records that the Australian Cabinet approved the draft prepared by the Australian Taxation Office, by Cabinet decision no. 534, on December 7, 1956: P. S. McGovern (Commissioner of Taxation) to the Secretary, Department of External Affairs, Canberra, ACT, September 14, 1957, in Australian Department of External Affairs file, 1957 Canada treaty, part 1.

\(^{205}\) “Agreement Between the Government of the Commonwealth of Australia and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income” (undated draft) (herein referred to as “the 1957 draft”) and “Notes on Draft of Agreement Between Australia and Canada for an Agreement for the Relief of Double Taxation on Income” (herein referred to as “the explanatory notes” and cited as “Notes on Draft Agreement”). Copies of both the 1957 draft and the explanatory notes are contained in the Canadian Department of External Affairs file, 1957 treaty, part 1; the Canadian Department of Finance file, 1957 treaty, vol. 1; and the Australian Department of External Affairs file, 1957 Canada treaty, part 1.

\(^{206}\) P. S. McGovern (Commissioner of Taxation) to the Secretary, Department of External Affairs, Canberra, ACT, January 17, 1957, in Australian Department of External Affairs file, 1957 Canada treaty, part 1.

\(^{207}\) Note 828/1/4 Department of External Affairs, Canberra, ACT to Office of the Canadian High Commissioner, January 25, 1957, in Australian Department of External Affairs file, 1957 Canada treaty, part 1, and Canadian Department of External Affairs file, 1957 treaty, part 1.

\(^{208}\) The high commissioner confirmed that the draft treaty and the explanatory notes had been referred to the appropriate Canadian authorities for consideration in Note no. 4 Office of High Commissioner for Canada, Canberra to Department of External Affairs (Canberra), undated, received February 1, 1957, in Australian Department of External Affairs file, 1957 Canada.
The explanatory notes summarized the differences between the 1957 Australian draft and the 1953 Australian draft discussed at the 1953 meetings in Ottawa. These included two relatively minor drafting matters, namely,

1. removing the references to “Australian tax” and “Canadian tax” in article I(1) and including a definition of “Australian tax” and “Canadian tax” in article II, to ensure that substantially similar taxes referred to in article I(2) would be covered by the respective definitions;\(^{210}\) and

2. broadening the definition of “Australia” to include the Cocos Islands.\(^{211}\)

More significantly, the explanatory notes pointed out that article II(2) had been inserted in response to an Australian Taxation Board of Review decision that had found that a UK company did not have a permanent establishment in Australia in circumstances analogous to those dealt with in article II(2).\(^{212}\) Article II(2) of the 1957 draft read as follows:

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\(^{209}\) A covering letter forwarding the 1957 draft and explanatory notes to the Department of Finance is not currently contained in either the Canadian Department of External Affairs file, 1957 treaty, part 1, or the Canadian Department of Finance file, 1957 treaty, vol. 1; however, J.M. Harrington, Under-Secretary of State for External Affairs, Ottawa to Dr. A.K. Eaton, Dept. of Finance, February 15, 1957, in Canadian Department of Finance file, 1957 treaty, vol. 1, refers to one copy of both documents being forwarded to Eaton on February 14, 1957. A document that appears to be the original covering letter is contained in the Canadian Department of Finance file, 1957 treaty, vol. 1. Documents that appear to be carbon copies of the original are contained in the Canadian Department of External Affairs file, 1957 treaty, part 1, and in the Australian Department of External Affairs file, 1957 Canada treaty, part 1.

\(^{210}\) “Notes on Draft Agreement,” supra note 205, at article I.

\(^{211}\) Ibid., at article II.

\(^{212}\) Ibid. This was the situation arising in *Case 110* (1955), 5 CTBR (NS) 656, where an Australian Board of Review held that the UK company was not taxable under the industrial or commercial profits article of the 1946 Australia-UK taxation treaty since it did not have a permanent establishment in Australia. For a discussion of the current relevance of the issues raised by *Case 110* and the decision of the English courts in *Firestone Tyre & Rubber Co. Ltd. v. Llewellyn (HM Inspector of Taxes)* (1957), 37 TC 111 (HL), see Richard J. Vann, “Tax Treaties: The Secret Agent's Secrets” [2006] no. 3 *British Tax Review* 345-82. Australia subsequently argued successfully for the insertion of an equivalent provision in its 1960 taxation treaty with New Zealand. A similar and, in the view of Australian taxation officials, improved provision was included in the 1966 NZ-UK taxation treaty but was not included in the original draft treaty.
(2) Where an enterprise of one of the Contracting States sells to a resident of the other Contracting State goods manufactured, processed, packed or distributed in the other Contracting State by an industrial or commercial enterprise or undertaking for, or at the order of, that first-mentioned enterprise and that first-mentioned enterprise participates in the management, control or capital of that other enterprise or undertaking, then, for the purposes of this Agreement

(a) that first-mentioned enterprise shall be deemed to have a permanent establishment in the other Contracting State and to be engaged in trade or business in that other Contracting State through that permanent establishment; and

(b) the profits derived by that first-mentioned enterprise from the sale of those goods shall be deemed to be attributable to that permanent establishment.213

Other differences between the 1957 draft and the 1953 draft related to concessions by Australia that had been agreed to in subsequent correspondence. Articles III(1) and (2) had been amended so that they no longer applied a force-of-attraction principle but confined source-country taxation of industrial or commercial profits to those that were attributable to a permanent establishment. The explanatory notes merely commented that paragraphs (1) and (2) had been expressed so as to accord with the principle agreed upon since the discussions in Ottawa.214 Article VI of the 1957 draft exempted from Australian tax dividends paid by a Canadian company from Australian-source profits irrespective of the residence of the shareholder, and provided for a corresponding exemption from Canadian tax for dividends paid by an Australian company funded from Canadian profits. As noted above, article VI of the 1953 draft had confined the exemption to the situation where the shareholder was resident in the other contracting state. The explanatory notes pointed out that article VI had been broadened so as to accord with the principles agreed upon in correspondence.215

Article VIII of the 1953 draft was not included in the 1957 draft. As discussed earlier, Eaton had recorded on May 28, 1953 that McGovern, in a telephone conversation with Eaton, had agreed to delete article VIII.216 The explanatory notes, without explicitly referring to the previous article by number, do refer to the omission of an article that Australia had requested in Ottawa and that would have ensured

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213 1957 draft, supra note 205, article II(2).
214 “Notes on Draft Agreement,” supra note 205, at article III.
215 Ibid., at article VI.
216 See supra note 73 and the accompanying text.
Australia’s right to revert to a former basis of calculating undistributed profits tax on private companies. This appears to be a reference to the omission of former article VIII. The explanatory notes describe the rationale behind former article VIII in terms similar to those used in the Canadian high commissioner’s despatch of March 18, 1954 reporting discussions that he had had with unnamed Australian taxation officials.

The explanatory notes included the following comment on the position in relation to undistributed profits tax in the 1957 draft:

The present draft makes no reference to undistributed profits tax other than in Article I. Australia will accordingly retain its right to impose undistributed profits tax. If Australia should at any time wish to revert to its former basis of calculating the amount of undistributed profits tax it will be necessary to limit that tax to the 15% mentioned in Article VII(1) or express its own law in terms enabling a return in full to the previous basis of calculating the tax.

The explanatory notes also included a comment on the entry-into-force provision in article XVI of the 1957 draft. Article XVI(1) stated:

(1) This Agreement shall come into force on the date on which the last of all such things shall have been done in Australia and Canada as are necessary to give the Agreement the force of law in Australia and Canada respectively and shall thereupon have effect:

(a) as regards Canadian tax, for the taxation year in which this Agreement comes into force, and subsequent taxation years; and

(b) as regards Australian tax, for the year of income in which this Agreement comes into force, and subsequent years of income.

The comment on article XVI in the explanatory notes was that the Australian government agreed that the treaty would apply for the purposes of Australian tax to income derived during the year of income commencing on July 1, 1957, and that article XVI would achieve this result if the treaty came into force in the year ending

218 Despatch, supra note 56. See the discussion in the text above at notes 111 to 114.
219 This is consistent with the position that Australia had taken in negotiating the 1946 Australia-UK taxation treaty and was subsequently to take in negotiating the 1967 Australia-UK taxation treaty and the 1969 Australia-Japan taxation treaty—namely, that source-country taxation of a class of income was unrestricted unless the treaty provided otherwise. For a discussion of the Australian view in those negotiations and its influence on Australian treaty practice, see Taylor, supra note 212; Taylor, 2012 ATF, supra note 12; Taylor, supra note 104; and Taylor, 2009 BTR, supra note 7.
221 1957 draft, supra note 205, article XVI.
June 30, 1958.\textsuperscript{222} The explanatory notes added the following comment relating to taxpayers with substituted accounting periods:

> It is mentioned that in the case of a taxpayer who furnishes a return for a period ending other than on 30th June, the Agreement would commence to apply to income of the period substituted for the year commencing 1st July 1957.\textsuperscript{223}

As will be seen below, Canadian Department of Finance officials subsequently requested further clarification of effect of article XVI.

After receiving the draft treaty, Eaton wrote to McEntyre (then the deputy minister [Taxation] in Canada’s Department of National Revenue) on February 18, 1957, saying that he had only glanced through the draft but that it looked “allright” [sic] to him.\textsuperscript{224} Eaton suggested that he and McEntyre have a session on the draft promptly so that the treaty could be concluded with as little delay as possible.

As a result of the meeting between Eaton and McEntyre, Eaton sent a telegram to McGovern on February 22, 1957 stating that, while the draft was “excellent,” Canada requested the deletion of “thereon” from article VII (the dividends taxation provision) and requested confirmation that a dividend paid on, say, July 1, 1957 would enjoy the treaty rates of tax if the agreement were entered into before June 30, 1958, there being no years of income for withholding tax purposes.\textsuperscript{225} Both requests had been discussed at Eaton’s meeting with McEntyre, at which McEntyre had pointed out that, otherwise, the Ford Motor Company and Massey-Harris-Ferguson would be deprived of the treaty rate on dividends paid by Australian subsidiaries (since, under then current Canadian tax law, dividends paid by subsidiary companies to parents were exempt from Canadian tax).\textsuperscript{226} McGovern replied by telegram on March 29, 1957 stating that deletion of “thereon” in article VII was acceptable and including the following explanation of the application provisions:

> If agreement given force of law in both countries by 30th June, 1958, dividends paid on 1st June 1957 get agreement rate except where recipient furnishes returns for period ending 30th June. If returns in lieu year ending 30th June 1957, be for the year ending 31 August, 1957, agreement rate would apply to dividends paid on 1st September 1957.

\textsuperscript{222} “Notes on Draft Agreement,” supra note 205, article XVI.

\textsuperscript{223} Ibid.


\textsuperscript{226} See supra note 200. It is clear from the correspondence between Eaton and McEntyre, supra note 225, that McEntyre raised this issue in their meeting between February 18 and 22, 1957.
If returns be for year ending 30th April agreement rate would apply if dividends paid on 1st May 1957.227

Following the receipt of McGovern’s telegram, Eaton wrote to McEntyre on April 2, 1957228 noting that McGovern was agreeable to dropping the word “thereon” in the two paragraphs in article VII but expressing uncertainty about the meaning of McGovern’s comments on the entry-into-force provision. According to Eaton’s reading of the telegram, McGovern seemed to imply that every recipient in Canada had to make an Australian return. Eaton did not know whether this was correct or not, but regarded McGovern’s reply as reassuring enough if the Canadian recipient did have to file a return.229 Eaton thought that Canada should now proceed to get the treaty approved and signed with the word “thereon” omitted from article VII. Since this was traditionally McEntyre’s job, Eaton assumed that McEntyre would “put it in the works with the memorandum to Cabinet explaining it.”230

Officials in the Taxation Division of the Department of National Revenue considered Eaton’s letter to McEntyre dated April 2, 1957, but, having done so, were still unable to follow the explanation of the application of the entry-into-force provision to the taxation of dividends paid by Australian companies. In a letter to Eaton dated May 28, 1957,231 a taxation official pointed out that, according to the department’s records, article XVI(1)(b) (the entry-into-force provision) of the 1953 draft treaty dealing with the application of the treaty for Australian tax purposes was as follows:

(b) in Australia, for the year of income commencing on the 1st day of July in the next year succeeding the taxation year in which the Agreement becomes effective in Canada.232

The recollection of the taxation official was that the original wording had satisfied everyone at the initial negotiations in 1953. The official requested that, before authority to sign the treaty was obtained from Cabinet, Eaton ask McGovern for further

228 Eaton to McEntyre, supra note 225.
229 At the time, Australia still taxed dividends paid to non-residents on an assessment basis. Australia introduced a withholding tax on dividends in 1959: Income Tax Assessment Act 1936, section 128B(1), added by the Income Tax and Social Services Contribution Assessment Act (No. 3) 1959.
230 Eaton to McEntyre, supra note 225.
231 For Director, Legal Branch, Department of National Revenue, Taxation Division, Ottawa to Office of Assistant Deputy Minister, Department of Finance, Ottawa, Attention Dr. A.K. Eaton, May 28, 1957, in Canadian Department of Finance file, 1957 treaty, vol. 1.
232 Ibid. Article XVI(1)(b) of the 1953 draft as amended at the 1953 negotiations, supra note 55.
clarification of the revised wording and an explanation of the reason for changing the wording previously agreed upon.

Neither the Canadian nor the Australian files currently contain a letter or telegram from Eaton to McGovern seeking further clarification and an explanation of the reason behind the revised wording of the entry-into-force provision. Following a request from the Canadian high commissioner in Australia, an official of the Department of National Revenue, Taxation Division wrote to the undersecretary of state for external affairs on May 28, 1957 comparing article XVI in the 1953 draft with article XVI in the 1957 draft and quoting extracts from the correspondence between Eaton and McGovern of February 22 and March 29, 1957. This letter formed the basis for and was substantially identical with a letter from the undersecretary of state for external affairs to the Canadian high commissioner in Australia dated May 30, 1957. The letter indicated that Eaton had been asked to approach the Australian authorities to obtain further clarification. It appears from the Canadian Department of External Affairs file that Eaton did write to McGovern requesting further clarification and received a reply from McGovern: the file contains a telegram dated August 22, 1957 from the Canadian high commissioner to the Department of External Affairs in Ottawa, stating:

If let Jun 28 j245/22 to Eaton of Finance from Australian Commissioner of Taxation clears up points mentioned in your letter (E?) 169 May 30 I should be glad to know if there is any likelihood progress being made with agreement so that legislative action might be taken.

The Canadian Department of External Affairs sent a copy of the telegram to Eaton, who replied to the undersecretary of state for external affairs on August 26, 1957, stating that McGovern’s letter to him was satisfactory and that immediate action would be taken to secure signature in Ottawa, which would clear the way for legislative action in Canada within a few months. Presumably McGovern had clarified

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233 Request by the high commissioner: MacDermot (High Commissioner for Canada, Canberra) to the Under-Secretary of State for External Affairs, April 29, 1957. Letter by the taxation official: For Director, Legal Branch to the Under-Secretary of State for External Affairs, Ottawa, Canada, May 28, 1957. Both documents are in Canadian Department of External Affairs file, 1957 treaty, part 1.


235 MacDermot (High Commissioner for Canada, Canberra) to External, August 22, 1957, in Canadian Department of External Affairs file, 1957 treaty, part 1. The Canadian Department of Finance file does not contain a copy of this telegram.

236 A.K. Eaton to Under-Secretary Department of External Affairs, Ottawa, August 26, 1957, in Canadian Department of External Affairs file, 1957 treaty, part 1. The Canadian Department of Finance file does not contain a copy of this letter.
the operation of article XVI and the reasons why it varied from the 1953 draft in a manner that convinced Eaton, since article XVI in the signed treaty is identical to article XVI in the 1957 Australian draft.

**THE SIGNING OF THE TREATY AND ITS SIGNIFICANCE FOR EACH COUNTRY**

With the word “thereon” removed from article VII, a treaty otherwise identical to the 1957 Australian draft was signed at Mont Tremblant, Quebec on October 1, 1957 by Sir Arthur Fadden (the Australian treasurer) and Donald M. Fleming (the Canadian minister of finance). In each country, a bill giving the treaty the force of law was subsequently passed by the relevant Parliament and received royal assent.

Canadian officials were evidently satisfied with the final treaty. In an internal memorandum to the minister of finance dated May 25, 1957, which was clearly written in anticipation of the signing of the treaty, an unidentified Canadian official advised the minister of “a few of the important features in the agreement.” The memorandum noted that Canada’s taxation treaties, except those with the United

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237 Supra note 1. The signature of the treaty is confirmed in a telegram from Australian High Commission, Ottawa to Taxation (Attention) Treasurer and Treasury, A/Min & Dept EA PM’s, September 30, 1957, in Australian Department of External Affairs file, 1957 Canada treaty, part 1.

238 The Canadian legislation was the Canada-Australia Income Tax Agreement Act, 1958, SC 1957-58, c. 27, which received royal assent on January 31, 1958 and entered into force on May 15, 1958 by proclamation in the Canada Gazette on May 31, 1958. The Australian Department of External Affairs was advised of the entry into force of the treaty by letter, Office of Australian High Commissioner, Ottawa to the Secretary, Department of External Affairs, Canberra, June 9, 1958, in Australian Department of External Affairs file, 1957 Canada treaty, part 1. The Australian legislation was Income Tax (International Agreements) Act 1958 (Cth), which received royal assent on May 25, 1958 as Act No. 25 of 1958. Details were conveyed to the Australian High Commission in Ottawa by telegram, Department of External Affairs to Australian High Commission, Ottawa, May 29, 1958, in Australian Department of External Affairs file, 1957 Canada treaty, part 1.

239 Memorandum to the Minister of Finance: Re: Canada-Australia Income Tax Agreement, May 25, 1957, in Canadian Department of External Affairs file, 1957 treaty, part 1. The opening paragraph of the memorandum reads, “To my knowledge there has never been any discussion whatsoever of the substance of a tax agreement at the time of signature. The signing is completely formal. The discussion of the content has already taken place and has been approved by the two governments. You might, however, feel more comfortable if you knew a few of the important features in the agreement.” A copy of the memorandum is not contained in the Canadian Department of Finance file, 1957 treaty, vol. 1. The present location of the memorandum may indicate that it was written by a Canadian Department of External Affairs official, but the amount of technical and comparative detail in the memorandum suggests that at least some of its content may have been derived from information supplied by Department of Finance officials. It is also possible that the entire memorandum was prepared by Finance officials who would normally write departmental memorandums. In that case, it may be that the present location of the memorandum merely indicates that a copy was provided to the Department of External Affairs and that the Department of Finance copy was either misfiled or lost.
States and the United Kingdom, followed a “rather standard” pattern and that the greater part of the treaty with Australia was similar to Canada’s treaties with Sweden, Denmark, the Netherlands, New Zealand, and Germany. The memorandum asserted that in the treaty Canada had given up almost nothing of substance, with all the concessions being made by Australia.

Evidently, allowing Australia to continue to levy undistributed profits tax on private companies was not regarded as an issue of substance, given that the tax did not apply to Australian subsidiaries of Canadian public companies. Other archival evidence referred to in this article suggests that Canada’s earlier concern over this issue may have reflected its dissatisfaction with the US system of undistributed profits tax at the time and/or a desire to avoid antagonizing the United States by allowing Australia greater scope to levy undistributed profits tax than Canada had allowed the United States in the 1942 Canada-US taxation treaty. It seems likely that, in the end, considerations based on the realization that the Australian undistributed profits tax would not apply to subsidiaries of Canadian companies in Australia (since they were all public companies for Australian tax purposes) and pressure from those Canadian companies led Canada to a pragmatic rather than a theoretical view of the issue.

The memorandum argued that the most significant concession related to dividends:

Article VII contains the most important item from our point of view. In it the Australian government agrees to limit its tax on dividends from an Australian company to a resident of Canada to 15% which is our rate. This represents a reduction from the present level of tax on dividends from 30% on the first £5000 with 40% on the excess. We gave up nothing for this concession. This is very important for Ford of Canada and Massey Harris who have subsidiaries in Australia. Incidentally, the Australians had already made this concession to the United States in exchange for a reduction by the United States in their rate. Apparently they felt they could do no less for us since our rate was already 15%.

The memorandum went on to point out that the other main concern to the Australians was article V, which taxed the profits of ships and aircraft on a residence basis. The memorandum noted that Australia had no shipping or aircraft traffic with Canada, while Canada had both shipping and aircraft traffic with Australia. Hence, the memorandum observed, Australia gave up taxing Canadian ships and aircraft while Canada gave up nothing. Although this issue had derailed potential discussions prior to 1953, it is not otherwise mentioned as being a significant issue in correspondence relating to the 1953 discussions or in subsequent correspondence. If anything, the correspondence from 1953 onward indicates that Australia, in the Australia-Canada context, conceded the shipping and aircraft point prior to the commencement of

240 Memorandum of May 25, 1957, supra note 239.
241 Ibid.
the 1953 discussions in Ottawa and that discussions would not have taken place otherwise. It may be that the memorandum is referring to Australia’s concerns about the shipping and aircraft exemption prior to the reopening of correspondence in 1952. In any event, as late as Australia’s treaty negotiations with Japan in the 1960s, Australia did not have a general policy of agreeing to the shipping and aircraft exemption, and in that instance it asked for matching concessions before agreeing to a shipping and aircraft exemption from source-country taxation.\textsuperscript{242}

The remainder of the memorandum outlined the broad effect of the industrial or commercial profits article, the foreign tax credit article, and the exchange-of-information article. The memorandum also stated that the reduced rate of Australian tax on dividends would apply to the 12-month period ending June 30, 1958 if the treaty was signed in the autumn of 1957 (by the Canadian calendar) and dealt with by Parliament before July 1, 1958.

The internal views of the Australian Treasury and the Australian Taxation Office prior to the Cabinet decision to enter into the treaty were set out in the statement of pros and cons discussed earlier. The explanatory notes on the Income Tax (International Agreements) Bill 1958 (Cth) circulated by the treasurer at the time the bill was introduced into the Australian Parliament\textsuperscript{243} give the official, for publication, Australian view of the treaty. In general, the explanatory notes paraphrase the content of the various articles in the treaty or make very general comments about their effect and about usual taxation treaty practice. Only those comments in the explanatory notes that relate to the issues that had been problematic in the negotiations will be discussed here. In general, those comments downplay the revenue or practical effects of the additional concessions made by Australia.

The explanatory notes made the following comment on the use of an attribution rather than a force-of-attraction basis for source taxation of the profits of a permanent establishment:

\begin{quote}
The limitation of Australian taxation to income attributable to the permanent establishment follows the principle of Article III of the United Kingdom agreement, but differs from that of the United States agreement. In the latter case, a United States enterprise engaged in trade or business through a permanent establishment in Australia is subject to Australian tax on its income from all sources in Australia. From the viewpoint of the revenue, the practical effect of this difference is not significant.\textsuperscript{244}
\end{quote}

The explanatory notes point out a further difference between the Australia-Canada treaty and the Australia-US treaty in relation to the calculation of the profits of a permanent establishment. While this difference does not appear to have been a

\textsuperscript{242} This aspect of the negotiation of the 1969 Australia-Japan taxation treaty is discussed in Taylor, “National Report” and 2012 \textit{ATF}, supra note 12.

\textsuperscript{243} Explanatory Notes to Income Tax (International Agreements) Bill 1958.

\textsuperscript{244} Ibid., at 7, comments on article III.
major issue in the negotiations, the comment in the explanatory notes is interesting given the subsequent history of business profits articles generally:

It is mentioned that paragraph (3) of Article III of the United States agreement contains specific reference to expenses, including executive and administrative costs, reasonably attributable to a permanent establishment. The paragraph requires that these expenses be treated as deductible in determining the profits of a permanent establishment which are to be subjected to tax. As in the case of the United Kingdom agreement, a similar provision is unnecessary in relation to Australia and Canada, as it is the established practice of both countries to allow such expenses as deductions in arriving at the amount of profits liable to tax.\textsuperscript{245}

After briefly explaining the effect of article V, dealing with shipping and aircraft profits, the explanatory notes make the following comment:

Where the Article does not apply, e.g., where the owner or charterer of a ship is resident in Canada and the port of registry is elsewhere, the profits will continue to be taxed on an origin basis and double taxation will be avoided by the allowance of credit by the country of residence of the enterprise.\textsuperscript{246}

A broader exemption from source taxation of dividends paid by a company resident in the other contracting state to shareholders other than residents of the first contracting state was a further concession made by Australia in the Australia-Canada taxation treaty. The explanatory notes focused on the practical difficulties associated with collecting tax on a source basis in this situation and concluded that the revenue loss would be minimal:

It may be noted that the exemptions are somewhat wider than the corresponding exemptions provided in the agreements which Australia has concluded with the United Kingdom and the United States of America. In those agreements the exemption is limited to dividends paid to shareholders resident in the country in which the company resides. Under the agreement with Canada, Australia will exempt all but its own residents on dividends paid by Canadian companies, while Canada will exempt dividends paid by Australian companies to all shareholders other than those residing in Canada. The extension will apply in only a few cases and involve little or no loss of revenue, since the collection difficulties already noted at present render it impracticable to enforce the existing liability.\textsuperscript{247}

Given the statement of pros and cons, the Australian Treasury presumably would not have been happy that the benefit from reductions in Australian-source taxation of dividends would have flowed directly to Canadian companies, such as the Ford

\textsuperscript{245} Ibid., at 8, comments on article III.
\textsuperscript{246} Ibid., at 9, comments on article V.
\textsuperscript{247} Ibid., comments on article VI.
Motor Company of Canada and Massey-Harris-Ferguson, that received dividends from Australian subsidiaries in which they held more than 25 percent of the issued share capital with voting rights. As mentioned earlier, such dividends were exempt from Canadian tax under the 1948 Income Tax Act.248 This avoided the treasury effect that had concerned Australia after it had entered into the 1946 Australia-UK taxation treaty. As discussed earlier, under that treaty, dividends paid by a wholly owned Australian subsidiary to its UK parent were exempt from Australian tax but were given foreign tax credit treatment in the United Kingdom. Australian concern about this issue had been so significant as to delay taxation treaty negotiations between Australia and the United States until 1953, and Australia had been satisfied that the treasury effect had been reduced in the 1953 Australia-US taxation treaty when Australia successfully argued for a uniform rate of 15 percent source taxation on dividends.249 By 1956, however, the Australian Treasury, as discussed earlier, was revisiting its previous opposition to attracting foreign investment via tax concessions, and the Australian commissioner of taxation was downplaying the significance of the concessional source-country rate on dividends and emphasizing the treasury effect. The Australian Treasury argument did not carry the day in the Australian Cabinet, and the following comment in the explanatory notes is more consistent with a view that reductions in source taxation of dividends would benefit Canadian investors rather than the Canadian treasury:

Under the 1946 Australia-United Kingdom agreement, dividends paid to a United Kingdom parent company by a wholly-owned Australian subsidiary are generally exempt from Australian tax. A corresponding exemption is not provided in the agreements with Canada and the United States of America. It may also be mentioned that whilst the 15% limitation on dividends paid to [a] United States shareholder is contingent upon the dividends being liable to United States tax, the corresponding requirement in the Canadian agreement is that the Canadian shareholder being [sic] liable to Canadian tax. The variation in terminology has been adopted because of the somewhat different procedure [that is, the provision of a foreign tax credit in the case of the United States and an exemption in the case of Canada] adopted under Canadian law in respect of foreign dividends received by Canadian parent companies.250

Australia would have been satisfied that the treaty with Canada did not restrict Australia’s ability to levy undistributed profits tax. The omission of article VIII of the 1953 draft, which would have facilitated a return to the previous Australian system of calculating undistributed profits tax, was a concession made by Australia. The presence of article VIII in the 1953 draft appears to reflect the provenance of that draft, which (as noted earlier) was based on the 1953 Australia-US taxation treaty.

248 See supra note 200. For a brief discussion of the exemption, see Gilmour, ibid., at 291.
249 For a discussion of subsequent Australian Cabinet minutes taking this view, see Taylor, “National Report” and 2012 ATF, supra note 12.
250 Explanatory notes, supra note 243, at 10, comments on article VII.
Article VIII had relevance for the earlier Australian system of calculating undistributed profits tax, but by 1957 that system was no longer in operation. Thus, article VIII would have had value only in the event that Australia decided to revert to its former system of calculating undistributed profits tax—something that, in fact, it never did. The explanatory notes, however, made no mention of undistributed profits tax other than to point out that, as part of the commonwealth income tax, it was a covered tax for the purposes of the treaty.251

Two other items discussed in the explanatory notes are worthy of mention having regard to subsequent Australian tax treaty practice, even though these particular matters do not appear to have been a source of significant disagreement in the negotiations.

The first item relates to the Australian view of the effect of the credit provisions in the treaty, given the presence of broad exemption provisions in Australian domestic law. The explanatory notes on the credit article in the treaty (article XIII) included the following comment:

Except in the case of a dividend, Australia does not tax its residents on income having a source outside Australia if that income is taxed in the country of origin. In these circumstances, Australia will not allow a credit as no double taxation arises. Where, however, a resident of Australia derives a dividend from a Canadian company, tax will be levied in Australia, which will allow a credit of an amount equal to the Canadian tax on the dividend, or the Australian tax on the dividend, whichever is the less. This credit takes the place of a credit which is now allowable under section 45 of the Income Tax Assessment Act.252

The view that treatment was no less favourable to taxpayers than credit treatment and that it provided equal relief from double taxation was understandable, given the limitations then current in Australian domestic law on the credit for tax on foreign-source dividends and the inability of taxpayers to carry forward excess credits.253

251 Ibid., at 4, comments on article I.

252 Ibid., at 12, comments on article XIII. Similar views on the relationship between Australia’s unilateral relief provisions and its taxation treaty obligations persist in the Australian Taxation Office, as evidenced by Taxation Ruling TR 2001/13, “Income Tax: Interpreting Australia’s Double Tax Agreements,” December 19, 2001. Paragraph 19 of TR 2001/13 states, “Australia uses the credit method in its DTAs [double taxation agreements] (with the DTA partners often providing for an exemption, on their part) though sometimes at domestic law Australia goes further than is required of it by the DTA and provides a full exemption. The use of the domestic law exemption method of double tax relief, rather than the credit method specified by the DTA, is common internationally and is regarded by the ATO as fully consistent with Australia’s treaty obligations.”

The explanatory notes also point out that article XIII contained deemed-source rules, which operated in the case of profits and remuneration for personal services, in relation to film rentals and related income, and in relation to certain income of non-resident insurance companies. There is no indication in either the Canadian Department of Finance file or the Canadian Department of External Affairs file that these deemed-source rules were controversial, but they were to be a significant issue in the negotiation of the 1967 Australia-UK taxation treaty and were subsequently extended in later Australian taxation treaty practice.254

Based as it was on the 1953 Australia-US taxation treaty, the 1957 Australia-Canada taxation treaty retained the basic structural features of the earlier treaty. It is notable that the Canadian and Australian archival records relating to the negotiation and drafting of the treaty contain no documents explicitly referring to previous draft conventions, draft articles, and reports on international double taxation developed first by the League of Nations and subsequently by the Organisation for European Economic Co-operation (OEEC). By contrast, there is evidence in the relevant archives of each country of awareness of the prior taxation treaty practice of the other country. It is also worth noting that the 1953 Australia-US taxation treaty had been influenced by the 1946 Australia-UK taxation treaty, which had been influenced by the 1945 UK-US taxation treaty, which in turn had been influenced by the 1942 Canada-US taxation treaty. Hence, rather than actual treaty practice in this period being influenced by model treaties developed by international organizations, the relationships between these treaties suggest that the influence was from actual prior treaty practice of the contracting states and third states.255

Since the draft treaty used in the negotiations and referred to in the correspondence was prepared by Australia, it is useful to note how the Australia-Canada taxation treaty of 1957 was similar to and differed from Australia’s two earlier taxation treaties

254 See the discussion on the negotiation and drafting of the 1967 Australia-UK taxation treaty in Taylor, supra note 212. For a discussion of this feature of subsequent Australian taxation treaty practice, see Taylor, supra note 104.

255 There is much discussion in the literature on the reports and draft conventions developed by international organizations. For a general though now somewhat dated account, see Sol Picciotto, *International Business Taxation* (London: Weidenfeld & Nicholson, 1992), at 38-63. The absence of explicit reference in archives to drafts and reports by international organizations does not necessarily mean that they were not influential. As mentioned in the text, the Australian draft sent to Canada was based on several predecessor treaties negotiated between 1942 and 1953 by Australia, the United States, the United Kingdom, and Canada. These earlier treaties had been influenced to some extent by League of Nations drafts and reports, and in turn influenced OEEC drafts and reports. For a discussion of the 1945 UK-US taxation treaty, see John F. Avery Jones, “The History of the United Kingdom’s First Comprehensive Double Taxation Agreement” [2007] no. 3 British Tax Review 211-54. For a discussion of the 1946 Australia-UK taxation treaty, see Taylor, 2009 BTR and “Dreary Subject,” supra note 7. For a discussion of the influence of the League of Nations drafts and of early treaties on the structure of modern taxation treaties, see C. John Taylor, “Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?” (2010) 34:1 Melbourne University Law Review 268-311.
and from Canada’s prior treaties. Those similarities and differences may be summarized as follows:

1. Industrial or commercial profits were defined in identical terms in the 1957 Australia-Canada treaty and the 1953 Australia-US treaty; however, in the treaty with Canada, source taxation of such profits was confined to profits attributable to a permanent establishment, whereas the force-of-attraction principle operated in the US treaty. The definition of industrial or commercial profits was also essentially identical to the definitions in the prior Canadian treaties referred to in the Canadian Department of Finance memorandum of May 25, 1957, all of which also used an attribution basis for delimiting source taxation of industrial and commercial profits. Like the 1953 Australia-US treaty, the 1957 Australia-Canada treaty included a “substantial equipment” provision in the definition of “permanent establishment,” as had the 1950 supplementary convention between Canada and the United States and the 1956 Canada-South Africa taxation treaty. As discussed above, article II(2) of the 1957 Australia-Canada treaty was not part of the original Australian draft of 1953 but was included in the revised draft in response to an Australian Board of Review decision in a case involving the equivalent article under the 1946 Australia-UK treaty. Similar provisions were to feature in subsequent Australian taxation treaties.

2. The industrial or commercial profits article in the Australia-Canada treaty also expressly preserved Australia’s right to tax foreign-controlled film businesses and non-resident insurers. This feature was also present in Australia’s two earlier taxation treaties but had been initially opposed by the United Kingdom in the negotiations leading to the 1946 Australia-UK treaty. No equivalent provision existed in the prior Canadian treaties referred to in the Canadian Department of Finance memorandum.

3. As was the case with the 1953 Australia-US treaty, under the Australia-Canada treaty the maximum rate of source-country tax to be imposed on dividends irrespective of the level of shareholding was 15 percent, except where the non-resident was engaged in a trade or business through a permanent establishment in the country of residence of the paying country. This was consistent with the prior Canadian taxation treaties referred to in the Canadian Department of Finance memorandum. By contrast, in the 1946 Australia-UK treaty, source-country taxation of dividends paid by a wholly owned subsidiary to its parent was zero, and source-country taxation of other dividends paid to residents of a contracting state was reduced by 50 percent. In the 1946 Canada-UK treaty, source taxation was generally limited to 15 percent but was zero in the case of dividends paid by a wholly owned Canadian subsidiary of a UK parent.

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256 Supra note 239 and the text accompanying note 240.

257 See supra notes 212-213 and the accompanying text.
company. Such dividends were exempt from Canadian tax where less than 25 percent of the gross income of the Canadian company was derived from interest and dividends (other than interest and dividends from any wholly owned subsidiary company).

4. Like the equivalent provisions in the 1946 Australia-UK treaty and the 1953 Australia-US treaty, the industrial or commercial profits article and the associated enterprises article in the 1957 Australia-Canada treaty contained a provision that gave the relevant taxation authority discretion to determine profits where the information required to ascertain the amount of those profits was inadequate. This provision had initially been opposed by the United Kingdom in the negotiation of the 1946 Australia-UK treaty, but Australia appears to have had little difficulty in persuading the United States and Canada to agree to it. An equivalent provision had been contained in the 1948 Canada-NZ taxation treaty but not in the other prior Canadian treaties referred to in the Canadian Department of Finance memorandum. It is likely that this provision had been requested by New Zealand and had been based on an equivalent provision in the 1946 Australia-UK treaty.

5. The Australia-Canada treaty omitted the specific article in the 1953 Australia-US treaty that allowed a contracting state, in imposing an undistributed profits tax, to not be constrained by the limits imposed by other articles on source taxation of dividends. At the same time, the Australia-Canada treaty did not prohibit a country from levying undistributed profits tax. As discussed earlier in this article, undistributed profits tax proved to be the major issue of dispute between Australia and Canada in the negotiations. This reflected the absence of an undistributed profits tax in Canada, prior Canadian taxation treaty practice, and possible Canadian anxiety about US undistributed profits tax and a possible adverse US reaction if Canada agreed to a more liberal provision in relation to undistributed profits tax than the one that it had agreed with the United States in their 1942 treaty. As noted above, the omission of this particular article was a consequence of the change in the Australian method of calculating undistributed profits tax and merely meant that a subsequent return by Australia to that method would be more difficult. By omitting any reference to undistributed profits tax, Canada’s 1957 treaty with Australia differed from all previous Canadian taxation treaties other than the 1951 Canada-France treaty and the 1956 Canada-South Africa treaty.

6. Article IX of the Australia-Canada treaty, dealing with cultural royalties, was identical to article X of the 1953 Australia-US treaty and did not apply to film or television royalties. Unlike the Australia-US treaty, the Australia-Canada treaty did not contain a specific provision preserving the operation of Australian domestic legislation in relation to film royalties258 but in the credit

258 Article XXI of the 1953 Australia-US taxation treaty.
article did deem income covered by those provisions to have an Australian source. Article IX provided for exclusive taxation of cultural royalties on a residence basis and was consistent with the prior Canadian taxation treaties referred to in the Department of Finance memorandum. The Australia-Canada treaty did not contain an article equivalent to article XI of the 1953 Australia-US treaty, which provided the option to have mineral royalties and rentals from real property taxed on a net basis as if they were income attributable to a non-resident’s permanent establishment. Article XI had been inserted in the 1953 Australia-US treaty, apparently at Australia’s request, so that Australian businesses receiving rents and mineral royalties from the United States could elect to be taxed on a net basis. This was understandable since Australia at the time taxed non-residents on rents and royalties on a net basis on assessment, whereas the United States imposed a 30 percent withholding tax on mineral royalties paid to a non-resident. I have found nothing in the archival sources that indicates the basis on which this variation from the 1953 Australia-US treaty was made in the Australia-Canada treaty, but it does not appear to have been a matter of extensive discussion. No prior Canadian taxation treaty had contained an equivalent article to article XI of the Australia-US treaty.

7. As was the case with the 1953 Australia-US treaty, no article in the 1957 Australia-Canada treaty dealt specifically with the taxation of industrial royalties. The Australian view, expressed at the time of negotiation of the 1953 Australia-US treaty, was that this omission meant that Australia retained full source-country taxing rights in relation to industrial royalties. The omission of specific articles dealing with industrial and mineral royalties and rents in the 1957 Australia-Canada taxation treaty would have meant, in the Australian view at the time, that Australia retained full source-country taxing rights in relation to all these types of income. Canada at the time imposed a 15 percent withholding tax on rents and industrial and mineral royalties paid to non-residents, but gave non-residents the option of being assessed on a net basis on rents and timber royalties. It may be that the option to have rents and timber royalties taxed in Canada on a net basis sufficiently alleviated Australian concerns about Canadian gross basis withholding tax on rents and mineral royalties to allow an equivalent article to article XI in the 1953 Australia-US treaty to be omitted from the 1953 Australian draft sent to

259 Article XIII(3)(b) of the 1957 Australia-Canada taxation treaty.

260 An article identical to article X of the 1953 Australia-US taxation treaty is contained in the copy of the 1953 Australian draft in the Canadian Department of Finance file, 1957 treaty, and became article IX in the final 1957 Australia-Canada taxation treaty, but no equivalent to article XI of the 1953 Australia-US taxation treaty is contained in the 1953 Australian draft in the Canadian Department of Finance file, 1957 treaty, vol. 1.

261 Memorandum, McGovern to Fadden, April 15, 1952, supra note 12, at 16, paragraph 127.
Canada. Including only an article dealing with the taxation of cultural royalties and not including an “other income” article was consistent with several earlier Canadian taxation treaties, and for that reason the treatment of royalties under the 1953 Australian draft would likely not have been problematic from a Canadian perspective.

8. The foreign tax credit provisions in article XIII of the Australia-Canada treaty were essentially in the same format as in article XV of the 1953 Australia-US treaty but had been adjusted for differences in the provisions for unilateral double taxation relief in Canada’s domestic law. As noted above, this was a change made in the final draft at the suggestion of Canada to accommodate changes in the Canadian treatment of foreign-source dividends received from wholly owned subsidiaries enacted since the preparation of the 1953 Australian draft.

9. The Australia-Canada treaty contained an exchange-of-information article (article XIV) in essentially similar form to the equivalent articles in the 1946 Australia-UK treaty (article XIII) and the 1953 Australia-US treaty (article XVIII) but, unlike the latter, did not contain even a limited assistance-in-collection article. Again, the archival sources that I have examined do not disclose any discussion of this variation from the 1953 Australia-US treaty. At the time of the negotiation of the US treaty, Australian officials had been concerned about possible constitutional difficulties with the limited assistance-in-collection provision, which apparently had been inserted at the request of the United States. A limited assistance-in-collection article had been included in the 1942 Canada-US treaty but had not been inserted in other Canadian taxation treaties up to 1957.

10. Like both the 1946 Australia-UK treaty and the 1953 Australia-US treaty, the Australia-Canada treaty did not contain an interest article, a capital gains article, or an “other income” article. In these respects, and in its definition of “industrial or commercial profits,” the Australia-Canada treaty followed what

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262 The 1946 Canada-UK taxation treaty, article 7; the 1948 Canada-NZ taxation treaty, article 6; the 1951 Canada-Sweden taxation treaty, article 7; the 1954 Canada-Ireland taxation treaty, article VII; and the 1955 Canada-Denmark taxation treaty, article VII.

263 No assistance-in-collection article is included in the 1953 Australian draft contained in the Canadian Department of Finance file, 1957 treaty, vol. 1.

264 In a memorandum to the Australian treasurer reporting on the initial negotiations with the United States in 1952, the Australian commissioner of taxation (McGovern) made the following comments on the limited assistance-in-collection provision: “The draft Article would involve a number of legal difficulties and will, doubtless, require revision. It was, however, included in the draft as an acknowledgement of a principle for the consideration of the two Governments. The Article is advanced as a matter of principle and with the knowledge that its form of expression and maybe the means of its implementation may raise a number of problems for examination by the legal authorities.” Memorandum, McGovern to Fadden, supra note 12, at 19, paragraphs 165-166.

265 Article XX of the 1942 Canada-US taxation treaty, supra note 89.
the Australian Taxation Office was later to describe as the “colonial model.” However, the term is something of a misnomer. In Canadian treaty practice during this period, this combination of features tended to be confined to treaties between countries where at least one of the official languages used in each country was English and where each country had a legal system influenced by the common law.

CONCLUDING OBSERVATIONS

As noted above, while the 1957 Australia-Canada taxation treaty was based on Australia’s 1953 treaty with the United States, the Canadian treaty differed from the US treaty in several respects. In addition, while the Canadian treaty with Australia was similar to earlier Canadian taxation treaties with countries other than the United Kingdom and the United States, it differed from those treaties as well. Generally, the differences resulted from Australia’s desire to protect the operation of specific features of its domestic law. Many of these differences were to be carried over into subsequent Australian taxation treaty practice, and some continue to this day. A few of the distinctive features of Canada’s treaty with Australia appeared in some subsequent Canadian taxation treaties; however, it seems likely that these did not become part of a Canadian draft or model, but rather were concessions that Canada would agree to when comparisons were drawn by the potential treaty partner with the 1957 Australia-Canada treaty. The impression gained from examining the negotiations and the final treaty is that in this period Canada was prepared to agree to unusual provisions in a treaty unless they conflicted with key features (such as the desired rate of source-country tax on passive income, the use of an attribution basis for determining the profits of a permanent establishment, and an agreement not to levy an undistributed profits tax) that Canada sought to include in its taxation treaties. This could well be a productive area for further research into the negotiation of other Canadian treaties in this period.

As noted above, during this period, it was unusual for Canada to initiate treaty negotiations. In this instance, Canada clearly did so because of pressure from Canadian businesses with direct investments in Australia (particularly Ford and Massey-Harris-Ferguson, but also shipping companies). Canadian businesses wanted a taxation

266 This terminology was used in Australian Taxation Office, Taxation Ruling TR 2001/12, “Income Tax and Capital Gains Tax: Capital Gains in Pre-CGT Tax Treaties,” December 19, 2001 and TR 2001/13; supra note 252. The term had previously been used in John Newman, United Kingdom Double Tax Treaties (London: Butterworth-Heinemann, 1979), at 2. While the pattern of defining industrial or commercial profits in terms that excluded other items applied to UK treaties with dominions such as Australia, Canada, and New Zealand in this period, it did not apply to the treaties with colonies (as distinct from dominions) examined by Newman in 1979. For a discussion of the continued influence of the “colonial model” on Australian taxation treaty practice up to 1980, see Taylor, 2012 ATFF, supra note 12.

267 All these features are present in Canada’s 1942 taxation treaty with the United States.
treaty with Australia because they already had investments there, and after Australia’s taxation treaties with the United Kingdom and the United States came into effect, they felt that they were at a disadvantage as compared with direct investors from those countries. The Canadian treatment of dividends paid by foreign subsidiaries to Canadian parent companies meant that the treaty provided little revenue gain for the Canadian treasury but did improve the profits and competitive position of Canadian businesses making direct investments in Australia. The treaty is an example of the exception that proves the rule—specifically, that in this period Canada’s generous unilateral provisions relieving residents from international double taxation meant that Canadian businesses did not generally press Canada to enter into taxation treaties. Australia’s case was exceptional since, at the time, Canada was a net capital exporter to Australia, and Australian domestic-law rates on corporate profits and dividends were higher than those in Canada.

Why, then, did Australia enter into a taxation treaty in which, apart from preserving the operation of certain of its domestic-law provisions, it appeared to concede much and gain little? Within Australia, there appears to have been division between government departments as to whether a treaty with Canada was desirable. The Australian Treasury seems to have been unconvinced that a treaty would stimulate Canadian investment in Australia and that such investment was desirable, particularly if the treaty would encourage remittance of the profits to Canada. The Australian External Affairs department and the government appear to have believed that the treaty might encourage Canadian direct investment in Australia and that the revenue cost was relatively small, but seem to have been primarily motivated by foreign relations considerations. That these considerations were dominant is consistent with analyses of Australian foreign policy at the time, which emphasize Australian xenophobia as a European outpost at the edge of Asia and Australia’s desire to align itself with other English-speaking democracies in the fight against what was perceived to be the global threat of communism.268

While the political decision makers were ultimately concerned with larger questions (in Canada’s case with pragmatic business and trade considerations, and in Australia’s with ideologically and psychologically grounded political and foreign policy considerations), the small group of part-time negotiators in both countries carried on a protracted correspondence on a few differences of principle, even though none of these had significant revenue implications for either country. The detachment of the political and bureaucratic policy decision makers from the negotiations existed in each country but was more extreme in Canada. Negotiating taxation treaties was still a novel experience for Australia, and Australian officials clearly believed that initial authorization from Cabinet was required to enter into negotiations and for the draft to be used in negotiations. The Australian commissioner of taxation also provided a detailed report of the initial negotiations to the Australian treasurer a few

268 For a survey of these analyses, see McLean, supra note 11, at 314-20.
months after they were completed. I have found no evidence in the archives of any action being taken at that time by the Australian treasurer in response to the recommendations of the commissioner of taxation. There is no evidence in the Canadian archives that Canadian officials felt similarly constrained in entering into negotiations, and no evidence that they felt any need to provide relevant ministers with detailed reports of the negotiations. Canadian ministers appear to have significantly intervened only to break the deadlock at a relatively late stage. Ironically, if Australian officials had been given more flexibility in negotiating or, conversely, if Canadian ministers had been more involved earlier, the treaty may well have been concluded in 1953 and thus could have been the fourth taxation treaty concluded by Canada. Instead, as the historical record shows, the negotiation process—containing, as it did, technical misunderstandings on both sides and featuring a lack of involvement by those with authority to make decisions and resolve matters—embodied the essence of farce.
The Process for Making Tax Policy: An International Comparison
Proceedings of a Round Table on the Tax Policy Process

Summary of Proceedings

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KEYWORDS: TAX POLICY ■ POLICY MAKING ■ TAX LEGISLATION ■ PROCESS

CONTENTS
Introduction 990
Overview of the Tax Policy Process in Selected Countries 992
  Australia 992
  Canada 994
  New Zealand 995
  United Kingdom 996
  United States 997
Human Resources Necessary for the Tax Policy Process 999
Consultation 1000
Other Aspects of the Tax Policy Process 1003
  The Need for Long-Term, Forward-Looking Tax Policy Work 1004
  The Relationship Between the Government Departments Responsible for Tax Policy and Tax Administration 1005
Politics and the Role of Politicians 1006
  The Role of the Media 1006
Best Practices and Conclusion 1007
INTRODUCTION

On June 20, 2013, the Canadian Tax Foundation (CTF) sponsored a one-day invitational round table in Ottawa to discuss the tax policy process in Canada and other selected countries. The round table was attended by senior Canadian tax practitioners (many of whom have previous experience with the federal Department of Finance), government officials from Canada and other countries, and representatives from the corporate sector, think tanks, and the Organisation for Economic Co-operation and Development (OECD). Larry Chapman, the CTF’s executive director and chief executive officer, and I chaired the discussions.

The round table focused almost exclusively on the process for developing tax policy, rather than the tax legislative process. Although there is considerable overlap between these two processes, for present purposes it is convenient to distinguish between them. In Canada, the tax legislative process may be considered to commence with the announcement of a tax change (often on the tabling of the annual federal budget by the minister of finance) and includes the introduction, consideration, and enactment of tax bills by Parliament. The process is transparent and reasonably well understood. In contrast, the tax policy process is not well known by those outside government, and it is difficult for anyone who has not worked in the Tax Policy Branch of the Department of Finance to find detailed information about the process. Generally, the process for developing Canadian tax policy can be considered to include all of the activities carried out by the Department of Finance and others before the announcement of a legislative change and the introduction of a bill in the House of Commons.\(^1\) Those activities include the generation of ideas for tax reform, research and data analysis, analysis of options for reform, design of tax reform proposals, consultation with the public, and the preparation of draft legislation.\(^2\)

Although the tax policy process is widely acknowledged to be important, it has not received much attention in Canada in recent years. Accordingly, the fundamental purposes of the round table were to give government officials and tax professionals a better understanding of the process for making tax policy, both in Canada and in other countries, and to initiate a conversation on the tax policy process among members of the Canadian tax community. In order to facilitate an assessment of the Canadian tax policy process, government officials and private-sector tax experts from selected countries—Australia, New Zealand, the United Kingdom, and the United States—prepared brief papers describing the most important aspects of their tax policy processes. With the exception of the United States, these countries were selected because they have parliamentary systems and legislative processes similar

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1 Aspects of the tax policy process continue during the legislative process—for example, the review and refinement of draft legislation.

2 As noted during the discussions, tax policy considerations may be taken into account in the administration of the tax system and in court cases. Moreover, the way in which the tax system is administered and the way in which tax cases are decided by the courts may have an impact on the need for tax reform.
to Canada’s and they have all recently made significant changes to their tax policy processes. In addition, the Department of Finance prepared a paper on the Canadian tax policy process. All of these papers are reproduced following this summary.

The participation of current and former government officials deserves special mention. The participating officials (or former officials) from outside Canada included Rob Heferen of the Australian Treasury; Struan Little of the New Zealand Inland Revenue; John Whiting of the UK Office of Tax Simplification, and non-executive director of the board of HM Revenue & Customs (HMRC); and Eric Solomon of Ernst and Young in Washington, DC, formerly assistant secretary (tax policy) in the US Treasury department. Representing Canada were several senior people from the Department of Finance, including Nancy Horsman, senior assistant deputy minister, and Brian Ernewein, general director of the Tax Legislation Division. Their participation and support, in particular, must be acknowledged. Without their willingness to be involved, the round table would probably not have been possible, and certainly would not have been as interesting and informative as it was.

As noted above, details of the tax policy process are best known to insiders, and without that perspective, trying to understand the process is almost impossible. In addition to preparing the papers, all of the contributors participated in the discussions openly, frankly, and with good humour, even when aspects of their tax policy process were subject to criticism.

All of the participants attended in their personal capacities, and the round table operated in accordance with the Chatham House Rule: the proceedings were not recorded and participants were told at the outset that this summary of the discussions would be published without the attribution of any comments to specific participants. As is customary, the seating for the presenters was set up in a rectangular format, in order to encourage discussion. Although the large number of participants and observers limited the opportunity for spontaneous interactions, the discussions were useful and at times lively. The tone and quality of the discussions reflected the high level of the participants’ knowledge and experience. There is a tendency for meetings such as this to turn into a litany of complaints, with government officials on the receiving end, and although critical comments were directed at both officials and tax practitioners concerning their roles in the tax policy process, the discussions were invariably respectful.

The agenda for the round table was straightforward. After a brief introduction, the first session involved a discussion of the strengths and weaknesses of the tax policy process in the countries represented. The second session looked at the human resources necessary to carry out an effective tax policy process. The third session focused on what is perhaps the most controversial aspect of the tax policy process in many countries, namely, public consultation on tax reform proposals. The fourth session featured a grab bag of topics involving the tax policy process, such as the relationship between the government departments responsible for tax policy and tax administration; the need for broad, systematic forward-looking tax policy research; the role of politics and politicians; and the role of the media. The final session considered whether it would be possible or desirable to develop best practices or model
guidelines with respect to the tax policy process for countries to follow, and what, if any, further steps should be taken in Canada to continue the conversation about the tax policy process started at the round table.

**OVERVIEW OF THE TAX POLICY PROCESS IN SELECTED COUNTRIES**

The first session of the round table consisted primarily of presentations concerning the tax policy process in Australia, Canada, New Zealand, the United Kingdom, and the United States. The background papers prepared for the round table provided basic descriptions of the process in these countries and insights about those processes that are unavailable elsewhere. Participants were expected to have read the papers in advance. As a result, the presentations focused primarily on identifying the strengths and weaknesses (or challenges and concerns, as some participants preferred to call them) of each country’s tax policy process, any recent changes to the process, and the major factors causing those changes. It was noted during the discussions that the strengths of any particular country’s process were also potential weaknesses.

**Australia**

Australia is a parliamentary democracy. Like Canada, it has a bicameral legislature (the House of Representatives and the Senate). Unlike Canada, however, in Australia the Senate is rarely controlled by the political party that forms the government, and therefore it has a significant role to play in the Australian legislative process.

Significant tax reform has been a priority for successive Australian governments since the 1980s. Since then, several broad reviews of the tax system have been undertaken, the most recent of which was the Henry review, the report of which was released in May 2010.\(^3\) The process for making tax policy has also been subject to serious scrutiny in the last 15 years.

Until 2002, broad tax policy was formulated by a small group in the Treasury, most of whom were economists; technical tax policy analysis (legislative design and the preparation of drafting instructions) was performed by the Australian Taxation Office (ATO), whose primary responsibility is the administration of the tax system. In 2002, the tax policy functions of the ATO (and many of the ATO officials who performed those functions) were transferred to the Treasury. The Office of Parliamentary Counsel drafts all federal legislation, including tax legislation on instructions prepared by the Treasury. Therefore, since 2002, the responsibility for tax policy has been centralized in the Treasury.

Although in general the Australian process for making tax policy works quite well, the centralization of the process in the Treasury means that there is a lack of

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\(^3\) Australia, Department of the Treasury, *Australia’s Future Tax System: Report to the Treasurer* (Canberra: Department of the Treasury, May 2010).
competing tax policy advice from inside or outside government. The government has attempted to compensate for this lack of contestability through consultation with the tax community on proposed tax changes. In effect, the government consults on how tax measures should be implemented, but not on why they should be adopted in the first place. The government rarely consults on fundamental tax policy issues for two main reasons:

1. the perceived desirability for political control, and
2. the desirability to avoid uncertainty for taxpayers with respect to tax policy matters.

That said, public consultation on tax reform proposals in a variety of forms is extensive, with consultations conducted by both the Treasury and the ATO. The extent of consultation is both a strength and a weakness of the Australian tax policy process. Its strength lies in the access that consultation provides to the views of the public, especially tax professionals. Its weaknesses are twofold: first, the private sector is experiencing “consultation fatigue” as a result of the need to participate in so many consultation exercises; and second, consultation sometimes produces mixed responses, with no clear direction for the government. Both weaknesses point to the necessity for tax professionals to coordinate their responses to consultations. In addition, since most input from tax professionals is provided on a voluntary, unpaid basis, there is some concern about the quality and independence of the advice.

Another strength of the Australian process is the role played by the Board of Taxation, a quasi-independent, non-statutory body consisting mostly of tax professionals. Funding for the board’s activities is provided by the Treasury. The board provides tax policy advice and conducts post-implementation reviews of recently introduced tax proposals on matters referred to it by the government. The government has also responded to the lack of competing advice on fundamental tax policy issues by recently funding a Tax and Transfer Policy Institute at the Australian National University to stimulate academic tax policy work.

In summary, the strengths of the Australian tax policy process are

- extensive consultations with the public by both the Treasury and the ATO,
- the role of the Board of Taxation, and
- periodic comprehensive reviews of the tax system.

The weaknesses are

- a lack of competing tax policy advice for government,
- a lack of consultation on fundamental tax policy decisions, and
- a degree of consultation fatigue among tax professionals.

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4 See “Tax Policy Formulation in Australia,” following this summary.
Canada

The process for making tax policy in Canada is not generally well known to Canadians. The responsibility for making tax policy rests with the Tax Policy Branch of the Department of Finance, although the Canada Revenue Agency (CRA) is involved in aspects of the process.5

Decisions about changes to the tax system are subject to the approval and close scrutiny of the minister of finance and the prime minister. This centralized control of the process raises the issue of the need for competing tax policy advice. The motto of the Canadian public service—“Fearless advice; faithful implementation”—was raised to highlight the challenges faced by tax policy officials in the Department of Finance. They are sometimes required to give advice that may not be consistent with the government’s chosen policy direction when they believe that the government’s proposals would result in poor tax policy. However, the government has the ultimate authority to make decisions concerning tax policy, and it is the duty of the public service to implement the government’s decisions.

The following strengths of the Canadian tax policy process were identified:

- the drafting of tax legislation is an integral part of the tax policy process;6
- the centralization of the tax policy function in the Department of Finance means that accountability is clear and provides “one-stop shopping” for stakeholders;
- the relationship between the Department of Finance and the tax community is generally good; and
- the staff of the Department of Finance are both motivated and dedicated in contributing to the tax policy process.

It was also noted that having a strong minister of finance, such as the current minister, was important for the proper operation of the tax policy process.

The challenges faced by Finance officials include the fact that they are seriously outnumbered by tax professionals and that tax professionals are sometimes reluctant to disclose the existence of loopholes in the legislation that operate to the advantage of their clients. The point was made that consultation should be a two-way street, with benefits flowing to tax professionals and their clients in terms of better-targeted policy and legislation, and to the government in terms of the elimination of loopholes.

The recent Canadian experience with a minority government also proved to be challenging for the development and enactment of tax proposals, since a minority government’s control of the legislative agenda is subject to more constraints than is the case for a majority government.

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6 As it is in New Zealand, but not in Australia or the United Kingdom.
It was also noted that the tax system has been used increasingly as a mechanism to deliver social and economic measures. As a result, the annual budget often deals with an expanding range of essentially non-fiscal matters that have complicated the tax system and the tax policy process. In addition, the growth in other priorities, such as ministerial correspondence, briefings, media requests, and access-to-information requests, detracts from the time available to deal with core tax policy analysis.

In summary, some of the weaknesses of the Canadian tax policy process are

- the difficulty for Finance officials to get unbiased and full disclosure from tax professionals about proposed tax measures,
- the extensive use of the tax system to deliver economic and social programs, and
- competing priorities that can limit the time available to do long-term thinking about the tax system.

New Zealand

New Zealand, being a small country (with a population of about 4.5 million), has a correspondingly small community of tax professionals, government officials, and academics. New Zealand is a parliamentary democracy with a unicameral legislature. Major tax reform in New Zealand began in the mid- to late 1980s with a strong minister of finance, Roger Douglas, and a small group of dedicated and capable officials in the Treasury. Some of the major new measures adopted included a broad-based goods and services tax, an imputation system, controlled foreign corporation rules, and foreign investment fund rules.

Responsibility for tax policy advice is shared jointly by the Inland Revenue Department and the Treasury. Within Inland Revenue, responsibility for tax policy, including drafting, rests with Policy and Strategy (formerly the Policy Advice Division), which is also responsible for the general administration of the tax system. There is also a small group in the Treasury that performs high-level tax policy analysis.

The relationship between the Treasury and Inland Revenue concerning the responsibility for tax policy became strained in the early 1990s, and in 1994 a committee chaired by Sir Ivor Richardson performed a comprehensive review of the organizational structure of Inland Revenue, including the role of the policy unit. As a result of this review, Inland Revenue and the Treasury acquired joint primary responsibility for tax policy. Inland Revenue is responsible for tax policy analysis, including data collection and analysis, legislative design, and drafting. The government also endorsed the recommendation of the organizational review committee to adopt a

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8 New Zealand, Organisational Review Committee, Organisational Review of the Inland Revenue Department: Report to the Minister of Revenue (and, on Tax Policy, also to the Minister of Finance) from the Organisational Review Committee (Wellington: Inland Revenue Department, April 1994).
“generic tax policy process” (GTPP) to govern the formulation of tax policy and legislation. The GTPP has not been enacted as a statute and is not binding on the government; however, in general, successive governments have adhered to the process. It is generally agreed that the GTPP works well.

The strengths of the New Zealand process for making tax policy are

- the participation of private-sector tax professionals in the process on both a formal and an informal basis;
- the open access to Inland Revenue tax policy officials and the minister accorded to tax professionals;
- the shared responsibility for tax policy and cooperation between the Treasury and Inland Revenue;
- the integration of the broad policy, legislative design, and drafting functions, coupled with a tight legislative process, which results in a tax policy process that is fast and certain; and
- the publication each year by Inland Revenue of its work program for the next 18 months, so that the public is notified on an ongoing basis of the tax issues that the government considers to be important.

The weaknesses of the New Zealand process are the following:

- The resources devoted to tax policy are shrinking at a time when demands on tax policy officials are increasing; as a result, insufficient strategic thinking occurs with respect to tax policy and fewer foreign consultants are used.
- There is insufficient post-implementation review of tax measures.
- Consultation on proposed tax measures limited to the New Zealand tax community is increasingly inadequate in a global economy.

**United Kingdom**

The United Kingdom is a parliamentary democracy with a bicameral legislature—the House of Commons and the House of Lords (though the House of Lords has no power in relation to tax legislation). It has been the model for the governments of many Commonwealth countries. The tax legislative process in the United Kingdom is an annual affair and is characterized by the speed with which tax measures can be enacted; measures announced in March, for example, can be enacted as early as July.

The process for making tax policy in the United Kingdom is centralized, with control vested in the chancellor of the exchequer. Responsibility for the tax policy process is shared by HM Treasury (HMT) and HMRC, with HMT doing the broad tax policy work and HMRC the technical aspects. When this shared responsibility works,
it works well; however, apparently it does not always work. Drafting is done separately by the Office of Parliamentary Counsel on instructions from HMRC.

The government recently adopted a new approach to making tax policy with the publication in June 2010 of *Tax Policy Making: A New Approach*. Under this new “TPM” approach, the government has committed to consult on all tax changes, even minor ones, and at all stages of the tax policy process. Previously, consultation was increasingly a feature of the UK landscape but the incoming government wanted to formalize the process—though consultation is a code of practice rather than a statutory requirement. This new approach appears to be working well generally, although it has not always been adhered to and some of the departures have arguably served to emphasize its importance.

The strengths of the UK tax policy process are

- centralized decision making, with HMT having primary responsibility, and
- the government’s recent commitment to extensive public consultation on tax changes.

The weaknesses of the process are the following:

- Extensive consultations are time-consuming and necessitate a serious commitment of human resources.
- HMT recruits generalists rather than tax specialists, and they lack experience in dealing with tax and tax policy issues. The structure of the process is not conducive to building such experience, since teams that work on policy issues are typically disbanded once a project is completed.
- There is seldom, if ever, a formal post-implementation review of tax legislation.
- There is a lack of long-term strategic thinking about the tax system, which makes it difficult to evaluate short-term changes.
- There is no competing tax policy advice, from outside government or from Parliament, to the advice provided by HMT, though naturally there are plenty of submissions from professional and business bodies and other interested parties.

**United States**

In international comparisons, the United States is often seen as exceptional. This exceptionalism is certainly true with respect to its system of government and the tax policy process. Unlike the process in the other countries reviewed here, the US process is decentralized, and intentionally designed as a system of checks and balances.

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Enactment of tax legislation requires the agreement of the House of Representatives, the Senate, and the president. Since the same political party does not usually control all three branches of government, the process works best when the key players cooperate. 11

The president, through the Department of the Treasury, prepares tax proposals that are sent to Congress. Both the House Ways and Means Committee and the Senate Finance Committee have important roles to play in virtually all aspects of the tax policy process. The Joint Committee on Taxation also plays an important role in developing legislative compromises on tax matters between the House and the Senate. The Treasury and the Internal Revenue Service (IRS), which is responsible for tax administration, generally work well together. Their respective roles are clearly defined, with the Treasury having no role with respect to specific taxpayers. The Office of Tax Policy in the Treasury includes both lawyers and economists, who have considerable expertise and experience that they apply in designing tax policy.

The strengths of the US process are

- transparency;
- extensive consultations (including, but not limited to, lobbying) on all tax issues; and
- the availability of considerable competing tax policy advice from within government and from taxpayers, tax professionals, think tanks, and academics outside government.

The weaknesses of the US process are generally the converse of its strengths:

- The checks and balances that are designed to ensure that diverse interests are taken into account sometimes result in polarized confrontation rather than agreement.
- Political partisanship and the role of the media and the Internet in conveying information to the public about tax proposals make political compromises difficult and sometimes impossible.
- The tax system is increasingly used to deliver economic and social programs.
- The huge US fiscal deficit makes the revenue effect of tax policy proposals critical in the current political environment; as a result, revenue forecasting about tax proposals is very important. 12

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12 In general, any proposal that is forecast to reduce taxes will be rejected unless coupled with proposals to increase taxes or reduce spending by at least an equivalent amount.
HUMAN RESOURCES NECESSARY FOR THE TAX POLICY PROCESS

The second session focused on the human resources necessary to carry out the tax policy process effectively. The purpose of the discussion was to get information about the resources devoted to the tax policy process in the five countries studied in order to facilitate comparisons among them. It was acknowledged at the outset that the tax community would naturally think that more resources should be allocated to the tax policy function. However, a comparative study published in 2012 concluded that the tax policy process was undervalued and under-resourced in every country.13

It should be acknowledged at the outset that it is difficult to draw comparisons among the countries with respect to the human resources involved in tax policy making, for several reasons. First, the availability and allocation of resources are constantly changing. Second, the estimates of the number of people employed in the tax policy department may not be comparable because some departments perform more functions (such as data collection and analysis and drafting) than others. With respect to the United Kingdom, HMT has its permanent policy groups and HMRC has its policy teams. The issue is the continuity of individuals assigned to the particular policy groups or to specific tax policy matters within those groups. As noted above, teams are often formed to work on particular projects but are usually disbanded when the work is complete. Moreover, the level of experience and expertise of tax policy officials are arguably at least as important as their numbers, if not more so. A simple chart prepared for the round table, reproduced as an appendix to this summary, summarizes the information provided in the papers.

All of the countries indicated that the number of tax policy officials would be shrinking over the next couple of years as a result of the financial situation of their governments, and this financial situation makes it difficult for tax policy departments to obtain additional resources. In addition, the compensation of tax policy officials is not generally competitive with compensation offered by the private sector to similarly qualified individuals, especially at the more senior and experienced levels. The reduction in human resources will make it even more difficult to perform long-term strategic tax policy work. Australia appears to be the exception in this regard, with long-term strategic planning carried out on an integrated basis with economic and social policy. Moreover, Australia carries out periodic fundamental reviews of the tax system more frequently than the other countries.

The extent of public-sector resources allocated to making tax policy raises the obvious questions of whether and how they might be supplemented through access to private-sector resources. However, it was noted that even prestigious private

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institutions have serious difficulty raising funds for tax policy projects. In general, private-sector resources were devoted to more immediate, short-term tax concerns, including responding to government consultations on tax issues.

The discussion indicated a wide range of country practices with respect to the use of interchanges with the private sector. Canada was the only country with a regular interchange program. Although the United States does not have an interchange program, there is a strong tradition of public service that encourages leading tax professionals to spend time during their careers working for Treasury or the IRS. For some countries, interchanges with the private sector seemed like a good idea, but only at relatively junior levels. In the United Kingdom, conflicts of interest have been raised as a problem with respect to temporary secondments from the private sector.\textsuperscript{14}

\textbf{Consultation}

The extent and the form of public consultation on tax reform proposals are among the most important and controversial aspects of the tax policy process. The papers confirm the intuitively obvious view that, in principle, consultation with the public is desirable, since it assists in avoiding unintended consequences and undue compliance burdens. Moreover, as the principal humourist in the group said, if the art of taxation consists of plucking the goose with the least amount of hissing, then probably the goose deserves a say.

However, consultation does have costs, and some of the papers raised concern about consultation fatigue, indicating that you can have too much of a good thing. As a result, it is important to ensure that public consultation on proposed tax measures is conducted in a way that maximizes the benefits and minimizes the costs to ensure that consultation is worthwhile.

In all of the countries with the exception of the United States, where public consultation takes place on everything, public consultation on technical amendments and integrity measures is typically limited to implementation issues and draft legislation.\textsuperscript{15} In general, consultation takes place after the fundamental tax policy decisions—identification of the problem and the identification and evaluation of the available options for dealing with the problem—have been made.\textsuperscript{16} This initial stage of the tax policy-making process, which is the focus of this paper, has not been sufficiently examined in the literature.

\textsuperscript{14} The concern is that tax practitioners might use the knowledge gained while on a temporary assignment with the tax policy department for private gain after returning to private practice.

\textsuperscript{15} In all of the countries, however, as noted below, periodic major consultations occur with respect to more fundamental tax policy design issues; for example, the Henry review in Australia (supra note 3), the Tax Working Group in New Zealand (A Tax System for New Zealand’s Future: Report of the Victoria University of Wellington Tax Working Group (Wellington: Victoria University of Wellington, Centre for Accounting, Governance and Taxation Research, January 2010)), and the Technical Committee on Business Taxation in Canada (Canada, Report of the Technical Committee on Business Taxation (Ottawa: Department of Finance, April 1998)).

\textsuperscript{16} Under the United Kingdom’s TPM (supra note 10), consultation should include the policy-making decision, but this is clearly not always adhered to.
policy process is the point at which tax professionals and taxpayers would like to see more consultation. The final stage of the tax policy process—post-implementation review—appears to be rare in most countries, although there appeared to be general agreement that such post-implementation reviews were desirable.

To begin the discussion on consultation, the participants in the round table were asked to address what types of issues are suitable for public consultation and what type of consultation is appropriate for different types of tax issues.

One view was that, as long as an issue was not one that the private sector could take advantage of, the issue was acceptable for consultation. Another participant suggested that, from a practical perspective, consultation was appropriate whenever there was an opportunity to influence the proposed tax changes and the government was prepared to listen. Several participants considered that consultation on broad policy issues at an early stage of the tax policy process was important for purposes of educating the tax community and the public at large, and perhaps avoiding the necessity of more consultation later in the process. The lack of involvement at an early stage left many feeling that the real policy decisions were often presented as faits accomplis. However, one concern expressed with respect to consultation at an early stage in the tax policy process was that it could turn into lobbying.

Several participants raised the point that trust between tax policy officials and tax professionals was crucial for consultation to be effective. Tax professionals had to feel that their suggestions were not only listened to, but also acted on in more than just rare instances. Tax policy officials had to feel that tax professionals were acting in an objective, unbiased way in the consultation process by raising issues that were sometimes against the interests of their clients. This is a very controversial issue, and not surprisingly, tax professionals take different views about how far the interests of their clients extend. The situation in New Zealand is quite interesting in this regard. As the New Zealand paper points out, there appears to be an excellent relationship of trust between New Zealand tax practitioners and government tax policy officials, and the paper notes several instances in which professional bodies have made recommendations that were contrary to the general interests of their clients.

One participant noted that consultation was more nuanced than simply obtaining the public’s views on all proposed tax changes. Different types of consultation were appropriate for different types of issues. Different types of consultation were appropriate for different types of issues. For example, one of the important purposes of some consultations is to educate the public or tax professionals about proposed tax changes. Also, governments sometimes consult privately with individual tax professionals or small groups of tax professionals. Most participants accepted that such private consultations were necessary and appropriate in certain circumstances, although concerns were raised about the lack of transparency. The view was expressed that experience with public consultations suggested that some people and

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17 An example of a different type of consultative exercise that proved to be very effective was the working group of tax advisers, financial institutions, and government officials set up by HM Treasury in 2000 to deal with Islamic finance in London.
organizations sent in comments just to have their names published in the list of those making submissions. Private consultations, on the other hand, could be more flexible and were especially useful for identifying tax reform options and deficiencies in proposed solutions. Most importantly, they allowed tax professionals to be candid in their dealings with tax policy officials.

Some participants suggested that, from the government’s perspective, another important purpose of consultations was to help governments to change course with respect to prior tax policy decisions. Public consultation can provide the government with an opportunity to say that it is changing course in response to input from the public.

Some participants raised the most important question of all: whether public consultation was worth the effort, time, and expense. Presumably, as a matter of principle, consultation could be justified (apart from making the public feel involved) only if the outcome—tax legislation—was better as a result. Others were strongly of the view that consultation in its various forms did improve the quality of a country’s tax policy and legislation. The point was made that the result of consultation was dependent on what questions the government asked and whom it asked. Some questioned whether governments were really receptive to input from tax professionals and whether tax professionals had the necessary broad tax policy expertise to be useful at early stages of the policy-making process. Consultation that consists of asking what tax professionals are thinking about, or what they think tax policy officials should be thinking about, was said to be a waste of time. Instead, specific proposals for change, often in the form of draft legislation, which has the salutary effect of focusing the mind, was said to be the more appropriate stage for tax professionals to exercise influence. Apparently, in Canada at least, the issuance of draft legislation for comment is unique to tax legislation. Others thought that consultation could also be valuable at earlier stages to deal with implementation issues and problems with existing legislation (for example, legislation to reverse the result of unacceptable court decisions).

Two important cautions to government were voiced with respect to public consultations. First, government officials should avoid going through the motions just so the government can say that it has consulted. Second, following consultation, the government needs to provide some type of feedback concerning the submissions received, including its reasons for adopting particular policy options. If these two concerns are not addressed, they have the potential to seriously undermine any attempt to conduct meaningful consultations on tax proposals.

Finally, participants mentioned that it was important to understand the many constraints on the tax policy process. One important constraint in Canada—the tradition of budget secrecy—means that advance public consultation on the nature and design of tax measures to be included in the budget is often not possible. Moreover, the budget process itself is not conducive to effective consultation because the decisions on what to include in the budget are taken in the context of other spending and fiscal decisions, and are often not made until the last minute, when it is too late for consultation. However, other participants suggested that budget secrecy was
primarily a political issue rather than a practical constraint on public consultations concerning proposed tax changes. Other countries have apparently found ways to deal with the issue of budget secrecy. For example, in New Zealand, two tax bills per year are dealt with outside the annual budget process.

Lack of time precluded any discussion of whether the role of public consultations as part of the tax policy process should be institutionalized, as it has been in Australia, New Zealand, and the United Kingdom. The role of the Board of Taxation in Australia was discussed briefly. Although the board is quasi-independent, it acts only in response to requests from the Treasury; it does not act on its own initiative. It is a business-friendly advisory body, and the Treasury uses the board to get the perspective of tax professionals on policy questions and post-implementation review of selected tax measures. In addition, as a result of concerns about inadequate disclosure of conflicts of interest, the Treasury is in the process of preparing a “Charter for Consultations on Tax Policy and Law” to govern the participation of tax professionals in the consultative process.\footnote{See “Tax Policy Formulation in Australia,” and “Some Additional Comments on Australia’s Tax Policy Process,” following this summary.}

The Australian Treasury also conducts semi-annual meetings with tax professionals to discuss tax policy issues in general, rather than measures under active consideration with respect to which some tax practitioners may have financial interests. The purpose of these meetings is to facilitate a shared understanding by all stakeholders, including the Treasury and the ATO, of their different perspectives.

In the United Kingdom, the recent adoption of the new process for making tax policy has been accompanied by the formation of a Tax Professionals Forum to review whether the new consultation process has been followed by the government. The forum is chaired by a Treasury minister and consists of eight members from the professional community. It issues an annual report but has no formal powers.

**OTHER ASPECTS OF THE TAX POLICY PROCESS**

The next session of the round table dealt with other important aspects of the tax policy process, including

- the need for long-term, forward-looking tax policy research and analysis;
- the relationship between the tax administration and the tax policy department with respect to the tax policy process;
- politics and the role of politicians; and
- the role of the media.

The discussion on each of these topics is summarized below.
The Need for Long-Term, Forward-Looking Tax Policy Work

It is widely acknowledged that the tax policy departments in government should be conducting long-range tax policy research in addition to day-to-day tax policy work, which generally responds to more immediate concerns. Such forward-looking tax policy research is important for the purposes of establishing directions and goals for the tax system. However, it was also acknowledged that tax policy departments are often stretched in terms of resources, and long-term tax policy research was usually accorded a lower priority than more immediate problems. As a result, the question arises as to whether such work is being done, or should be done, by the private sector. The lack of resources and the absence of any obvious immediate payoff were mentioned as factors that discourage private-sector involvement in long-range tax policy work.

Several participants pointed out that meaningful tax policy research required access to government data that might not be available to researchers outside the government or might be costly to obtain, and sometimes the necessary information simply does not exist. Another problem is that it is often necessary to know what information is available in order to ask for information. Obviously, confidential information about specific taxpayers is not available to outside researchers, but ideally there should be easy outside access to information that is not taxpayer-specific. The UK Office of Tax Simplification has access to the data prepared by the data analysis group in HMRC.

Despite the difficulties, long-term tax policy research is done periodically. For example, the Mirrlees review in the United Kingdom, the Henry review in Australia, and the Victoria University of Wellington Tax Working Group (TWG) in New Zealand were mentioned as exemplary in this regard. New Zealand’s TWG was a joint effort of the government, academics, and tax professionals. The group was used to provide a neutral environment in which contentious issues could be discussed freely, while the government stood back until clear options were identified. Tax officials worked closely with the chair of the TWG to design the agenda, and the government supported the work by providing analytical and other resources. In addition, the New Zealand Institute of Chartered Accountants has established a Tax Advisory Group (TAG) consisting of 12 volunteers from the major accounting firms, with 3 to 4 permanent full-time professional staff. The TAG has done some longer-range tax policy work, resulting in recommendations that occasionally conflict with

20 Supra note 3.
21 Supra note 15.
22 Therefore, the government could, if necessary, distance itself from the group’s recommendations.
the interests of the institute's members, although the bulk of the TAG's recent work focuses on detailed technical analysis.

The role of universities and academics in providing long-range tax policy research was also discussed. The Institute for Fiscal Studies (IFS) is the predominant tax and economic research organization in the United Kingdom and was formed in 1969 with a view to challenging government tax policy. It now has 30 to 40 economists on staff and focuses on economic policy generally. It has also established a Tax Law Review Committee with 20 to 25 members, which makes periodic recommendations concerning the tax system. Oxford University's Centre for Business Taxation is relatively new but has produced some excellent tax policy research; it is funded by the United Kingdom's 100 largest companies. Another recent initiative is the establishment of a centre for the study of tax administration at the University of Exeter, in conjunction with the IFS and with the support of HMRC.

The Relationship Between the Government Departments Responsible for Tax Policy and Tax Administration

In New Zealand, Inland Revenue is responsible for both tax policy and tax administration; therefore, cooperation between officials responsible for the two functions is purely an interdepartmental matter. In the other four countries, however, tax policy and tax administration are dealt with by separate departments, although in the United Kingdom both HMT and HMRC deal with aspects of tax policy. This separation poses potential problems for the tax policy process, which (arguably at least) requires the integration of broad tax policy (economic and statistical) analysis, technical analysis, and drafting. The formulation of tax policy requires input from the tax administration with respect to the administrability of, and taxpayer compliance with, proposed tax measures. Therefore, close cooperation between the two departments is important.

In the United States, the relationship is not problematic because the roles of the Treasury and the IRS are relatively well defined and distinct. In Canada, the relationship between Finance and the CRA is also working well at present. There is daily interaction on various issues, as well as cooperation on special projects such as a joint working team on the OECD's base erosion and profit-shifting project. In addition, the CRA and the Department of Justice attend legislative drafting sessions in the Department of Finance, and Finance officials participate in meetings of the CRA's committees on adverse decisions and the general anti-avoidance rule. In the United Kingdom, the new "tax policy partnership" between HMT and HMRC (following the 2005 reorganization) has taken time to develop satisfactorily but is now thought to be working reasonably effectively, although not perfectly. In Australia, where the ATO had a significant role in tax policy until 2002, there is occasionally tension in the relationship between the Treasury and the ATO, which manifests itself in the ATO's practice of litigating some cases on a basis that is contrary to the Treasury's understanding of the tax policy underlying the legislation.

According to some participants, the key to a good working relationship between the tax policy department and the tax administration is good personal relationships
between the officials involved, but they felt that it was difficult to institutionalize these relationships.

**Politics and the Role of Politicians**

The reality is that politicians have the ultimate decision-making authority with respect to tax policy, including the tax policy process. One of the issues raised during the discussions was the difficulty of getting politicians, other than the responsible minister, engaged in tax policy issues. Typically, individual members of Parliament are not knowledgeable about tax policy, or the tax system in general, and have few resources to call on for assistance with tax policy issues. In countries with a centralized tax policy process, one suggestion was for the private sector to help educate Opposition party members about tax issues. It was acknowledged that it was important for private institutions to provide an effective check on the centralized control of tax policy by the government. Various methods of doing this were raised, such as being proactive with the media, interacting with parliamentary committees, and educating the public generally. Some expressed hope that the good tax policy ideas expressed publicly in the media might drive out, or at least suppress, some of the inappropriate tax policy ideas that politicians come up with. Another suggestion was that government should make more frequent use of truly independent reviews of the tax system, such as those conducted through royal commissions, even though such reviews generally provide a snapshot rather than an ongoing scrutiny of the tax system.

One extraordinary fact that emerged from the discussion is that in New Zealand the tax policy advice prepared by Inland Revenue for newly elected governments (and the similar document prepared by the Treasury) becomes a public document once the responsible ministers have had sufficient time to consider the advice. This has become standard practice and works well.

One point made during the discussion was that an important role for tax policy officials was to advise against the adoption of measures contrary to good tax policy. This role can be especially problematic given that the tax system can be used as a mechanism to deliver social and economic programs. Not surprisingly, a 2010 recommendation of the TWG in New Zealand, to develop more institutionalized arrangements to ensure that tax policy is treated by the government as a long-term or quasi-constitutional exercise, garnered little support from the major political parties.

**The Role of the Media**

The discussion concerning the role of politics and politicians in the tax policy process led seamlessly to a spirited discussion of the role of the media with respect to tax policy. The question posed was how to encourage the media to become more engaged with tax policy issues (and be more responsible when they do engage) when, in general, they do not appear to be interested unless an issue can be reduced to a short sound-bite. Some participants sounded an optimistic note, suggesting
that there were some responsible journalists, perhaps in niche media, who could be encouraged to become more engaged in tax policy issues. Others were concerned that few journalists were interested in (or perhaps capable of) becoming better informed about tax policy and prepared to deal with the issues in a responsible way. Nevertheless, despite their misgivings, many participants agreed that journalists play an important role in influencing politicians. Consequently, government, governmental organizations, and private institutions working on tax policy issues need to have a strategy for dealing with the media; otherwise, it was suggested, lobbyists would exploit the absence of objective, unbiased, and informed opinion. In the United Kingdom, HMRC has recently become more proactive with the media and holds periodic briefings on tax issues for the media.

In summary, although there appeared to be a consensus that efforts should be made to educate the media about tax policy issues, there was no consensus on how to do so or whether the media were interested in becoming better informed. If the media were better informed about tax policy issues, the public would be better informed and public confidence in the tax system would be improved.

**BEST PRACTICES AND CONCLUSION**

Not surprisingly, given the round table’s full agenda, the time available to discuss best practices with respect to the process for making tax policy was limited. This may have been just as well since some participants noted that the term “best practices” was outmoded, and perhaps the development of one or more model tax policy processes would be more appropriate. Another participant suggested that a catalogue of good ideas for tax policy making would be worthwhile and should include the collection and availability of reliable data, adequate human resources, a media strategy, and provision for post-implementation review of tax measures. Another participant thought that public consultation should be added to the list. Several participants liked the suggested distinction between “Big P” tax policy issues (broad issues of tax structure, design, incidence, distributional effects, etc.) and “Little P” issues (more technical tax issues). Tax professionals do not deal with or have expertise in the Big P issues; as a result, it is necessary have some type of external body perform this type of tax policy research, which could serve both as a supplement to the work done by government and as a check on that work. The point was made that increased consultation and transparency might come at the cost of less grandfathering and tighter effective dates for new measures, in order to prevent taxpayers from exploiting any delay in the implementation of proposed tax measures.

Some participants thought that the tax policy process was too dependent on each country’s particular situation to develop a model process that would suit each country’s needs. For example, New Zealand’s situation is so special in many respects (and not just because of the country’s small population) that its GTPP is not readily transferable to other countries. Nevertheless, it was suggested that it would be worthwhile to develop model or best practices with respect to the institutionalization of the relationships among the principal players in the tax policy process.
The round table concluded without much time for discussion of the next steps that might be taken to continue the conversation, apart from the publication of the proceedings. One suggestion was for a similar round table discussion of the tax policy process with politicians. Larry Chapman informed the group that, at the very least, the CTF would facilitate a broader discussion of the tax policy process with the membership of the Foundation.
APPENDIX TABLE 1  Human Resources Assigned to the Tax Policy Process in Australia, Canada, New Zealand, and the United Kingdom

<table>
<thead>
<tr>
<th></th>
<th>Number of professionals (excludes administrative staff)</th>
<th>Qualifications/ experience</th>
<th>Internal training</th>
<th>Private-sector interchanges</th>
<th>Consultants</th>
<th>Tax administration issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>190 (45 in data, 20 in law design, 6 drafters)</td>
<td>Tertiary qualifications in economics, law, public policy, and accounting</td>
<td>Extensive</td>
<td>Yes</td>
<td>Yes: ad hoc</td>
<td>Two-way secondments with ATO</td>
</tr>
<tr>
<td>Canada</td>
<td>160(^a) Economists with graduate degrees; lawyers and accountants</td>
<td>Not available</td>
<td>Yes: 1-2 regularly for senior roles</td>
<td>Not available: ad hoc</td>
<td>CRA responsible for tax administration</td>
<td></td>
</tr>
<tr>
<td>New Zealand</td>
<td>51.5 Average: —Senior advisers, 11 years —policy managers, 18 years</td>
<td>Yes</td>
<td>No</td>
<td>Yes: ad hoc</td>
<td>IRD responsible for policy and administration</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>HMT—120 HMRC—Not available (no permanent group dedicated to tax policy)</td>
<td>Generalists</td>
<td>Not available</td>
<td>Yes, on unpaid basis</td>
<td>Rarely</td>
<td>Supplied by HMRC</td>
</tr>
</tbody>
</table>

Note: No detailed human resources data were included in the US presentation at the round table.

\(^a\) Includes legislative draftsmen but not staff devoted to revenue forecasting.

ATO = Australian Taxation Office.
CRA = Canada Revenue Agency.
HMRC = HM Revenue & Customs.
HMT = HM Treasury.
IRD = Inland Revenue Department.

Sources: Papers presented at the round table, reproduced herein.
Tax Policy Formulation in Australia

Rob Heferen, Nicole Mitchell, and Ian Amalo*

KEYWORDS: TAX POLICY ■ POLICY MAKING ■ TAX LEGISLATION ■ PROCESS ■ AUSTRALIA

INTRODUCTION

Just as Australia’s political system is a unique mix of elements, some drawn from other countries and others developed domestically, its tax system also has a unique character. Australia’s representative democratic system1 is key to that character and informs the development and assessment of tax reform ideas.

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1 Australia is a federation, with three levels of government: the federal Australian government (or the commonwealth government), the governments of the six states and two territories, and
In this regard, tax policy making is different from monetary policy making in Australia. There is no tax entity independent of government that plays a role similar to that played by the Reserve Bank of Australia in setting monetary policy. In contemporary Australia, tax policy is an increasingly contested policy debate. Tax debates often concern tradeoffs between different values and priorities, and so tax policy making appropriately sits with elected officials. Successive governments have introduced a range of innovative institutions and practices aimed at improving the quality of tax policy making in Australia, including greater involvement of the private sector, extensive consultations, and accountability mechanisms.

This paper focuses solely on tax policy making by the Australian government. This is not to suggest that an examination of tax policy formulation by the Australian states and territories would be unwarranted. The Australian states, territories, and local governments levy a range of taxes in their own right (accounting for around 20 percent of total tax revenue) and have undertaken important reviews and reforms in recent years. In the interests of brevity, however, the ensuing discussion will focus on the federal (or commonwealth) level.

**STAGES IN TAX POLICY FORMULATION**

**Development Stage**

Under Australia’s parliamentary system, the government is formed by the party with control of the House of Representatives (the lower house or “the house of government”). Ministers are appointed from both the House of Representatives and the Senate (the upper house or “the house of review”) to form the executive government, with policy decisions being made by Cabinet. (The Senate’s role as a house of review is discussed in a separate section below.) Ministerial responsibility for tax policy lies with the treasurer, who also has ministerial responsibility for economic, fiscal, and monetary policy (among other matters). The treasurer is supported by the other Treasury portfolio ministers. Ultimately, the power to make tax laws rests with the Parliament. It is rare in Australia for the government to have a majority in the Senate, and so legislation often needs the support of senators from the Opposition or minor parties to become law. Under Australia’s system of government, the Cabinet (which is made up of senior ministers) is the key decision-making body of government. While the Cabinet’s makeup and internal processes are subject to the prime minister’s prerogative, and the shape and arrangements have changed over time, a core feature is that all major policy proposals are considered by Cabinet.

Tax policy development is a highly contested space. Reform, research, and policy options are generated by a multitude of sources, including electoral parties, Senate inquiries, academics, think tanks, lobby groups, tax representatives, and the media.

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around 700 local government authorities. One of two major political groups usually forms the government, federally and in the states—the Australian Labor Party (the centre-left party) and the Coalition, which is a formal grouping of the Liberal Party and its minor partner, the National Party (the centre-right parties).
Governments have recognized this increasingly contested policy environment by ensuring that the Treasury undertakes greater policy consultation, including early “non-transactional” engagement, in order to be in a position to provide more comprehensive advice.\(^2\) In recent years, the then Rudd government also commissioned a comprehensive tax review (the Henry review),\(^3\) and has established an independent tax studies institute at the Australian National University to improve the quality of public debate on tax reform. Governments have also made recent improvements in tax policy consultation processes (discussed later in this paper). As the department that serves the treasurer, the Treasury is the most influential public-sector advising body on tax, though its influence varies, of course, according to the precise nature of each issue.

Other processes for generating ideas, gathering information, and identifying solutions within government are discussed below, in the section describing the respective roles of the Treasury and the Australian Taxation Office (ATO) in formulating tax policy. That discussion highlights recent efforts to improve communication between the two agencies and outlines Australia’s history of tax reviews. The Australian government requires that a regulation impact analysis be undertaken by responsible departments to inform all decisions, including tax policy changes, that are likely to have a non-trivial regulatory impact on business or not-for-profit organizations. This analysis involves consideration of impacts, costs, and benefits of proposed regulatory options and is provided to the relevant decision maker (for example, Cabinet) along with the policy proposal, unless an exemption is granted by the prime minister for exceptional circumstances.

Tax proposals typically attract additional requirements, including the requirement that they be proposed by the treasurer. In practice, the great bulk of tax policy is developed and evaluated during the annual budget process, although significant policy measures are increasingly being introduced through the mid-year budget update process.

As outlined above, while the exact arrangements differ from government to government, it is fair to describe the budget process as an iterative one. Budget bids are first submitted to senior ministers (typically the prime minister, the treasurer, and the minister for finance and administration) in October, and costed proposals are considered by senior ministers between February and April through the Expenditure Review Committee, a formal subcommittee of Cabinet with delegated authority to make decisions. By tradition, the budget for the next financial year is delivered by the treasurer to Parliament on the second Tuesday of May.

It is worth noting here that while budget decisions are classified until budget night, targeted and confidential consultations with stakeholders are undertaken on


more complex proposals prior to a final decision, to ensure that the proposed policy meets its objectives. These consultation processes remain confidential following the budget process.

Once a decision requiring legislative change is made, the Treasury is responsible for instructing legislative drafters in the Office of Parliamentary Counsel on tax matters, producing explanatory materials and regulation impact statements for tabling, conducting community consultation on tax policy, managing the legislation program, and assisting the government in securing the passage of bills through Parliament. In short, the Treasury has a central role in ensuring that legislative products match their policy intent.

**Legislative Stage**

For a tax bill to become an Act, it must be passed in the same form by the House of Representatives and the Senate and then assented to by the governor general. Section 53 of the Australian constitution\(^4\) prevents bills that authorize the spending of money (appropriation bills) and bills imposing taxation from originating in the Senate, so all tax bills must originate in the House of Representatives.

Despite this constitutional restriction, the Senate's role in tax policy remains important. This is because the Senate performs a well-developed house of review function through its committees, with tax policy considered by the Senate Standing Committee on Economics. Notwithstanding some fluctuations, the number of bills referred to Senate committees has trended upward in recent decades.

**Post-Implementation Review Stage**

As part of the regulation impact analysis described above, departments are required to provide information on how the preferred regulatory option will be implemented, monitored, and reviewed. More formal post-implementation reviews, initiated within one to two years of implementation, are required for all regulations that initially proceeded without a compliant regulation impact statement.

In addition, specific post-implementation reviews on tax policy are conducted by the Board of Taxation. The Board of Taxation, which was established following the 1999 Review of Business Taxation (the Ralph review),\(^5\) is a non-statutory advisory board charged with providing advice to government, from a business and broader community perspective, on improving the design and operation of taxation laws. As part of its functions, the board also conducts post-implementation reviews of legislation to assess their quality and effectiveness. Since its establishment in 2000, the Board of Taxation has conducted 29 reviews and consultations, with 6 of those reviews covering the post-implementation phase.

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\(^4\) Commonwealth of Australia Constitution Act.

GOVERNMENT DEPARTMENTS WITH A ROLE IN TAX POLICY FORMULATION

The Treasury’s role in developing tax legislation has been outlined above. The Treasury also has primary responsibility for advising on tax policy; more specifically, the Treasury formulates and provides advice to government on policy options, produces regulation impact statements, and prepares official costings, which together with the overall revenue forecasts underpin the government’s budgets. All of these activities are undertaken in close conjunction with the ATO, the statutory authority responsible for the administration of Australia’s taxation and superannuation laws and the government’s principal revenue collection agency.

In recognition of the importance of the relationship between the ATO and the Treasury, in September 2012 the secretary to the treasury and the former commissioner of taxation substantially redrafted the “Treasury and the Australian Taxation Office—Tax and Superannuation Protocol.”6 The protocol aims to improve the working arrangements between the Treasury and the ATO. It is applied in the design of new policies and laws that form part of these systems, and in the administration of the law once enacted.

Tax Policy Reviews

Australia has a rich history of tax policy reviews. The report of the Taxation Review Committee (the Asprey review) released in 19757 was seminal and marked a watershed moment in the realm of tax policy reviews. Justice Ken Asprey’s review shifted the emphasis away from tax policy motivated solely by the adequacy of revenue to fund growing public provision, to a greater focus on improving the equity, efficiency, and simplicity of the tax system.

A key theme of the Asprey review was the need to broaden the tax base. Key reforms recommended by the Asprey review were implemented over the next two decades, including capital gains tax and fringe benefits tax (in the late 1980s) and the goods and services tax (in 2000). Other reviews, including the 1999 Ralph review and the Board of Taxation’s review of international taxation arrangements in 2002-38 had more immediate policy impacts, with reform packages announced alongside the review’s public release or shortly thereafter.

More recently, a comprehensive review of the tax and transfer system, the Henry review,9 was conducted over 18 months in 2008 and 2009. The Henry review added

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8 Australia, Board of Taxation, Review of International Taxation Arrangements (Canberra: Board of Taxation, February 2003).
9 Supra note 3.
the design principles of policy consistency and sustainability to the principles identified by the Asprey review. Essentially, the requirement for consistency ensures that tax and transfer policy are internally consistent, while the requirement for sustainability ensures that the tax system has the capacity to meet the changing revenue needs of government on a continuing basis without recourse to inefficient taxes.

Consistent with Australia’s system of responsible government, tax reviews are provided to the relevant minister. The government decides how the review will be released and what policy changes (if any) it wishes to make in response to the recommendations. While review panels do not make policy decisions, they do facilitate such decisions by identifying areas of concern in the tax system and promoting public discussion about tax reform.

**RESOURCE ALLOCATION IN THE TREASURY**

Within the Treasury, Revenue Group formulates advice to the government on taxation policy. The work of the group includes

- analysis and the provision of advice to the relevant minister on tax and superannuation policy options and their economic and social impacts;
- the provision of revenue forecasts and costings of taxation policies;
- extensive policy-based and non-transactional consultations; and
- legislative support, including providing instruction to parliamentary counsel on the design of taxation laws and support for the passage of tax legislation through Parliament.

Revenue Group accounts for over 20 percent of Treasury staff members, and nearly a sixth of the group’s staff are engaged in preparing tax legislation. The group is headed by an executive director and structured into seven divisions, with almost half of the staff employed at the junior (Australian public service, or APS) level (see table 1).

Following a review in 2012 of Revenue Group’s capabilities, the Law Design Practice was established to better identify legislative priorities and provide greater quality assurance of legislative products, as well as provide a clearer career pathway for specialist law design officers. Officers engaged in the Law Design Practice have legal qualifications and/or extensive experience in law design. In a similar vein, the overwhelming majority of officers engaged in the Tax Analysis Division have specialist skills and are trained in economics and/or quantitative studies (mathematics, statistics, or actuarial studies). Officers in the remaining divisions possess tertiary qualifications in law, economics, finance, and/or statistics. Thus, Revenue Group employs both specialists and generalists, reflecting a need to strike a balance between both sets of skills. A few officers also have private sector experience.

The Treasury has an active two-way secondment program with the ATO. This provides an opportunity for Treasury officers to gain direct experience of the administration of Australia’s tax system and the implementation of tax policies, with the aim of enhancing an officer’s overall skills in policy and legislative development.
By the same token, ATO officers are routinely seconded to the Treasury to gain experience in tax policy development. Revenue Group employs private-sector consultants from time to time, most often to review existing processes or to provide technical assistance. The Treasury has a program of temporary secondments from the private sector and also encourages such secondments in tax policy, particularly in the secretariat that the Treasury provides to the Board of Taxation. More generally, Revenue Group taps into the expertise of private-sector tax specialists for specific projects on a paid consultancy basis.

Of course, it is not just government agencies that are devoting resources to the formulation of tax policy in Australia and, more broadly, throughout the world. The Big Four accounting firms derive between 20 and 30 percent of their global revenues from the provision of taxation services, and around 20 percent of their workforce is employed in taxation—proportions that have remained generally stable over the past few years. Information on the websites of these firms suggests that similar allocations apply to their Australian operations.

It is at least arguable that this extensive devotion of resources by the private sector results in more tax system complexity. While there is general confidence in the Australian tax system, a recent survey by Per Capita that explored the public’s attitude toward taxation and government expenditure revealed that Australians find the tax system “burdensome.” This finding seems consistent with the fact that over

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**TABLE 1 Staffing Resources in Revenue Group, Australian Treasury**

<table>
<thead>
<tr>
<th>Division</th>
<th>Total division staff</th>
<th>SES</th>
<th>EL</th>
<th>APS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax System Division</td>
<td>19.87</td>
<td>2.00</td>
<td>5.27</td>
<td>12.60</td>
</tr>
<tr>
<td>Corporate and International</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Division</td>
<td>30.40</td>
<td>5.00</td>
<td>11.00</td>
<td>14.40</td>
</tr>
<tr>
<td>Small Business Tax Division</td>
<td>17.88</td>
<td>0.80</td>
<td>6.80</td>
<td>10.28</td>
</tr>
<tr>
<td>Indirect, Philanthropy and Resource Tax Division</td>
<td>25.35</td>
<td>2.00</td>
<td>12.35</td>
<td>11.00</td>
</tr>
<tr>
<td>Personal and Retirement</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income Division</td>
<td>31.55</td>
<td>3.00</td>
<td>14.64</td>
<td>13.91</td>
</tr>
<tr>
<td>Tax Analysis Division</td>
<td>45.47</td>
<td>3.60</td>
<td>19.87</td>
<td>22.00</td>
</tr>
<tr>
<td>Law Design Practice</td>
<td>30.25</td>
<td>1.73</td>
<td>12.52</td>
<td>16.00</td>
</tr>
<tr>
<td>Executive team</td>
<td>4.80</td>
<td>1.00</td>
<td>1.00</td>
<td>2.80</td>
</tr>
<tr>
<td>Total, Revenue Group</td>
<td>205.57</td>
<td>19.13</td>
<td>83.45</td>
<td>102.99</td>
</tr>
</tbody>
</table>

*a Full-time equivalent staff as at May 2013.

SES = senior executive service.

EL = executive level.

APS = Australian public service.

Source: Australian Treasury internal data.

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70 percent of Australian tax lodgers rely on tax agents to complete their personal tax returns—a proportion that has remained broadly unchanged over recent years. According to data published by the Organisation for Economic Co-operation and Development (OECD), Australia has the third-highest rate among 16 OECD member countries for personal tax returns filed by tax agents (see figure 1).

CONSULTATION

Until the early 2000s, tax policy consultations in Australia were infrequent and largely confined to administrative matters. Today, consultation forms an integral part of the tax design process, with a large number of measures being subject to consultation in both the policy design and draft legislation phases.

Tax consultations serve a number of purposes and are subject to diverse influences. The major aims of consultation are

- to act as a discovery process that will provide valuable input on the most effective way to implement government policy, and to assist in minimizing compliance and administration costs, as well as to avoid (to the extent possible) unintended consequences;
- to elucidate on the policy intent of proposed changes;
- to serve as a vehicle to formulate current and future tax policy; and
- to improve situational and strategic awareness to better inform Treasury thinking.

Both the Treasury and the ATO have an active consultation program that focuses on the particular areas of responsibility of each agency. The ATO is a full participant in consultation arrangements undertaken by the Treasury.

In the normal course of events, consultation involves the public release of an initial discussion paper, followed by an exposure draft of legislation or regulation. From time to time, however, consultation is more targeted, either to a public audience or to a more confidential group. Consultation on some measures may include more than one approach.

In the case of confidential consultations, participants are required to sign an undertaking not to divulge details of the consultation. However, if participants wish to discuss a confidential consultation with someone who is not a party to the consultation, they can request that this party also be given the opportunity to sign an undertaking and participate.

Participants in targeted consultations are generally chosen because they have expertise in the area or because they belong to a group that may be specifically affected by the legislation. Responses can be in the form of discussions at meetings or written submissions.

Public consultations are open to the general public, including individuals. Such consultations may be advertised in newspapers and posted on the Treasury website. For open public consultations, discussion (or policy) papers and/or exposure drafts
of legislation are generally prepared and made available. Submissions are sought in response to these papers, and these are also frequently made public on the website.

The nature of tax consultations can be characterized by the state of knowledge of a particular matter by the Treasury and the ATO on the one hand, and by stakeholders on the other. The $3 \times 3$ matrix (table 2) depicts this graphically. The rows indicate the state of information that the Treasury and the ATO have about industry conditions, and the columns indicate stakeholders’ understanding of policy.

Cell A represents fairly routine, basic “care and maintenance” law changes. These may arise from Treasury/ATO law fix registers or from stakeholder consultations. Cell A could also represent situations of policy deadlock; progress is possible only by compromise and not necessarily through further consultation.

Cell B reflects complex “care and maintenance” law changes that may well reflect more fundamental problems in tax law. Tax-avoidance issues could be present.

Cells C and D represent complex situations where the Treasury and the ATO do not have a full or sufficient appreciation of industry conditions. This will tend to occur at turning points in the economic cycle, during periods of structural change (as is the case at the time of writing), and when policy change spans overlapping regulatory domains.

Table 2  Tax Consultation Characterization Matrix

<table>
<thead>
<tr>
<th>Treasury/ATO</th>
<th>Stakeholders</th>
<th>Know</th>
<th>Don’t Know</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Know</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Implementing well-understood policy in ordinary industry conditions</td>
<td>Implementing newish policy in ordinary industry conditions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>e.g., basic care and maintenance; possibly deadlocked policy</td>
<td>e.g., complex care and maintenance; anti-avoidance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Basic consultation effort</td>
<td>Above basic consultation effort; policy dissemination</td>
</tr>
<tr>
<td></td>
<td>Don’t know</td>
<td>C</td>
<td>D</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Implementing well-understood policy in new or changing industry conditions; overlapping regulatory domains</td>
<td>Implementing newish policy in changing industry conditions; overlapping regulatory domains; new judicial doctrine</td>
</tr>
<tr>
<td></td>
<td></td>
<td>e.g., tax consolidation care and maintenance</td>
<td>e.g., resource rent tax, tax measures for carbon pricing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Well above basic consultation effort; private-sector experts supplement Treasury’s knowledge base; layered consultation ensures integrity of consultation process</td>
<td>Significant consultation effort; private-sector experts supplement Treasury’s knowledge base; layered consultation ensures integrity of consultation process, including drawing on international experience</td>
</tr>
</tbody>
</table>

Cell C represents situations where stakeholders are better informed about certain tax practices, including those that seek to undermine the policy intent of a measure. In such situations, the Treasury should draw on contracted private-sector expertise. The Treasury should also undertake multilayered consultations that cover a range of interests affected by the policy measure, in order to manage the risk that certain vocal and possibly influential voices might otherwise unduly distort the stakeholder experience.

Cell D represents mutual lack of information. This situation could arise with respect to new taxes, or when a judicial decision throws open an established way of thinking about a tax issue. In both situations, the Treasury and the ATO should be learning together with stakeholders and should seek to be informed through multi-layered consultations and international experience, as appropriate.

In practice, tax consultations often entail multiple stages and approaches. For example, consultations on the minerals resource rent tax legislation in 2011 were conducted in two stages: first, the detailed policy design, led jointly by a government minister and a senior industry representative; and second, more detailed legislative implementation, led by the Treasury and involving a broader industry and practitioner group. This approach, in part, follows from the Treasury’s role in such consultations.
While the Treasury may often lead consultations, its role is to listen to participants, advise the government on the views of stakeholders, and provide policy advice. The Treasury does not take policy decisions—that is ultimately the role of Parliament.

In addition to the well-developed program of consultations on announced measures, Revenue Group has in recent years conducted a program of semi-annual non-transactional consultations and has increased early-stage pre-policy consultations with stakeholders. The Revenue Group stakeholder consultation program aims to supplement Treasury consultations on specific tax measures and to engage the taxpayer community in a wider conversation about strategic tax policy issues.

Similarly, the early-stage consultations facilitate broader conversations about tax policy tradeoffs. In the past two years, pre-policy consultations have been undertaken on the business tax system, base erosion and profit shifting, and not-for-profit sector tax concessions. Each of these groups has been composed of a range of business, union, and community representatives. While this diversity might make it more difficult for groups to reach consensus on tax policy recommendations, it does expose sectoral interest arguments to appropriate scrutiny.

The tax system in Australia operates with a number of tax governance bodies (listed in table 3), each serving a perceived need. The ATO plays a central governance role as the government’s principal revenue collection agency and administrator of tax and superannuation laws.

The Parliamentary Budget Office is the latest independent governance body to become operational and will give Parliament the ability to better evaluate tax policy measures. The Parliamentary Budget Office is intended to inform Parliament by providing independent and non-partisan analysis of the budget cycle, fiscal policy, and the financial implications of proposals. It is relatively well resourced (with around 25 staff employed currently and the intention of employing between 30 and 35 permanent staff), has experienced policy officers among its ranks, and has access to Treasury data and models.

The Tax and Transfer Policy Institute at the Australian National University was recently established to serve as a centre for excellence, collaborating with academics and institutions across Australia and overseas. The institute is expected to raise the quality of national debate on tax reform and the awareness of tax policy issues.

**Conclusion**

The tax system is a fundamental part of Australia’s social and economic infrastructure. This paper has outlined the role of key agencies, such as the Treasury and the ATO, as well as some of the more significant developments in governance and consultation arrangements in Australian tax policy formulation over the past decade. Underlying that discussion, Australia’s system of responsible government remains central: All tax policy decisions are made by the democratically elected government of the day, and not by bureaucratic, academic, or other elites.
<table>
<thead>
<tr>
<th>Organization</th>
<th>Type</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian Taxation Office</td>
<td>Independent statutory agency</td>
<td>The government’s principal revenue collection agency, and part of the treasurer’s portfolio. Administers the tax and superannuation laws.</td>
</tr>
<tr>
<td>Board of Taxation</td>
<td>Non-statutory advisory body</td>
<td>Advises the treasurer on improving the general integrity and function of the taxation system. Provides business and broader community perspectives. Established in 2000.</td>
</tr>
<tr>
<td>Taxation Ombudsman</td>
<td>Independent statutory agency</td>
<td>Investigates complaints from taxpayers and tax professionals about the administrative actions of the ATO. Also uses information from complaints to identify potential systemic problems in tax administration. Established in 1995.</td>
</tr>
<tr>
<td>Australian National Audit Office</td>
<td>Independent statutory agency</td>
<td>Undertakes financial statement audits and performance audits examining the economy, efficiency, and administrative effectiveness of the ATO’s administration of the tax system.</td>
</tr>
<tr>
<td>Tax Practitioners Board</td>
<td>Independent statutory board</td>
<td>Responsible for the registration and regulation of tax practitioners and for ensuring compliance with the Tax Agent Services Act 2009. Replaces six state-based tax agents’ boards.</td>
</tr>
<tr>
<td>Tax and Transfer Policy Institute</td>
<td>Independent research centre</td>
<td>Established in 2013 as an independent centre for excellence at the Australian National University.</td>
</tr>
<tr>
<td>Joint Committee of Public Accounts and Audit</td>
<td>Statutory committee in Parliament</td>
<td>Since 2007, has conducted public hearings with the ATO commissioner with respect to the administration of the tax system.</td>
</tr>
<tr>
<td>Senate Economics Committee</td>
<td>Statutory committee in Parliament</td>
<td>Investigates specific matters of policy, government administration, or performance.</td>
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Some Additional Comments on Australia’s Tax Policy Process

Graeme Cooper*

INTRODUCTION

These comments refer only to income tax matters (though I have no reason to believe that consultation on other federal taxes works in a significantly different manner), and they should be read subject to the general caveat that they are based only on what is publicly visible.

GENERAL DESCRIPTION OF THE PROCESS

It is a striking feature of the Australian tax world that, dating from about 10 years ago, consultation on every major tax announcement is expected and will occur. Just what accounts for this situation is not obvious, but it seems that our politicians have listened to years of complaints from business and tax professionals about the lack of consultation, and so there is an expectation that major policy announcements will be released for public comment prior to formal enactment. This will often take the form of a discussion paper and perhaps one or more drafts of indicative legislation.

However, while there is a lot of consultation, it almost always occurs ex post: day-to-day tax policy proposals almost always emerge from government as a fait accompli without the benefit of any transparent, prior, and external involvement. Instead of being involved in policy development, the participation of actors external to government is typically limited to policy refinement and issues of implementation. The one exception is policy announcements that have been prompted by lobbying, but that too is not conducted in public.

The usual situation is that the government will announce some measure, and then invoke a consultative process to refine and implement that measure. A typical example is the recent proposal to amend the tax secrecy rules to permit disclosure by the ATO of the tax position of corporations with taxable income over AU$100 million. The measure was announced by the treasurer on February 4, 2013, along with the proposal to examine “advice from Treasury and views of the community . . . with a view to introducing any necessary legislative changes this year.”11 In April, the Treasury released a brief paper, allowing three weeks for comment.12

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There is nothing new in the observation that external public consultation is rarely conducted ex ante; it is a constant complaint. The 1999 Review of Business Taxation was keen to see what it described as a “participative” approach to the formulation of tax policy. Recommendation 1.8 of its report proposed that tax policy be formulated in conjunction with the business community, and advocated “a more open and integrated approach to the initiation of policy proposals relating to business taxation.” In a similar vein, the 2008 Tax Design Review Panel recommended that the Government consult on new tax proposals at the initial policy design stage. This would allow the early input of private sector ideas and expertise to analyze the policy issue and find an appropriate and workable policy response.

This fait accompli method of operating has drawbacks that occasionally become obvious. Proposals can be based on mistakes: the erroneous claims upon which the recent amendments to Australia’s general anti-avoidance rule (GAAR) were based were never tested. Changes can be ineffectual: the recent repeal and re-enactment of Australia’s domestic transfer-pricing rules probably does nothing to change Australian law, although it was promoted as a change. Or the change is simply unworkable: one of my favourite examples is the Treasury’s proposals in the early 1990s to allow the pooling of depreciable assets rather than asset-by-asset depreciation; it was not possible for taxpayers to pool assets because the capital gains tax rules insisted upon tracking costs asset by asset.

Australia’s more ambitious tax policy projects, which seem to occur every decade, tend to be more road-tested before implementation, and the lesson of grand projects is that many do not survive serious external scrutiny. Key elements of the Asprey review, such as the introduction of a value-added tax, were not pursued. Many of the reforms suggested by the 1999 Review of Business Taxation were never adopted, especially key proposals such as replacing the fringe benefits tax with tax imposed directly on the employee, the proposal to tax trusts as companies, the proposed tax value method, and the proposed regime for taxing “leases and rights.” A similar story can be told about the Henry review: almost all of its recommendations were ignored at the time the report was released; a handful have been enacted since. In some cases, the failure of a proposal has undoubtedly been due to politics and factors other than the merits of the proposal—but in many cases, a proposal was abandoned simply because it was shown to be misconceived once it was publicly scrutinized.

13 Supra note 5.
14 Ibid., at recommendation 1.8.
16 Supra note 7.
17 Supra note 3.
GOVERNMENT DEPARTMENTS WITH A ROLE IN TAX POLICY FORMULATION

While the Treasury has formal responsibility for formulating income tax policy, it is inevitable that administrative agencies will make policy, and the ATO is definitely a key player in deciding the shape of Australia’s tax settings.

There have been many examples over the years of occasions when the ATO, by administrative edict, has unilaterally added refinements, imposed restrictions, or simply rejected policy settings. These are just a few such cases:

- Non-portfolio dividends from foreign subsidiaries would be tax-exempt only if received directly by the parent company, and not if the dividend flowed to the company via a wholly owned trust.
- Interest incurred to earn foreign (exempt) dividends would be deductible only for dividends earned in the same tax year.
- Company tax treatment would be denied to a trust in the face of legislation that treated the trust as a company “for all the purposes of the Act.”
- An instrument could not be classified as debt despite an economic compulsion to repay (contradicting the explanatory memorandum, which referred to this very example three times).
- GAAR could be used to deny tax credits to holders of instruments classified as equity under Australia’s debt-to-equity tests.
- Loans by in-house finance companies would be treated as akin to equity investments.
- The key building blocks of tax law relating to trusts are viewed as being unresolved, despite 70 years of jurisprudence.

While it may not be obvious to outside observers, these are not simply instances of an administrator taking a position because of a lack of clarity, or acting to remedy a perceived weakness in the drafting, or trying to give effect to what the ATO presumes would be the policy. To my mind, they contradict policy settings. As one judge recently put it,

the real problem for the Commissioner [of Taxation] in the present case is that he seeks to cancel, in reliance on the [GAAR], tax consequences intended by Parliament to be conferred on a company . . . joining a consolidated group.

These ATO policy decisions are not subject to any external and formal review process; it is not possible to say whether they are subject to any formal internal ATO review. The lore in the profession is that they are unilateral decisions taken individually by powerful, apparently unchecked, senior ATO officials.

19 The ATO eventually abandoned its resistance in Taxation Ruling TR 2008/3.
On the other hand, the ATO has put in place an extensive set of committees that consult with the tax profession. (I have heard that there are more than 100 such committees.) Indeed, the ATO conducts far more consultations each year than the Treasury does on tax matters. The discussions of these bodies are not limited to matters of administration and technical detail. Whether and how the deliberations of these ATO-sponsored committees are fed into the Treasury’s formal processes is not obvious, but—at least sometimes—they definitely are. For example, the many revisions of Australia’s taxation of financial arrangements regime appear to have been driven largely by the issues raised by the non-governmental members of the Finance and Investment Subcommittee operated by the ATO.

The newly appointed commissioner of taxation is understood to be keen to reduce the current level of consultation, which he views as excessive and inefficient.

**CONSULTATION**

**Formal Processes for Consultation with External Actors**

Consultation on implementing policy is conducted in an ad hoc manner despite the existence of formal institutions for this process. Different models can be seen in practice:

- Sometimes policy proposals will be referred to the Board of Taxation, a standing committee (drawn from the tax profession, the private sector, and administrative agencies) charged with contributing “a business and broader community perspective to improving the design of taxation laws and their operation.”

  Several recent reform projects (consolidation, collective investment vehicles, private company dividends, controlled foreign corporation rules, charities, share redemptions, etc.) were referred to the board.

- Sometimes a special ad hoc committee will be struck to assist with the refinement and implementation of policy. Special committees were struck, for example, for the minerals resource rent tax, reductions to the corporate tax rate, the project on reducing delays and improving tax law, the GAAR review, and the base erosion project.

- There are instances of selective secret consultations, where the Treasury will conduct informal discussions with a handful of experts of its own choosing, or with organizations representing particular industries, prior to releasing its legislation. This is understood to have occurred for some of the recent projects affecting the funds management industry.

- Sometimes a proposal is simply revealed to the general tax community, and interested observers are invited to comment. This has occurred, for example, with respect to the trust-law reform project, the minimum income tax regime,

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21 The board’s charter is available at www.taxboard.gov.au.
the limited recourse debt rewrite, the special regime for losses suffered on infrastructure projects, the corporate loss carryback regime, and so on. This consultation usually occurs around a draft bill and before a formal bill is introduced in Parliament.

- There are still instances where there is no precommencement consultation. A measure is announced and a bill enacted without external review.

These models are not necessarily discrete (for example, in the review of Australia’s GAAR, there was both a publicly announced ad hoc panel and secret consultations), but in many instances they are (sometimes the Board of Taxation will be approached; sometimes it will be ignored in favour of an ad hoc committee). There is no apparent logic that drives this decision.

The only consistent pattern is that public post-implementation reviews—and there have only ever been a handful of these—appear to be solely allocated to the Board of Taxation.

**Those Consulted**

Another significant dimension of this part of the topic is, who is consulted and why. The Treasury and the ATO rely to varying degrees on experts they have selected, individuals invited from a leading private-sector player, individuals nominated by the industry bodies, and individuals nominated by professional organizations, all volunteers. There is clearly a temptation (and it is probably also the practice) for private-sector actors to inveigle their way onto panels in order to advocate for their firms, their industry, or clients.

The resulting tension is inevitable: the very people who will best foresee the problems are the people with the greatest potential conflicts of interest. The Treasury is trying to manage this tension by introducing its proposed “Charter for Consultations on Tax Policy and Law” (in addition to the oath of secrecy, enforceable by criminal sanctions, which is routinely sought from experts). The same charter will apparently apply both to partisan players (the Treasury’s own experts, and people who represent an affected industry or group) and to those who might be disinterested—professionals with technical expertise in tax.

The problem is difficult. The role expected of those being consulted is rarely made clear to them. In the case of industry experts, for example, have they been invited to represent and advocate for the industry, or have they been invited to explain the industry’s position so that its concerns can be understood? The Treasury appears to have a notion of “key stakeholders” who must be involved in consultations. If people are selected because they are “stakeholders,” they are not being selected for their disinterested expertise. Tax professionals might be expected to be disinterested, though many will be invited precisely because of their client base.

The Treasury’s draft charter attempts to deal with the problem by requiring that conflicts of interest be made transparent and by asking participants to advance the national interest. It is not clear what is meant to happen when everyone declares a conflict. It seems to me inevitable that anyone in the room who is an expert will
have some conflicting interest, and few delegates, even those acting from the best of motives, are likely to see as a “national interest” a position that is inconsistent with their own/their clients’ pecuniary interests.

Moreover, this approach mismatches roles and responsibilities. Everyone expects the ultimate decision maker (the minister or board member) to be impartial and disinterested, while everyone expects a lobbyist to be entirely partial. Those being consulted on tax matters are not decision makers, so it is implausible to insist that they accept strictures appropriate for those with real authority.

Perhaps what this really shows is that the Treasury lacks the skills and judgment to be able to differentiate the partisan from the disinterested, and it is trying a workaround to change the dynamic of the consultation process. From my observation, the Treasury and the ATO are not good at distinguishing the zealot from the sage or the expert from the charlatan (though admittedly sometimes these people are foisted upon them).

Effectiveness of Consultation

The professional bodies and some of the individuals who participate in consultation routinely ponder whether consultation exercises are worthwhile. The professional accounting and tax bodies have staff devoted more or less full-time to attending consultation meetings or answering requests for submissions on the latest legislation or topic. Much of this effort is devoted to negotiating with the ATO, which has by far the largest number of consultation events.

The consensus seems to be that consultation is not worthwhile—announced policies rarely change unless there is a single, coordinated, “over-my-dead-body” response. There have been a few notable instances where the professional bodies have combined to defeat major reforms. Examples are the proposal to tax trusts as companies, the tax value method, the leases and rights project, the first iteration of the tax-preferred leasing rules, the ATO’s paper on section 974-80, and the ATO’s position against streaming income classes via trusts. A common feature of these examples is that the proposals did not emerge from the government as announced policy and so could be disowned by the government without political damage.

But even consultation just on refinement and implementation seems often to be ineffective in modifying errors or removing the impractical elements of proposals. The professional bodies have decided to pool resources and offer joint comments to the ATO, prepared on a rotating basis; evidently they have come to the conclusion there is little to be gained from investing separate time and effort.

To be fair to the government agencies, it is not common to receive consistent responses from external consultants. Except in cases where there is only one industry representative, they are unlikely to be presented with a single set of clear recommendations.

Regardless of its effectiveness in improving legislative outcomes, consultation will probably continue in much the same vein as currently. No single professional body will abandon the field to its rivals, and individual practitioners like it to be known that they are heavily involved in matters of great moment, even if they “can’t
really talk about it”; the major firms clearly see a benefit in demonstrating their connection with government.

It is significant that, as part of the negotiation surrounding the Treasury’s Charter for Consultations on Tax Policy and Law, the quid pro quo sought by the profession was a promise by the Treasury to explain its decisions on submissions made during consultation. This may not change the profession’s perception that “we invested all this time and effort and nothing changed,” but at least the profession hopes that it will now know why.
The Process for Making Tax Policy in Canada

Brian Ernewein and Nancy Horsman*

**KEYWORDS:** TAX POLICY ■ POLICY MAKING ■ TAX LEGISLATION ■ PROCESS ■ CANADA

**CONTENTS**

Overview 1032
General Description of the Process 1032
  Development Stage 1032
    Generation of Ideas for Tax Changes, Including Identification of Problems in the Existing Tax System 1032
    Research, Information Gathering, and Study 1033
    Identification and Evaluation of Solutions 1033
    Drafting of Legislation 1034
  Legislative Phase 1034
  Post-Enactment Review Stage 1034
Government Departments and Advisory Bodies with a Role in or Responsibility for Tax Policy Formulation 1035
  Primary Responsibility for Formulating Tax Policy 1035
  Responsibility for the Administration of the Tax System 1035
  The Role of Advisory Bodies and Parliamentary Committees 1036
Resources Devoted to the Formulation of Tax Policy 1037
  Professional and Other Staff 1037
  Private Sector Consultants 1037
  Temporary Secondments from the Private Sector 1037
Consultations with the Public and Tax Professionals 1038
  Consultation Process 1038
  Issues Considered Suitable for Public Consultation 1039
  Timing and Form of Public Consultation 1040
  Effectiveness of the Consultation Process 1040

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Canada has a federal system of government. The federal government and each of the 10 provincial and 3 territorial governments develop and enact tax legislation. The federal and provincial governments do so under their own constitutional authority; the territorial governments do so under power delegated by the federal government.

At the federal level, legislation is enacted by the Parliament of Canada. Each province or territory has its own legislature that enacts provincial or territorial laws. Federal laws apply across the country. Provincial and territorial laws apply within the boundaries of the province or territory.

The federal and provincial governments each have jurisdiction to levy taxes on personal and corporate income and to impose sales taxes. However, the constitution of Canada restricts provincial taxing powers to direct taxation within a province. Only the federal government can impose indirect taxes (such as import duties).

The description below outlines the federal tax policy process.

**GENERAL DESCRIPTION OF THE PROCESS**

**Development Stage**

*Generation of Ideas for Tax Changes, Including Identification of Problems in the Existing Tax System*

The Tax Policy Branch (TPB) of Canada’s Department of Finance is responsible for the development of tax policy at the federal level. TPB personnel conduct internal research and analysis (for example, conducting economic analysis and reviewing case law) to generate ideas for tax initiatives and to analyze ideas for tax changes from other sources. The Canada Revenue Agency (CRA), which administers most federal taxes, is an important source of ideas for tax initiatives. In addition, TPB personnel are in regular contact with other branches of the Department of Finance, other federal departments, and representatives of provincial and territorial governments. Other sources of policy initiatives include

- elected officials (either individually or by way of recommendations of a parliamentary committee);

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1 Constitution Act, 1867, 30 & 31 Vict., c. 3, section 92.
submissions from individual taxpayers, tax advisers, industry groups, and tax practitioner groups (for example, the Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada [“the CBA-CPA joint committee”] and the Tax Executives Institute);

- expert panels appointed by government (for example, the Expert Panel on Financial Security for Children with Severe Disabilities and the Independent Panel on Federal Support to Research and Development);

- studies and research by private groups (for example, the C.D. Howe Institute and the Canadian Tax Foundation);

- international bodies (such as the Organisation for Economic Co-operation and Development [OECD] and the G8/G20); and

- academic research and advisers from the academic community.

Research, Information Gathering, and Study

The TPB is made up of five divisions: Personal Income Tax; Sales & Excise Tax; Business Income Tax; Tax Legislation; and Intergovernmental Tax Policy, Evaluation and Research. All except the Tax Legislation Division carry out quantitative and qualitative economic research and analysis regarding contemplated policy options. Members of the Tax Legislation Division and the Sales & Excise Tax Division review case law and commentary published by practitioners and academics. TPB staff review submissions by taxpayers, practitioners, and expert committees such as the CBA-CPA joint committee. The research undertaken depends on the nature of the issue.

The CRA has developed a large database using data from taxpayers’ return information. Department of Finance staff have access to this database for research and analytical purposes. It is a major source of information for the quantitative portion of the TPB’s policy analysis and allows TPB staff to model the projected outcomes of policy proposals.

Identification and Evaluation of Solutions

The annual federal budget is normally the major vehicle for the introduction of new tax policy initiatives; accordingly, the policy options analysis process normally tracks the annual budget cycle. Options are analyzed in anticipation of their potential acceptance as measures to be adopted in the budget.

For measures considered for inclusion in the budget, the legislative feasibility of various policy options, their consistency with the government’s priorities and with tax policy objectives (fairness, neutrality, simplicity, etc.), the economic and distributional impacts, the cost/revenue impact, potential provincial/territorial impacts, and other considerations are all reviewed. In addition, all tax measures are reviewed for their gender and environmental impacts. This is done by way of preparation of a briefing package for consideration for ministerial approval.

Similar analysis is conducted for potential tax changes considered outside the budget cycle.
Drafting of Legislation

Federal income tax legislation is drafted by members of the Tax Legislation Division in consultation with the Department of Justice and the CRA. Federal sales and excise tax legislation is drafted by members of the Sales & Excise Tax Division in consultation with the Department of Justice and the CRA (and the Canada Border Services Agency [CBSA] in some instances). Department of Justice lawyers are assigned to the Tax Counsel Division, which works within the TPB but is part of the Department of Justice. TPB staff also prepare the associated explanatory notes for use by parliamentarians and taxpayers.

Tax legislation is normally released in draft form and the public has the opportunity to submit comments, usually for a period of 60-120 days. Comments received on the draft legislative proposals are considered in finalizing the legislation before its introduction in Parliament.

Legislative Phase

The Department of Justice prepares government bills for introduction in Parliament. Tax legislation is normally tabled in Parliament by the minister of finance. Federal legislation must be passed by both chambers of Parliament (the House of Commons and the Senate). The House and the Senate will generally study proposed legislation in committee before passing it. Legislation becomes law upon receiving royal assent (received from the governor general).

Post-Enactment Review Stage

Administration of tax legislation is the responsibility of the CRA. If the CRA identifies issues with the application of the legislation, it will advise the TPB accordingly. TPB staff also have ongoing contact with stakeholders and review court decisions to identify issues in existing legislation.

Individual taxpayers may find that legislation has an impact that they believe is not within the policy intent of the legislation. In such circumstances, taxpayers (or their advisers) may contact the TPB. If, upon review, TPB officials consider that the technical application of a particular provision is not in accord with its underlying policy intent, a senior TPB representative may issue a comfort letter advising of their intention to recommend to the minister of finance an appropriate technical amendment to the legislation. Taxpayers (and their advisers) generally rely on comfort letters issued by the Department of Finance in proceeding with transactions and in preparing tax returns—although accounting standards may require certain firms to identify in their financial reports that a legislative amendment is required to support the tax position that the firm has taken. The CRA will also rely on these comfort letters, either to assess tax in accordance with the policy articulated by the Department of Finance or, in certain cases, to suspend an assessment of tax pending enactment of the particular change.
Primary Responsibility for Formulating Tax Policy
The Department of Finance is responsible for formulating federal tax policy. The department develops policies and provides advice to the government with the goal of creating a healthy economy for all Canadians. Activities include the following:

- analyzing and designing tax policy and carrying out the related research and evaluation;
- recommending policy and legislative changes to the minister of finance;
- planning and preparing the tax portion of the federal government’s budget;
- drafting amendments to the tax statutes and related regulations;
- consulting provincial governments regarding tax policy and legislation;
- negotiating tax treaties and tax information exchange agreements with foreign governments;
- consulting with stakeholders; and
- negotiating tax administration agreements with aboriginal governments, and tax collection and sales tax harmonization agreements with provincial governments, as well as making payments pursuant to these agreements.

Responsibility for the Administration of the Tax System
The CRA is the agency responsible for the administration of the federal income tax. In addition, the CRA administers

- the personal income tax of the territories and all provinces except Quebec;
- the corporate income tax systems of the territories and all provinces except Quebec and Alberta;
- the federal goods and services tax (GST) in all provinces except Quebec; and
- the provincial sales taxes of the five provinces that have adopted the harmonized sales tax (HST), which combines the 5 percent federal GST with a provincial component whose rate is set by the province.

In general, Quebec administers the Quebec sales tax (the QST, its value-added tax) as well as the GST/HST in Quebec. Quebec entered into a sales tax harmonization agreement with Canada in March 2012, the terms of which require that the QST be harmonized with the GST on a going-forward basis. British Columbia, Manitoba, and Saskatchewan administer their own retail sales taxes. (Alberta does not impose a provincial sales tax.) The CBSA collects applicable federal and provincial sales tax at the border.

Taxpayers are generally required to self-assess their income taxes payable (if any) and to report them in annual returns (signed declarations) filed with the CRA.
The CRA reviews these returns and may reassess taxes payable. The tax law contains authority for the CRA to review the records of taxpayers that are relevant to the determination of their taxes payable, and also provides certain collection powers not available to ordinary creditors. Taxpayers are entitled to an internal review within the CRA of the amount of tax assessed and have a further right of appeal to the courts (in the first instance to the Tax Court of Canada, then to the Federal Court of Appeal, and finally, with leave, to the Supreme Court of Canada).

The Role of Advisory Bodies and Parliamentary Committees

From time to time, expert committees and advisory panels are appointed to advise the government on specific issues or in respect of specific areas of tax. Examples in recent years include

- the Advisory Panel on Canada’s System of International Taxation,
- the Expert Panel for the Children’s Fitness Tax Credit,
- the Expert Panel on Financial Security for Children with Severe Disabilities,
- the Technical Advisory Committee on Tax Measures for Persons with Disabilities, and
- the Technical Committee on Business Taxation.2

In addition, parliamentary committees issue reports that may provide input for ongoing policy development. Recent examples include reports of the House of Commons Standing Committee on Finance on tax evasion and the use of tax havens,3 and on the use of tax incentives to encourage charitable giving by Canadians.4

Recommendations of these committees and advisory panels are seriously considered and in some cases implemented by the government. For example, a number of recommendations of the Advisory Panel on Canada’s System of International Taxation have been implemented.

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2 The findings and recommendations of these various panels and committees can be found in the following reports: respectively, Advisory Panel on Canada's System of International Taxation, Final Report: Enhancing Canada’s International Tax Advantage (Ottawa: Department of Finance, December 2008); Canada, Report of the Expert Panel for the Children’s Fitness Tax Credit (Ottawa: Department of Finance, October 2006); Canada, A New Beginning: The Report of the Minister of Finance’s Expert Panel on Financial Security for Children with Severe Disabilities (Ottawa: Department of Finance, December 2006); Canada, Disability Tax Fairness: Report of the Technical Advisory Committee on Tax Measures for Persons with Disabilities (Ottawa: Department of Finance, December 2004); and Canada, Report of the Technical Committee on Business Taxation (Ottawa: Department of Finance, April 1998).


RESOURCES DEVOTED TO THE FORMULATION OF TAX POLICY

Professional and Other Staff

The TPB currently has approximately 160 staff, including both professional and support staff. As of April 1, 2013, the active staffing complement for the TPB was as follows:

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<tr>
<th>Division</th>
<th>Staff</th>
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<tbody>
<tr>
<td>Senior Assistant Deputy Minister’s Office</td>
<td>7</td>
</tr>
<tr>
<td>Personal Income Tax Division</td>
<td>32</td>
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<tr>
<td>Tax Legislation Division</td>
<td>27</td>
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<tr>
<td>Sales &amp; Excise Tax Division</td>
<td>44</td>
</tr>
<tr>
<td>Business Income Tax Division</td>
<td>29</td>
</tr>
<tr>
<td>Intergovernmental Tax Policy, Evaluation and Research Division</td>
<td>17</td>
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The majority of the professional staff of the TPB are economists and other social policy professionals. The Tax Legislation Division and parts of the Sales & Excise Tax Division are staffed primarily by lawyers and accountants. Most of the economists on staff have a graduate degree, and a number of the professionals in the TPB have graduate degrees in tax, business, or public policy.

Typically, new staff are hired through university recruitment or from other branches of the Department of Finance or other federal departments, rather than as experienced hires from the private sector. New staff are trained as tax policy professionals within the TPB.

Private Sector Consultants

Depending on the nature and complexity of the issue, advice from the private sector may be sought to ensure that all possible considerations associated with the contemplated policy change are looked at. This is particularly relevant when the contemplated policy change has the potential to significantly affect market transactions or stakeholders in a particular segment of the economy.

Temporary Secondments from the Private Sector

The TPB arranges for the secondment of private practitioners to fill senior roles within the branch on an as-needed basis. For example:

- A senior tax partner with a major accounting firm recently joined the Department of Finance under the federal government’s executive interchange program and acted as director of the Tax Legislation Division for almost two years.
- A partner from another major national accounting firm has joined the Tax Legislation Division under the same program, to work on foreign affiliate issues.
- On the sales tax side, accountants and a lawyer from major national firms have assisted with the examination of the GST/HST treatment of financial services.
CONSULTATIONS WITH THE PUBLIC AND TAX PROFESSIONALS

Consultation Process

The minister of finance engages in a series of consultations with members of the public prior to each budget. The House of Commons Standing Committee on Finance also holds pre-budget hearings and presents a report on these hearings.

In addition, the government engages in public consultations on specific issues. Examples of recent public consultations on tax issues include the following:

- **Scientific research and experimental development (SR & ED) tax incentive program.** In October 2007, the Department of Finance and the CRA issued a consultation paper and invited submissions on how the SR & ED tax incentive program could be made more effective for Canadian businesses and how it could be designed to play an even greater role in fostering a more competitive and prosperous Canadian economy.5

- **Non-resident trusts.** A consultation was completed in 2010 pursuant to revised proposals for the taxation of non-resident trusts and foreign investment entities outlined in the 2010 federal budget.6 The consultation consisted of a panel of experts commenting on detailed proposals.

- **Reporting of tax-avoidance transactions.** The 2010 budget released for consultation a proposal that avoidance transactions that met certain benchmarks be required to be reported to the CRA.7

- **Taxation of corporate groups.** The 2010 budget announced that Canada was exploring new rules for the taxation of corporate groups, such as a more formalized system of loss transfers or a form of consolidated reporting.8 A discussion paper was released in November 2010 and comments were invited.9

- **Employee profit-sharing plans (EPSPs).** As announced in the 2011 federal budget,10 the government undertook consultations for the purpose of reviewing the existing rules for EPSPs. As part of these consultations, the Department of Finance invited comments on the rules that apply to EPSPs.11

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6 Canada, Department of Finance, 2010 Budget, Budget Plan, March 4, 2010, at 371-78.

7 Ibid., at 382-84.

8 Ibid., at 386.

9 Canada, Department of Finance, *The Taxation of Corporate Groups: Consultation Paper* (Ottawa: Department of Finance, November 2010).

10 Canada, Department of Finance, 2011 Budget, Budget Plan, June 6, 2011, at 291.

- **Registered disability savings plans (RDSPs).** In October 2011, the Department of Finance announced that it was undertaking a review of RDSPs, to ensure that such plans are meeting the needs of Canadians with severe disabilities and their families.\(^\text{12}\) The review sought public input on a number of matters that are crucial to the success of RDSPs, including access to plan savings, plan termination, and the administration of the RDSP program.

- **Life insurance policyholder taxation.** The 2012 federal budget proposed changes to the life insurance policyholder taxation rules and announced a related consultation with key stakeholders.\(^\text{13}\) A consultation paper was released to an industry working group on May 31, 2012. TPB officials discussed the proposals outlined in the paper extensively with industry representatives.

- **Contingency fees related to the SR & ED tax incentive program.** As announced in the 2012 federal budget,\(^\text{14}\) the government undertook consultations on contingency fees charged by SR & ED tax preparers to determine whether these fees diminish the benefits of the SR & ED tax incentive program to Canadian businesses and the economy.

As noted earlier, tax legislation is generally released in draft form for public comment before it is introduced in Parliament. Written comments are solicited, and may be provided by either mail or e-mail. Meetings are also often held with stakeholders, either in relation to particular measures that affect a particular taxpayer or group, or, in the case of input provided by organizations such as the CBA-CPA joint committee or the Tax Executives Institute, on most or all of the measures put forward in the particular package of draft legislative proposals.

Parliamentary committees, of both the House of Commons and the Senate, hold hearings on proposed tax legislation as part of its passage by Parliament.

TPB staff have regular meetings with stakeholder groups such as the commodity tax committees of the Canadian Bar Association and the Chartered Professional Accountants of Canada, and the Tax Executives Institute.

**Issues Considered Suitable for Public Consultation**

Public consultation can be particularly useful in the following circumstances:

- Where new policies are proposed, consultations may reveal unintended consequences or, alternatively, may reveal a gap in the policy.
- With policies that may be sensitive or controversial, consultations may provide an opportunity to explain concerns that might be addressed in the legislation.

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\(^{13}\) Canada, Department of Finance, 2012 Budget, Budget Plan, March 29, 2012, at 400-2.

\(^{14}\) Ibid., at 71.
Often, changes that are required to tighten existing legislation take effect at the time they are announced, in order to prevent revenue losses. In these cases, consultations occur after the announcement, and generally relate to technical issues rather than the policy aspects of the tightening change.

Consultations may be used to review the effectiveness of existing tax measures.

Through the release of draft legislation, the tax practitioner community is given an opportunity to comment on proposed amendments addressing technical issues identified by the TPB, the CRA, or taxpayers and their advisers.

**Timing and Form of Public Consultation**

The stage at which consultation is carried out varies with the purpose of the consultation. For example, the consultation process

- may occur at an early stage and provide the impetus for a tax change (such as when a parliamentary committee studies a particular issue or the minister of finance engages in pre-budget consultations);
- may be carried out to elicit views on a range of options, or on one particular option, to address an issue;
- may be carried out with respect to the implementation of a tax change that has been announced by the government; or
- may occur on the release of draft legislation for comment.

The Department of Finance’s main approach to formal consultation involves a news release and the posting of a consultation paper or draft legislation on the department’s website inviting comments from interested stakeholders.

Consultations may also be in the form of informal meetings between TPB staff and taxpayers, industry groups, tax practitioners, or the other stakeholders.

**Effectiveness of the Consultation Process**

Consultations are useful for learning about new policy ideas, for identifying issues associated with new tax policies, and for identifying technical issues with proposed legislation. Consultations are also useful for identifying sensitive aspects of policies and for explaining government positions on policy issues.

**OTHER ISSUES**

**Academic Research**

The tax policy community would benefit from more academic scholarship in the area of tax law. Canada has a limited number of academics at universities and other organizations who focus their research on tax policy issues.

**Transparency**

The budget process and the development of legislation are generally secret. Consequently, there are important limits to the extent that information is shared with
respect to the development of tax initiatives. However, comfort letters issued by the Department of Finance are made public, as are advance tax rulings and technical interpretations issued by the CRA.

The Department of Finance and the CRA are both subject to the Access to Information Act,\(^\text{15}\) which may require the release of information in certain circumstances.

**The Role of Politics and Politicians**

In the field of taxation, only the government can introduce a measure that would impose a new or additional tax. However, measures to reduce taxes may be introduced either by the government, or by parliamentarians as private members’ bills.\(^\text{16}\)

In addition to the House of Commons Standing Committee on Finance, the Senate’s Standing Committee on Banking, Trade and Commerce and the Senate’s Committee on National Finance study tax legislation, and tax issues more generally, as part of their respective mandates.

**The Role of International Organizations**

The Department of Finance and the CRA are actively involved with the OECD at the working-party level and with the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes. As well, a senior representative of the Department of Finance sits on the OECD Committee on Fiscal Affairs. The Department of Finance actively supports the work of the International Monetary Fund and the World Bank. The OECD model tax convention\(^\text{17}\) generally serves as a model for Canada’s tax treaties.

**The Role of Independent Tax Reform Bodies**

There are several non-governmental organizations in Canada that play an important role in the development of tax policy and the advancement of tax reform:

- The Canadian Tax Foundation promotes and facilitates the study of, and discussion about, Canada’s tax system. Drawing its members from all branches of the tax community, in Canada and abroad, the Foundation is the predominant Canadian organization in this area. Its publications include the *Canadian Tax Journal*, conference reports, regular tax updates, and monographs on a range of tax topics.
- The CBA-CPA joint committee acts as a nexus for the tax practitioner community to present concerns to the Department of Finance.

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\(^{15}\) RSC 1985, c. A-1, as amended.


The Tax Executives Institute represents corporate in-house tax professionals. A number of independent think tanks, other research institutions, and professional bodies (for example, the C.D. Howe Institute, the Fraser Institute, the Association de planification fiscale et financière, and the University of Calgary’s School of Public Policy) publish work relating to the economics of taxation and other aspects of tax policy.
Development of Tax Policy in New Zealand: The Generic Tax Policy Process

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**KEYWORDS:** TAX POLICY ■ POLICY MAKING ■ TAX LEGISLATION ■ PROCESS ■ NEW ZEALAND

**CONTENTS**
Introduction 1044  
Genesis of the GTPP 1044  
The GTPP 1045  
   Strategic Phases 1046  
   Tactical Phases 1046  
   Operational Phases 1048  
   Legislative Phases 1048  
   Implementation and Review Phases 1049  
How the GTPP Operates in Practice 1049  
   The Role of the Private Sector 1050  
   Consultation 1051  
The Role of Independent Tax Reform Bodies — The Victoria University of Wellington Tax Working Group 1052  
The Role of the Media 1053  
Costs and Benefits of the GTPP 1054  
Transportability of the GTPP 1055  
Resources Devoted to the Formulation of Tax Policy 1055  
Conclusion 1056

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INTRODUCTION

New Zealand has a tax policy process that is widely seen to work relatively well. There is a degree of cooperation between the private and public sectors that is quite rare internationally. There is a large element of working together to provide a tax system that is best for “New Zealand Inc.” (New Zealand as a whole).

In understanding the tax policy process and why it works well, it is helpful to consider some important facts about New Zealand. New Zealand is a small country, where the key players involved in tax policy in the government and the private sector all know one another. There are repeated interactions. While these could potentially either build or destroy trust, there are strong incentives to cooperate and build trust. Private-sector tax professionals also are known by and have good access to government ministers, particularly through conferences and the work of the New Zealand Institute of Chartered Accountants and the International Fiscal Association. Open channels exist for expressing concerns to ministers if those in the private sector think that tax policy officials are getting things badly wrong.

New Zealand has a formalized generic tax policy process (GTPP), which importantly includes a strong consultative component. The GTPP has a high degree of support from the private sector, tax officials, and government ministers. The private sector voices strong concerns when important tax policy changes are not put through the full GTPP.

GENESIS OF THE GTPP

In 1984, New Zealand elected a reformist Labour government. Policy moved quickly in the direction of a “broad-base, low-rate” (BBLR) tax system. By lowering rates and broadening tax bases, the reforms were aimed at reducing the distorting impact of taxation, making things fairer, and ensuring the tax system’s ability to raise the revenue necessary to fund government spending. In many ways, this policy shift paralleled tax changes that were taking place in other countries, including the United States and Australia, but in New Zealand the reforms arguably went further. With some chopping and changing, this BBLR framework has, for the most part, continued until today.

Not only was there a radical change in tax policy in the mid-1980s; there was also a fundamental shift in willingness to consult. The government established consultative committees to review and better implement proposed tax policy reforms.

The first of these committees was set up to consider the goods and services tax (GST). It worked spectacularly well and allowed a well-designed GST to be brought in very quickly. The original framework of the GST (which came into effect in 1985) continues to this day. There was a wealth of goodwill in making tax policy changes, and now a very open and consultative environment in which to do so.

It was clear that by the end of the 1980s, much had been achieved. There was, however, less consensus on the direction of future policy changes.

Concerns about the tax policy process were among the reasons for the government’s decision, in 1993, to ask a review committee (chaired by Sir Ivor Richardson)
to carry out a fundamental strategic review of the Inland Revenue Department and its activities. The scope of this review was broader than just tax policy, but tax policy was an important element in the review.

The Organisational Review Committee reported in April 1994.¹ On the policy side, the committee identified the following key concerns:

- Things were working much less well than they had during the early 1990s.
- It was difficult to see how tax policy fitted into the government’s broader economic objectives.
- There was not a strong enough tax policy group within the Inland Revenue.

The review expressed concern that while both Inland Revenue and Treasury were involved in tax policy, there was anecdotal evidence that “[Inland Revenue] tax policy advice [was] often overpowered by the advice from Treasury and the private sector.”²

The committee suggested the establishment of a major policy arm in Inland Revenue able to match the intellectual capability of the Treasury and the private sector. The reasons for this recommendation are not made explicit. But there may have been a concern that practical tax problems were not being addressed in the legislation. There may have also been a concern that real compliance costs of tax legislation did not have a sufficient focus and that this focus might increase with a greater Inland Revenue presence on tax policy.

There was also a concern that policy and legislation were not sufficiently linked, leading to unnecessarily complex legislation. The Organisational Review Committee also suggested the establishment of a legislative function in Inland Revenue and a fundamental rewrite of the Income Tax Act.³

**THE GTPP**

Before the Organisational Review Committee had reported, the government had signed on to the committee’s recommendation of a formalized GTPP. The main objectives of the GTPP were

- to encourage early consideration of key policy elements and tradeoffs,
- to provide an opportunity for substantial external input into the policy formation process, and
- to clarify the responsibilities and accountability of participants in the process.

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¹ New Zealand, Organisational Review Committee, *Organisational Review of the Inland Revenue Department: Report to the Minister of Revenue (and on Tax Policy, also to the Minister of Finance) from the Organisational Review Committee* (Wellington: Inland Revenue Department, April 1994).

² Ibid., at 79.

³ All other government legislation is drafted by the Parliamentary Counsel Office (PCO). Inland Revenue is unique in this respect.
The committee suggested a multiphase formalized GTPP that included the following:

1. **Strategic phases**: economic strategy; fiscal strategy; three-year revenue strategy
2. **Tactical phases**: rolling three-year work program; annual work and resource plan
3. **Operational phases**: detailed policy design; formal detailed consultation and communication; ministerial and Cabinet signoff of detailed policy
4. **Legislative phases**: drafting of legislation; ministerial and Cabinet signoff of legislation; introduction of bill; select committee phase; passage of legislation
5. **Implementation and review phases**: implementation of legislation; post-implementation review; identification of remedial issues

Subject to a few minor amendments, these original suggestions continue to provide the basis for today’s GTPP, which is illustrated in figure 1.

Another key legacy of the organisational review is that Inland Revenue and the Treasury are jointly responsible for developing tax policy—through the Policy Advice Division (now referred to as Policy and Strategy) within Inland Revenue and through a smaller policy group within the Treasury. This joint provision of tax policy advice is not common internationally. It does, however, create safeguards for the government by increasing the extent to which tax policy advice is tested internally before issues are put to ministers or released for public consultation.

### Strategic Phases

The strategic phases of the GTPP involve the development of an economic strategy, a fiscal strategy, and a revenue strategy. Broad policy proposals may be publicized through channels such as budget documentation.

### Tactical Phases

The tactical phases of the GTPP involve planning and form the basis for policy delivery for the following 18 months. An 18-month work program is developed jointly with the Treasury, consulted on, approved by ministers and Cabinet, and published. This published work program is consistent with the government’s economic objectives.

In developing the work program, the international environment within which New Zealand operates is a key consideration. This includes identifying emerging trends in tax policy both internationally and politically. The role of the chief economist (a position within Policy and Strategy) is to provide expertise and leadership on the development of the economic and strategic direction of tax policy. In addition, the chief economist provides leadership for the forecasting function and economic advice across all tax and strategy matters.

A core aspect of the GTPP is research, including data analysis, and Policy and Strategy has a Forecasting and Analysis Unit. Data from this unit are used regularly in the development of tax policy. Another source of information is the specialist...
Output from phases 1-3 widely publicized by government—possibly through budget documentation

Phases 3-5 are linked with the budget process and have a high degree of simultaneity

External input: External input, as appropriate, through green paper (ideas) stage and/or through white paper (detail) stage by either
1. secondment of personnel from private sector,
2. a permanent advisory panel,
3. issues-based consultative committees, or
4. submissions on consultative document

Issues encountered at later stages of the process, and decisions taken to change policy, may lead to reconsideration of earlier phases

Consultative committee may be required to explain the intent of its recommendations to select committee

* Cabinet decision.
research, evaluation, and analysis undertaken by the National Research and Evaluation Unit within Inland Revenue.

As noted above, monitoring international trends in tax policy is an important element of good tax policy design. New Zealand has strong links with international organizations. Staff within the policy unit are active members of a number of the Organisation for Economic Co-operation and Development (OECD) working parties.

Operational Phases

The operational phases consist of detailed policy design, detailed consultation, and gaining ministerial and Cabinet approval of recommendations. This phase culminates in government approval of practical tax policy initiatives that are ready to be introduced in Parliament and implemented.

On major reforms, consultation will often involve the release of a government discussion document. This gives people something specific to react to. It is critical for the language of the document to cater for its intended audience and especially to take into account whether or not readers are likely to be tax specialists. Normally, about six weeks are allowed for submissions, and during the submission period officials have intensive face-to-face meetings with affected taxpayers. After the submissions have been received and considered, officials will report to the government on them. The government may either decide to proceed to legislation taking into account what has been learned from submissions, or ask for further consultation on certain issues. This may involve direct consultation on specific points or the release of an officials’ issues paper and subsequent consultation.

A good tax policy process cannot be just written down in a set of rules of engagement. There needs to be considerable goodwill. The public and private sectors need to be willing to engage and listen to each other (not talk at each other). Consultation needs to be real, with the government being willing to pick up valid suggestions put forward by the private sector.

Not every proposed reform requires a government discussion document. For smaller issues, consultation may involve discussions or correspondence with a much smaller group of people or even just a telephone call. Often remedial issues are dealt with as raised rather than through a large-scale review.

During these phases, an Inland Revenue design area (outside Policy and Strategy) supports the development of policy, such as exploring the administrative impacts of various policy options. This design area has responsibility for engaging the wider Inland Revenue. This also allows for the consideration and suggestion of practical options to ensure a sustainable and reliable outcome that still meets the policy intent. The result is that the design area directly contributes to robust policy design, ensuring that the resulting law can be properly administered, that it is suited to its intended purpose, and that costs and impacts for both the government and taxpayers are minimized.

Legislative Phases

In the legislative phases, the detailed policy recommendation is translated into legislation. This occurs in parallel with the operational phases described above, which
speeds up the process by ensuring that legislation is ready for introduction in Parliament once all policy issues have been resolved. It also ensures that the proposed reforms can be expressed clearly in legislation.

Once a bill has been introduced, it is publicized on Inland Revenue’s website (as well as Parliament’s website), along with a specially prepared commentary that explains the rationale for the proposed policy changes. External consultation takes place through public submissions to the select committee considering the bill. A benefit of the GTPP is that by the time legislation comes before a select committee, the private sector should be thoroughly familiar with the reasons for change.

**Implementation and Review Phases**

The implementation and review phases include the post-implementation review of new legislation, after it has had time to “bed in,” and the identification of any remedial issues that need to be addressed for the new legislation to have its intended effect. Opportunities for external consultation are also built into this stage.

**HOW THE GTPP OPERATES IN PRACTICE**

There have been a number of major reviews in recent years. One example is the 2006 Business Tax Review. An initial discussion document was released in July 2006, seeking consultation on proposals to reduce the company tax rate, along with the tax rate on certain widely held savings vehicles, from 33 percent to 30 percent, and to introduce targeted tax credits for research and development (R & D), export market development, and skills training. Three officials’ issues papers followed, in November 2006, which refined the original policy proposals and initiated further consultation.

Interestingly, not all business-friendly options proposed by the Business Tax Review were supported by business groups. In particular, there was little public support for export market development and skills training tax credits. These were dropped. However, there was support, on balance, for an R & D tax credit and strong support for rate cuts.

Legislation introducing tax rate cuts for companies and savings vehicles was introduced, went through the select committee process, and was ultimately passed. The company tax rate and tax rates for widely held savings vehicles were cut from 33 percent to 30 percent for the 2008-9 income year. A 15 percent R & D tax credit was also introduced, starting that year.

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An interesting aspect of the tax environment in New Zealand is the extent to which private-sector practitioners are prepared to push for tax changes that are not in their own direct financial interest. The R & D tax credit provided strong business benefits to major accounting firms; there was a considerable amount of financially rewarding work in helping firms to identify which expenditures could reasonably be considered to be R & D. Nevertheless, these firms strongly opposed the R & D credit, on the ground that it was not in New Zealand’s best interests. In their view, it would be better to abandon the credit in favour of a non-incentivized BBLR framework. The R & D tax credit lasted only a year and was dropped by the new National Government elected in November 2008.

**The Role of the Private Sector**

Key participants in the private sector that are engaged in the tax policy process include professional bodies, sector-specific groups, and the large accounting and advisory firms.

The New Zealand Institute of Chartered Accountants has a national Tax Advisory Group (TAG) with a long history of engaging with government on tax policy development. The members of the TAG are volunteers and include two tax partners from each of the Big Four firms along with four to six other tax experts drawn from corporate, academic, and public practice. The TAG is supported by a secretariat provided by the institute, consisting of three to four full-time equivalent tax professionals. The TAG makes submissions on all tax legislation and policy changes, and engages frequently with officials and government during policy formation, legislation, and implementation.

The TAG operates with a stated objective of achieving tax policy outcomes that are in the public interest. Where the commercial interests of the institute’s members seem in conflict with the public interest, the TAG’s view of the public interest prevails. This is evident in the R & D example outlined above, and in recent policy proposals developed by the TAG to radically simplify tax compliance for small and medium-sized enterprises (SMEs). (Simplification would reduce the tax compliance fees earned by members from clients but may improve the economic performance of SMEs.)

The New Zealand Law Society operates a Tax Committee that also engages in tax policy development. It is not as well resourced as the TAG and tends to focus more on the legal position of the policy, but it too is a respected participant in the GTPP. It also operates with the public interest as its key framework.

Another important participant is the Corporate Taxpayers’ Group (CTG), comprising 39 of New Zealand’s major corporate taxpayers. The CTG’s model includes a subscription basis (with corporate members funding through shared costs), secretarial support, submissions, and advice provided by major law and accounting firms. Unlike the TAG and the Law Society’s Tax Committee, the CTG’s primary focus is the interests of its 39 corporate members. However, it also pursues those interests within a wider public interest framework, recognizing that New Zealand is a highly interdependent and small economy.
The Big Four accounting and advisory firms in New Zealand also devote considerable senior resource and research capability to tax policy development. Partly this arises from the desire to be involved in the process, in order to remain in touch and retain professional credibility with their clients. But it also arises from a strongly held belief and tradition in these firms that contributing resources to tax policy development is in the best interests of New Zealand and the wider economy. Because the firms themselves are significant NZ businesses, they see this as an appropriate contribution to make.

Contributing to tax policy development in the public interest is not always an easy path for the private sector. Private firms must balance the (at times) competing interests of their clients (which themselves are often in conflict as between clients) and their own commercial interests (with respect to the expenditure of non-billable time on policy engagement), and competitive tensions between the various firms. Managing these conflicts while making a meaningful contribution with New Zealand’s best interests as the focus is, at times, a delicate task.

Having a shared understanding of what is in the best interests of New Zealand in the long run makes it possible to navigate a path through these conflicts. This shared understanding has been established and is maintained by extensive interaction between the private sector, government, and officials through forums such as conferences and working groups, and through open and constructive engagement. This climate of cooperation was further enhanced by direct and open access to the previous, long-serving minister of revenue (the Honourable Peter Dunne), who devoted considerable time and effort to meeting with and speaking to those working in the private sector. The Honourable Peter Dunne resigned as minister of revenue in June 2013. The new minister of revenue, the Honourable Todd McClay, has continued the previous minister’s high level of engagement with the private sector.

Because of the willingness of private firms to argue for what they believe is in New Zealand’s best interests, the private sector has a very important role in initiating policy changes as well as modifying proposals and making them work better. The process only works, however, if there is a willingness by officials and the government to engage and listen, and to accept good suggestions. As noted earlier, a key factor that makes the GTPP work well is the high level of buy-in by the private sector to the government’s BBLR framework.

**Consultation**

Much has been said about the importance of consultation. But what is consultation? Useful consultation will depend on the subject. In many cases, tax consultation works through the publication of consultative documents, and much of the consultation is with tax practitioners. This is often but not always appropriate. For example, for consultation on the taxation of charities, it was useful to run things in a much less formal way and have large informal meetings to discuss issues, including town hall meetings. This ended up involving people that the government might not otherwise have reached. For consultation on student loan arrangements, it was useful to have a blog and to release discussion documents through an online forum. For consultation
on the tax treatment of indigenous authorities, regional hui (meetings) were organized using indigenous networks.

Full-scale consultation is not required on everything, and is not always possible. At times, consultation may just involve discussions with key affected parties. With respect to base maintenance provisions, it is understood that often there cannot be full consultation, especially if tax changes are closing some loophole. This base maintenance exception to the GTPP is acknowledged and accepted by the private sector as being appropriate (although at times there are different views as to what qualifies as base maintenance).

THE ROLE OF INDEPENDENT TAX REFORM BODIES—THE VICTORIA UNIVERSITY OF WELLINGTON TAX WORKING GROUP

While the GTPP has led to very good links and considerable collaboration with private-sector tax practitioners, there have in the past been fewer links with the academic community. There has also been a limited pool of academics doing research on tax policy in New Zealand.

Concerns about New Zealand’s tax system had been voiced in Inland Revenue and Treasury briefings to incoming ministers following the election of a national government in November 2008. Both Inland Revenue and the Treasury were concerned about the integrity of the tax system, but the Treasury was also concerned about whether or not New Zealand’s tax structure, and in particular its reliance on personal and company income tax, was having an adverse impact on growth. There was a general concern about the fairness, efficiency, and effectiveness of current tax settings.

One approach to these concerns has been to consciously build a role for academic institutions into the policy process. In 2009, a Tax Working Group (TWG) was set up by the Centre for Accounting, Governance and Taxation Research at the Victoria University of Wellington, in conjunction with Inland Revenue and the Treasury. Although an independent group, the TWG was formed with the support of both the minister of finance and the minister of revenue. It was chaired by Professor Bob Buckle of Victoria University and brought together expert tax practitioners, academics, business people, and officials to consider key problems with the current tax system and options for reform.

The TWG proved to be a considerable success. It was a good forum for debate of the pros and cons of various tax changes. The TWG provided an open discussion process, with papers from the meetings and a record of debates being published on the Internet. This helped to inform the wider public on key tax policy issues.

The TWG reported in January 2010.6 It expressed concerns about the structure of the tax system and its reliance on tax bases that impeded growth; about the coherence,

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The TWG recommended a number of tax changes, including a reduction in personal tax rates and alignment between the company, trustee, and top personal marginal tax rates (or, failing that, at least between the trustee and top personal marginal tax rates). The TWG also recommended that a number of base-broadening reforms should be considered. In addition, it canvassed the possibility of a capital gains tax, while noting that most members of the TWG had significant concerns about the practical challenges of such a tax, and indicated that there was majority support for a land tax.

The government quickly announced that it would not introduce either a capital gains tax or a land tax, but the other measures recommended by the TWG were largely reflected in tax policy changes announced in the government’s budget in May 2010. In particular, the budget announced cuts in all personal tax rates, with the top rate falling from 38 percent to 33 percent. This aligned the top personal marginal tax rate with the trustee tax rate. There was also a reduction in the company tax rate from 30 percent to 28 percent, along with the base-broadening measures (including raising the GST to 15 percent) that had been canvassed by the TWG.

The TWG worked well from the government’s perspective. It allowed possible tax changes to be aired publicly and debated openly, and it brought the academic community into important tax policy debates. However, a large element in its success was the cooperation and engagement of key tax practitioners. This was built on the engagement and cooperation that had been built up through many years of working with the GTPP.

**THE ROLE OF THE MEDIA**

Tax policy matters are widely debated in the NZ media. This has been a phenomenon for many years, but it gained further traction with the wide public discussion on the work of the TWG. The media report tax changes and seek a wide range of commentary from private-sector experts, and they are prepared to give space to opinion pieces on tax matters. While this does not always result in consistently balanced reporting, it does raise the level of public consciousness with respect to tax policy matters and engages with the public on the tradeoffs in decision making.

For example, the introduction of a broad-based capital gains tax in New Zealand has for many years had little support. However, in recent years the issue has been canvassed extensively from all perspectives in the media, such that there is a vigorous public debate about the desirability or otherwise of such a tax.

The higher level of public sophistication around tax policy choices achieved by media coverage has helped governments to largely resist sector-specific pressure for a departure from the BBLR framework in several areas, such as the introduction of tax incentives targeted at particular industries or exemptions from the GST.

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COSTS AND BENEFITS OF THE GTPP

The GTPP provides a number of important benefits. It affords an explicit focus on how tax policy fits in with the government’s broader economic objectives. Consultation with the private sector on the development of the work program, combined with published information about the current work program, means that the private sector has a high degree of awareness of changes being contemplated. Because there is extensive public and private-sector consultation, by the time legislation is drafted officials normally have a very clear understanding of potential concerns. Private-sector views will often lead to changes in and improvements to proposed tax policies before legislation is introduced.

The more transparent the economic framework, the better the process works. As described above, there are constant interactions between officials and the private sector. This not only improves the particular policies being consulted on, but also creates a climate in which the government, officials, and the private sector are working together to do what is best for New Zealand as a whole. In addition, taxpayers can participate and raise issues of policy concern. Among tax practitioners, the GTPP is very well accepted. If practitioners feel that the GTPP is not being honoured, they will complain.

There are inevitably some costs associated with the GTPP. The process involves considerable time and resources for both the private sector and policy officials. It also means that tax policy reforms take longer to enact than would otherwise be the case, possibly resulting in the loss of certain strategic advantages for New Zealand.

As noted above, consultation can result in the improvement of policy proposals before legislation is introduced. However, this is not always the case. The willingness to consult and address every concern can also result in compromises being made to the detriment of good tax policy design, for both the government and the private sector. There is a risk that, in the process, the original policy intent may be lost.

Compromise does require tradeoffs to be made, but are those tradeoffs the right ones?

Also, consultation is based on the premise that interested parties will engage at the appropriate stage of the GTPP. A recent scenario highlighted the fragile nature of the GTPP. Although a full consultative process was undertaken, the depth of private-sector concern was not truly evident (at least from the perspective of government officials) until the bill was before a select committee. This resulted in a solid policy proposal being overturned at the 11th hour. In this case, perhaps officials and private-sector representatives were only talking past each other, and a degree of “consultation fatigue” set in.8

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Frequent and sometimes informal interaction raises the danger that officials may be “captured” by key people in the private sector. There is no perfect way of guarding against this. The process requires both officials and private-sector stakeholders to operate with high levels of integrity.

TRANSPORTABILITY OF THE GTPP

When considering the transportability of the GTPP, it is important to recognize that because New Zealand’s relatively small size facilitates interactions between key tax practitioners and officials, it is easier for the GTPP to work in New Zealand than would likely be the case in a much larger economy. The GTPP also works well in New Zealand because there is a clear and coherent policy paradigm that is well understood, and the private sector has bought into the process. To that extent, policy settings that are amenable to the GTPP will be less flexible than would otherwise be the case. For example, New Zealand’s BBLR framework requires reasonable alignment between the company tax rate and the top personal marginal tax rate. This is a reasonably inflexible paradigm if a government wishes to push up the top personal marginal rate or reduce the company rate.

RESOURCES DEVOTED TO THE FORMULATION OF TAX POLICY

For the year ended June 30, 2012, Inland Revenue’s Policy Advice Division had 43.5 full-time equivalent staff devoted to the formulation of policy advice. This figure includes policy analysts, managers, forecasting staff, and analysts seconded to ministerial offices. The Treasury has 8 full-time equivalent staff devoted to the formulation of policy advice, including manager time.

Inland Revenue policy analysts have a range of qualifications, mainly in the fields of law, economics, and accounting; some analysts also have an arts or science degree.

Professional development is encouraged, and analysts and managers regularly provide or participate in training in a number of areas. A professional development session occurs every week, with attendance encouraged for analyst staff. This session is led by policy managers or analysts and covers a range of topics, including current tax policy issues, current economic research, or the fundamentals of the NZ tax system (entity taxation, residence, fringe benefit tax, etc.).

Graduate analysts attend a “Principles of Taxation” course, which is a five-day residential course. All analysts attend a Tax and Policy course repeated on an 18- to 24-month cycle, with new case studies being presented in each cycle. (The current case study, for example, is a GST issue.)

Optional training includes courses covering the following:

- machinery of government
- microeconomics
- presentation/writing skills
New Zealand Institute of Chartered Accountants and Law Society one-day courses on a range of tax and/or legal issues
- a senior leaders technical conference (internal)
- regimes training (a four-day course)
- managing policy costs
- courses provided by the New Zealand Association of Economists
- select committee training
- OECD outreach (by nomination)

For the first seven years of an analyst’s career (from entry at the graduate analyst level to the level of senior analyst), salaries are aligned to market rates for similar roles.

For the year ended June 30, 2012, a small number of private-sector consultants were engaged at a cost of $135,641. However, regular input on a confidential basis is provided by interested parties in the private sector on an informal basis, as policy matters are developed and move through the GTPP.

Policy and Strategy does not regularly use temporary secondments from the private sector.

CONCLUSION
Tax policy works fairly well in New Zealand. An important reason is the formalized GTPP process, which encourages consultation early and often in the development of tax policy.

However, a good tax policy process goes beyond formalized consultation. For the GTPP to work well, there need to be coherent policy settings that the private sector can buy into. Moreover, a good tax policy process is not something that can be captured in a written road-map. It requires willingness between the government, officials, and the private sector to truly listen and engage. It is critical that the government be open to acting on good suggestions put forward by the private sector.

While the GTPP has led to a very open and collaborative approach to tax policy reform between tax professionals and the government, New Zealand has been less successful, until recently, in engaging with the academic community. The Victoria University TWG provided a good forum for such engagement, allowing major policy changes to be debated openly and leading to some major tax policy changes. Further work on collaborating on tax research is under way.

There will never be a finalized point with the GTPP. Tax reforms will continue, and so will consultation. Mistakes will be made. A strong benefit of the GTPP, however, is that by maximizing consultation and engagement with the private sector, the process ensures that tax policy development is as good as it can be, barring occasional mistakes. It also ensures that when mistakes are made, the framework for correcting them is already in place.
Tax Policy Making in the United Kingdom

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Keywords: TAX POLICY • POLICY MAKING • TAX LEGISLATION • PROCESS • UNITED KINGDOM

Contents

Introduction 1058
The United Kingdom’s Parliamentary Process 1058
General Description of the Tax Policy Process 1060
   Developing Ideas 1060
   Research, Information Gathering, and Study 1062
   Identification and Evaluation of Solutions 1062
   Drafting Legislation 1062
   The Legislative Stage 1063
   Post-Enactment Review Stage 1063
Government Departments and Others with a Role in or Responsibility for Tax Policy Formulation 1064
   Government Departments 1064
   Independent Advisory Bodies 1065
   Politics and the Role of Politicians 1065
Resources Devoted to the Formulation of Tax Policy 1067
Consultation 1068
   Issues Considered Suitable for Public Consultation 1069
   Stages of the Policy Process for Consultation 1069
   The Process for Public Consultation 1070
   Private Consultation 1071
   Politics and the Role of Politicians 1071
   Effectiveness of the Consultation Process 1071
Other Issues 1072
   Data Collection and Analysis 1072
   Transparency 1073
   International Organizations 1073
   Independent Tax Reform Bodies 1073

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INTRODUCTION

On December 3, 1798, the British prime minister and chancellor of the exchequer, William Pitt, rose in the House of Commons to deliver a budget speech that lasted only an hour but contained a key proposal for “a general tax [to be] imposed on all leading branches of income.” ¹ Pitt said he was a “late convert” to the idea of an income tax, but now he argued for it vigorously. Ultimately the proposal was adopted, but the debate in Parliament was fierce, as it was over the coming years as this new fiscal burden was refined and eventually (though temporarily) repealed.²

Two policy-making threads can be discerned from Pitt’s epoch-making move, which have affected all the countries represented at this conference. First, behind Pitt there were clearly some nameless officials who did a good deal of preparatory work. Second, genuine political debate ensued in Parliament that analyzed and tested this tax idea, and continued to do so over the years. No doubt the latter at least was influenced, to a degree, by what we would now call the media.

The point is that a huge shift in tax policy was effected within Parliament and officialdom. Over the succeeding 200 years or so, arguably not a lot changed. But in the last 20 years or so, that picture of tax policy being brewed and hatched centrally, usually behind closed doors, has changed a good deal in the United Kingdom. We now have a generally more open, consultative approach to tax policy making—though that is never guaranteed, and (as if to remind us that Parliament, and more particularly the government, is in charge of tax policy making) at times policies emerge through a process that Pitt might recognize.

THE UNITED KINGDOM’S PARLIAMENTARY PROCESS

Before examining the United Kingdom’s tax policy-making process, it is necessary to consider the parliamentary procedures that apply to tax changes. The reason is that these procedures have a huge influence (as they must in other parliamentary democracies) on how tax policies are developed. The path of tax legislation through Parliament in the United Kingdom is swift (in legislative terms) and relatively painless (for the tax authority).³

The normal procedure is that the budget speech is delivered in mid-March.⁴ That speech may announce changes to take effect almost immediately, at the start

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¹ Hansard, quoted in B.E.V. Sabine, A Short History of Taxation (Butterworths: London, 1980), at 115-16.
² The income tax was repealed in 1816 but reintroduced, in substantially the same form, by Robert Peel in 1842.
³ The United Kingdom has an almost entirely centralized tax system, with Westminster controlling almost everything. Some devolution of taxing powers to Scotland and the Scottish Parliament in Holyrood is taking place, and calls have been made for Wales and Northern Ireland to have similar limited fiscal autonomy.
⁴ There was a relatively brief experiment in the 1990s with the budget speech taking place in November/December. That swept in the “autumn statement”—the mid-year economic
of the coming tax year,⁵ or at a later date. The speech is followed by some days of political debate and a formal order for the finance bill to be printed.⁶ A few clauses in the finance bill are considered by a Committee of the Whole House (the full House of Commons). But the bulk of the bill is sent off to a standing committee of around 25 to 30 members of Parliament (MPs) who, in principle, work through it line by line.⁷ That process takes place in May and June; around the end of June or early July, there is the report stage and third reading of the finance bill in the House of Commons. By this time the bill is substantively enacted.

But what, you may ask, is the House of Lords doing? The answer is, virtually nothing.⁸ The Lords have a single day to debate the bill (under two hours in 2013!) and are not able to either alter it or delay it.⁹ Their part in the process normally takes place in July, and royal assent will be given before the end of the month.¹⁰

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⁵ Bear in mind that the United Kingdom continues to use the eccentric April 6 as the start of the tax year.

⁶ The “budget resolutions” proposed by the chancellor of the exchequer provide the necessary authority for certain tax changes to take effect on budget day (usually changes in excise or stamp duties) and are voted on at the end of the debate on the budget speech. The resolutions also provide the authority needed for measures to be included in the finance bill.

⁷ There is no provision for the committee to take evidence or input in any form from outside experts, though some professional and trade bodies do try to influence the debate by sending in briefing papers to committee members.

⁸ The House of Lords Economic Affairs Committee has, on its own initiative, established a finance bill subcommittee. In recent years, the subcommittee has selected a small number of finance bill measures (usually politically uncontroversial ones) for examination and report following the budget. The subcommittee employs two former senior policy officials (retired from HM Revenue & Customs [HMRC]) as part of its secretariat and has taken evidence from outside individuals (including both authors of this paper) and interested bodies. In 2013, the timing of the subcommittee’s work moved to January, following the government’s publication of draft finance bill legislation with the autumn statement in the previous December. It is too early to say whether the subcommittee’s work will have any influence on the eventual content of the bill, although in 2013 an important change was made to the draft general anti-abuse rule after an issue was raised in evidence to the subcommittee and the subcommittee subsequently raised the issue with HMRC.

⁹ Legislative authority to determine the content of a “money bill”—essentially, a tax revenue-raising bill—is reserved to the House of Commons, with the Lords having no power to alter or delay it.

¹⁰ The pace of the bill’s passage through Parliament has been dictated by the Provisional Collection of Taxes Act, which preserves the right to levy the main direct taxes for the current tax year provided that a bill renewing those taxes is enacted within a specified period (originally one expiring in early August but now extended to October).
The result is that the government of the day can all but guarantee that a tax change is on the statute book within four months from the first announcement.\textsuperscript{11} Amendments to the government’s draft will be few and normally only what the government wants; the built-in majority on the committee ensures this. More subtly, since there is a guaranteed finance bill every year, an almost limitless number of tax changes can be pushed through in short order.\textsuperscript{12}

Some observers may also reflect that, through acceptance of this procedure, the United Kingdom’s parliamentary system becomes unicameral in what is arguably its most important function, namely, raising tax revenues. The remainder of this paper will examine how the policy-making approach puts some better mechanisms—checks and balances perhaps—around the powerful legislative process that the government of the day has at its command.

\textbf{GENERAL DESCRIPTION OF THE TAX POLICY PROCESS}

\textbf{Developing Ideas}

Where do ideas for changes to the tax system come from? The trite answer might be, “Everywhere.” Certainly, in the United Kingdom many people have an interest in changing the tax system, and views are widely expressed. But that means of influencing public policy is essentially informal; there is no formal process for those outside government to contribute ideas to generate changes in the tax system.\textsuperscript{13}

Most ideas for change are generated by HM Treasury (HMT), HM Revenue & Customs (HMRC—the UK tax authority), and, of course, Treasury ministers. The creation of HMRC in 2005 (merging the previous Inland Revenue and Customs & Excise) also introduced “the tax policy partnership.” This links HMT and HMRC: both are supposed to have a role in policy making. In broad terms, HMT is concerned with overall policy (for example, “Should we have corporation tax?”) while HMRC is concerned with operational aspects (for example, “How should the controlled foreign company [CFC] rules operate from day to day?”). Inevitably there are a lot of overlaps: basically, both sides will be involved to a degree in everything and will certainly be involved in broader operations (such as “Should we have CFC rules?”), or minor policy concerns. We will return to the issue of the overlap between HMT and HMRC later in this paper.

\textsuperscript{11} There is one major exception to this speedy process: national insurance contributions (NICS—the United Kingdom’s social security tax and the second biggest revenue raiser for the government). NICS are not officially a tax, and changes have to go through the normal parliamentary bill process, usually as part of a social security bill. Perhaps that is why much of NICS is governed by secondary legislation.

\textsuperscript{12} Suggestions for tax changes are sometimes met with the excuse that “there is no space in the finance bill for such things.” Since the bill currently before Parliament is some 615 pages—a length beaten only by 2012’s 680 pages—that excuse appears a little hollow at times.

\textsuperscript{13} Though the Treasury did recently experiment with inviting comments via its website prior to the autumn statement. As yet, there has been no report back on the results.
The two departments have the focus that might be imagined, and that does accord with the tax policy partnership. It is HMT’s job to consider major tax changes—perhaps driven by the simple need to raise money. HMT will also be the department that considers how to use the tax system to address shortcomings in business behaviour.

HMRC will see the need for changes because of shortcomings in the existing rules. That perception by HMRC can in turn come from a number of sources, including

- front-line staff—difficulties with running the system;
- avoidance—seeing avoidance take place; and
- representations—submissions from taxpayers, agents, business and professional bodies, etc.

Those representations may also go to HMT; indeed, many will be initially addressed to the chancellor of the exchequer. But most will end up with HMRC at some stage.

One major factor that currently affects UK policy development is the existence of a coalition government with a formal coalition agreement. That agreement has some major policy shifts (for example, “[w]e will increase the proportion of tax revenue accounted for by environmental taxes”)\textsuperscript{14} but also includes some quite detailed provisions (such as reforming the taxation of holiday rentals in line with EU requirements). This has given the United Kingdom some long-term planning frameworks in some areas—an approach that is relatively unusual in tax terms. A development has been a commitment by the chancellor to a competitive business tax system (indeed, to make it the most competitive in the Group of Twenty), leading to a clear direction of development for the corporation tax system, at least as far as rates are concerned. This framework has had useful benefits and has led to calls for more use of similar overrides.

We must also not ignore the European Union. Overriding rules emanating from Brussels may force some changes to the UK tax system, but in the direct tax field,\textsuperscript{15} the main impact comes from cases before the Court of Justice of the European Union that show that the United Kingdom’s tax rules are in breach of EU treaty principles in some way. The changes to holiday rentals referred to above are one example; another is the changes being made in the Finance Act 2013 (FA 2013) to the system of exit charges.\textsuperscript{16} Typically, the UK rule is found to discriminate in favour of the United Kingdom in some way (for example, the tax privileges for furnished

\textsuperscript{14} See United Kingdom, HM Government, \textit{The Coalition: Our Programme for Government} (London: Cabinet Office, May 2010) (www.gov.uk/government/publications/the-coalition-documentation), at 31. A subsidiary agreement led to the creation of the Office of Tax Simplification (OTS)—a significant decision for at least one of the authors of this paper.

\textsuperscript{15} The European Union has greater competence in the field of indirect taxes, in particular customs duties and value-added tax (VAT).

\textsuperscript{16} United Kingdom, Finance Act 2013 section 229 and schedule 49.
holiday rentals were for UK properties only) or to breach freedom of establishment rules (for example, the exit charges for companies moving businesses to other states within the European Union or the European Economic Area).

**Research, Information Gathering, and Study**

Much tax research, information gathering, and study is carried out through consultation (discussed below). Apart from consultation, this type of work tends to be internal. The policy teams in HMRC and HMT will do their own research and study, and gather information from their own systems. The amount of information contained within those systems must not be underestimated—and, naturally, that information is not available to those working on policy outside HMRC and HMT.

One key contributor to this process is the Knowledge Analysis and Information (KAI) team in HMRC. This is a significant unit of economists and analysts who essentially “do the numbers”—work out estimates for tax yield/cost on proposals. They will have input at various stages of the policy process: again, with their access to HMRC data, they are able to do far more than external groups.\(^{17}\)

HMT and HMRC will occasionally carry out research projects to gather further information, but this seems to be unusual at the early policy-making stage. One recent example is a joint project carried out with the Office of Tax Simplification (OTS) when the OTS was working on a simpler system for the smallest businesses. That led to proposals for a cash basis for the smallest businesses, a revised form of which is in the FA 2013. Research seems to be more frequent in terms of gathering data to input into operational matters, and therefore tends to be carried out by HMRC rather than HMT.

**Identification and Evaluation of Solutions**

HMT and HMRC share responsibility for identifying and evaluating solutions. Recommendations are made to ministers, who make the final decision as to which route to follow. If the consultation process has worked properly, by now there should be a good deal of input to draw on.

**Drafting Legislation**

Legislative drafting is carried out by the Office of Parliamentary Counsel (OPC). This is a separate unit of legal draftsmen (now based in the same building as HMRC/HMT) who work on all government legislation. There is a certain amount of specialization, but tax law is not drafted by a tax lawyer as a matter of course.

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\(^{17}\) An interesting sidelight on this is the debate in the United Kingdom about the “tax gap”—the difference between the projected and the actual yield of taxes. The KAI estimate is currently about £35 billion—approximately 6 percent—with avoidance costing around £5 billion. Some campaigners have suggested that the figure should be many times greater, but one cannot help feeling that with its access to all the HMRC data, KAI is likely to be closer to the real figure.
The OPC works from instructions provided by HMRC. Those instructions (which are not published) are intended to set out the purpose of the new provision and how it is to be effected, providing as full a picture as possible. That is turned into legal language by the OPC team. It is often said that any problems with the eventual result are down to shortcomings in the instructions, which do have to be totally clear and comprehensive. However, a bigger problem is often time pressure. As described above, the legislative process is tight as far as time is concerned; often decisions to proceed are taken at the last minute. If problems are identified during the actual passage of the bill, there is considerable pressure on the draftsman to come up with the answer in almost real time.

There have been some experiments with using private-sector assistance to draft material. Broadly speaking, we believe that HMRC has not regarded these experiments as offering significant improvement or, indeed, as being especially successful.

The Legislative Stage
The legislative process has been described above.

Post-Enactment Review Stage
Post-enactment review of tax policy is largely lacking in the UK process. It is rare that a provision is passed with any formal commitment to a post-implementation review. Sunset clauses are almost unheard of. The OTS identified the lack of proper review of tax law after implementation as a contributor to complexity in its report on tax reliefs; specifically, too many relief provisions seemed to have just been left on the statute book without any attempt to see if they still served a useful purpose or had a continuing application. As a result, relief provisions remained that had drifted away from their original policy aim, and in some cases were simply not doing the job that they were supposed to be doing.

Professional and trade bodies have often made the point that in the business world, new projects are invariably reviewed for effectiveness after implementation.

18 HMRC is unique in that policy officials (and not HMRC’s lawyers) brief parliamentary counsel. In all other government departments, the departmental lawyers brief parliamentary counsel.
19 From the late 1990s until 2010, the United Kingdom pursued a “tax-law rewrite” under which all income tax and corporation tax legislation was rewritten in a new, “simpler” style. The rewrite team was organized and run from within HMRC and included draftsmen seconded from the OPC. Generally speaking, the change in drafting style established by the rewrite has been maintained in subsequent finance acts.
20 There have been examples of changes made by secondary legislation that have been required to be enacted in primary legislation within a specified time.
21 Sticking to its principles, the OTS recommended that its proposed disincorporation relief should be time-limited. That is being carried through in the FA 2013, with the relief having a five-year life.
Apart from making sure that projects are working as intended, there is an interest in learning lessons from the process. Why should a similar process not be used, as a matter of routine, for tax changes of significance? Partly this may be a result of the way that policy is staffed: typically, a team is built up in HMT/HMRC to develop a new policy and carry it through to legislation. Once the legislation is on the statute book—or even before then—the policy team is usually disbanded, and the ownership of the new matter is handed over to the operational side. Operational staff may have had limited involvement in the development of the policy; their job is to make it work. It may be that making the legislation work reveals issues that need to be attended to through legislative change, but there is nobody with an interest in standing back, taking stock of the new provision, and asking the question: Is it working as intended? And, more pertinently, is it raising/costing the money envisaged?

It would be wrong to say that such reviews do not happen. Some do: but they seem to be haphazard and may be driven by political considerations as much as anything. Two recent examples can be cited:

1. The introduction of the 50 percent top rate of income tax in 2010 was inevitably a source of much debate and political argument. The yield of the measure was always going to be studied, and figures have been produced to show that it had a negligible (or even negative) yield. That paved the way for a cut in the rate to 45 percent from April 2013.

2. At the smaller end of the market, the new government introduced relief from national insurance contributions (NICs, the social security tax) for a small business taking on extra staff. This was targeted at areas outside London and the South East. However, data came in to suggest that the relief was ineffective and little used. The government took the sensible decision to scrap it and introduce a much simpler cut in pay-as-you-earn (PAYE)/NIC bills.

**Government Departments and Others with a Role in or Responsibility for Tax Policy Formulation**

**Government Departments**

HMT and HMRC are the main departments involved in tax policy formulation. As noted earlier, they have a joint responsibility, with HMRC having responsibility for administration of the tax system.

At least two other government departments have an interest in tax matters and may promote changes:

1. The Department for Work & Pensions (DWP) is responsible for many benefits, some of which are taxable (such as the state pension). A major reorganization of the UK benefits system is under way, which will see the emergence of universal credits (under the DWP) and the demise of child and working tax credits (under the control of HMRC).
2. The Department for Business, Innovation & Skills is involved in projects around general business promotion, and particularly the promotion of employee share ownership.

HMT continues to have overall responsibility for tax policy formulation and will make sure that it is involved in projects of other departments that affect tax.

**Independent Advisory Bodies**

Royal commissions seem to be a thing of the past. Review committees likewise seem rarely to be used. One recent example of the use of an independent body to review an aspect of the tax system has been the working group set up under Graham Aaronson, QC, to consider the case for a general anti-avoidance rule (GAAR) in the United Kingdom. That approach seems to have been successful in many ways, and it is clearly possible that it will be emulated for some future projects where there is a probable need for a solution but a genuine uncertainty about whether and how to proceed.

Another interesting case study in the use of differing mechanisms has been the evolution of a statutory residence test (SRT). The SRT has its origins in submissions to the government from a number of professional and trade bodies arguing that there was a need for such a test. The minister concerned effectively challenged the bodies to work together (and with other groups) to make the case for an SRT and formulate a basic outline for one. Over five years later, the SRT has now been enacted in the FA 2103.

**Politics and the Role of Politicians**

As in every country, politics is a factor in tax policy making in the United Kingdom. The coalition agreement has already been noted. Ministers have the ultimate role in tax policy making: any initiative will have to be signed off by a Treasury minister.

Individual politicians take varying amounts of interest in the tax system. Some will pursue issues raised by constituents, often business-linked. Realistically, their chances of achieving change are limited, but there will be occasions when ideas are taken up by ministers and the Treasury.

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22 The Keith committee was a group that considered the powers of the taxman in the 1980s and produced seminal reports that were largely implemented. When it was decided, sensibly, to carry out a thorough review of the taxman’s powers following the creation of HMRC (not least to try and harmonize them across the newly merged department) many called for “Keith Mk 2,” that is, a full review by an independent group. This was not heeded: instead HMRC set up their own project team to carry out the work. This was carried through well, but lacked the objective independence of the original.

23 Note that HMRC is a “non-ministerial” department—that is, it is not under direct ministerial control, in order to avoid any suggestion of political interference in the administration of the tax system.
Politicians have the most impact on the tax system through parliamentary committees. There are two key House of Commons committees:

1. The Treasury Select Committee (TSC) has formal responsibility for oversight of the Treasury’s functions and the tax system generally. Committee reports are influential, but the TSC cannot initiate change as such.
2. The Public Accounts Committee (PAC) has the role of overseeing the government’s spending but of late has increasingly concerned itself with the running of the tax system. A particular interest is corporate tax avoidance. The PAC cannot directly affect tax policy, but its findings and reports have influence (particularly, at the moment, through media coverage).

There are all-party parliamentary groups that focus on specific issues and will promote changes to help their particular interest area.24 There is an all-party tax group, but it is (perhaps surprisingly) small and focuses on operational issues rather than tax policy. (This may demonstrate how political an issue tax is, in that it is difficult to get a mixed group of politicians together to develop common ideas.) Occasionally an MP will secure a debate on a particular tax issue, to which a Treasury minister will respond. Backbench MPs on the Finance Bill Committee will raise points and propose amendments, but hardly any of the latter are taken up by the government. The (subliminal?) message is that the finance bill is going through as HMT/HMRC/the government intended.25

One important point to make in the context of politicians is the lack of tax expertise for them to draw on. While Treasury ministers draw on HMT and HMRC, the average MP of any party has no such access. MPs can develop information through the use of parliamentary questions, and they can do their own research. But there is a distinct lack of technical support on tax matters—there is no equivalent of the US Congressional Budget Office for MPs to draw on. Firms and professional bodies will contribute some resources to help, particularly to the Opposition party/parties and particularly around the finance bill process. That enables more challenges to legislation to be mounted than might otherwise be the case. But the lack of available

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24 For example, one on “micro businesses,” which has been active in arguing for simpler tax systems for such businesses.

25 Backbench successes against government opposition are memorable because they are so rare. In the 1970s the “Rooker-Wise” amendment required annual indexation of personal allowances (the annual exempt band of income and gains), and in 1995 a backbench amendment required HMRC to produce a report on tax simplification, which eventually led to the tax-law rewrite program. More general political pressure in Parliament may well lead a government to change tack on particular legislation before any risk of defeat on a backbench amendment materializes. As a general matter, however, the government always commands a majority, and its backbench MPs will not want to be seen to inflict a parliamentary defeat on the government with such an important bill as the finance bill.
technical (and practical) tax expertise for politicians is something of a handicap—though it does result in policy being developed solely through HMT/HMRC.

RESOURCES DEVOTED TO THE FORMULATION OF TAX POLICY

HMT’s tax policy-making group is around 120 strong. Some have a tax background (mainly from HMRC), but most do not. They tend to be relatively young; few will have worked outside Whitehall. There is a developed tradition in the UK civil service of the generalist, often moving from post to post in different departments to gain experience. Tenure can be short—two years is a long period. Those formulating policy may be experts in policy development and the workings of the “government system”; they will usually lack the in-depth tax knowledge that might be expected.

This, of course, is where HMRC comes in. That organization has some 67,000 staff (around 17,000 tax professionals). It can contribute knowledge of the tax system; it should also be able to contribute relevant tax technical expertise. But even with the combination of HMT and HMRC there can be a lack of understanding of the real potential impact on taxpayers, both individual and (especially) business—which is where consultation enters the picture (or should do).

Private-sector consultants are used occasionally, though these are likely to be specialists in areas such as systems or environmental matters rather than tax experts. Both HMT and HMRC are readier to hire people who have private-sector experience than they used to be, though these would be staff hirings rather than contracting a consultant for a project. The advice of outside specialist tax counsel, on both existing and proposed tax legislation, may on occasion be sought as part of the policy development process.

The issue of temporary secondees is a very live matter. Both HMT and HMRC have for some years taken in a small number of secondees from the private sector, mostly unpaid. This is sensible: HMT and HMRC gain practical insights from secondees, who in turn develop an understanding of the policy-making process. Secondees will no doubt return to the private sector with a good knowledge of the area they have been working on. What has made this a political hot potato is the claim by the PAC that (in effect) secondees are able to ensure that there are loopholes in the legislation that they have been involved with, and they are then able to return to their firms and exploit the loopholes for the benefit of their clients. It remains to be seen how this issue will be resolved, but it would surely be to the detriment of all if the secondment into tax policy making of a few people from the side of the taxpayers were no longer possible.

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26 As an example, the recently appointed head of the HMT tax group is from a civil service background but spent a good portion of her recent career with Accenture.
CONSULTATION

Consultation is a major feature of the UK tax system. Over the last 20 years or so, the amount of consultation has increased markedly, to the point that it is the norm. Given the speed of the finance bill process, it will be observed that good prior consultation is a very necessary balance. The fact that measures have been subject to consultation is having an influence on that process, though this does not—yet?—extend to a certification that the legislation has been reviewed through consultation, or to any requirement for government to respond to issues raised by consultee bodies.

The United Kingdom has no formal private-sector body involved in tax policy development or consultation in the manner of the Australian Tax Practitioners Board or (for economic policy) the UK Office for Budgetary Responsibility. Various bodies do get involved—professional bodies such as the Chartered Institute of Taxation (CIOT), trade bodies such as the Confederation of British Industry (CBI), specialist groups such as the Low Incomes Tax Reform Group, and think tanks such as the Institute for Fiscal Studies (IFS)—and they do liaise and at times coordinate efforts. But most are essentially volunteer-led.

Though consultation is neither compulsory nor formalized, it is now enshrined as normal practice thanks to the current government’s new approach to tax policy making (TPM) introduced in 2010.

27 Most of the comments in this paper are made with reference to the processes for primary legislation. The United Kingdom makes significant use of secondary legislation (statutory instruments or SIs), normally for the mechanical or administrative aspects of rules that have been laid down in primary tax law. There is no hard-and-fast rule as to when law is laid down wholly in primary legislation or when secondary legislation is used. Sometimes it seems to simply come down to expediency, though all sides prefer all the real rules to be in primary tax law. The policy issues discussed in this paper do not really apply to SIs. Some will be consulted on through drafts being exposed, normally informally to professional bodies and often on a short time scale. HMRC also produces a large amount of guidance material that will be non-statutory but naturally persuasive. In recent years, HMRC has started to send drafts of such material to professional bodies for comment—a change in practice that is surely constructive.

28 But see infra note 30 regarding the role of the Tax Professionals Forum established by the coalition government.

29 HMRC does now publish, in certain cases, consultation response documents that record the main points made in consultation and include some explanation of why the government has or has not accepted particular points.

30 See the initial document, United Kingdom, HM Treasury and HM Revenue & Customs, Tax Policy Making: A New Approach (London: HM Treasury, June 2010) and the response document, United Kingdom, HM Treasury and HM Revenue and Customs, The New Approach to Tax Policy Making: A Response to the Consultation (London: HM Treasury, December 2010). The government has appointed a Tax Professionals Forum (of which one of the authors of this paper is a member) to monitor TPM and to report annually on its success or otherwise. For further information, see www.gov.uk/government/policy-advisory-groups/tax-professionals-forum.
Issues Considered Suitable for Public Consultation

TPM commits to consulting on everything but naturally makes some exceptions:

- **Tax rates.** This is basically (and understandably) a decision for politicians.\(^{31}\)
- **Avoidance.** Consultation on whether to block an apparent loophole seems unlikely, but consultation on the actual blocking changes is sensible and increasingly done unless revenue is put at risk.\(^{32}\)

Stages of the Policy Process for Consultation

Consultation is something that needs to take place in proper stages and over a sensible time scale. TPM recognizes this and sets out three main stages in the development of tax policy:

- **Stage 1:** set out objectives and clarify options.
- **Stage 2:** determine the best option and develop a framework for implementation.
- **Stage 3:** draft legislation to effect the proposed change.

The expectation is that there would be consultation at each stage. The norm for the consultation process is set at 12 weeks, though inevitably this is not always met. The TPM document identified the need for the following improvements in the process:

- Consultation should be provided for at each identifiable stage, where it is proportionate and practical to do so, and where revenue is not at risk.
- Where there is no consultation at a particular stage, explain why.
- Set out the stages of the policy cycle.

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31 Though some might argue that there is plenty of scope for consulting about the impact of rate changes. Examples might be the recent UK experiment with a 50 percent top rate of income tax and a previous sudden increase in oil taxation rates.

32 The point being that consultation can help to ensure that the measure is properly targeted. However, such consultation can be frustrating: a current UK example is capping of income tax relief. In the 2012 budget, a plan to cap the amount of relief for individuals was announced in the wake of some publicity about “nil bills” for some very high net worth individuals. Consultation produced some changes, including dropping charitable donations from the ambit of the provision. But the result, in the FA 2013, risks affecting valid diversification of enterprises, and has led to a feeling that consultation should have taken place on how best to tackle the mischief, instead of simply focusing on the details of a chosen method. The failure to consult on this measure is unclear, given that we believe that it was preceded by detailed work within HMRC and was not a last-minute policy announcement. Possibly it was judged that prior consultation might offer too great an opportunity for the measure to be frustrated by opposition to it (as the exclusion of charitable relief illustrated).
- Set out the clear policy objectives, assumptions, and impact analysis.
- State who is leading on each consultation and set out a strategy for stakeholder engagement.

This translates to the following ideal cycle:

- March, year 1: budget speech announcing that the government plans to change the tax treatment of something and setting out the reasons
- May-August: consultation on how the change might be effected
- September-November: response document and announcement of the route to be followed; consultation on mechanics
- December: publication of draft legislation, with explanation of proposed route and method; comments invited, normally until late February
- March, year 2: budget speech confirming that the change will take place and how it is to be effected
- End of March: Finance bill published
- May/June: Finance bill debated; possibility of final amendments following submissions to HMT/HMRC and politicians
- End of July: royal assent

The new provisions may be effective from a variety of dates—sometimes April of year 2 (often quite reasonable, since the draft legislation will have been available for some months); sometimes from royal assent; sometimes from a later date (possibly even April of year 3).

One important feature of consultation is feedback—an explanation of why a particular route has or has not been chosen. In a sense, those who contribute to the process deserve evidence that their input has been received and considered. The stages and timetable set out above encourage such feedback, and it is increasingly a feature of the consultation process, often in the form of a “response document” that summarizes the responses to the questions posed and the government’s decisions on the way forward.

The Process for Public Consultation

The main method of initiating the process is the publication of a consultation document that invites responses (paper or electronic) by a set date. As noted above, the target is to allow 12 weeks for the consultation period; this is not always kept to, but the record in recent years is generally good. Bodies such as the CIOT will often make the point that a proper consultation period will allow better information gathering from members (for example, via a member survey on an important issue, or at least proper time to have technical committee meetings to consider the matter), and thus produce a better-founded response.

HMT/HMRC will, on occasion, set up special meetings to publicize the issue under consideration and to solicit views from a wider group, or at least target a particular group or sector from which input is clearly needed. These meetings may take
place during the consultation period—emphasizing that the policy development process is continuous.

**Private Consultation**

HMRC will also on occasion, arrange for private consultations (“soundings” may be a better term) regarding an idea that is under development. This seems a sensible use of trusted contacts, provided that it is only a “sense check” before the open consultation process.

**Politics and the Role of Politicians**

Consultations have to be signed off by ministers. The current government is seen to be supportive of proper consultation and keen to ensure that open consultation is properly carried out. At the same time, political considerations can force decisions in advance of proper consideration of alternatives or simply truncate the time available for consultation. At times, consultees are told that “ministers have decided” on a particular route. While that is a demonstration of what ministers are there to do, it can be very frustrating when evidence seems to be mounting that there may be a better route. Officials will only very rarely go back to the minister to ask for reconsideration.

**Effectiveness of the Consultation Process**

Consultation is effective—if it is allowed to be. Consultation is now well established as part of the process of tax policy making in the United Kingdom. Tax professional bodies and business groups are well geared to consider and respond to consultations. HMT and HMRC in turn are used to develop new ideas through consultation, against a proper time scale.

The acid test is really whether proposals are modified in the light of well-informed and sensible input during consultation. One of the most frustrating features of consultation is feeling that participants on the government side are only going through the motions in what might be termed a “tick-the-box” exercise. That complaint has been made strongly in the past, and seems to have been absorbed; today it is less of an issue, but there are still frustrations when consultation only starts partway

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33 A decision in 2011 to withdraw the child benefit—a universal payment, historically tax-free—from the “higher-paid” was clearly, and probably understandably, made on a political need basis. The problem was that there was no opportunity to discuss how best to achieve the broad objective; the resulting mechanism is complex, to say the least.

34 There is, though, arguably a distinct danger of “consultation fatigue” setting in. The full process now being followed requires three stages of input, whereas in the past only one response would be required. That does not necessarily mean three times as much effort, but it does mean much more work for representative bodies. The payback for the increased number of stages is more chance to influence, but the burden on volunteers and the limited number of paid staff is beginning to be a problem. Of course it is all worthwhile if consultation input is listened to.
through the process, so that there is no chance to influence the actual design of the change. Perhaps that is always going to be the case—though if consultation were a requirement rather than “best practice,” it might help.

Consultation also requires good engagement from consultees. UK policy makers seem to have that available. But the opportunity must not be abused. Consultees do not, of course, expect to be paid for their trouble, and some are undoubtedly lobbying for an advantage to their sector. But most are participating in a genuine attempt to make the system operate better and, in particular, to make it less burdensome on those who will have to comply with the new rules. The need for proper response documents to give feedback has already been noted. Fundamentally, consultation should result in sensible points being taken into account, especially on practical aspects. The United Kingdom’s process scores reasonably well in all of this, though occasions when the wheels come off serve to show that a satisfactory outcome is not guaranteed (and perhaps also serve as a useful reminder for the authorities).

OTHER ISSUES
Data Collection and Analysis

The work of the HMRC KAI unit has already been mentioned, and the KAI team does provide high-quality data on proposals. The problem is that KAI’s expertise is not available to taxpayers and their representatives, nor is there a comparable organization in the private sector that is able to help develop responses to proposals. Thus, private-sector responses to proposals usually lack costing data; or what seem like sensible contributions can turn out to be based on a misunderstanding of a proposal’s effect. It would undoubtedly be useful to have a KAI-style organization available outside HMRC/HMT to improve the quality of responses.

35 For example, the GAAR consultation document of June 2012 (United Kingdom, HM Revenue & Customs, A General Anti-Abuse Rule: Consultation Document (London: HM Revenue & Customs, June 2012)) attracted over 14,000 responses, with 169 substantive ones that replied to the questions posed.

36 The 2012 budget launched a number of changes, including some seemingly minor technical amendments to VAT (goods and services tax) that were to take effect in October. Some of the changes set out in the budget were clearly planned to reverse losses by HMRC in tax cases. However, several were widely attacked as having a much bigger impact than had been anticipated. An example was the changes around the taxation of hot takeaway food, which led to “pastygate” (when the tax treatment of meat pasties became a particular cause célèbre). A better route would surely have been to announce a plan to consult on certain areas of difficulty that were clearly giving rise to contentious boundary issues in practice, and go into things with an open mind. The process would have taken six months longer but would have got to a better—and probably smoother—result.
Transparency
Inevitably the process of tax policy making is not fully transparent. The consultations that take place are a major contribution to transparency, and parliamentary debates are, of course, public. But many decisions are taken on the basis of “advice to ministers,” which is not published. External groups that have contributed to the policy development process through consultation have to trust that the advice is given fairly. But such advice has the potential to override a lot of preceding work and expert input.

International Organizations
As noted earlier, the European Union has an influence on UK tax policy making, given the need to consider EU rules around such matters as competition and non-discrimination, and prohibitions on support for particular sectors.

Independent Tax Reform Bodies
Professional bodies such as the CIOT have a certain influence, as do business bodies such as the CBI and the Federation of Small Business. There are a good number of think tanks, such as Reform, with the IFS at the top of that sector. The Oxford Centre for Business Taxation has built a good reputation and is increasing its influence.

The IFS has an outstanding reputation for input to debates on overall policy matters, backed by their analysts. Exeter University and the IFS are responsible for the operation of the Tax Administration Research Centre, which was launched on January 1, 2013 with the benefit of substantial funding from the Economic and Social Research Council, HMRC, and HMT. The centre has been set up to undertake research on tax administration, with a view to strengthening the theoretical and empirical understanding of tax operations and policies. Its research is multidisciplinary, and the research team involves economists, accountants, experimentalists, and psychologists. An important role of the centre is to build capacity for future tax research.

We must also mention the Mirrlees report,37 which was produced by a group coordinated by the IFS, and which set out a major analysis of the UK tax system and how it might be reformed.

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The Process for Making Tax Policy in the United States: A System Full of Friction

Eric Solomon*

KEYWORDS: Tax policy • Policy making • Tax legislation • Process • United States

Contents
Introduction 1075
Federal Tax Legislation 1077
Sources of Legislative Ideas 1077
The Federal Tax Legislative Process 1080
Government Officials Involved in the Tax Legislative Process 1081
Some Observations About the Current Legislative Scene 1082
Regulations 1083
Conclusion 1085

Introduction
The American Revolution (1775-1783) resulted in the independence of 13 of Great Britain’s North American colonies. In the 1780s, leaders of the new American nation realized that the national government, formed under the articles of confederation, was too weak. In 1787, representatives of the new states met in Philadelphia to consider ways to strengthen the national government, although many of them feared that a national government with enhanced authority had the potential to usurp power from the states and oppress the people.1 The result of the Philadelphia convention was the US constitution. The constitution gave many additional powers to the national government. At the same time, the constitution addressed the fear of

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1 The Declaration of Independence (1776) asserted that the reason for severing ties with Great Britain was the abusive exercise of power by the British government: “The history of the present King of Great Britain is a history of repeated injuries and usurpations, all having in direct object the establishment of an absolute Tyranny over these States.” A long list of alleged oppressions follows this statement, including “imposing Taxes on us without our Consent.”
governmental abuse by creating a structure with checks and balances, including a bicameral legislature, an independent executive, and an independent judiciary.2

This system of checks and balances fundamentally affects the formation of policy in the United States today, including the formation of tax policy. Ultimately, federal tax legislation in the United States must be approved by both houses of Congress (the House of Representatives and the Senate) and signed by the president (or, if the president vetoes the bill, Congress must override the veto). This legislative structure creates the framework for the development and enactment of US federal tax laws. This structure is quite different from the structure in many other countries, including, for example, countries with a parliamentary system of government.

Legislation is not the only vehicle by which US federal tax policy is made. It is made in various additional ways, including

- Treasury department regulations,
- other published guidance by the Treasury department that is generally applicable to all taxpayers,3
- guidance by the Internal Revenue Service (IRS) relating to particular taxpayers,4
- IRS administrative initiatives5 and IRS internal guidance,6
- tax treaties and other intergovernmental agreements,7 and
- court opinions in litigated cases.

This paper will focus on the development of US federal tax policy through legislation, followed by a brief discussion of regulations.

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2 In Federalist Paper no. 51 (1788), James Madison explained, “If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.” Consequently, it is necessary to “contriv[e] the interior structure of the government as that its several constituent parts may, by their mutual relations, be the means of keeping each other in their proper places” (James Madison, “The Structure of the Government Must Furnish the Proper Checks and Balances Between the Different Departments,” New York Packet, February 8, 1788). See also John M. Blum, Bruce Catton, Edmund S. Morgan, Arthur Schlesinger Jr., Kenneth M. Stampp, and C. Vann Woodward, The National Experience: A History of the United States, 2d ed. (New York: Harcourt Brace & World, 1968), at 131-38.

3 For example, Revenue rulings, Revenue procedures, and notices.

4 For example, a private letter ruling that can be relied upon only by the taxpayer who received the ruling.

5 For example, efforts to find offshore bank accounts.

6 For example, IRS procedures contained in the Internal Revenue Manual, infra note 23.

As a preliminary matter, it is helpful to describe the tax function in the executive branch of the federal government. The executive branch consists of the president, the White House, and various departments (such as the Treasury department) and agencies. The tax function has two primary parts. The Treasury department’s Office of Tax Policy, which has approximately 100 lawyers, economists, and accountants, advises and represents the administration regarding tax legislation. It also participates in the preparation of regulations and other generally applicable published guidance, negotiates tax treaties, represents the United States in meetings of multilateral organizations dealing with tax policy matters, and prepares revenue estimates for the administration. The IRS, which has more than 90,000 employees, administers the tax law and deals with all matters involving particular taxpayers, such as the filing of returns, collections, audits, and litigation. The Justice department also conducts tax litigation. The responsibilities of the Office of Tax Policy and the IRS are generally separate and distinct, but they do work together on published guidance generally applicable to all taxpayers, such as regulations.8

One other important observation is that during the 1600s and 1700s, the 13 American colonies developed as 13 separate sovereignties under the rule of England. The constitution was drafted by representatives of the new states and ratified by the states, which intended to retain most of their original sovereignty. The constitution grants various enumerated powers to the federal government, including the power to “lay and collect Taxes.”9 However, the federal government is the product of a federation of the states and, as articulated in the 10th amendment to the US constitution, the “powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.”10 Among the powers retained by the states is the power to levy taxes. Consequently, the states (and local governments) have their own tax systems and develop their own tax policy.11

FEDERAL TAX LEGISLATION
Sources of Legislative Ideas

In the United States, there are many sources of legislative ideas. First and foremost, members of Congress (with the assistance of their staff) develop tax policy ideas and introduce tax legislation (in the form of bills). Tax proposals can either be broad reform proposals or focus more narrowly on particular areas or specific issues.

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8 This separation of duties is a consequence, in part, of the Watergate era in the early 1970s, when the White House attempted to use the IRS to harass President Nixon’s enemies.
9 US constitution, article I, section 8.
10 Tenth amendment to the US constitution (1791).
11 For example, unlike the federal government, state and local governments impose franchise taxes, sales and use taxes, and property taxes.
In the House of Representatives, primary jurisdiction over tax matters is exercised by the Ways and Means Committee. For example, since 2011, this committee and the Senate Finance Committee have held numerous hearings about many aspects of tax reform. Congressman Dave Camp, the chair of the Ways and Means Committee, has issued discussion drafts about reform of international taxation (October 2011), financial products taxation (January 2013), and small business taxation (March 2013). He has indicated that he will introduce a comprehensive tax reform package that will be considered by the full Ways and Means Committee.

In the Senate, primary jurisdiction over tax matters is exercised by the Senate Finance Committee. In 2012-13, the committee issued numerous papers listing options for reform of various areas of US tax law. In September 2012, Senator Michael Enzi, a member of the committee, introduced a bill to reform international taxation. In November 2013, Senator Max Baucus, the chair of the Senate Finance Committee, issued discussion drafts about reform of international taxation, tax administration, and cost recovery and accounting.

In addition, members of Congress who are not on the House Ways and Means Committee or the Senate Finance Committee develop tax policy ideas and introduce legislation. For example, Senator Carl Levin has introduced the Stop Tax Haven Abuse Act to address concerns about the use of offshore entities to avoid or evade US tax.12 He has also chaired hearings of the Senate Permanent Subcommittee on Investigations examining offshore profit shifting by US corporations.

An important office serving Congress in tax matters is the Joint Committee on Taxation. The staff of this committee consists of lawyers, economists, and accountants who assist committees and members of the House and Senate on tax legislative matters. The staff publish numerous documents on all aspects of federal tax law, and prepare the official congressional revenue estimates for tax legislation.

The president and his administration also play an important role in the development of tax policy. Every year, normally in early February, the administration issues its proposal for the government’s budget for the coming fiscal year (starting on October 1). Included in the budget proposal are tax legislative proposals prepared by the Treasury’s Office of Tax Policy, with input from White House staff, such as the National Economic Council. The administration puts forth other tax policy documents as well. For example, in February 2012, the Obama administration issued “The President’s Framework for Business Tax Reform,” a joint report by the White House and the Treasury department that set forth five principal elements for business tax reform. The administration also creates commissions. President George W. Bush created the President’s Advisory Panel on Federal Tax Reform, which in November 2005 put forth two different reform proposals. One proposal would have reformed the income tax system; the other would have blended elements of both an income tax and a consumption tax. In December 2010, a majority of President

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12 S. 1533, introduced on September 19, 2013.
Obama’s National Commission on Fiscal Responsibility and Reform recommended substantial federal spending reductions coupled with tax reform that would eliminate many deductions, reduce tax rates, and reduce budget deficits.

The IRS, which administers the tax law, also contributes ideas to improve tax administration. These ideas are often reflected in the administration’s annual proposal for the government’s budget. In addition, the IRS Taxpayer Advocate, an independent organization within the IRS that helps taxpayers resolve problems arising from their interactions with the federal tax authority, recommends law changes to prevent future taxpayer difficulties, including changes to protect taxpayer rights.

Other governments and governmental organizations contribute to the development of US federal tax policy. For example, formalized groups of countries, such as the Group of Eight (G8) and the Group of Twenty (G20), both of which include the United States, meet periodically about common issues. The G8 and the G20 have focused on tax issues, including exchange of information among countries, tax avoidance and tax evasion, and base erosion and profit shifting. Both groups have also expressed their support for the work of the Organisation for Economic Co-operation and Development (OECD) in the area of base erosion and profit shifting. The OECD (of which the United States is a member, along with 33 other countries) has undertaken a project on this subject. In February 2013, it published a report on the issue, including discussion of possible solutions, which was followed by the publication of an action plan in July 2013. Although the findings and recommendations of the OECD are not binding on the United States, they do influence the US debate on tax policy and may lead to US actions, such as actions within the authority of the executive branch or proposed legislation.

Non-governmental organizations also contribute significantly to the development of tax policy in the United States. There are numerous policy organizations across the entire political spectrum, including think tanks such as the Urban Institute, the Center on Budget and Policy Priorities, the Tax Foundation, and the Heritage Foundation. These organizations employ public-policy experts who publish papers, make proposals, and otherwise play an active role in the tax policy debate.

In addition, professional organizations make an important contribution to the US tax policy discussion. For example, the American Bar Association Section of Taxation has prepared papers discussing options for tax reform in various areas of the tax law. As another example, the New York State Bar Association Tax Section has submitted technical comments on Chairman Camp’s international tax reform discussion draft.

Finally, constituents, including businesses, organizations, and individuals, contribute to the development of tax policy. Discussions with members of Congress, the administration, and the White House are a common and accepted part of the process.

US policy-making process. A substantial industry has developed, particularly in Washington, DC, in which lobbyists provide information and advocate on behalf of their clients to members of Congress and the administration.14

The Federal Tax Legislative Process

The US federal tax legislative process starts with the introduction of a bill by a member of Congress. The constitution requires that all bills for raising revenue shall originate in the House of Representatives.15 Tax bills introduced in the House are referred to the House Ways and Means Committee. The House Ways and Means Committee considers the bill and can process it, often in a public setting called a “markup.” If the Ways and Means and Committee approves the bill (by majority vote), the bill is sent to the full House (the House floor) for consideration. The House can then approve the bill by majority vote.

In the Senate, tax legislation is referred to the Senate Finance Committee. The Senate Finance Committee considers the bill and can process it, again often in a markup. Sometimes the Senate Finance Committee has a conceptual markup, in which it does not have specific statutory language before it. If the Senate Finance Committee approves the bill (by majority vote), the bill is sent to the full Senate (the Senate floor) for consideration. The rules of the Senate allow filibusters, a parliamentary tactic used to delay or prevent a bill’s passage.16 Under Senate rules, a filibuster can be stopped only by invoking “cloture” and obtaining the vote of 60 of the 100 senators to proceed. Thus, in practice, in the Senate a bill needs 60 votes to be approved. Because filibusters can have the effect of preventing Senate action on many matters, there have been recent debates about changing the rules to prevent filibusters in certain situations.17 Nevertheless, today the ability to filibuster legislation continues. If there is no filibuster on a bill or the filibuster is overcome, the entire Senate can approve a bill by majority vote, with the vice-president breaking a tie.

The bills passed by the House and Senate might not be identical. In fact, as the result of negotiations and amendments in the House and Senate proceedings, the bills passed by the two houses of Congress might be quite different. Consequently, if the bills are different, a conference committee made up of leading members of the House Ways and Means Committee and the Senate Finance Committee negotiate

14 There is a legend that the term “lobbyist” was first used by President Grant (1869-1877) to describe people who approached him for favours while he was enjoying brandy and a cigar in the lobby of the Willard Hotel in Washington, DC, although in fact the word originated before Grant’s time in office.
15 US constitution, article I, section 7.
16 The Senate rules do not allow filibusters on reconciliation bills, which deal with budget issues.
17 On November 21, 2013, in a highly controversial action, the Senate voted to end the ability to filibuster presidential nominations for executive-branch and most judicial positions.
to achieve a compromise bill. If the negotiations are successful, the compromise bill is sent back to the House and Senate for passage.

Finally, an identical bill passed by the House of Representatives and the Senate is then sent to the president for his signature. If the president signs the bill, it becomes law. However, if the president vetoes it, it is sent back to Congress and does not become law unless both the House and the Senate override the veto by a two-thirds majority vote in both houses.

A primary purpose of this discussion summarizing the US federal tax legislative process is to emphasize the diffusion of responsibility for tax policy and the effect of the checks and balances created by the constitution, requiring passage by both houses of the legislative branch and approval by the executive branch. The US federal system is quite different from the systems in many other countries, including, for example, the parliamentary systems in the United Kingdom, Australia, Canada, and New Zealand, where the ruling party can achieve the enactment of tax legislation in a much quicker and more efficient manner. Some would argue that the checks and balances of the US federal tax system are an obstacle to action. Others would argue that the system operates as the framers of the constitution intended, to promote debate and ensure consensus. The Tax Reform Act of 198618 is cited as an example where, despite challenges along the way, the system ultimately produced a successful outcome.

**Government Officials Involved in the Tax Legislative Process**

Consistent with the diffusion of responsibility described above, there are numerous government officials involved in the development and enactment of US federal tax policy. Of course, members of Congress, in particular members of the House Ways and Means Committee and the Senate Finance Committee, are primary participants. Because members of Congress have so many responsibilities besides tax, and because the tax law is so complicated, staff members play a critical role, especially the staffs for the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation.

In the executive branch, the Treasury’s Office of Tax Policy and White House staff play a role in the tax legislative process. Their participation varies depending on the bill and the political environment. For example, during the period leading up to the enactment of the Tax Reform Act of 1986, President Reagan was a vocal supporter of tax reform and the Treasury department played a critical role in the process, by (among other things) issuing two comprehensive studies with legislative proposals. In contrast, more recently, the role of the administration in tax legislation has varied, in part because of increased political partisanship. The level of the administration’s involvement can depend on which party controls the houses of Congress and the presidency.

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There are many people, both inside and outside the US federal government, who have extensive experience in tax policy issues. Leaders of the House Ways and Means Committee and the Senate Finance Committee have worked on tax matters for many years. Various other government participants, such as congressional staff members and employees of the Treasury’s Office of Tax Policy, usually have extensive private-sector business, legal, or academic experience. After their government experience, they generally return to the private sector and often interact with current government officials. Some even return to the government at a later time. This interchange between the public and private sectors is beneficial because it enables government policy makers to understand current trends and issues. On the other hand, it contributes to the perception of a revolving door, whereby former government officials have special access to current government officials and personally profit from this access.

**Some Observations About the Current Legislative Scene**

As previously discussed, in the US system there is a diffusion of responsibility that has a profound effect on the formation of tax policy. The checks and balances created by the constitution, combined with the existence of two distinct political parties, have created many points of friction, including, for example, Democrats versus Republicans, the House of Representatives versus the Senate, and Congress versus the administration. These frictions make it difficult to reach agreement. Adding to the difficulty is intense political partisanship, which has created an environment of mistrust with standoffs and brinkmanship. For example, Congress and the Obama administration faced a “fiscal cliff” at the end of 2012 when 2001/2003 tax relief was scheduled to expire. The United States faced other crises when the federal debt limit was reached in the summer of 2011 and the fall of 2013.

In the current environment, it is difficult to reach political compromises. Contributing to the challenging atmosphere is the role of the media and electronic communications. The media, through television, radio, and the Internet, heavily influence public opinion and the views of members of Congress, the administration, and other government officials. Instant electronic communication, whether by the media or by interested organizations and individuals, provides helpful transparency, but at the same time concerns about disclosure can discourage politicians and other government officials from engaging in sensitive discussions that can be helpful in finding a middle ground.

The inability to resolve problems results in continuing uncertainty, which hampers planning for individuals and businesses. In the near term, it will be difficult for Congress and the administration to reach agreement on two of the most pressing domestic issues, spending and taxes, including tax reform. Some have expressed the fear that only as a result of a crisis can the obstacles to compromise be overcome.

The US federal budget deficits also have a substantial impact on the tax legislative process. The annual US federal budget deficit has exceeded US$1 trillion in several recent years. Because of concerns about revenue impact, revenue estimates prepared by the staff of the Joint Committee on Taxation play a major role in all tax
legislation. Furthermore, to minimize the revenue impact of revenue-losing provisions, such as tax incentives, Congress has enacted dozens of temporary provisions that expire after a year or two. Upon expiration, Congress is compelled to revisit the provisions, which are usually reenacted for another temporary period. In addition, sometimes Congress enacts tax increases to offset the costs of non-tax programs. For example, in 2010, Congress included various taxes in the Patient Protection and Affordable Care Act\(^1\) and the Health Care and Education Reconciliation Act\(^2\) (“the health-care acts”) to offset the cost of health-care measures.

A final observation about the US federal legislative process is that the Internal Revenue Code\(^3\) is used for purposes besides raising revenue to fund the government. In particular, it is used to achieve social and economic policy objectives. For example, the health-care acts impose taxes on employers who decline to provide, and employees who decline to obtain, health-care coverage. Tax provisions can also serve as an alternative to direct spending. For example, there are numerous tax incentives to effectuate energy policy and refundable tax credits to assist disadvantaged individuals and families. Because of the use of the Internal Revenue Code for social and economic policy purposes, it is very complex and a political battleground.

**REGULATIONS**

The Internal Revenue Code is the foundation of the US federal tax system. However, it does not answer all the tax questions that arise in a complex society and economy. Accordingly, in section 7805 of the Code, Congress has given general authority to the secretary of the treasury (or his delegate) to “prescribe all needful rules and regulations for the enforcement of [the tax laws].” Furthermore, various sections of the Code give additional authority to the Treasury department to issue regulations in particular areas.\(^4\)

Because there are so many unanswered questions in the Internal Revenue Code, the Treasury department has issued thousands of pages of regulations. Consequently, in addition to the enactment of legislation included in the Internal Revenue Code, the promulgation of regulations is a fundamental part of the articulation of tax policy in the United States. For this reason, a brief discussion of the regulatory process is appropriate.

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\(^{3}\) Internal Revenue Code of 1986, as amended (herein referred to as “the Code”).

\(^{4}\) For example, section 1502 of the Code states that the “Secretary [of the treasury (or his delegate)] shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability [of the group and its members], and in order to prevent avoidance of such tax liability.”
The preparation and issuance of regulations is a joint effort of the Treasury’s Office of Tax Policy and the IRS. Participants in the process generally include lawyers (and sometimes economists on projects such as transfer pricing) in the Office of Tax Policy and lawyers in the IRS Office of Chief Counsel. The development and drafting of regulations is a lengthy process, which usually begins with an announcement that the government intends to undertake a particular project. Every year, the assistant secretary for tax policy (who heads the Office of Tax Policy and reports to the secretary of the treasury), the IRS commissioner, and the IRS chief counsel jointly publish a priority guidance plan that lists the regulations and other published guidance projects that the Office of Tax Policy and the IRS will work on in the coming year. The process for issuing regulations normally involves internal memorandums, drafts, meetings, and briefings.

In preparing and issuing regulations, the Office of Tax Policy and the IRS follow the Internal Revenue Manual (an internal IRS document)\textsuperscript{23} and the Administrative Procedure Act.\textsuperscript{24} Accordingly, there is generally formal notice and the opportunity for comment by the public. In addition to formal procedures for comment, there is informal interaction between the government and the private sector about issues being considered in regulatory projects. In these informal discussions, government employees are careful not to divulge confidential or otherwise sensitive information, such as the specific content of the regulations or their effective date.

Regulations are first issued in proposed form. A notice and comment period follows. If requested, a public hearing is held. Regulations are finalized after receipt and consideration of the public comments. Most regulations have an effective date as of the date of finalization. Some regulations are both proposed and temporary (that is, immediately effective) in order to provide currently needed guidance or to prevent abuse.

Regulations have the force of law. Their validity can be challenged, but a challenger must satisfy a relatively high standard in order to prevail. In Mayo Foundation v. United States,\textsuperscript{25} the US Supreme Court applied a two-part analysis in upholding the validity of a regulation. Under this analysis, a challenge will be successful only if the regulation is contrary to a statute that is unambiguous or if the regulation is an unreasonable interpretation of the statute.

\textsuperscript{23} See Internal Revenue Service, Internal Revenue Manual (Washington, DC: IRS), at part 32.1 regarding regulations.

\textsuperscript{24} See 5 USC section 553.

\textsuperscript{25} 131 S. Ct. 704 (2011).
CONCLUSION

The US constitution established a system of checks and balances that underlies the structure of the US federal legislative process, including the process for enacting tax legislation. The system of checks and balances is intended to promote debate and ensure consensus. The tax policy debate in the United States is extensive, with substantial interaction within the government and between government officials and the public. The level of the debate is enhanced by the participation of numerous tax policy experts, both inside and outside the government.

Although the system of checks and balances has certain advantages, it operates today in an environment of intense partisanship and a pervasive concern about budget deficits. This combination of factors has made it difficult for Congress and the president to achieve the agreement necessary to resolve pressing fiscal issues, including the need for tax reform.
Policy Forum: Editors’ Introduction—
The First-Time Donor Tax Credit

Over the past 20 years, Canada’s charitable sector has seen declining levels of direct government support; however, during the same period, the federal government has introduced a series of amendments to the tax credit for charitable donations, which are intended to increase the level of private giving. The inclusion in the March 2013 federal budget of an enhanced “super credit” for first-time donors is the latest of these legislative initiatives.\(^1\)

The introduction of the enhanced credit is ostensibly the federal government’s response to the report on tax incentives for charitable giving released by the House of Commons Standing Committee on Finance in February 2013.\(^2\) However, this particular type of incentive was not referred to in testimony before the standing committee, nor does it appear as a recommendation in the committee’s report. In fact, the report provides six separate tax recommendations, all of which are expressly stated to be subject to the government’s intention to balance the budget in the medium term.\(^3\) Two of the more significant substantive recommendations are (1) that the government should explore the feasibility of adopting a “stretch tax credit,” whereby individuals would be provided with an enhanced credit amount for charitable donations that exceed those made in a prior year; and (2) that the government should explore the feasibility and cost of eliminating capital gains tax on charitable donations of real or immovable property and/or shares of private corporations. The latter idea is an extension of the capital gains tax relief already provided for gifts of Canadian cultural property, publicly listed securities, and ecologically sensitive land. The former idea, however, has no obvious legislative precursor apart from its broad conceptual roots in the two-tier credit system, which adjusts the amount of the credit upward for donations above a modest threshold amount. In this respect, the first-time donor credit (FTDC) also may be seen to have similar conceptual roots to the

\(^1\) Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013, at 236-39; see also annex 2, Tax Measures: Supplementary Information and Notice of Ways and Means Motions—Tax Measures: Supplementary Information, at 333-34, and Notice of Ways and Means Motion To Amend the Income Tax Act and Other Tax Legislation, resolution (2). The first-time donor tax credit became law in June 2013 with the addition of subsections 118.1(3.1) and (3.2) to the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended): SC 2013, c. 33, section 10(2), applicable in respect of gifts made after March 20, 2013.


\(^3\) Ibid., at 27.
notion of a stretch tax credit, although these two types of incentives are otherwise much different in focus, and presumably in their intended effect.

Capital gains tax relief for gifts of publicly listed securities was the subject of a Policy Forum feature in 2003. Given the significance of the charitable sector in Canada, it seemed to us that the introduction of the FTDC presented an opportunity to revisit some of the policy issues associated with income tax relief for charitable giving generally, and more particularly to consider whether and to what extent the FTDC may be capable of realizing the goals underlying this choice of policy instrument. To that end, we invited an economist, a political scientist, and a legal scholar to comment on the FTDC as an incentive to increase private giving to charity. Each of our invited commentators gave testimony before the standing committee, and each has an established academic career in the study of the charitable sector. The different perspectives that these three writers bring from their respective academic disciplines, as reflected in the articles that follow, are instructive in thinking about the FTDC in the broader context of the federal government’s policy choice to operate, through the income tax system, the functional equivalent of a matching grant program for private gifts to charity.

In the first article, Abigail Payne questions whether the FTDC will have anything more than a short-term effect, given its legislative status as a five-year temporary measure (applicable for taxation years 2013 through 2017). She suggests that the cause of declining levels of reporting of tax-receipted gifts is unclear; moreover, it is unclear what role government should adopt to support a more sustainable environment conducive to private charitable giving. Her article sets out a framework for how tax policy makers might consider this important issue. As Payne notes, it does not appear that the same framework for policy analysis was employed in the thinking underlying the introduction of the FTDC.

In the second article, Rachel Laforest expresses skepticism regarding the ability of the FTDC to realize its stated goal of increasing first-time donations, particularly by younger Canadians, who are identified as a primary target group. Laforest argues that, even accepting that the FTDC may encourage a higher level of new charitable giving, it is nevertheless a poorly designed instrument for the regeneration of Canada’s “civic core” that is necessary in the longer term. She contrasts the one-time enhanced tax relief of the FTDC with the ongoing relief provided by a stretch tax credit as an instrument to foster a culture of sustained private giving.

In the third article, Adam Parachin provides a fresh and provocative perspective on the intersection of the income tax system and the charitable sector. He argues that an unintended consequence of enhanced tax relief for charitable giving could be an increased regulatory footprint for the charitable sector, particularly if the relief is

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5 As Laforest explains, this term refers to the small proportion of the adult population that accounts for the majority of volunteering, charitable giving, and community activities in Canada.
narrowly targeted at specific types of gifts, donors, and charities. Designing relief in this manner undermines a characterization of relief for charitable giving as part of a normative income tax and, as Parachin emphasizes, can lead to regulation that goes beyond administration and enforcement of the conditions for relief specified in income tax legislation. Parachin points out that this kind of regulatory presence operates at cross-purposes to one of the reasons for choosing a system of tax relief over direct subsidies—namely, maintenance of the independence of the charitable sector through a preference for private giving over government funding. Whether this will be the legacy of the FTDC depends greatly on the kind of subsequent income tax initiatives that it may motivate.

Drawing on the past as a possible prologue to the future, we note that capital gains tax relief for gifts of publicly listed securities was initially introduced in 1997 as a temporary measure. In contrast to the FTDC, this form of enhanced tax relief was accompanied by an express statement by the government of the day that the measure could become a permanent feature of the income tax system, in the event that certain specified criteria were satisfied. It was, in essence, a five-year experiment that the federal government subsequently declared to be a success. In the case of the FTDC, as Abigail Payne observes, the new measure will at least provide an opportunity to learn more about short-term and long-term donor behaviour. It remains to be seen whether the FTDC will have a sufficiently strong and positive impact on behaviour that the government will declare the measure a success and adopt it as a permanent feature of the matching grant program for charitable giving.

Tim Edgar
Kevin Milligan
Editors
Policy Forum: The First-Time Donor Credit—Sound Policy or Short-Term Fix?

A. Abigail Payne*

KEYWORDS: TAX CREDITS ■ CHARITABLE DONATIONS ■ INCENTIVES ■ CHARITIES ■ TAX POLICY

CONTENTS
Introduction 1091
The First-Time Donor Credit 1092
The Government’s Role in the Charitable Sector—Policy Considerations 1093
Assessment of the FTDC as a Policy Response 1095
Supporting Evidence 1096
Incentive Versus Subsidy 1097
Sustainable Financial Support for the Charitable Sector 1099
Conclusion 1101

INTRODUCTION
“You shouldn’t look a gift horse in the mouth.” This is the saying that popped into my head when I began looking at commentary on the federal government’s announcement of a “super tax credit” for first-time reporting of tax-receipted gifts to charities.1 With the exception of one lukewarm response, all the comments came across as either positive or, in the words of Dragnet’s Joe Friday, a reporting of “just the facts, ma’am.” And if the federal government is willing to offer some of its revenues as a tax incentive to encourage more giving to charity, why wouldn’t we be positive about the announcement? The perspective I take in this article is to consider whether the super tax credit is a sufficient remedy for the issue that the government is seeking to address. Drawing on testimony and written submissions to the Standing Committee on Finance in its hearings on tax incentives for charitable giving, the

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1 Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013, at 236-39; see also annex 2, Tax Measures: Supplementary Information and Notice of Ways and Means Motions—Tax Measures: Supplementary Information, at 333-34, and Notice of Ways and Means Motion To Amend the Income Tax Act and Other Tax Legislation, resolution (2).
government noted in the 2013 federal budget that “there is a need to foster and promote a culture of giving, and that tax incentives can play a role both in increasing the number of new donors and [in] encouraging existing donors to give more.”

The government’s response was to amend the charitable donation provisions of the Income Tax Act to include a new, temporary “first-time donor credit” (FTDC) to encourage new donors to give to charity. As will be elaborated upon below, who these new donors are and how a temporary measure resolves the perceived problem is less clear.

Having reflected on the available research (my own and others’) and on the various submissions presented to the Standing Committee on Finance, I have come to the opinion that the FTDC represents a band-aid approach that only partially addresses the bigger issue referred to in the budget—namely, the promotion of a stronger culture of giving by Canadians. It seems clear that such a culture is needed to develop a vibrant and healthy set of charitable organizations capable of delivering important services to Canadian individuals, families, and communities. Before I elaborate on my thoughts, let’s start with some basic facts about the FTDC and, more broadly, the factors that we should consider when we think about the role of tax credits in inducing giving.

**THE FIRST-TIME DONOR CREDIT**

In essence, the FTDC provides a one-time enhanced credit for the reporting of charitable donations on an individual’s tax return if the taxpayer (or her or his spouse) has not previously claimed the charitable donation tax credit (CDTC) or the FTDC for any year after 2007 and before the current taxation year. The FTDC allows the taxpayer to claim an additional 25 percent credit over and above the CDTC claimed in respect of first-time donations up to a maximum donation amount of $1,000. This amounts to a 40 percent credit for donations of $200 or less, and a 54 percent credit on the part of the donation that exceeds $200. The restriction of the credit to a one-time claim introduces a complication for some, and possibly most, potential users—specifically, those taxpayers who can afford to make only small donations. To take full advantage of the credit, the taxpayer will have to hold onto her receipts and not report the donation until she has accumulated $1,000 in receipts, and she will have to donate that amount within the lifetime of the credit (that is, between March 20, 2013 and December 31, 2017).

Figure 1 illustrates the respective values of the FTDC and the CDTC, using the provincial tax credits available for donations for Ontario and assuming that the donor’s

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2 2013 Budget, Budget Plan, supra note 1, at 237.
3 Subsection 118.1(3.1) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Subsection 118.1(3.1) and the companion subsection 118.1(3.2) were added by SC 2013, c. 33, section 10(2), applicable in respect of gifts made after March 20, 2013.
4 Subsection 118.1(3.1).
the first-time donor credit—sound policy or short-term fix?

The tax liability for the year is equal to or greater than the value of the credit. In Ontario, a taxpayer may claim an additional tax credit of 7.9 percent for donations of $200 or less, or 17.4 percent on amounts exceeding $200. The solid line depicts the value of the CDTC if the taxpayer is not eligible for the FTDC. For example, for a donation of $500, the taxpayer receives a credit of $185. With the FTDC, for donations of $1,000 or less, the taxpayer receives a higher credit that effectively changes the slope of the line depicting the total credit. The $500 donation is now worth a credit of $310 (an increase of $125). At $1,000, the taxpayer eligible for the FTDC receives a credit of $667. Beyond gifts of $1,000, there is a $250 difference in the value of the credit between FTDC eligible and non-FTDC eligible taxpayers.

FIGURE 1  Comparison of the Value of the First-Time Donor Credit (FTDC) and the Standard Charitable Donation Credit to an Ontario-Resident Taxpayer

The Government’s Role in the Charitable Sector—Policy Considerations

From an economic perspective, why might we want to encourage giving through tax credits? Part of the reasoning is tied to how we think about charitable giving. Take, for example, a good or service that helps someone in need—for instance, by providing a bed (shelter or housing assistance), food (a food bank or a hot meals program), or assistance after a natural disaster. Starting with this characterization of charitable goods, suppose that a community has a high number of homeless people and the community is seeking to build a shelter. Who builds the shelter—the government or a group of private citizens? Assume that the shelter will be built privately by a local charity. If we think of the shelter as we might think of most publicly provided goods, standard economic theory suggests that the shelter might not be built (or
built to meet the needs) if we rely only on private donations. In essence, there is an incentive for individuals to free-ride off the generosity of other individuals, and this will result in the underprovision (or no provision) of the shelter.

How can a tax credit help? With no tax credit, the after-tax cost to a taxpayer for a $1 donation to support the shelter is $1. With the FTDC, the cost per dollar donated is 60 cents if the taxpayer donates $200 or less, and a higher amount if he donates more than $200. The tax credit therefore reduces the relative price of giving, and this reduction in price should induce more giving. Thus (the argument goes), by providing taxpayers with an incentive to donate, and/or to donate larger amounts, the likelihood that the shelter will be built is increased.

But the tax credit is not free money. The government is forgoing revenues in exchange for encouraging charitable donations. Through these donations, a need that the government might otherwise support is covered through private funding. Alternatively, the government could take the money earmarked for tax credits and provide a direct subsidy to fund the shelter.

Does it matter if the government provides direct funding for the shelter or instead funds it indirectly through tax credits? Yes and no. With direct funding, the government is responsible for choosing which charity receives the subsidy. (I will return to this point below.) From a theoretical perspective, direct government funding could result in a decline in private giving, and thus a net benefit to the shelter of zero. This result is commonly referred to as "crowding out." The idea behind crowding out is that if donors observe the government stepping in and providing assistance to the shelter, using the same logic that explains why the charitable good if privately provided may result in underprovision of the good, the increase in government funding may result in private donors reducing their giving such that for every dollar of new government funding, private giving falls by a dollar.5

If this is the case, then the better solution would be for the government to subsidize the shelter indirectly through the introduction of a tax credit. However, continuing with the focus on community and social welfare goods such as shelters, recent empirical analysis suggests that while an extra dollar of direct government funding results in a decline in private giving, that decline is mostly attributable to a reduction in fundraising by the recipient charity, rather than a change in donors’ willingness to give.6 Potentially, if a charity maintained its fundraising efforts, private


giving might not decline. Thus, the question becomes one of which is cheaper: for the charity to incur the costs of fundraising to keep private giving high in the face of direct government funding, or for the government to incur the costs of monitoring taxpayers to ensure that their reporting of tax-receipted gifts on their tax returns is accurate?

But as I suggested above, there is a second consideration that should be taken into account when evaluating whether government support of charities should be direct or indirect—namely, the question of who should choose which charity is the beneficiary of the government support. In the case of direct subsidies, the government decides. In the case of tax credits, the individual taxpayer decides. While we often discuss charities with reference to organizations such as shelters, food banks, or international relief agencies, there are many other types of organizations that also can qualify as registered charities. These include, for example, arts organizations, organizations that preserve and manage historical buildings, environmental and conservation groups, religious organizations, and educational and health organizations. Thus, when debating the choice between direct government subsidization and a tax incentive for private giving, one must also balance out issues around how the flow of private donations might differ from the flow of government subsidies.

ASSESSMENT OF THE FTDC AS A POLICY RESPONSE

We can begin by considering how the concepts described above relate to the FTDC. Importantly, the new credit is available only for new donors. Thus, it addresses the potential problem that a broader incentive (such as a more generous CDTC) might simply support existing donations by individuals who are already giving. What is less clear is why a super credit is being proposed for only first-time reporters of donations and is not also encouraging additional donations by existing givers. From a fairness perspective, it seems somewhat unfair that a recent new donor—for example, an individual who reported on her 2012 tax return first-time donations—cannot reap the benefit of the FTDC. Also from a philanthropical perspective, it is not clear how a one-time credit will address issues around sustained giving by individuals. Implicit in the policy is the assumption that once an individual has made his first donation and received the tax credit, he will continue to give to charity in subsequent taxation years. The basis for making such an assumption is not clear.

Of course, this is where the gift horse re-enters. The government estimates that the FTDC will cost a total of $50 million in forgone revenues over the next two years (2013-14 and 2014-15). This is a lot of money that could otherwise be used to

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7 See 2013 Budget, Budget Plan, supra note 1, at 237.
make direct grants to charities. Should we care if this infusion of new money into
the charitable sector is short-lived and does not have lasting effects?

In fact, there are at least three reasons to criticize the FTDC from an economic
perspective:

1. a lack of evidence to support this policy over other policies that could have
   been introduced;
2. the assumption that an incentive is more effective than a subsidy in meeting
   the government’s objectives; and
3. the ability of the credit to sustain the desired level of private giving.

Each of these apparent shortcomings is discussed in more detail below.

**Supporting Evidence**

Speaking as someone who has spent most of her career developing data sets and
making the best of what is available, it is sad to see the government design a new
policy initiative without employing resources that it has at its fingertips to explore
in greater depth issues around the use of tax credits and reported tax-receipted do-

cations, and the challenges currently faced by charities. On the first point, there are
data sets that would allow the government to study the reporting of donations on
tax returns, to understand better who is and who is not reporting tax-receipted gifts
and the extent to which taxpayers regularly or infrequently report charitable dona-
tions. By first understanding who reports donations and the patterns of reporting,
we would better understand how the tax system might be used to promote a stronger
culture of giving.8

From publicly available statistics, we know that on surveys of giving and volun-
teeering, a high proportion of the survey participants—around 84-85 percent—identify
themselves as donors.9 Yet when we look at reported donations on tax returns, we see
that over the last 20 years there has been an overall decline in the share of tax filers
reporting tax-receipted gifts, and this share is in the range of 23-24 percent—far
below the survey rate of 84-85 percent.10 This raises a puzzle: Which number is more
accurate? If a high proportion of individuals are donors but a low proportion report
their donations on their tax returns, this might suggest that the problem is centred

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8 Possibly in introducing the FTDC, the government is conducting an experiment to better
understand how tax credits influence charitable giving. Even if this were so, I would question
the research framework for such an experiment, given that new donors cannot obtain the full
benefit of the credit until they have accumulated $1,000 in donations.

9 See Martin Turcotte, “Charitable Giving by Canadians,” Canadian Social Trends, Statistics
Canada catalogue no. 11-008-X (Ottawa: Statistics Canada, April 16, 2012).

10 See Statistics Canada, CANSIM table 111-0001, “Summary of Charitable Donors.” See also
A. Abigail Payne, “Changing Landscapes for Charities in Canada: Where Should We Go?”
not so much on the tax price of giving but maybe more on the level of giving. Given the structure of the tax system, a married couple receives a higher tax credit by reporting all donations on a single return. However, this fact alone does not explain the large discrepancy between the share of people who report giving to charity when responding to a survey and the observed reporting of donations on tax returns.

We also know from surveys and from reported donations on tax returns that while a lot of people give to charity, only a few people give a lot to charity. Admittedly, one issue with survey data is that there may be a greater incentive to identify oneself as a donor rather than risk creating the impression that one is a Scrooge. But since the government already has information on donor behaviour in its tax-return data, it could engage in an analysis that would better hone in on why the donation rate for tax filers reporting tax-receipted gifts has been declining, and better identify the reasons for differences in the level of giving by big and small donors. With this information, we could better understand whether an FTDC or other credit might be more appropriate if the goal is to encourage more individuals to give and/or to encourage a higher level of giving.

**Incentive Versus Subsidy**

We also may want to think more carefully about whether in all cases a tax incentive will result in better support of charities as compared with the provision of a direct subsidy. As explained above, one justification for not providing a direct subsidy to charities is that the subsidy may end up crowding out private donations. However, in explaining crowding out, I have ignored an important point—namely, that the types of charities that the government subsidizes may be different from the types of charities to which individuals donate. While a tax incentive may increase donations, are these donations being targeted at the types of charitable goods and services for which the incentive was intended?

For the accompanying figures 2 through 5, I rely on measures contained in charity information returns filed with the Canada Revenue Agency (CRA) for the period 2009-2011.11 I use one observation per charity, based on the most recent return filed by the charity. Figure 2 shows the distribution of charities by type (principal area of activity), as classified in the CRA’s data set; figure 3 reports the distribution of tax-receipted donations to charities, by type of charity; figure 4 shows the distribution of total government grants received by the various types of charities; and figure 5 reports the overall reliance on tax-receipted gifts and government grants, based on total revenues reported by charities.

Several observations can be made, based on the information presented in these figures. First, the distribution of tax-receipted donations versus government grants varies dramatically by type of charity. The bulk of tax-receipted gifts flows to religious organizations, with educational and welfare-oriented organizations receiving the

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11 Data obtained from the Canada Revenue Agency, Charities Directorate, as transformed by the Public Economics Data Analysis Laboratory at McMaster University, Hamilton, Ontario.
FIGURE 2  Distribution of Charities by Type, Based on Number of Organizations

Source: Data obtained from the Canada Revenue Agency, Charities Directorate, as transformed by the Public Economics Data Analysis Laboratory at McMaster University, Hamilton, Ontario.

FIGURE 3  Distribution of Charities by Type, Based on Share of Total Tax-Receipted Gifts

Source: Data obtained from the Canada Revenue Agency, Charities Directorate, as transformed by the Public Economics Data Analysis Laboratory at McMaster University, Hamilton, Ontario.
next highest levels of donations. The bulk of government grants, however, flows to health and educational organizations. In terms of reliance on these revenue streams, there are also significant differences across the types of charities. Most rely more on government grants than on tax-receipted gifts, with the biggest exception being religious organizations, for which the opposite is true.

These figures are simple illustrations of a point that we should keep in mind when we think about tax incentives versus direct subsidies: These funding approaches may not be interchangeable if we focus on issues around the use of the funds for the provision of charitable goods and services.

**Sustainable Financial Support for the Charitable Sector**

The FTDC may represent a band-aid approach toward strengthening of the charitable sector, because it is not clear that the credit will promote the kind of long-term sustainable environment that charities need in order to operate effectively. Going back to the notion of how direct subsidies may crowd out private giving, recall that recent work suggests that the anticipated crowding-out effect of government funding on private giving is attributable not to a decline in donors’ willingness to give, but rather to a decline in fundraising.12 Moreover, this research suggests that charities

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12 See Andreoni and Payne (Journal of Public Economics and NBER Working Paper no. 17635), supra note 6. This research, however, is of limited scope because it focuses on social welfare and community organizations. Whether it would be true for other types of charitable goods is not known.
do not behave optimally when it comes to fundraising. There is evidence that, on average, charities are inefficient in their fundraising in that they do not spend enough and thus leave potential donations on the table. From a media perspective, this may be considered a good thing; that is, charities view fundraising as a necessary evil. Moreover, there seems to be a widely held view that charities should focus more on the immediate provision of goods and services, and less on long-term sustainability. Most people assume that incurring administrative expenses through fundraising, and paying reasonable wages for staff instead of using volunteers, for example, represents a wasted use of resources. But the existence of a great many small charities, the majority of which likely cannot cover their expenses on a regular basis, is also an indication of potentially wasted funds.

While there are a few big charitable organizations in Canada (the top 1 percent of charities report revenues in excess of $28 million),\(^\text{13}\) much of the charitable sector

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\(^{13}\) Supra note 11.
is an agglomeration of very small charities. Of course, size is not always a good predictor of the successful delivery of services, but there are usually some benefits to be derived from economies of scale and scope in any organization. Using the most recent set of charity tax returns (2011), approximately 55 percent of small Canadian charities report total revenues of less than $100,000.14 Approximately 90 percent reported total revenues of less than $1 million. In light of these facts, I wonder if we should not be doing more to encourage charities to make investments that would include spending money on fundraising and other administrative activities in order to encourage longer-term sustainability. A March 2013 TED Talk by Dan Pallota explores this notion in greater depth.15

Overall, the Canadian charitable sector has seen an increase in donations and revenues from fundraising over the last two decades—but along with this growth, there has also been a growth in the number of charities.16 An expansion in the number of charities inevitably leads to increased competition for donations, leaving many charities hurting for lack of funds. Is an increase in the number of charities, a high number of small charities, and increased competition for donations a good thing? I don’t know, and I suspect that few people do; at least, there are few studies that have used the available data on donations and charity operations to assess whether the current structure of our charitable sector is sound, and whether an initiative such as the FTDC will help to strengthen it.

CONCLUSION

Over the last several years, the financing of charities and how the government can encourage a culture of giving have been at the forefront of Canadian policy concerns. From a tax perspective, there is certainly evidence that the reporting of tax-receipted gifts on individual tax returns has been declining. What is less clear is what is driving that decline and what role the government should take to promote a more sustainable environment for charity operations. I fear that the new FTDC will have a short-term effect, serving as a mere band-aid solution to a bigger issue. However, at the very least, perhaps by studying the impact of the credit, we can learn more about whether, and how, this type of incentive might change donor behaviour over both the short term and the long term, and thus begin to better understand how that bigger issue might be addressed.

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14 Supra note 11.
15 Dan Pallotta, “The Way We Think About Charity Is Dead Wrong,” TED Talk (www.ted.com/talks/dan_pallotta_the_way_we_think_about_charity_is_dead_wrong.html).
16 Supra note 11.
Policy Forum: Assessing the First-Time Donor Credit—Can It Increase the Charitable Donation Levels of First-Time Donors?

Rachel Laforest*

**KEYWORDS:** TAX CREDITS ■ CHARITABLE DONATIONS ■ INCENTIVES ■ CHARITIES ■ TAX POLICY

**CONTENTS**
Introduction 1103
Current Facts About the Charitable Sector 1105
Potential Impact of the FTDC 1106

**INTRODUCTION**

The voluntary sector is a significant social, political, and economic force in Canada. It accounts for 8.6 percent of the country’s gross domestic product (GDP) and has a full-time equivalent workforce of over 2 million.1 More importantly, it brings value to all aspects of our communities and has a direct impact on the quality of life of Canadians. Typically, the voluntary sector relies on three main sources of revenue: government funding, charitable donations, and earned income. Over the past decade, the federal government and some provincial governments have had to deal with serious budgetary constraints. Already federal government expenditures have decreased from 23.4 percent of GDP in 1992 to 14.6 percent in 2013.2 The current deficit reduction

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measures have translated into a reduction in contributions from various levels of government to the voluntary sector. Paradoxically, this shift is occurring at a time when many services formerly provided by government also are being reduced or transferred to voluntary sector organizations, the assumption being that they will have the capacity and resources to take on this additional burden. There is cause to worry about the current state of the voluntary sector and its ability to meet this challenge; the consequences of these changes will likely be felt in our communities, in the quality of services that we receive, and ultimately in our quality of life.

Given declining government resources, it is not surprising that charitable donations have become even more important as a source of revenue to support the voluntary sector. In 2006, more than half of the $112 billion raised in this sector came from private funding, a significant proportion through the charitable contributions of individual Canadians. This proportion is expected to grow. Since 1994, the federal government has adopted a number of initiatives to make the tax treatment of charitable donations more generous and to offer an indirect form of support to the voluntary sector in a context of fiscal restraint. Not only has the government reduced the point at which the 29 percent tax credit first applied; it has also increased the annual ceiling on eligible donations. In line with these initiatives, the government recently introduced the first-time donor credit (FTDC). Contrary to other tax initiatives that have targeted wealthier donors and have provided more favourable tax treatment for donations of assets, the FTDC is unique in its focus on first-time donors and individuals with limited means, particularly young Canadians. As the government stated in the budget announcement,

[t]his new credit will significantly enhance the attractiveness of donating to a charity for young Canadians who are in a position to make donations for the first time and—by helping to rejuvenate and expand the charitable sector’s donor base—will have an immediate impact in supporting the sector.

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4 The FTDC was announced in the 2013 federal budget: Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013, at 236-39; see also annex 2, Tax Measures: Supplementary Information and Notice of Ways and Means Motions—Tax Measures: Supplementary Information, at 333-34, and Notice of Ways and Means Motion To Amend the Income Tax Act and Other Tax Legislation, resolution (2). The new tax credit became law in June 2013 with the addition of subsections 118.1(3.1) and (3.2) to the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended): SC 2013, c. 33, section 10(2), applicable in respect of gifts made after March 20, 2013.

5 2013 Budget, Budget Plan, supra note 4, at 237.
The FTDC enhances the value of the existing federal charitable donation tax credit (CDTC) by increasing its value by 25 percent for first-time donors. The standard tax credit for a charitable donation is 15 percent on the first $200, and increases to 29 percent for amounts above that. The new tax measure extends the credit to 40 percent on the first $200 and 54 percent for amounts above that, to a maximum of $1,000. However, the FTDC is available only if taxpayers and their spouses have not previously claimed the CDTC in any taxation year since 2007. There are two other notable features of the new tax credit. First, it is a sunset program and therefore of limited duration: it will apply on up to $1,000 for cash donations made between March 21, 2013 and December 31, 2017. The second is that it is a one-time credit—that is, it will be available to taxpayers and their spouses only in the year in which they first claim it. So if a donor’s first-time contribution is $200 and she claims an FTDC, the credit will no longer be available in respect of any subsequent donations. However, the legislation enables donors to save their receipts and maximize the FTDC by claiming all charitable donations (up to the $1,000 limit) in one year.

This article discusses the impact of this recent initiative and assesses whether it has the potential to meet its stated goals and increase donations for first-time donors, particularly young Canadians. Before analyzing the potential impact of the FTDC, it is important to situate the analysis in the context of the current state of charitable giving in Canada.

CURRENT FACTS ABOUT THE CHARITABLE SECTOR

Canada currently has one of the highest levels of charitable giving in the world. According to data collected by Statistics Canada, Canadian tax filers claimed $8.3 billion in donations in 2010, an increase of approximately $500 million from 2009. However, those data obscure another reality: While the total amount of donations made has indeed increased, the number of donors has actually declined, from 30 percent in 1990 to 23.4 percent in 2010. In effect, the base of donors in Canada has been steadily shrinking over the past decade. This trend is further aggravated by the fact that a high proportion of the total amount of charitable contributions is borne by a few individuals. The 2004 Canada Survey of Giving, Volunteering and Participating shows that 9 percent of donors are responsible for 62 percent of charitable donations. These data indicate that the measure of our society depends to a large extent on a small proportion of Canadian adults known as the “civic core.” Together, this small group of individuals accounts for more than two-thirds of all volunteering, giving, and community activities in Canada.

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6 Ibid.
Analysis of this civic core demonstrates that the individuals who display these contributory behaviours have a number of characteristics in common. Charitable donors tend to be older, religious, well educated, in higher-status and higher-income occupations, and with children aged 6-17 living in the home; they also tend to live in smaller communities rather than major metropolitan centres. If we take these characteristics as indicators from which to make projections about the future of the donor base in Canada, it becomes evident that there is cause for worry. First, with the aging of the population, the most generous segment of our society—those born before 1945—is rapidly shrinking. Second, we are facing a decline of religious belief that will most likely have a long-term effect on overall levels of charitable giving. Because the donor base in Canada is neither wide nor deep, these trends place charitable giving in a precarious situation. If they remain unchanged, and no action is taken to offset their impact, the long-term consequences will likely be a serious depletion of civic resources and a diminished capacity for voluntary organizations to support the well-being of Canadians.

Given these trends, can the FTDC—which was created as an incentive that would appeal to younger donors and help foster the next generation of philanthropists—meet the challenges facing the voluntary sector in Canada?

**Potential Impact of the FTDC**

There have been a number of studies that examine the effect of tax incentives on the “cost” of charitable contributions. The assumption of these analyses is that a reduction in tax costs of $1 should result in an increase of more than $1 in charitable contributions in order for a tax incentive to be considered effective. The measure of the impact of a given incentive is price elasticity, defined as the percentage change in donations that results from a 1 point change in the price of giving, all else being equal. When the price elasticity is negative, a decrease in the price of giving should lead to an increase in giving. Unfortunately, econometric studies linking tax incentives to levels of charitable giving are inconclusive, presenting a huge variation in price elasticity. This suggests that we may need to turn to other evidence in order to infer relationships between the FTDC and levels of charitable giving.

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The first element that we need to examine is the takeup of the FTDC. While the FTDC provides a maximum credit for the first $1,000, it is unlikely that first-time donors will take full advantage of the credit, for a number of reasons. In 2010, the average annual amount per donor was $446. However, this number is artificially high because, as noted earlier, a small number of donors make relatively large donations, pulling the average upward. Only 25 percent of donors make a donation above $358. In effect, when we look at the median amount, we can observe that half of all donors made an annual donation below $123. When we factor in age, the median amount falls drastically, to $30 for 15- to 24-year olds. Moreover, since first-time donors are by definition not accustomed to claiming charitable tax credits, they may not have sufficient awareness of the FTDC to save their tax receipts from year to year in order to maximize their claim.

As we can see, the factors that motivate charitable behaviours do not affect everyone in the same way. Youth are less likely to make donations, and when they do, they are inclined to give smaller amounts. In fact, both the average and the median annual amounts donated increase with age. In addition, the price elasticity of giving varies by income level and is significantly lower for taxpayers in lower income brackets. Youth who are entering the workforce generally fit this category. Takeup rates of the FTDC may therefore be low among youth and low-income donors.

Furthermore, the face of philanthropy is changing, particularly among young Canadians. Many fundraising efforts now focus on securing smaller donations from a larger donor base, a system that appeals particularly to young donors because they see an opportunity to bring about change through small contributions. Me to We, for example, is one of the biggest movements of youth culture today, mobilizing tens of thousands of individuals. The FTDC is based on the assumption that a first-time donor would be willing to make a contribution of $1,000; yet potential first-time donors with lower means may well prefer to participate in organizations such as Me to We. It is important that our tax policies reflect these new trends.

When we factor in these elements, we can anticipate that the FTDC will have a relatively small impact in terms of forgone government revenue. Its importance will likely be more symbolic—recognizing the act of making a first-time donation. While it may encourage those who have never before made a donation to take that first step and, in the process, increase the overall donor base in a given year, it may not contribute to the regeneration of the civic core in the long term, or help to foster a new generation of philanthropists, for a number of reasons. First, the enhanced credit is available only in respect of one taxation year—the year in which the donor or

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13 Ibid.

14 Ibid.

15 Fack and Landais, supra note 11.
his spouse files a claim. This feature of the FTDC is not conducive to the development of a new culture of giving because it does not reinforce philanthropical behaviour over time. Moreover, research has shown that taxpayers do not respond immediately to changes in tax policy. Clotfelter has noted that “there are substantial lags in giving behavior, with the result that short-run responses are much less complete than those in the long run.”

The stretch tax credit that has been advocated by a number of charitable organizations would have been a more suitable alternative for the purpose of shifting the culture of giving in Canada. A stretch tax credit would provide a tax credit on amounts that exceed a donor’s highest giving level, thereby encouraging individuals to increase their levels of giving gradually over time. It would provide donors with a goal to strive for and to surpass. The fact that a stretch tax credit could be used by donors over multiple years would also encourage donors to try to donate just a little bit more and make charitable donations a regular habit that turns into a routine. This is what our policy makers should be concerned about. Given the support that the stretch tax credit generated in the recent report of the Standing Committee on Finance, and the reality of Canada’s declining civic core, this policy option may reappear on the government’s agenda in the near future. In the meantime, it is my opinion that the FTDC will most likely have a limited fiscal and behavioural impact.

Policy Forum: Reflections on the First-Time Donor Credit—The Link Between Donation Incentives and the Regulation of Legal Charity

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KEYWORDS: TAX CREDITS ■ CHARITABLE DONATIONS ■ INCENTIVES ■ SUBSIDIES ■ CHARITIES ■ TAX POLICY

CONTENTS

Introduction 1109
Perspectives on the FTDC 1110
The Link Between Donation Incentives and the Regulatory Posture of the State Vis-à-Vis Charities 1113
The Policy Goals of Donation Incentives 1118

INTRODUCTION

The 2013 federal budget introduced a new charitable donation incentive for first-time donors.1 The “first-time donor credit” (FTDC) is a targeted tax concession with the express goal of attracting gifts to charity from “new donors”—effectively, individuals (other than trusts) who have not claimed a credit for charitable donations more recently than 2007.2 It augments the existing charitable donation tax credit...
(CDTC) by providing an additional 25 percent credit for cash (but not in-kind) donations up to $1,000 made after March 20, 2013 and before January 1, 2018. The FTDC can only be claimed in a single taxation year, even if the total donation amount available to be claimed in that year is below the $1,000 limit.

The FTDC brought an anti-climactic conclusion to a policy review process that appeared to be on a trajectory toward more significant reform. The process originated in 2010 with private member’s motion 559, which proposed that the House of Commons Standing Committee on Finance “undertake a study of the current tax incentives for charitable giving with a view to encouraging increased giving.” Although private members’ motions often fail to find an audience, motion 559 struck a chord with parliamentarians and passed unanimously with support from all parties. Following the passage of motion 559, a number of reform proposals vied for the standing committee’s endorsement. The two proposals attracting the most attention were a proposed exemption from capital gains tax of donations of land and private securities, and the introduction of a “stretch tax credit.” Under the former proposal, the capital gains exemption currently available under paragraph 38(a.1) for donations of publicly listed securities would be extended to donations of land and securities of private corporations. Under the latter proposal, the CDTC would be increased by 10 percentage points for donations in excess of a taxpayer’s previous highest level of charitable giving (with a proposed ceiling of $10,000). The standing committee concluded in its final report, released in February 2013, that the federal government should “explore the feasibility and cost” of both reforms (among others). The standing committee’s support in principle for these reforms fuelled anticipation that one or both of them might be adopted in the 2013 federal budget. The announcement of the FTDC instead came as a surprise, given that it was not among the recommendations made to or by the standing committee.

PERSPECTIVES ON THE FTDC
There are three predictable responses to the FTDC. The first—the cynical response—will attribute the introduction of the FTDC to political considerations. The review process appears to have left the government in something of a political muddle. The

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3 Subsection 118.1(3.1).
4 Subsection 118.1(3.2). An individual and her spouse or common-law partner can both claim the FTDC in any given taxation year. However, the cumulative donations claimed by the two taxpayers cannot exceed $1,000.
5 Canada, House of Commons, Debates, March 2, 2011, 1825.
7 Canada, House of Commons, Tax Incentives for Charitable Giving in Canada: Report of the Standing Committee on Finance, 41st Parl., 1st sess., February 2013, at 27. The recommendations were qualified as being “[s]ubject to the government’s stated intention to balance the budget in the medium term” (ibid.).
government evidently did not see the case for, or could not at this time justify the cost of, the particular reforms recommended to and endorsed by the standing committee. However, shelving the standing committee’s final report might have proved politically problematic. Not only would this result in a lost opportunity for the government to build political capital by associating itself with the good works of charities, but it would also disappoint the very expectations that the government had created within the charitable sector that donation incentives were going to be liberalized in some fashion. As a temporary and targeted tax measure, the FTDC presented a politically attractive, albeit minimalist, way for the government to keep faith with the charitable sector without committing itself to as significant a spending measure as either the stretch tax credit or the exemption of donations of land and private securities from capital gains tax.

The second response—the tax expenditure critique—will raise many of the familiar criticisms that have historically been levelled against tax expenditures generally. It will be pointed out that the FTDC introduces further complexity into the law, violates the traditional tax norms of neutrality and horizontal equity, and commits the government to a form of politically motivated and disguised spending for which there will be little accountability. It will also be observed that the horizontal inequity of the new measure revives an old defect that previous reforms had remedied. One of the very reasons why the charitable gift deduction for individuals was replaced in 1988 with the CDTC was to ensure that the income tax recognition of donations did not vary from taxpayer to taxpayer, owing to the upside-down effect of deductibility. The FTDC is, however, deliberately designed to ensure that two taxpayers—taxpayer A and taxpayer B—earning the same income and donating the same amount to the same charity in a given taxation year will be treated differently if in prior years A has donated faithfully and generously while B has traditionally preferred conspicuous consumption over charitable giving. The disparate treatment of these two taxpayers not only undermines horizontal equity but does so in a way that is inconsistent with the idea that donation incentives can be viewed as a reward for generosity.8 The very criterion used to disqualify taxpayer A from the FTDC is her consistent pattern of generosity. One could very well question whether this is an appropriate basis for treating the two taxpayers unequally.

The third response—the economic response—will evaluate the FTDC from the perspective of its efficiency in attracting new donations. Economic analysis has long since represented the dominant methodology for the study of donation incentives. Economic analyses focus on whether donation incentives inefficiently reduce the after-tax cost of donations that would be made without the incentive. Recognizing that at least a portion of total charitable giving is going to be inelastic—that is, unresponsive to donation incentives—the concept of treasury efficiency is used as a

benchmark to determine when a tax concession is sufficiently efficient (or, if you will, not excessively inefficient). It is based on the idea that the cost of a donation incentive in terms of forgone tax revenue should equal, or at least approximate, the amount of new charitable giving attracted by the incentive. Given the centrality of treasury efficiency to analyses of donation incentives, judgments formed of the FTDC will predictably be centred on (1) the accuracy of the government’s cost estimates for the tax credit ($25 million for each of 2013-14 and 2014-15) and (2) the ratio of forgone tax revenue to new donations attracted by the tax credit. While I will leave such analysis to those versed in the methodology of empirical economic research, I will at least observe that the government’s cost estimate of $25 million annually appears to correspond to only a small increase in cumulative charitable giving.

All three of these perspectives have merit. Nevertheless, they all miss something fundamental to the evaluation of the FTDC specifically and to the evaluation of donation incentive reform generally. Policy makers are understandably interested in knowing whether donation incentive reform is likely to affect donor behaviour by inducing higher levels of charitable giving. What would be the point of enhancing incentives if levels of giving would remain more or less the same? I would suggest, however, that policy makers should also be concerned with the potential impact of donation incentive reform on governmental behaviour—specifically, its impact on the regulatory posture of the state vis-à-vis charities. In the discussion that follows, I develop two points. The first is that reforms concerned with enhancing donation incentives and/or targeting donation incentives at particular categories of taxpayers arguably carry with them the prospect of heightened regulatory scrutiny of charities. The second is that such a regulatory trajectory, should it occur, would potentially undermine what I understand to be one of the crucial policy goals of donation incentives, which is to subsidize charities while preserving a certain separateness and independence of charities from government.

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10 2013 Budget, Budget Plan, supra note 1, at 237.

11 If the $25 million projected annual cost is calculated with reference to only the 25 percent FTDC, this projected cost corresponds with a modest annual increase in total donations of no more than $100 million. It would still be necessary, however, to net out new donations that would have been made even without the FTDC. In addition, the cost estimate presumably has to be based not just on the 25 percent FTDC but rather on the total cost of induced donations—that is, the costs arising from the CDTC and other donation incentives augmented by the FTDC. Once this is done, the net increase in charitable giving is reduced considerably further.
THE LINK BETWEEN DONATION INCENTIVES AND THE REGULATORY POSTURE OF THE STATE VIS-À-VIS CHARITIES

The FTDC modifies existing donation incentives in two ways of potential relevance to the regulatory treatment of charities. The first is that it enhances the generosity of current incentives. The second is that, unlike the CDTC, which has historically been available to all taxpayers without distinction, it restricts eligibility for the enhanced donation incentive to a targeted class of taxpayers, namely, first-time donors. In any analysis of how these two defining features of the FTDC might affect the regulatory treatment of charities, one must remain mindful that the new tax credit is a modest and time-limited measure. It may well be—in fact, very likely will be—the case that the FTDC expires as scheduled without having had any immediate or long-term regulatory impact. The FTDC is nonetheless significant from a regulatory perspective because it signals a certain receptiveness to reforms directed at making donation incentives more generous, albeit on a more targeted basis. Since the ultimate legacy of the FTDC may prove to be the successor reforms that it inspires, the analysis here is (at least) as much concerned with future reforms modelled after this new measure as with the FTDC itself. More specifically, the analysis that follows is focused on how shifting to an enhanced and formally targeted donation incentive might attract a different kind of regulatory environment for charities relative to the comparatively modest donation incentive generally available to all taxpayers making charitable donations that we have lived with to date.

The design features of donation incentives are not normally thought of as carrying with them regulatory implications for charities. However, the two are indeed linked in ways that are instructive to consider. The issue ultimately connecting the two is the familiar one of whether the income tax recognition of donation incentives is properly viewed as a normative income-defining feature of tax law, as famously argued by William Andrews,12 or as a tax expenditure, the far more widely held view. The argument advanced by Andrews is, essentially, that charitable donations are not “income”—that is, they are not included in the normative tax base—because they are neither taxable consumption nor savings.13 Andrews draws on this insight to conclude that the income tax recognition of charitable donations is a structural income-defining feature of tax law concerned not with subsidizing charities, but rather with the proper measurement of tax-paying capacity. In his words, the tax treatment of charitable gifts is a “refinement in our notion of an ideal personal income tax, rather than a


13 Andrews bases this argument on the contention that an ideal personal income tax would tax consumption on “divisible, private goods and services whose consumption by one household precludes enjoyment by others” but would exclude from the tax base consumption of “collective goods whose enjoyment is nonpreclusive or the nonmaterial satisfactions that arise from making [charitable] contributions.” Ibid., at 314-15.
departure from it.” The tax expenditure perspective advances just the opposite position: Since charitable donations qualify as taxable income, the income tax recognition of charitable donations is best understood as a way of subsidizing charities by reducing the after-tax cost of charitable giving.

While both views allow for regulatory interventions aimed at preserving and safeguarding the public trust inherent in charitable subscriptions, they differ significantly in relation to at least four key regulatory issues. The first issue is whether regulatory interventions into the affairs of charities can be justified as a way of preserving the state’s economic investment in charitable works. Whereas a subsidy view supplies a policy basis for such regulatory interventions, the tax base view frustrates this reasoning through its denial that there is any state subsidy at play here. The second issue is whether the definition of charity can be viewed as a mechanism for determining which institutions qualify for a state subsidy. Whereas a subsidy view might incline (and has indeed inclined) courts and regulators to define charity in terms of rationing the state’s economic support of charities, the tax base view supports a conception of charity formally unaffected by tax revenue considerations. The third issue is whether charity regulations should be developed on the basis that charities possess a public character. Given its denial that charitable donations involve any element of state subsidy, the tax base view is consistent with the claim that charitable donations are an exclusively private (in the sense of non-governmental) source of funding for charities. In contrast, the subsidy view sees charitable donations as a mixed public-private source of funding for charities. While it does not automatically follow that charities should be regulated as though they were public institutions per se, the subsidy view nonetheless exposes a public element that could be taken into account when developing charity regulations. The fourth issue is whether donation incentives should be subject to the same constitutional scrutiny as that accorded to direct government expenditures. While it has been argued that the economic similarity of direct and tax expenditures should result in their being treated identically for constitutional-law purposes, that argument is obviously frustrated by the tax base view that there is no form of state subsidy at play.

Given the very different regulatory postures fostered by the two views of donation incentives, it is relevant to determine which view will govern how the FTDC, or

14 Ibid., at 312.
15 See, for example, *AYSA Amateur Youth Soccer Association v. Canada (Revenue Agency)*, 2007 SCC 42. The Supreme Court’s use of tax expenditure reasoning in this decision is discussed in Adam Parachin, “Legal Privilege as a Defining Characteristic of Charity” (2009) 48:1 *Canadian Business Law Journal* 36-75.
any similar successor reforms, are received into Canadian law. Although the tax base view continues to attract pockets of support,\(^\text{18}\) it is almost inconceivable that it will play a very meaningful role in any policy debates following from the enactment of the FTDC. The tax base view is vulnerable to numerous compelling critiques,\(^\text{19}\) including what is perhaps the fatal criticism that the two-tier structure of the CDTC (which becomes a three-tier structure when we include the FTDC) belies any suggestion that income measurement is the sole, or even primary, tax policy goal being pursued.\(^\text{20}\) Given this shortcoming of the tax base view, it seems inevitable that the subsidy view will dictate the regulatory implications, if any, of the FTDC.

It might be helpful, then, to identify more specifically how a subsidy view of the CDTC has to date played out in recent charity-law debates. It is fair to say that the primary, if not singular, way in which a subsidy view of donation incentives is invoked in analyses of charity law is to rationalize constraints on charities in the form of either governmental interventions into the affairs of charities or restrictive interpretations of the legal meaning of charity. In practically no regulatory context is the idea that charities benefit from a tax subsidy ever invoked, other than to somehow justify or make sense of regulatory restrictions that might otherwise seem inappropriate. To cite a few recent examples, the subsidy view has been invoked to support the following propositions:

- that charities should be subject to legislated salary caps;\(^\text{21}\)
- that charities should be regulated as effectively public rather than private institutions;\(^\text{22}\)


\(^{20}\) The CDTC is calculated using the lowest marginal tax rate of 15 percent for donations up to $200 and the highest marginal tax rate of 29 percent for donations in excess of $200 (see subsections 117(2) and 118.1(3)). High-income donors therefore pay more tax on the first $200 of charitable gifts than the amount that they receive back in the form of a tax credit. The opposite holds true in relation to each dollar above $200 donated to charity by all donors not in the highest marginal tax bracket. For these donors, the tax credit does not simply operate to refund the tax paid on the income donated to charity but instead returns a surplus. The credit would not be structured in this manner if its sole purpose was to match income tax obligations with tax-paying capacity.

\(^{21}\) See the House of Commons debates on Bill C-470, which proposed what was in effect a cap of $250,000 on the compensation of any individual officer or employee of a charity. In particular, see Canada, House of Commons, \textit{Debates}, April 19, 2010, at 1631 (the Hon. Sukh Dhaliwal), 1633 (the Hon. Andrew Kania), 1632 (the Hon. Kelly Block), 1634 (the Hon. Paul Szabo), and 1635 (the Hon. Albina Guarnieri). See also \textit{Debates}, March 15, 2010, at 420 (the Hon. Albina Guarnieri).

\(^{22}\) See Brody and Tyler, supra note 16.
that courts should define charity with a view to the fiscal consequences following from an award of charitable status;\textsuperscript{23}

- that charities should be subject to restrictions on political advocacy;\textsuperscript{24}

- that religious institutions should not qualify as charities for the purposes of tax law;\textsuperscript{25} and

- that charities should be subject to anti-discrimination requirements going beyond those applicable to non-governmental entities generally.\textsuperscript{26}

We can sketch from this some potential regulatory implications of reforms that would make donation incentives more generous and more targeted. It seems unlikely that enhancing incentives could achieve anything other than to exacerbate whatever tendency already exists for a subsidy view of donation incentives to support both interventionist approaches to regulating charities and fiscally driven approaches to constraining the meaning of charity. More specifically, it seems likely that if the state subsidy for charities were to increase, legislators and regulators would see themselves as having increased latitude, if not the responsibility, to subject charities to new regulatory measures aimed at safeguarding, and perhaps exerting greater control over, the state’s economic investment in charities. Further, if the fiscal dimension of legal charity were to become more pronounced, the courts would presumably become increasingly willing to formally embrace a fiscal consequences test for charitable status, the likely result of which would be a more restrictive and less adaptable legal definition of charity. More generally, an increased public subsidy would bring a heightened tendency for charities to be viewed as public institutions, predisposing law makers to approach the governance and operation of charities as matters of public concern.

Likewise, shifting the policy focus to a more targeted donation incentive could attract a new source of regulation for charities in the form of constitutional scrutiny. A still developing point of law is whether donation incentives specifically, and tax expenditures more generally, should be constitutionally scrutinized identically to direct

\textsuperscript{23} Supra note 15.


\textsuperscript{26} See, for example, Nicholas Mirkay, “Losing Our Religion: Reevaluating the Section 501(c)(3) Exemption of Religious Organizations That Discriminate” (2009) 17:3 William and Mary Bill of Rights Journal 715-72.
expenditures. At stake is whether the state can fund through tax expenditures activities that it is constitutionally prohibited from directly carrying out or directly funding. Canadian courts have not squarely addressed the matter, and US cases have produced mixed results.\textsuperscript{27} The argument has, however, been made many times—including with specific reference to tax concessions enjoyed by charities—that courts should view tax subsidies and direct subsidies as not only economic equivalents but also constitutional equivalents.\textsuperscript{28} This would presumably require that the common-law meaning of charity, which is used to determine eligibility for charitable status for income tax purposes, conform with Charter\textsuperscript{29} principles normally restricted to governments. Since the common-law meaning of charity has the effect of defining the scope of permissible activities for charities, the effect would be similar to charities being directly subject to the Charter.

Notably, not all donation incentives are equally likely to attract constitutional scrutiny. Zelinsky argues that, as a state subsidy becomes more targeted, it by definition becomes a “more particularized, more intimate” form of state sponsorship.\textsuperscript{30} This could matter from a constitutional perspective, or so it has been argued, because it makes it easier to link the state with the activities of the institution being subsidized than would otherwise be the case.\textsuperscript{31} It is for this reason that a targeted donation incentive might attract constitutional scrutiny that would not otherwise exist under a donation incentive formally available to all taxpayers without distinction. The analysis is necessarily contextual. Just as not every enhancement in the amount of the CDTC would necessarily yield corresponding regulatory enhancements for charities, neither would every effort at targeting the credit necessarily attract constitutional scrutiny. My goal here is therefore not to make dogmatic predictions of what specific regulatory reforms would or should necessarily follow.


\textsuperscript{29} Canadian Charter of Rights and Freedoms, part I of the Constitution Act, 1982, being schedule B to the Canada Act 1982 (UK), 1982, c. 11 (herein referred to as “the Charter”).

\textsuperscript{30} Zelinsky, supra note 27, at 410-12.

\textsuperscript{31} Ibid.
from enhancing and/or more specifically targeting the CDTC, but rather to identify the trajectory of regulatory reform that such a policy change might have a tendency to yield. There are plausible reasons to suggest that if there were any regulatory effect at all, it would tend toward augmenting existing regulations. I turn next to consideration of whether such a development would remedy a regulatory void or undermine any of the CDTC’s crucial policy objectives.

THE POLICY GOALS OF DONATION INCENTIVES

From the point of view of policy makers, the appeal of an enhanced and targeted donation incentive is understandable. Assuming (as the empirical studies suggest that we can) that the demand for charitable giving is not price inelastic, enhancing donation incentives is one way to achieve the ultimate policy goal of attracting charitable donations. Further, those who view efficiency as an essential characteristic of a “good” donation incentive will have reason to prefer a targeted incentive over a uniform incentive available to all taxpayers without distinction. Unlike a uniform incentive, a targeted measure allows policy makers to contain costs and reduce inefficiency by attracting donations from specific taxpayers—for example, those who will be most responsive to donation incentives, those for whom existing incentives are insufficient to alter behaviour, or those who are most likely to support charitable causes favoured by the government of the day. We might also conclude that an enhanced and targeted donation incentive is in some respects consistent with the theoretical thinking behind donation incentives. The extensive body of scholarship dealing with donation incentives has identified a number of reasons why a tax subsidy for charities in the form of a donation incentive is preferable to a direct subsidy. The arguments include the claims that a donation incentive

- fosters a form of direct democracy unavailable under a direct subsidy, by enabling donors to vote (through donations) how tax dollars are spent;33
- better allocates the costs of charitable programming between taxpayers generally and individual donors who value that programming;34 and
- offers efficiency advantages, at least inasmuch as the incentive is treasury-efficient.35

32 See Peloza and Steel, supra note 9.
If this were all there were to it, then it could be said that an enhanced incentive aimed specifically at donors who are not currently making charitable contributions would help achieve all of the policy goals behind the charitable tax credit, provided at least that it was effective at inducing donations from its target demographic.

There are, however, other metrics to consider, including the extent to which donation incentive reform would affect the regulatory treatment of charities. We might conclude that one of the critical policy objectives of donation incentives will have been frustrated if, as I suggested above, the FTDC (or any successor reforms that it inspires) prompts regulatory reforms compromising the separateness and independence of charities from government. Interestingly, the relative lack of government control and oversight over charities has been criticized as an incurable defect of the CDTC, and one that is of sufficient concern to warrant repeal of the credit. However, this criticism may well miss the point. The goal of donation incentives is not merely to attract donations, but rather to attract donations without also attracting the same kind of government control and oversight that would typically exist under either a direct subsidy or a government-supplied good or service. A recurring theme in the academic literature dealing with charity tax concessions is that charities are, and should remain, “separate from government.” A donation incentive has been said to be superior to a direct state grant in the sense that it represents the funding mechanism most respectful of the separateness of charities from government, in that it “lessens the involvement of government in the affairs of charities.” Likewise, a tax subsidy has been rationalized on the basis that it “carries with it a sense of leaving the nonprofit sector inviolate.” According to this reasoning, a permanent tax concession available to all institutions meeting stable eligibility criteria not only removes charities from the annual process of petitioning the state for subvention, but also “keeps government out of the charities’ day-to-day business.”

To be clear, the claim is not that a tax subsidy immunizes charities from any form of state oversight. A tax subsidy will inevitably tend to bring with it some degree of state regulation aimed at preserving and protecting the public funding implicit in donation incentives. At the minimum, this is apt to include regulations ensuring that

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36 Brooks, supra note 25.
38 Ibid., at 845.
40 Ibid., at 586. Though Brody makes this point with specific reference to the tax-exempt status of charities, I do not understand her argument to preclude applying the identical reasoning to donation incentives.
official donation receipts can only be issued for qualifying contributions,\textsuperscript{41} that donations are properly valued,\textsuperscript{42} that private inurement is restricted,\textsuperscript{43} and that abusive donation schemes are excluded from the tax expenditure program.\textsuperscript{44} State regulation can even include selective interventions into the internal management of charities by, for example, prohibiting charities from being operated for political purposes.\textsuperscript{45} The argument that a tax subsidy is somehow protective of the independence of charities does not ignore the inevitability of such state regulation. It merely posits that, compared to a direct state grant, a tax subsidy is apt to attract a muted and less vigorous form of state oversight.

The suggestion that diminished government control is a desirable feature of the CDTC that is worth preserving runs the risk of being written off as libertarian politics masquerading as scholarly analysis. However, there is greater substance to this suggestion than is acknowledged by such a retort. Since the goal of the CDTC is to attract donations to particular institutions—those qualifying as charitable at common law—the design of the credit should arguably be attentive to the preconditions for charitable status at common law. It is notable then that, although a blurring of charitable and governmental pursuits has occurred through time, the common-law authorities continue to contemplate the separateness of charity from government. So, for example, donations to governmental departments for their general purposes and to certain trusts for the purpose of carrying out governmental policy have been held not to qualify as charitable gifts.\textsuperscript{46} Also, the UK charity commission, whose policy documents are generally regarded as authoritative throughout the Commonwealth, observes that charitable trusts must be independent from government.\textsuperscript{47} In

\begin{itemize}
\item \textsuperscript{41} A contribution to a charity must qualify as a “gift” (paragraph 38(a.1) and subsections 110.1(1) and 118.1(3)). Subsection 248(30) elaborates on the requirements of a “gift.” There is also an extensive body of case law, as well as administrative publications issued by the Canada Revenue Agency, dealing with the prerequisites of gifts.
\item \textsuperscript{42} Receipts can only be issued for the “eligible amount” of gifts, as defined in subsection 248(31). In addition, there are valuation rules specific to certain kinds of donations; see, for example, subsection 248(35).
\item \textsuperscript{43} See, for example, the definitions of “charitable foundation” and “charitable organization” in subsection 149.1(1). In addition, paragraphs 149.1(2)(c), (3)(b.1), and (4)(b.1) prohibit gifts by charities to non-qualified donees, and subsection 188.1(4) provides a penalty applicable where a charity confers an “undue benefit” on any person.
\item \textsuperscript{44} The Act includes a number of anti-avoidance measures designed to respond to abusive donation schemes. See, for example, subsection 46(5), which denies favourable capital gains tax treatment to art flips; subsection 118.1(13), which provides for the non-recognition of gifts of non-qualifying securities; and paragraph 248(32)(b), which is meant to frustrate abusive leveraged donations.
\item \textsuperscript{45} See, for example, subsections 149.1(6.1) and (6.2) and the secondary sources cited supra note 24.
\item \textsuperscript{47} United Kingdom, Charity Commission for England and Wales, \textit{The Independence of Charities from the State}, RR7 (London: Charity Commission for England and Wales, February 2001).
\end{itemize}
the view of the commission, if the purpose of a trust is ultimately to implement the policies of government, or if the trust operates such that it merely carries out the directions of government, it will not qualify as charitable. The best explanation for this is that charities are not government and cannot be operated or established as an arm of, or under the immediately control of, government. We can think of donation incentives as a funding mechanism that respects this characteristic of legal charity. The diminished government control relative to a direct subsidy is therefore arguably not an accidental defect, but rather a concession to the unique nature of charitable trusts. This is not to suggest that direct state funding is inherently incompatible with the prerequisites for charitable status. It is merely to say that there is a principled basis for viewing the relative lack of government control under a tax subsidy as something worth preserving.

Likewise, we find in the rationales for subsidizing charities through tax concessions a basis for embracing diminished state control as a virtue of the CDTC. In addition to the rationales mentioned above, another commonly accepted rationale is that charitable programming offers comparative advantages over government programming in the sense of greater pluralism, innovation, quality, and diversity.48 If these advantages are illusory, as has been argued,49 then perhaps it is time to re-evaluate the case for the continued existence of the CDTC. But if the comparative advantages are real, then donation incentives should be designed with a view to fostering the kind of regulatory infrastructure within which those comparative advantages are most likely to flourish. It would be self-defeating to adopt a tax concession whose ultimate effect was to erode the very characteristics that qualify charities as suitable candidates for a state subsidy in the first place. It seems at least plausible to suggest that this is exactly what could occur if the design features of a tax concession have a tendency to attract reforms resulting in charities being regulated, through constitutional law or otherwise, and controlled as extensions of government. The more that charities are regulated and controlled by government, especially in relation to matters of program delivery, the more they will presumably resemble offshoots of government and the less they will presumably offer comparative advantages over government. So if the goal of donation incentives is to enable the comparative advantages of charities over government, we find in that goal at least one tenable reason to preserve some degree of separateness of charities from government.

The argument advanced here is vulnerable to the critique that governments fund charities not only through tax subsidies but also through direct state grants. In fact, direct state grants represent the principal source of funding for many charities. One might say, then, that it is redundant to insist that donation incentives be designed with a view to insulating charities from the very kind of government control and

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49 Brooks, supra note 25.
oversight to which they are already subject as a result of receiving direct state grants. However, the fact that some charities receive direct subsidies does not render the argument set out here moot. Since not all charities are offered, or choose to accept, direct subsidies, not all charities are currently subject to the control and oversight that accompanies direct grants. More importantly, even in contexts where direct state grants are common, the scope and form of governmental control and oversight can be tailored to address specific policy concerns. In contrast, regulations inspired by an overly generous and overly targeted donation incentive would likely apply indiscriminately to all charities as a precondition for being permitted to issue official donation receipts. The regulation of legal charity should, however, be more respectful than this of the sheer breadth and diversity of charitable pursuits. To say that there is value in preserving the separateness of charities from government is not to deny that some charitable purposes (for example, health care) should attract a greater degree of governmental control and oversight relative to others (for example, the advancement of religion). It is merely to raise questions about reforming donation incentives in ways that could attract regulatory interventions similar to those fostered by a direct state grant. A defensible way to acknowledge the disparate regulatory concerns raised across the various categories of legal charity is to continue the longstanding practice of funding charities in two distinct ways: (1) through donation incentives that are deliberately designed to preserve as much as possible the separateness of charities from government; and (2) through direct state grants that are delivered to select charities and that attract enhanced accountability to government as appropriate to the context.

For these reasons, it could be argued that donation incentive reforms with the potential to attract the enhanced regulatory scrutiny of charities contradict at least one of the goals of the charitable tax credit. I have suggested that reforms directed at enhancing and more specifically targeting the charitable tax credit have this potential. The perspective I have articulated draws upon judgment and reasoned reflection rather than empirical analysis. There is therefore no bright-line test for identifying precisely when a donation incentive should, from this vantage, be judged as overly generous and/or overly targeted. The FTDC is likely too limited a measure to, in and of itself, bode long-term regulatory consequences for charities. Should the FTDC leave a legacy, it will be the successor reforms that it inspires. Reform discussions following from the FTDC will predictably be centred on the amount of and eligibility for the CDTC. My aim in this brief policy note has been to guide such discussions by identifying reasons why a modest incentive available without distinction to all taxpayers making charitable donations might be the best way to balance the various policy goals of the charitable tax credit.

50 Although the Act sets private foundations apart from other charities for unique regulatory treatment, it does not otherwise distinguish between charities—at least not on the basis of the four categories of legal charity: the relief of poverty, the advancement of education, the advancement of religion, and other purposes of public benefit. Income tax law, as currently constituted, is therefore a somewhat blunt instrument for regulating charities.

51 See supra note 50.
LIVING WITH THE FOREIGN AFFILIATE DUMPING RULES

Ian Bradley***

The foreign affiliate dumping rules place significant restrictions on investments by foreign-controlled Canadian corporations in foreign affiliates. Such investments may be effectively treated as distributions out of Canada, with corresponding tax consequences. The scope of the foreign affiliate dumping rules is broad, while exceptions are narrow and technically complex. As a result, the rules can apply in unexpected ways to a wide variety of bona fide business arrangements. Foreign-controlled Canadian corporations must consider carefully the effect of these rules on all of their business activities.

This article provides a general overview of the foreign affiliate dumping rules and reviews their application to the different stages of a foreign affiliate investment. It highlights the significant practical issues that can result from unexpected applications of the rules, and discusses how investments may be structured to address these concerns.

KEYWORDS: FOREIGN AFFILIATES ■ DEBT ■ DUMPING ■ FOREIGN INVESTMENT ■ NON-RESIDENT ■ RESTRICTIONS

CONTENTS

Introduction 1148
Overview of the FA Dumping Rules 1149
Conditions for Application 1149
Exceptions 1150
Effect of the Rules 1151
Control by a Non-Resident Corporation 1152
Control by Holding Companies 1152
Control by Partnerships 1152
Temporary Control 1154

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INTRODUCTION

The foreign affiliate dumping (“FA dumping”) rules are a major change to the tax rules governing foreign investments by foreign-controlled Canadian corporations. In the past, Canadian subsidiaries of foreign multinationals generally were free to invest in foreign affiliates on the same basis as other Canadian taxpayers. The FA dumping rules now seek to deter any such investments that can erode the Canadian tax base.¹

The FA dumping rules are found in section 212.3 of the Income Tax Act.² The rules generally apply to investments by foreign-controlled Canadian corporations in foreign affiliates. Such an investment is essentially treated as a distribution out of Canada, in the form of either a reduction of paid-up capital (PUC) or a deemed dividend subject to non-resident withholding tax. Exceptions to the rules are narrowly drafted and subject to numerous carve-outs.

The FA dumping rules were introduced in the March 29, 2012 federal budget and enacted in Bill C-45.³ Proposed amendments to the rules were released on

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¹ See Canada, Department of Finance, Explanatory Notes Relating to the Income Tax Act, the Excise Tax Act and Related Legislation (Ottawa: Department of Finance, October 2012) (herein referred to as “the 2012 explanatory notes”), at 86.

² 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.

³ Bill C-45, Amendments to the Income Tax Act and Related Regulations, first reading October 18, 2012; enacted by SC 2012, c. 31, section 49(1).
August 16, 2013. These proposals address several technical deficiencies identified by stakeholders, as well as concerns of the Department of Finance. Despite these changes, the FA dumping rules can still produce many unexpected results, even for regular business transactions that pose no threat to the Canadian tax base.

Taxpayers must carefully examine all transactions involving foreign-controlled Canadian corporations and foreign affiliates, to assess the impact of the FA dumping rules. This article explores some key practical issues that may arise at different stages of an investment. It highlights anomalies in the rules that may trap the unwary, as well as opportunities for minimizing the effect of the rules on bona fide business arrangements.

**OVERVIEW OF THE FA DUMPING RULES**

A general overview of the FA dumping rules is set out below, to provide context for the discussion that follows. A more detailed technical discussion of the rules is beyond the scope of this article.

**CONDITIONS FOR APPLICATION**

Subsection 212.3(1) sets out the circumstances in which the FA dumping rules will apply. The rules will apply if all of the following requirements are satisfied:

- **Investment test**: A corporation resident in Canada (referred to as a “CRIC”) makes an “investment” in a non-resident corporation (referred to as “the subject corporation”) at a particular time (referred to as “the investment time”).
- **Foreign affiliate test**: The subject corporation is a foreign affiliate of the CRIC immediately after the investment time, or becomes a foreign affiliate as part of a series of transactions that includes the investment.
- **Control test**: The CRIC is controlled by a non-resident corporation (referred to as “the parent”) at the investment time, or becomes so controlled as part of a series of transactions that includes the investment.
- **No exceptions**: None of the exceptions described below applies to the investment.

The August 2013 proposals will narrow the control test described above. This test will be met only if the parent controls the CRIC at the investment time, or after the investment time as part of a series that includes the investment, and one of the following conditions is satisfied:

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4 Canada, Department of Finance, *Legislative Proposals in Respect of Foreign Affiliates* (Ottawa: Department of Finance, August 2013) (herein referred to as “the August 2013 proposals”). Assuming that the amendments are enacted as proposed, they will generally apply to transactions or events occurring after March 28, 2012 (the same effective date as for the current rules). Certain amendments that are more restrictive than the current rules will apply to transactions or events occurring on or after August 16, 2013.
at the investment time, the parent, together with non-arm’s-length persons, owns shares of the CRIC constituting at least 25 percent of its voting rights or fair market value (FMV);

the investment is a preferred share investment described in subsection 212.3(19) (discussed below); or

an unrelated person or partnership has in any material respect the risk of loss or the opportunity for gain or profit in respect of property related to the investment.

An “investment” in a subject corporation is defined in subsection 212.3(10). The investment concept is quite broad and includes, among other things, acquiring shares or debt of a subject corporation, making capital contributions to a subject corporation, and acquiring shares of a Canadian corporation that derives more than 75 percent of its FMV from foreign affiliate shares.

**Exceptions**

An investment will not be subject to the FA dumping rules if one of the following exceptions applies:

- **Strategic business expansion:** Subsection 212.3(16) provides an exception for certain strategic business investments where the business activities of the subject corporation (and its subsidiaries) are more closely connected to the Canadian business activities of the CRIC (or other Canadian members of the corporate group) than to the business activities of other non-resident group members. This narrow exception may be available only in limited circumstances.

- **Indirect funding:** Subsection 212.3(24) provides a limited exception for certain indirect financing arrangements through a foreign affiliate group where a direct investment would have qualified for the subsection 212.3(16) exception.

- **Reorganizations:** Subsection 212.3(18) provides exceptions for share acquisitions in the course of certain corporate reorganizations and distributions. These exceptions generally apply to internal group transactions in which no incremental value is invested.

- **Pertinent loan or indebtedness (PLOI):** Paragraphs 212.3(10)(c) through (e) provide that the FA dumping rules will not apply to a debt investment if the CRIC and the parent elect to treat the debt as a PLOI in accordance with subsection 212.3(11). The CRIC is deemed to have received at least a minimum amount of interest income on the PLOI, computed at a prescribed rate.5

These exceptions are subject to two significant limitations. First, the exceptions for strategic business expansions and for many reorganizations will not be available where the investment consists of preferred shares of the subject corporation, unless

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5 Section 17.1.
the subject corporation is a wholly owned subsidiary. Second, the exception for strategic business expansions will not be available where the proceeds of the investment are used to make an indirect investment that the CRIC could not have made directly without the application of the FA dumping rules. The August 2013 proposals will extend this indirect investments limitation to the indirect funding exception in subsection 212.3(24).

**Effect of the Rules**

The application of the FA dumping rules to an investment may result in a deemed dividend or a PUC reduction, as described below.

Where the FA dumping rules apply, paragraph 212.3(2)(a) deems the CRIC to have paid a dividend to the parent for non-resident withholding tax purposes. A “dividend substitution election” may be filed under subsection 212.3(3) to deem this dividend to have instead been paid by a “qualifying substitute corporation” (QSC), or received by a non-arm’s-length foreign corporation. The QSC concept, discussed below, generally includes upper-tier Canadian corporations in the CRIC’s corporate group.

The amount of the deemed dividend is generally equal to the value of the consideration provided by the CRIC for the investment. However, subsection 212.3(7) (as modified by the August 2013 proposals) reduces the amount of the dividend by the PUC of certain classes of shares (referred to as “cross-border classes” of shares), and reduces the PUC of these cross-border classes by an equal amount. A cross-border class is a share class of the CRIC or a QSC, any shares of which are owned by the parent or by a non-arm’s-length foreign corporation. Thus, the deemed dividend is automatically converted to a PUC reduction, to the extent that sufficient cross-border PUC is available.

The amount of the deemed dividend does not include the value of any CRIC shares issued in relation to the investment (such as CRIC shares issued in exchange for subject corporation shares). However, any PUC increase from issuing such shares is denied under paragraph 212.3(2)(b).

Any PUC that has been reduced under subsection 212.3(2) or (7) can potentially be reinstated under subsection 212.3(9) when property traceable to the investment is repatriated from Canada, to offset the PUC reduction arising on this repatriation.

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6 Subsection 212.3(19).
7 Subsection 212.3(23).
8 The wording of paragraph 212.3(2)(b) appears to be quite broad in that it refers to any increase in the PUC of CRIC shares “that can reasonably be considered to relate to the investment.” However, the 2012 explanatory notes indicate that this provision is intended to apply only to a PUC increase that is directly related to an investment in a subject corporation. For example, paragraph 212.3(2)(b) should not apply where CRIC shares are issued in exchange for cash and this cash is used to make an investment in a subject corporation, because the share issuance is one step removed from the investment. See the 2012 explanatory notes, supra note 1, at 88.
Control by a Non-Resident Corporation

The impact of the FA dumping rules must be considered at each stage of an investment by a foreign-controlled Canadian corporation. The first step is to determine whether the Canadian corporation is controlled by a non-resident corporation and is therefore within the ambit of the rules. The control test raises several practical and interpretive issues, which may influence how non-residents choose to structure their Canadian investments.

Control by Holding Companies

Investments in Canadian corporations are often made by groups of unrelated non-resident investors, such as private equity funds. Before the introduction of the FA dumping rules, these groups often invested through foreign holding companies. Centralizing ownership in a single foreign entity simplified Canadian tax-compliance obligations. However, these holding structures may produce unfavourable results under the new rules.

Consider a situation in which five unrelated non-resident corporations invest in a CRIC through a foreign holding company. Each investor owns 20 percent of the shares of the holding company, which owns all of the CRIC’s shares. Since the holding company controls the CRIC, the control test in subsection 212.3(1) is satisfied, even though none of the investors is in a position to control the CRIC.

The control test should produce different results if each non-resident investor holds its CRIC shares directly. Since each investor owns only 20 percent of the CRIC’s shares, no investor should control the CRIC. The CRIC should not be controlled by a non-resident corporation, and the FA dumping rules should not apply.

The August 2013 proposals include proposed paragraph 212.3(15)(b). This rule deems a CRIC to be controlled by a non-resident corporation if a related group of non-resident corporations is in a position to control the CRIC. Notably, this deeming rule does not apply to unrelated groups of non-resident corporations. This is consistent with the case law on group control, which indicates that shareholders of a widely held corporation must have a common connection in order to constitute a group of persons that controls the corporation.9

Unrelated non-resident corporations may wish to invest in Canada directly, rather than through a foreign holding company. Non-resident individuals may also prefer to invest directly, since the FA dumping rules apply only to CRICs that are controlled by non-resident corporations.

Control by Partnerships

Canadian investments by foreign partnerships raise challenging interpretive questions. Subsection 212.3(25) provides several partnership deeming rules that apply for the purposes of section 212.3. In particular, paragraph 212.3(25)(b) deems the

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partners of a partnership to own their proportionate shares of the partnership’s property, based on the relative FMV of their partnership interests. This suggests that when applying the control test in subsection 212.3(1), CRIC shares that are held by a partnership should be allocated to the partners in proportion to their partnership interests. Thus, if all of a CRIC’s shares are held by a partnership and a non-resident corporation has a 51 percent economic interest in the partnership, it could be argued that the non-resident corporation controls the CRIC for the purposes of the FA dumping rules.

However, control is not simply a matter of share ownership. Control is the ability to exercise a majority of votes in the election of a corporation’s board of directors. While this ability is generally based on share ownership, courts may also consider restrictions on voting rights imposed by a corporation’s constating documents, including unanimous shareholders’ agreements. Accordingly, even if a person is deemed to own a majority of a CRIC’s voting shares, that person may not necessarily control the CRIC.

This issue is most apparent where CRIC shares are held by a limited partnership. The general partner of a limited partnership often has the authority to vote shares held by the partnership. For this reason, the Canada Revenue Agency (CRA) has expressed the view that a corporation whose voting shares are held by a limited partnership is controlled by the general partner of the partnership. The CRA has not indicated whether it will apply this position in the context of the FA dumping rules.

If a CRIC owned by a limited partnership is considered to be controlled by the general partner, the FA dumping rules could produce unexpected results. This can be illustrated by a limited partnership in which the general partner holds a 1 percent interest and the remaining 99 percent is held by the limited partners. The partnership holds all of the shares of a CRIC. If the general partner is a non-resident corporation, it could be argued that the control test in subsection 212.3(1) is satisfied, even if the limited partners are Canadian residents or unrelated non-residents. On the other hand, if the general partner is a Canadian corporation, it could be argued that the control test is not satisfied, even if the limited partners are related non-resident corporations.

The limited partnership issue is particularly relevant to investments by private equity funds. These funds often invest through limited partnerships, in which the limited partners are unrelated investors and the general partner is a corporation owned by the private equity firm. Although in the past these partnerships have generally invested in Canada through foreign holding companies, the FA dumping rules could make such holding structures undesirable, as discussed above.

The ambiguity regarding the control test could cause considerable uncertainty for investments made through partnerships. This issue was brought to Finance’s

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attention in the initial submissions responding to the 2012 budget proposals.\textsuperscript{12} However, subsequent revisions to the FA dumping rules did not resolve this uncertainty.

**Temporary Control**

Where a CRIC would otherwise be controlled by several non-resident corporations in the same ownership chain, paragraph 212.3(15)(a) generally deems the CRIC to be controlled only by its direct non-resident parent. For example, one non-resident corporation (“NR 1”) owns another non-resident corporation (“NR 2”), which owns a CRIC. According to general principles, NR 1 and NR 2 both control the CRIC.\textsuperscript{13} However, for the purposes of the FA dumping rules, the CRIC is controlled only by NR 2. Paragraph 212.3(15)(a) is generally a relieving rule that prevents the FA dumping rules from applying multiple times to the same investment. However, this rule can produce unusual results where CRIC shares are transferred within a corporate group.

These anomalous results can be illustrated using the corporate group described in the previous paragraph. In this example, the CRIC makes an investment in a foreign affiliate. As part of the same series of transactions, the CRIC’s shares are transferred up the ownership chain, from NR 2 to NR 1. When NR 1 acquires the CRIC shares, it becomes the CRIC’s direct parent company, and paragraph 212.3(15)(a) no longer applies. The CRIC is controlled by NR 2 at the investment time, and becomes controlled by NR 1 as part of the series that includes the investment. The FA dumping rules could therefore apply twice to the same investment, once from the perspective of NR 1 and once from the perspective of NR 2.

The control test as modified by the August 2013 proposals is not satisfied where the parent ceases to control the CRIC before the investment time. The inappropriate tax consequences described above could be avoided by reordering the transactions, so that the CRIC makes the investment after its shares have been transferred to NR 1. In this case, the FA dumping rules should apply only once. This demonstrates that corporate reorganizations involving the transfer of CRIC shares should be structured carefully, to avoid multiple applications of the FA dumping rules.

**Making an Investment: PUC Reduction Issues**

A deemed dividend arising under paragraph 212.3(2)(a) is automatically reduced to the extent of any cross-border PUC. This PUC reduction avoids the immediate withholding tax consequences of a deemed dividend. As noted above, PUC that is reduced when an investment is made can potentially be reinstated when property traceable to

\textsuperscript{12} The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, “Re: 2012 Federal Budget—International Taxation Proposals,” June 8, 2012, at 18-20.

\textsuperscript{13} Subsection 256(6.1) provides that, for greater certainty, a subsidiary corporation that is controlled by a parent corporation is also controlled by any person or group of persons that controls the parent corporation.
the investment is repatriated from Canada. Thus, a PUC reduction may avoid permanent negative tax consequences, although it will temporarily reduce the CRIC’s equity for the purposes of the thin capitalization rules.14

Unlike a PUC reduction, a deemed dividend cannot be reversed at a later date. In fact, withholding tax may be imposed again when the proceeds of the investment are repatriated from Canada, resulting in double taxation. For this reason, taxpayers making investments that are subject to the FA dumping rules will generally want to ensure that sufficient cross-border PUC is available to prevent a deemed dividend from arising. Arrangements to facilitate PUC reduction and future PUC reinstatement must be in place before the investment is made, because it may not be possible to fix mistakes once the investment has been made.

**Timing of PUC Creation**

Subsection 212.3(7) reduces the deemed dividend only to the extent of the cross-border PUC available immediately before the time the dividend is paid. Taxpayers need to monitor the timing of their investments in order to ensure that any cross-border PUC required to offset a potential deemed dividend related to an investment is created in advance.

Under the current rules, deemed dividends and PUC reductions under subsections 212.3(2) and (7) occur at the investment time. This can cause problems where the parent does not control the CRIC at that time. The August 2013 proposals address this issue by delaying the application of subsections 212.3(2) and (7) where the parent does not control the CRIC at the investment time but controls the CRIC at the end of the series of transactions that includes the making of the investment. In these circumstances, the deemed dividends and PUC reductions do not arise until the earlier of the time when the parent acquires control and 180 days after the investment time.15 This change provides some relief where a CRIC invests in a subject corporation before the parent invests in the CRIC. However, timing mismatches can still arise in situations where the parent already controls the CRIC at the investment time.

Timing problems can arise if the creation of PUC in the CRIC occurs simultaneously with the making of the foreign affiliate investment. Consider a transaction in which a CRIC buys shares of a foreign affiliate from a third party, the parent pays the purchase price on behalf of the CRIC, and the CRIC issues shares to the parent in consideration for this payment. The share issuance should create PUC equal to the value of the foreign affiliate investment. However, this PUC does not exist until the investment is made. The CRIC may therefore have insufficient PUC immediately before the investment, when subsection 212.3(7) applies.

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14 A corporation’s “equity amount” for the purposes of the thin capitalization rules is defined in subsection 18(5) to include the corporation’s PUC.

15 See proposed subsection 212.3(1.1), which generally replaces the “investment time” test with a “dividend time” test.
Timing issues can also occur if a CRIC purchases foreign affiliate shares and payment of all or a portion of the purchase price is deferred until after the acquisition owing to earnouts or price adjustment clauses. If the funds for the purchase are invested in the CRIC only as they are needed, there may be insufficient cross-border PUC at the investment time (the time the shares of the foreign affiliate are acquired by the CRIC).

Consider an example in which a non-resident parent owns CRIC shares with nominal PUC. The CRIC wishes to acquire a foreign corporation (“Forco”) worth $100 million. The CRIC acquires all of Forco’s shares, paying $80 million cash up front and $20 million one month after the purchase. The parent subscribes for CRIC shares for $80 million, and the CRIC uses the subscription proceeds to pay the up-front purchase price. The investment produces a $100 million deemed dividend, but the amount of cross-border PUC available immediately before the investment time is only $80 million, so a $20 million dividend remains.

A non-resident can avoid this result by transferring funds to the CRIC representing the full price of the investment before the investment is made, even if these funds will not be needed until a later date; however, this may cause practical issues when the deferred amounts to be paid are uncertain.

**Non-Wholly Owned Share Classes**

PUC is computed for a particular share class and then averaged among the issued shares of that class. Therefore, a PUC reduction under subsection 212.3(2) or (7) applies equally to all shares of the affected class, including any shares held by arm’s-length persons. In contrast, a deemed dividend under paragraph 212.3(2)(b) is paid entirely to the parent (or to a non-arm’s-length foreign corporation if a dividend substitution election is made).

The subsection 212.3(7) PUC reduction can effectively transfer part of the tax burden of the FA dumping rules from the parent to unrelated shareholders, even if those shareholders have no influence on the investment decision. While the PUC reduction under the existing rules is elective where CRIC shares are owned by arm’s-length non-residents, the August 2013 proposals make the PUC reduction automatic in all circumstances. This means that taxpayers must be aware of this issue and plan accordingly. One potential solution is to organize the CRIC’s share structure so that unrelated shareholders hold all of the shares of a separate class.

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16 See the definition of “paid-up capital” in subsection 89(1).

17 Where there are multiple cross-border share classes, subsection 212.3(7) (as modified by the August 2013 proposals) allocates the total PUC reduction between classes so as to maximize the PUC reduction on shares owned by the parent or by non-arm’s-length foreign corporations. However, the PUC of shares owned by unrelated shareholders can still be reduced by subsection 212.3(7) where there is only one cross-border share class, or where the total PUC reduction exceeds the PUC of cross-border share classes that are wholly owned by the parent or by related non-resident corporations.
Shares of a cross-border class may also be held by Canadian members of the parent’s corporate group. Subsection 212.3(7) can therefore reduce the PUC of shares held by related Canadian corporations, as well as the PUC of cross-border shareholdings. This may produce favourable results, since PUC within a Canadian corporate group is generally less useful than cross-border PUC. Taxpayers may try to structure their investments to maximize the PUC reduction on shares held by related Canadian corporations. The application of section 245 (the general anti-avoidance rule) to any such arrangements would need to be considered.

**Paragraph 212.3(2)(b) and Unrelated Shareholders**

The PUC reduction in paragraph 212.3(2)(b) applies where the PUC of CRIC shares is increased in relation to an investment. This PUC reduction can also apply to shares held by unrelated parties. Consider a CRIC with a single class of shares. Most shares are owned by a non-resident parent corporation, while the remainder are owned by unrelated minority shareholders. The CRIC acquires foreign affiliate shares from its parent in exchange for newly issued CRIC shares. Any increase in the PUC of the CRIC shares resulting from this share issuance is denied under paragraph 212.3(2)(b). Thus, the overall PUC of the CRIC shares is unchanged. However, a greater portion of this PUC is allocated to shares owned by the parent, because the parent now owns additional shares. PUC has effectively been reallocated from the minority shareholders to the parent. In this case, the problem can be addressed by ensuring that the newly issued CRIC shares are of a separate class from the existing shares.

A more difficult problem can arise where CRIC shares are issued to unrelated shareholders in relation to an investment. Consider the situation where a foreign-controlled CRIC acquires the shares of a foreign corporation (“Forco”) from unrelated vendors. The consideration paid to the vendors includes CRIC shares, under an earnout arrangement. The acquisition of the Forco shares is an investment by the CRIC. However, the value of the newly issued CRIC shares is not included in computing the deemed dividend under paragraph 212.3(2)(a). Instead, the PUC of these shares is reduced under paragraph 212.3(2)(b). Thus, the share consideration effectively transfers some of the tax burden from the non-resident parent to the vendors. In contrast to the previous example, this result cannot be prevented by issuing shares of a separate class. This suggests that CRICs should be wary of issuing share consideration in arm’s-length acquisitions.

**Partnerships and Qualifying Substitute Corporations**

The QSC concept can be very important where a CRIC is part of a larger Canadian holding structure. The PUC of QSCs may increase the cross-border PUC available for the subsection 212.3(7) PUC reduction. Where CRIC shares are held through a QSC, the dividend substitution election may allow the parent to access reduced treaty rates for dividend withholding tax.

A QSC is defined in subsection 212.3(4) (as modified by the August 2013 proposals) as a Canadian-resident corporation.
that is controlled by the parent (or by a non-arm’s-length foreign corporation),
that has an equity percentage in the CRIC, and
shares of which are owned by the parent (or by a non-arm’s-length foreign
corporation).

The “equity percentage” concept is imported from the foreign affiliate rules and is
defined in subsection 95(4). A taxpayer’s equity percentage in a particular corpora-
tion is generally the aggregate of the taxpayer’s direct and indirect shareholdings
in the corporation. QSCs are therefore upper-tier Canadian corporations in the
parent’s corporate group that directly or indirectly own CRIC shares. The QSC con-
cept helps to produce appropriate results where a CRIC is held indirectly through
other Canadian corporations.

The QSC test may not apply as intended where a Canadian holding structure
includes a partnership. The equity percentage concept considers shares that are in-
directly held through other corporations, but does not consider shares held through
partnerships. While subsection 212.3(25) provides lookthrough rules for partner-
ships, these deeming rules apply only for the purposes of section 212.3. Section 93.1
contains similar lookthrough rules for determining the foreign affiliate status of
non-resident corporations held through partnerships, but these rules apply only for
the purposes of certain specified provisions. It could be argued that the QSC test
effectively imports the equity percentage definition into section 212.3 and that the
rules in subsection 212.3(25) are therefore relevant when applying the equity per-
centage concept in the QSC context. However, it could also be argued that these
deauling rules do not apply to the equity percentage definition in subsection 95(4).
It is therefore unclear whether CRIC shares that are held through a partnership are
considered in the equity percentage concept for the purposes of the QSC test.

Because of this ambiguity in the QSC test, it could be argued that an upper-tier
Canadian corporation cannot be a QSC if the CRIC is held through a partnership. If
this argument were accepted, a CRIC whose shares were held by a Canadian partner-
ship would have no QSCs, even if the partnership interests were owned by related
Canadian corporations. This CRIC would have no cross-border PUC for the pur-
poses of subsection 212.3(7), so an FA dumping investment would produce a deemed
dividend. Since the dividend substitution election would not be available, this divi-
dend might not qualify for reduced treaty rates of withholding tax. This uncertainty
suggests that taxpayers should exercise caution when partnerships are included in
Canadian holding structures.

REFINACING AN INVESTMENT:
PREVENTING DOUBLE TAXATION

Once a CRIC has made an investment, it may wish to refinance or redeploy the in-
vested funds within its foreign affiliate group without first repatriating the funds to
its parent. However, the FA dumping rules place significant restrictions on these
types of transactions. Taxpayers seeking to restructure an investment must plan their
transactions carefully, to ensure that the FA dumping rules do not apply twice to the same invested funds.

**Term Extensions**

Extending the maturity date of a subject corporation debt (other than a PLOI), or extending the redemption date of subject corporation shares, is considered an investment in the subject corporation under paragraph 212.3(10)(e). Subsection 212.3(5) deems the value of property transferred to the subject corporation in relation to the investment to be equal to the principal amount of the relevant debt obligation, or the FMV of the relevant shares. Thus, extending the term of an investment can cause the FA dumping rules to apply a second time to the entire investment, instead of applying only to any incremental increase in invested funds. This rule applies even if the length of the term extension is insignificant, or if the term extension is undertaken for bona fide commercial reasons.

Finance has stated that the policy objective of this rule is to treat a term extension as a repayment and reinvestment of the original investment. However, if the original investment is actually repaid, a PUC reinstatement may be obtained by repatriating the investment proceeds to the parent. If paragraph 212.3(10)(e) applies, the same invested funds can trigger two PUC reductions. However, only one PUC reinstatement is available when these funds are ultimately repatriated to the parent. This rule can therefore result in double taxation.

The negative consequences of term extensions may cause taxpayers to explore other options for refinancing maturing investments. This may include making a PLOI election (in the case of debt investments) or taking advantage of the reorganization exceptions in subsection 212.3(18).

**Reorganization Exceptions**

Subsection 212.3(18) provides exceptions for acquisitions of subject corporation shares in a variety of related-party transactions, at both the affiliate and the CRIC levels. However, these exceptions are subject to some important limitations.

Subsection 212.3(19) restricts the acquisition of preferred shares on a reorganization. Specifically, it denies the reorganization exceptions for affiliate-level transactions where the subject corporation shares acquired by the CRIC are not fully participating, unless the subject corporation is a wholly owned subsidiary of the CRIC. In determining whether the subject corporation is a wholly owned subsidiary, the CRIC is considered to own all subject corporation shares that are owned by other Canadian corporations that are wholly owned subsidiaries of the CRIC, or of which the CRIC is a wholly owned subsidiary. Accordingly, the preferred share restriction should not apply where the subject corporation is wholly owned by Canadian companies within the CRIC’s ownership chain. However, the restriction will apply if subject corporation

18 See the 2012 explanatory notes, supra note 1, at 93.
shares are owned by another foreign affiliate of the CRIC, or by a Canadian sister corporation, even if all shares are indirectly held by the Canadian corporate group.

Paragraph 212.3(10)(e) may prevent a CRIC from extending the term of redeemable preferred shares, while subsection 212.3(19) may prevent the CRIC from replacing such shares with new preferred shares. While subsection 212.3(18) would allow the CRIC to replace the preferred shares with common shares, this may not be commercially feasible in some situations. It may therefore be difficult to refinance maturing preferred share investments without triggering a second application of the FA dumping rules.

None of the reorganization exceptions applies to debt investments. A CRIC’s options for refinancing maturing debt are apparently limited to repaying the debt and distributing the proceeds to the CRIC’s parent (as discussed below), making a PLOI election, or replacing the debt with shares.

The existing version of subsection 212.3(18) appears to provide broad exceptions where debt is exchanged for shares. Subparagraph 212.3(18)(b)(i) exempts debt-for-share exchanges to which subsection 51(1) applies, while paragraph 212.3(18)(d) exempts all other debt-for-share exchanges. Paragraph 212.3(18)(d) as currently drafted appears quite broad, and could potentially apply where debt of a corporation is replaced with shares of another corporation. The August 2013 proposals restrict paragraph 212.3(18)(d) to provide an exemption only for debt-for-share exchanges to which subsection 51(1) would have applied if the debt had had a conversion feature. This essentially means that debt can be exchanged only for shares of the same corporation, and the debt must be capital property of the holder. Finance apparently views this amendment as clarifying the scope of paragraph 212.3(18)(d), rather than narrowing it.19

The August 2013 proposals also introduce proposed subsection 212.3(18.1). This provision denies all reorganization exceptions for property acquired as repayment or settlement of a PLOI. This rule essentially prevents a CRIC from avoiding the tax consequences of the FA dumping rules by making a PLOI investment that is not subject to the rules, then replacing the PLOI with a share investment under the reorganization rules.

While tax-deferred transactions between foreign affiliates can provide opportunities to redeploy an investment, they can also make it more difficult to access the PUC reinstatement mechanism in subsection 212.3(9) when exiting the investment. This issue is discussed below.

**Interaffiliate Transactions**

The FA dumping rules generally apply to transactions between a CRIC and a foreign affiliate, rather than transactions between foreign affiliates. Accordingly, there may be opportunities to refinance or redeploy invested funds at the affiliate level without

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altering the CRIC’s investment in the subject corporation. For example, a CRIC could invest in a foreign affiliate holding company, which would then invest in operating affiliates. The CRIC’s investment would be subject to the FA dumping rules. However, the holding company’s investment could subsequently be redeployed at the level of the operating affiliates without affecting the CRIC’s investment and triggering a second application of the FA dumping rules. Among other things, the holding company could transfer operating affiliate shares to another foreign affiliate in exchange for debt, despite the restrictions on debt investments in subsection 212.3(18).

EXITING AN INVESTMENT: PUC REINSTATMENT ISSUES

When a CRIC unwinds a foreign affiliate investment, the CRIC cannot reinvest the proceeds from the investment in another affiliate without triggering a second application of the FA dumping rules. Instead, the CRIC must distribute the investment proceeds to its parent, which may then reinvest them in the CRIC. A dividend distribution may be subject to non-resident withholding tax, while a return of capital can generally be made tax-free if sufficient PUC is available. Accordingly, the PUC reinstatement mechanism in subsection 212.3(9) is often needed to prevent double taxation on exiting an investment.

As modified by the August 2013 proposals, subsection 212.3(9) generally applies if PUC has been deducted from a share class under subsection 212.3(2) or (7), and the PUC of that class is reduced at a subsequent time (for example, on a reduction of legal stated capital, or on a redemption or cancellation of shares). Subsection 212.3(9) reinstates the PUC of that share class immediately before the subsequent time, so that this PUC is available to offset the subsequent PUC reduction. Essentially, where subsection 212.3(9) operates as intended, a CRIC can repatriate the proceeds of an investment from Canada without incurring a second PUC reduction.

The amount of the PUC reinstatement is equal to the least of three amounts:

1. the PUC reduction on the share class at the subsequent time;
2. the total amount of all PUC reductions on that share class under subsections 212.3(2) and (7) (which have not previously been reinstated under subsection 212.3(9)); and
3. the FMV of property traceable to the investment.

Each of these three limitations can create practical difficulties, which are discussed below.

ACCEPTABLE REPATRIATION TRANSACTIONS

The first limit on the PUC reinstatement is the amount of the PUC reduction at the subsequent time. The current version of subsection 212.3(9) refers to this limitation as “the amount of the reduction of the paid-up capital at the subsequent time.”
This could be interpreted as restricting subsection 212.3(9) to situations where PUC is reduced by a return of capital. However, the August 2013 proposals amend subsection 212.3(9) to clarify that PUC may be reduced by other transactions, such as a redemption or cancellation of shares.\textsuperscript{21}

Although the August 2013 proposals confirm that PUC may be reduced by different methods, they preserve the basic requirement that the investment proceeds must be distributed from Canada by way of a PUC reduction. A CRIC cannot, for example, obtain a PUC reinstatement by distributing the investment proceeds to a related corporation as payment of a debt. This limitation may be relevant when unwinding existing intragroup financing arrangements.

The starting point for computing the PUC of a share class is the stated capital of that class, as determined under the relevant corporate law.\textsuperscript{22} Thus, a transaction like a return of capital or a share redemption will generally reduce PUC for the purposes of the Act only if stated capital is reduced under corporate law. If a share class has insufficient stated capital, a PUC reduction may not be possible. Once legal stated capital has been reduced, it can be difficult to restore it to its former level without triggering a deemed dividend under subsection 84(1). Taxpayers should therefore ensure that the legal stated capital of cross-border share classes is preserved, even if subsection 212.3(2) or (7) reduces the PUC of these share classes for the purposes of the Act.

\textbf{Continuity of Shares}

The second limit on the PUC reinstatement for a class of shares is the amount of subsection 212.3(2) or (7) PUC reductions on that share class. In other words, the PUC reduction and the PUC reinstatement must occur in respect of the same class of shares. If shares that were subject to a PUC reduction are exchanged for shares of a new class, the PUC reinstatement will not be available. This restriction even applies to related-party share exchanges that are otherwise tax-deferred.

Consider a non-resident parent that subscribes for common shares of a CRIC, which uses the subscription proceeds to make a foreign investment. The PUC of the common shares is reduced under subsection 212.3(7). The CRIC then reorganizes its share capital. The common shares are exchanged for new preferred shares. Subsection 86(1) provides a tax deferral for this share exchange, while subsection 86(2.1) limits the PUC of the preferred shares to the PUC of the common shares. However, the PUC of the preferred shares cannot be reinstated when the investment proceeds are subsequently distributed to the parent. This distribution may therefore be subject to non-resident dividend withholding tax.

\textsuperscript{21} See the 2013 explanatory notes, supra note 19, at 9. In the CRA’s view, share redemptions are also acceptable forms of PUC reduction under the current version of subsection 212.3(9); see CRA document no. 2013-0483751C6, May 23, 2013.

\textsuperscript{22} Subsection 89(1) defines the “paid-up capital” of a class of shares at a particular time as “the paid-up capital in respect of that class of shares at the particular time, computed without reference to the provisions of this Act,” subject to certain specific statutory adjustments.
This share continuity rule can significantly restrict a non-resident’s ability to restructure its Canadian investments. This issue was brought to Finance’s attention in 2012, but has not been addressed in subsequent amendments to the FA dumping rules.23

Subsection 212.3(22) provides continuity rules for vertical amalgamations under subsection 87(11) and windups under subsection 88(1). These rules generally deem the amalgamated corporation to be a continuation of its predecessors and the parent to be a continuation of the wound-up subsidiary. It could be argued that these rules implicitly deem the shares of the successor corporation to be the same as the shares of the predecessor, and therefore the same shares for PUC reinstatement purposes. However, it is not clear whether these deeming rules have this effect. Subsection 87(3.1) provides a share continuity election for amalgamations. This election generally deems a particular share class of the amalgamated corporation to be the same as a particular share class of a predecessor, for the purposes of computing the PUC of the share class of the amalgamated corporation. Since subsection 212.3(9) is essentially a PUC computation rule, it could be argued that the subsection 87(3.1) election provides the share continuity needed for PUC reinstatement purposes.

Taxpayers should take care when planning reorganization transactions involving CRICs and QSCs to ensure that access to PUC reinstatement is preserved. Taxpayers should also note that if a PUC reduction under subsection 212.3(2) or (7) occurs in respect of shares of a QSC, the subsequent repatriation transaction must be made through the same QSC. Where a PUC reduction is spread across the cross-border share classes of multiple corporations, complex repatriation planning may be needed to ensure that the full PUC reinstatement is obtained on exit.

**Continuity of Investment**

The third limit on the PUC reinstatement is generally the value of property traceable to the investment. Where subject corporation shares (or substituted shares of another foreign affiliate) are actually distributed to the parent in the repatriation transaction, the PUC reinstatement is generally limited to the FMV of the shares at the time of the repatriation. In other situations, the PUC reinstatement is essentially limited to the FMV of property that can be traced to proceeds from the disposition of the investment, or to dividends or qualifying returns of capital.24 Under the August 2013 proposals, the PUC reinstatement may also be traced to interest or principal payments on a debt investment.

The tracing test described above is subject to several restrictions that may trap unwary taxpayers. First, the investment proceeds must generally have been received

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24 A “qualifying return of capital” is generally defined in subsection 90(3) as a reduction of paid-up capital on a foreign affiliate share, which would otherwise be deemed to be a dividend under subsection 90(2), in respect of which an election is made under subsection 90(3).
within 180 days of the repatriation transaction. Thus, waiting too long to repatriate the proceeds of an investment could jeopardize access to the PuC reinstatement. Second, the investment proceeds cannot have been received as part of a transaction to which subsection 212.3(18) applied. (The August 2013 proposals extend this restriction to catch proceeds received as part of any investment in a subject corporation to which subsection 212.3(2) did not apply.) This could limit a taxpayer’s ability to exit an investment by way of tax-deferred reorganization transactions.

**ORDINARY-COURSE FINANCIAL ARRANGEMENTS**

The FA dumping rules do not just apply to capital investments. An investment in a subject corporation includes any transaction by which an amount becomes owing by a subject corporation to a CRIC (paragraph 212.3(10)(c)), or any acquisition of a subject corporation debt obligation by a CRIC (paragraph 212.3(10)(d)), unless an exception applies. Thus, many ongoing financial arrangements within a multinational group can also raise FA dumping concerns.

Multinational groups often optimize their cash management by pooling the excess cash balances of group members in a central treasury company, then redistributing this cash to group members as needed. Cash transfers are generally made by way of frequent short-term loans between the group members and the treasury centre. If a CRIC participates in cash-pooling arrangements with its foreign affiliates, any cash-pooling loans to these affiliates could be considered investments subject to the FA dumping rules.

Trade debts can also be problematic. Members of multinational groups may purchase supplies or inventory from other group members on credit, through centralized procurement systems or vertically integrated supply chains. Trade debts owing by a foreign affiliate to a CRIC could also be considered FA dumping investments.

Multinational groups may also enter into factoring arrangements, in which the accounts receivable of group members are transferred to a single financing company. While factoring arrangements often involve customer credit, they may also deal with intragroup receivables. The transfer of foreign affiliate debts to a CRIC could result in an investment under paragraph 212.3(10)(d).

Paragraphs 212.3(10)(c) and (d) provide exceptions for ordinary-course debts and PLOIs. However, the financial arrangements described above typically involve many advances and repayments of funds, and outstanding loan balances, that fluctuate frequently. Loans are often accounted for on the basis of net outstanding balances, rather than by tracking specific debts. These characteristics can make the exceptions difficult to apply in practice, as discussed further below.

**Ordinary Course of Business Exception**

Paragraph 212.3(10)(c) contains an exception for debts arising in the ordinary course of a CRIC’s business that are repaid within 180 days, other than as part of a series of loans or other transactions and repayments. This exception raises several practical issues.
First, if debt balances fluctuate so frequently that it is impractical to track specific advances and repayments, it may be difficult to establish that the 180-day deadline has been met. In these circumstances, it seems reasonable to determine the length of time during which a particular loan is outstanding on a first in, first out (FIFO) basis. The CRA has stated that FIFO can be an acceptable method of tracking loans and advances where the amounts owing are of a similar nature—for example, debts arising from “numerous individual acquisitions of product[s] or services on credit.” However, where the amounts owing are of a different nature, the CRA will expect specific repayments to be linked to specific advances.

Where numerous similar advances and repayments are made (for example, in cash-pooling or trade receivable arrangements), there is a risk that the repayments could be disregarded on the basis that they form part of a series of advances and repayments. It could be argued that these repayments are not part of a series, since they relate to distinct underlying business transactions rather than disguising a single ongoing loan. However, the CRA’s position on this issue is somewhat unclear. The CRA has stated that its views on the series test in paragraph 212.3(10)(c) are the same as those set out in Interpretation Bulletin IT-119R4, which deals with a similar series test in the shareholder loan rules. In this interpretation bulletin, the CRA notes that the series issue is a question of fact. However, it states that repayments of a temporary nature may be evidence of a series. The CRA has also suggested that cash-pooling arrangements could be an example of temporary repayments. The CRA’s comments create uncertainty as to whether cash-pooling and similar financial arrangements qualify for the ordinary-course exception.

Paragraph 212.3(10)(d) provides a similar exception for debts acquired in the ordinary course of a CRIC’s business. This exception is not subject to a series test or a 180-day time limit. However, the debts must be acquired from arm’s-length persons. Therefore, factoring arrangements involving intragroup receivables generally cannot qualify for this exception, and may be subject to the FA dumping rules.

**Pertinent Loan or Indebtedness Exception**

A debt will not be considered an investment under paragraph 212.3(10)(c) or (d) if the taxpayer elects to treat the debt as a PLOI in accordance with subsection 212.3(11). Taxpayers should note that the PLOI election is not automatic, even if the actual

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27 IT-119R4, supra note 26, at paragraph 28.


29 See Ken J. Buttenham, “Are You Ready for the Upstream Loan Rules?” International Tax Planning feature (2013) 61:3 Canadian Tax Journal 747-68, for a discussion of similar issues in the context of the upstream loan rules in subsections 90(6) through (15), which include a similar ordinary course of business exception.
interest rate on a debt exceeds the prescribed rate for PLOIs. A separate PLOI election must be made for each individual debt. Although the CRA will allow PLOI elections in respect of multiple debts arising in the same taxation year to be filed as a single form, this form must identify each specific debt.30

The PLOI filing obligations may cause practical difficulties in the context of the ordinary-course financial arrangements described above. Making a separate election for each debt could be cumbersome, especially if balances fluctuate frequently and accounting systems do not link particular advances to particular repayments. This process would be more manageable if a taxpayer could elect on the basis of the net change in the outstanding loan balance over a period of time, instead of tracking each advance and repayment. For example, a CRIC could treat a net increase in the amount owing by a subject corporation over the course of a week as a PLOI, and could treat a net decrease as a repayment of an existing PLOI, on a FIFO basis. However, it is not clear whether the CRA would accept this method.

The treatment of the PLOI under the tax law of the subject corporation’s home country should also be considered. If an interest-free loan is deemed to bear interest for Canadian tax purposes, this deemed interest may not be deductible in computing the subject corporation’s income under the foreign tax law. This issue can be addressed by charging actual interest on the PLOI. However, taxpayers must still ensure that the interest charged is consistent with the relevant foreign transfer-pricing rules.

The above discussion shows that while the FA dumping rules provide exceptions for ordinary-course debt obligations, it may be difficult to apply these exceptions in practice to many common intragroup financial arrangements. This suggests that the FA dumping rules can create significant complications for the everyday business operations of multinational groups.

CONCLUSION

The FA dumping rules significantly alter the tax environment for foreign affiliate investments by foreign-controlled Canadian corporations. These rules are wide ranging and can apply to many ordinary business arrangements within multinational groups. Although the exceptions provided can mitigate the impact of the rules, these exceptions are narrow and technically complex.

As this article demonstrates, the FA dumping rules can create practical difficulties for many aspects of a foreign affiliate investment. The control test can result in the unexpected application of the rules. Anomalies in the PUC reduction and reinstatement rules can result in double taxation. Restructuring an existing investment can trigger additional applications of the FA dumping rules. In addition, the rules applying to debt investments can cause problems for common intragroup financial arrangements. Taxpayers must carefully consider the application of the FA dumping rules at each stage of an investment in order to avoid inappropriate tax results and minimize the disruption of bona fide business investments.

Personal Tax Planning
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SELECTED CONSIDERATIONS IN THE USE OF PROFESSIONAL CORPORATIONS

Gabriel Baron**

Professional corporations (PCs) allow certain professionals to access the same tax benefits that small-business owners can enjoy. Many professionals have not adopted PC use because of uncertainty about the tax benefits, as well as the burden of the associated administrative and operational requirements. However, PCs offer the ability to save substantially more income than is generally possible where the same amounts are earned and taxed as personal income. For early-stage professionals, who may not be saving a large component of their earnings, there are also other potential benefits, such as funding initial capital requirements and optimizing the tax rates on personal remuneration. When compounded with an income-splitting strategy, the PC can become a tool for material wealth enhancement. This article describes how these tax benefits can be achieved, by structuring and operating the PC in such a way as to mitigate the risk of challenge by the Canada Revenue Agency and denial of the associated tax benefits.

KEYWORDS: PROFESSIONAL CORPORATIONS ■ INCOME SPLITTING ■ INTEGRATION

CONTENTS

Introduction 1168
Structural Considerations: How Will the PC Integrate into the Professional’s Practice? 1168
Why Use a PC? 1170
Primary Benefit: Deferral of Personal Tax 1170
Other Tax Benefits 1171
Funding Capital Requirements and Non-Deductible Expenses 1171
Absolute Tax Savings from Provincial Rate Arbitrage 1172
Tax-Effective Borrowing To Fund Personal Debt While Simplifying Personal Tax Compliance 1173
Monetization of Partnership ACB 1174

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INTRODUCTION

Professional corporations (PCs) have become a popular component of tax planning for professionals. Although incorporation can afford certain liability protection and tax-deferral benefits, many professionals continue to earn substantial business income personally. This article examines various initial practical considerations, certain tax-planning benefits for early-stage professionals, income splitting using a PC, and operational considerations. The article provides an overview of the issues that an adviser would discuss with a client when considering whether a PC may be appropriate to the client’s situation, as well as administrative requirements for the effective operation of a PC. The discussion focuses on professionals who would typically render services through a partnership, rather than sole practitioners, and assumes that corporate shareholders are not permitted (that is, the PC is not a holding corporation).

STRUCTURAL CONSIDERATIONS: HOW WILL THE PC INTEGRATE INTO THE PROFESSIONAL’S PRACTICE?

Advisers who provide counsel on the use of PCs should not assume that merely establishing a PC will achieve its intended corporate tax benefits. As noted in a 2006 conference paper, the Canada Revenue Agency (CRA) has been issuing advance tax rulings on certain PC setup structures “by simply assuming [that] the necessary facts exist in order to give favourable rulings and opinions” with respect to, among other
things, determinations on the existence of a personal services business (PSB) and specified partnership income (SPI). However, the CRA does not provide suggested guidance or facts in its advance rulings that would assist in conforming to those rulings. Therefore, once the professional and his or her adviser have determined that a PC would provide significant tax benefits, the next fundamental consideration is managing the administration of the PC structure to ensure that it achieves the intended benefits. If the PC/professional practice fails to comply with administrative requirements, particularly tax requirements, there may be a concern about reputational risk to the professional and the firm. The resulting damage could outweigh the cost of ensuring compliance.

Two common PC operating structures are as follows:

1. An individual who is a member of a professional partnership transfers his or her interest in the partnership to a new PC. The partnership allocates income and makes distributions to the PC.

2. The individual remains a partner of the professional partnership with respect to administrative services or functions. The new PC renders professional services to the partnership and bills the partnership for its services.

In both cases, the individual is an employee of the PC.

There are two primary differences between these structures, in relation to the ability to access the small business deduction (SBD) under section 125 of the Income Tax Act and in terms of operational/administrative complexity.

With respect to the SBD, as noted above, under the first structure the PC receives an allocation of partnership income. In the absence of further planning or a reorganization, the SBD available in respect of that income is limited by SPI based on the partner’s underlying interest in the partnership. In contrast, under the second structure, the PC is considered to be conducting an active business—rendering services to the partnership for which it charges a fee—and therefore it should generally be able to utilize the full SBD (currently available for the first $500,000 of the corporation’s income for the year for federal and most provincial purposes) to the extent of its net income. Using a $500,000 SBD limit and a hypothetical average 10 percent differential between general and small business corporate tax rates, there is a $50,000 additional deferral opportunity where the SBD is available. As discussed

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2 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.

3 Paragraph 125(1)(a) and subsection 125(7), the definition of “specified partnership income.”

4 Subsection 125(2). The small business limit is $500,000 in all provinces except Manitoba and Nova Scotia, both of which have adopted a limit of $400,000.
below, the SBD and general rates of income are effectively integrated when earnings are distributed. However, if earnings are distributed annually, the lost deferral opportunity could be costly over the extended life of a PC structure, particularly when considering the cost of compliance and administration.

The second consideration relates to administrative complexity (also discussed below). A transfer of the partnership interest to a PC can be relatively straightforward, with limited changes being required at the operating partnership level. For example, the partnership may continue to distribute draws out of partnership income in the usual manner, and the preparation of the annual T5013 information return (“Statement of Partnership Income”) will not be affected, except for the substitution of the name of the PC for the partner’s name. On the other hand, a change in business model where the PC is responsible for billing for professional services requires a fundamental change in financial reporting and evaluation. As noted above, respecting the structure of the fee-for-services model is important to prevent the application of the PSB/SPI rules.

**WHY USE A PC?**

**Primary Benefit: Deferral of Personal Tax**

The tax-deferral benefits of incorporation can be significant when a professional saves a portion of his or her earnings and does not withdraw them from the corporation (see appendix table 1 following the conclusion to this article). The deferred personal tax can be either invested to earn a return in excess of the overall cost of distribution, or flowed through an income-splitting vehicle that converts the cost of distribution into an absolute saving. Fundamentally, a PC allows for a greater pool of corporately investable capital from active business earnings as compared with the amount of after-tax funds available where the same income is earned as personal income. For example, $400,000 of partnership earnings taxed at an average 41 percent personal tax rate leaves a professional with $236,000 of after-tax cash. The same income earned by a PC would leave approximately $336,000 or $292,000 after corporate tax, assuming tax rates of either 16 percent or 27 percent for income subject to the SBD and general rates of tax, respectively. The use of tax deferral through a PC represents a significant increase in available investable cash.

As indicated in appendix table 1, there may be an overall cost in distributing business earnings from a PC in the form of dividends. However, the overall cost can often be absorbed in two to three years if the corporation earns a reasonable market rate of return on the deferred component of taxes. For example, in Ontario, there is an overall 1.8 percent cost to distributing general rate active business income as a dividend. However, with 19.91 percent of deferred personal tax, the overall “cost” can be covered if the deferred taxes are invested at a 4.5 percent after-tax rate of return for two years.

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5 The 16 percent and 27 percent rates represent estimated averages for the SBD and general rates of tax, respectively, based on federal and provincial statutory rates in effect for 2013.
Other Tax Benefits

Professionals who must spend all or substantially all of their earnings may still find that there are tax and financial benefits to using a PC, such as cash flow and tax remittance flexibility, funding capital requirements, and monetizing the adjusted cost base (ACB) of the partnership interest. Furthermore, there may be significant disadvantages to delaying the use of a PC where income splitting is an ultimate objective. However, given the additional costs of maintaining and operating a PC, in determining the benefits of incorporation, it will be important to compute the absolute tax savings and investment value of the tax deferral relative to these costs.

Funding Capital Requirements and Non-Deductible Expenses

Some partnerships specify that a component of invested capital cannot be borrowed from the firm or pledged as security for a bank loan. This investment is typically financed from draws or distributions over a set period of time. Alternatively, it may come from personal savings contributed by individual partners. Additionally, professional practices may have substantial non-deductible expenses, typically meals and entertainment, where 50 percent of the expense represents taxable income for which no distributions are received to fund the corresponding tax on income.

Since both an accumulation of capital and the payment of non-deductible expenses require funding with after-tax cash, incorporation as a PC could allow corporate earnings that have been taxed at lower corporate rates to be used for these purposes instead of personal after-tax dollars, and thereby generate absolute tax savings. For example, if a partner’s capital requirement is $50,000 and has to be self-financed from partnership earnings, at a 46 percent marginal personal tax rate approximately $94,000 of earnings will be required. On the other hand, assuming small business and general corporate tax rates of 16 percent and 27 percent respectively, the same self-funded investment using after-tax corporate cash will require approximately $59,000 or $68,000 for income subject to the SBD and general rates of tax, respectively. If the excess earnings are distributed as salary (that is, beyond the corporate funding requirements), the professional will have incremental after-tax personal cash of approximately $18,000 or $13,000 (for income that is subject to the SBD and general rates of tax, respectively).

The same principle applies to the ongoing allocation of non-deductible expenses. Using the same tax rates above, the personal cash required to fund the tax cost of, for example, $20,000 of annually allocated non-deductible expenses would be approximately $9,200, relative to corporate tax ranging from $3,200 to $5,400. This represents an annual absolute tax saving of $3,800 to $6,000, which may well exceed the ongoing administrative costs of operating the PC.

One of the most significant non-deductible expenses that a professional may incur is life insurance. If the professional owns the policy and pays the annual premiums, more personal income will be required to pay the non-deductible premiums. If, however, the PC owns the policy and pays the non-deductible premiums, the lower corporate tax rate means that less pre-tax income is required to fund this expense.
Where the PC is the beneficiary of the policy, on death, the proceeds can generally be added to the corporation’s capital dividend account (CDA), which can be distributed tax-free. Accordingly, the funding of properly structured non-deductible life insurance through a corporation can generate material tax savings.

Absolute Tax Savings from Provincial Rate Arbitrage

Annual tax savings can be achieved by using a PC where the professional’s top marginal personal tax rate is lower than the blended rate applicable to professional income based on provincial allocation percentages.

Under the regulations to the Act, an individual partner is deemed to earn business income in the various provinces where the partnership operates with a permanent establishment. This exposes the individual to multijurisdictional tax rates regardless of the province in which the individual is resident, and the blended provincial rate may be higher than the top rate in the professional’s home province.

A PC allows a professional to overcome the effect of multijurisdictional tax rates so that the income is taxed at the rate applicable in the professional’s province of residence, provided that the employment is exercised in that province. By paying deductible wages to the professional, the PC can convert corporate business income into an individual’s employment income to be taxed at provincial rates based on the individual’s province of residence on the last day of the calendar year.

To achieve this result, a professional may, but is not required to, draw a salary from the PC. Where the professional employee rendering services to the PC is also the primary active shareholder, the CRA will apply its longstanding policy to waive the requirement that remuneration be reasonable. Therefore, the professional has complete flexibility to select and stream earnings of the PC as corporate or personal earnings, the latter being paid out as deductible wages.

The provincial rate recharacterization strategy can be applied to a portion of the PC’s earnings. For example, it can be limited to the cash earnings of the business such that any non-deductible amounts (or cash earnings retained by the business) are retained in the corporation and taxed at the low corporate rates.

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6 Paragraph (d) of the definition of “capital dividend account” in subsection 89(1), and subsection 83(2).
7 Part XXVI of the regulations.
8 Regulation 2601(2).
9 It is assumed that the professional is rendering services in his or her capacity as an employee of the PC, which in turn earns business income directly (or indirectly via a partnership), and thus the general deductibility test of paragraph 18(1)(a) is met.
10 Regulation 2601(1).
The benefits of this strategy will likely be limited to individual professionals who are members of partnerships that operate in multiple provinces and who are resident in Alberta or Newfoundland, where the top marginal personal tax rates on ordinary income are lower than in other provinces.

**Tax-Effective Borrowing To Fund Personal Debt While Simplifying Personal Tax Compliance**

A professional who has personal debt (a mortgage or a line of credit) may borrow on a short-term basis from a PC (by way of a shareholder loan) at generally lower rates than the current cost of the personal debt.

The personal tax applicable to withdrawals from a PC will depend on the nature of the payments. Salary and dividends are taxable in the year of receipt, whereas shareholder loans and advances are not immediately taxable. In order to avoid eventual full personal income inclusion of these advances, such loans must be repaid to the PC by the end of the calendar year following the taxation year in which the funds are drawn. During this intervening period, a deemed interest benefit will accrue to the professional to the extent that interest paid on the loan is less than the prescribed rate.

Concurrently, a PC may accrue wages or bonuses payable to its employee and deduct the accrual from its net income for tax purposes. The accrued amount must be paid within 179 days following the end of the PC’s taxation year during which the amount was accrued. The practical benefit of this strategy is that source withholdings and remittance of taxes need only be made once rather than throughout the year, as would be the case with periodic salary payments.

A professional operating through a PC may draw all of the cash earned by the PC to pay down debt and generate financial savings through reduced outstanding principal balances. No tax will arise provided that the prescribed rate is paid and the loans are repaid within the required time frame. The PC would accrue a wage payable to the professional and pay the accrued amount on or before the 179th day following its taxation year-end. The payment of the wage and repayment of the shareholder loan would occur through a setoff agreement. The professional would be required to at least repay in cash a sufficient amount to fund the source deduction remittances, as well as employer health tax for large bonuses, as applicable.

The practical outcome of this plan is that cash flow could be accessed well in advance of the date on which quarterly personal tax instalments would have been

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12 Subsections 15(2) and (2.6).
13 Subsection 80.4(2).
14 The prescribed rate is defined in subsection 80.4(7) and by reference to regulation 4301(a).
15 Subsection 78(4).
16 Actually, the repayment within 179 days required under subsection 78(4) results in repayment of the shareholder draw approximately six months prior to its required subsection 15(2.6) repayment date.
due had the income been in the form of partnership allocations earned personally. The cost of accessing this financing is limited to the personal tax on the prescribed-rate benefit. As prescribed rates of interest increase in the future, the savings from the plan may decrease, depending on the spread between the prescribed rate and the interest rate on personal debt.

**Monetization of Partnership ACB**

Where a partner has an accumulated ACB in the partnership interest—for example, from the accumulation of non-deductible expenses—there is a one-time opportunity to monetize and convert the ACB into a tax-paid shareholder loan by transferring the partnership interest to the PC and taking back a note representing the ACB amount. The fair market value of the partnership interest transferred must be at least equal to or exceed the ACB. Where the partnership interest is not transferable and there is no guaranteed return of capital or retirement benefit, this may not be the case.

The PC could pay down the note due to the shareholder using after-tax cash without the shareholder being required to pay personal tax. The tax saving would equal the difference between the applicable corporate tax rate and the marginal personal tax rate, multiplied by the ACB amount.

Greater benefits are available if the partnership interest is transferred at the time when the ACB is maximized.\(^{17}\)

**Income Splitting**

Tax savings may be achieved through income splitting using after-tax funds accumulated within a PC. It is important, however, to consider the various attribution and anti-income-splitting rules.\(^{18}\)

**Spousal Attribution**

In order to avoid the various income attribution rules applicable to transactions between spouses,\(^ {19}\) it is critical that the spouse use his or her own funds to acquire the subject property in the income-splitting structure. Alternatively, if a loan is made to a spouse to acquire the property, a prescribed-rate loan should be used.\(^ {20}\)

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17 Paragraph 53(2)(e) and, potentially, subsection 96(1.01).

18 For a more detailed discussion of these rules, see Maria Elena Hoffstein and Michelle Lee, “Revisiting the Attribution Rules,” in 2012 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2012), 9:1-40.

19 Subsections 74.1(1) and 74.2(1).

20 Subsection 74.5(2). Attribution of income and gains will not apply on property (or substituted property) acquired by a spouse with a loan bearing interest at the lesser of the prescribed rate (as prescribed by regulation 4301(c)) and an equivalent arm’s-length rate, provided that the amount of interest in respect of the loan is paid annually, but not later than January 30 of the following year.
Attribution with Minors

The income attribution rules applicable to certain minors\(^{21}\) will apply only until the beginning of the year when the minor turns 18.\(^{22}\) There is no attribution of capital gains/losses realized by relevant minors on transferred or loaned property except in certain non-arm’s-length transactions\(^{23}\) described below with respect to the “kiddie tax.” The income-splitting distributions contemplated by a PC typically fall within the kiddie tax rules, and therefore the “ordinary” attribution rule for minors should not apply.\(^{24}\)

Attribution Arising from Reorganizations with Family Shareholders

The formation of a PC or a share capital reorganization of an established PC will typically involve a transfer of property to a corporation by an individual. Accordingly, the corporate attribution rules\(^{25}\) will need to be addressed in order to determine whether income splitting will be permitted. These rules will often mitigate the benefits of income splitting with “designated persons” unless the PC maintains its status as a small business corporation (SBC).\(^{26}\) “Designated persons” are a spouse or common-law partner, non-arm’s-length minors, and nieces or nephews who are minors.\(^{27}\)

Given that one of the benefits of using a PC is to defer personal tax by leaving earnings in the corporation, the accumulation of funds will prevent the PC from maintaining SBC status. Depending on the underlying value of the partnership interest, an accumulation of investment assets representing more than 10 percent of aggregate corporate asset value will put the PC offside SBC status.

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21 Generally, a person under 18 years of age who does not deal at arm’s length with, or is a niece or nephew of, the lender/transferor.
22 Subsection 74.1(3).
23 Subsection 120.4(4).
24 Subsections 74.1(1) and (2), 74.3(1), and 75(2) do not apply to any amount that is included in computing a specified individual’s split income for a taxation year.
25 Subsection 74.4(2).
26 Subsection 248(1) defines “small business corporation,” in part, to mean a particular corporation that is a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which at [any particular] time is attributable to assets that are
   (a) used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it,
   (b) shares of the capital stock or indebtedness of one or more small business corporations that are at that time connected with the particular corporation (within the meaning of subsection 186(4) on the assumption that the small business corporation is at that time a “payer corporation” within the meaning of that subsection), or
   (c) assets described in paragraphs (a) and (b).
27 Subsection 74.5(5).
In the case of corporate attribution, the amount of income attributed to the transferor shareholder is calculated by applying the prescribed rate to the “outstanding amount”\(^{28}\) of the transferred property, and is reduced by any interest or taxable dividends paid to that individual and the taxable amount of dividends that are split income received by the designated person. It may be possible to mitigate or eliminate the effects of corporate attribution by putting in place a properly structured arrangement for the future repayment of the outstanding amount. In order to avoid the corporate attribution rules, the interest of any designated person in the PC may be structured through a trust the terms of which limit distributions of income and capital.\(^{29}\) Although all designated persons will be precluded from receiving distributions from the trust (practically speaking, the PC) while they remain designated persons, income splitting with non-arm’s-length minors will be permitted once they become adults.

**Tax on Split Income (Kiddie Tax)**

“Split income”\(^{30}\) includes, among other things, taxable dividends and shareholder benefits received by “specified individuals”\(^{31}\) in respect of shares of a private corporation. Distributions from the PC to minors will be subject to the kiddie tax, which will tax split-income streams at the highest marginal personal rate and, generally, limit the availability of most personal tax credits.\(^{32}\) However, the kiddie tax will apply only until the end of the year in which the specified individual is 17.

**Reversionary Trust Rules**

Typically, tax planning involving minors requires the use of a trust. Accordingly, consideration must be given to the reversionary trust rules in subsection 75(2). Very generally, these rules will apply where property is contributed to a trust and is held on condition that it may revert to the contributor, that it may pass to persons to be determined by the contributor, or that it cannot be disposed of except with the consent of or in accordance with the direction of the contributor. Although the immediate consequence is that income or gains on the contributed property will be attributed and taxed to the contributor, the greater concern may be that a companion rule limits the tax-deferred transfer of any property out of the trust.\(^{33}\)

These rules may present a trap for those who want to maintain control over the trust when they are also contributors of property. Accordingly, a contributor of

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\(^{28}\) Defined in subsection 74.4(3).

\(^{29}\) Subsection 74.4(4).

\(^{30}\) Defined in subsection 120.4(1).

\(^{31}\) As defined in subsection 120.4(1).

\(^{32}\) As a result of the “not less than” formula in subsection 120.4(3), the tax on split income calculation only factors in the benefits of the dividend tax credit and the foreign tax credit.

\(^{33}\) Subsection 107(2).
property should not be a capital beneficiary and should also not be the sole or controlling trustee. If the settlor or other contributor to the trust must be a trustee, there should be a minimum of three trustees and decisions should be made by a simple majority. In this way, the contributor could be outvoted on decisions relating to the distribution and disposition of trust property.

**Income-Splitting Structures**

Keeping in mind the impediments to income splitting outlined above, two potential income-splitting structures are considered below.

**Income Splitting When Non-Professionals Are Permitted as Shareholders**

Where non-professional family members are permitted as shareholders of the PC, an opportunity exists to benefit from the lower personal tax rates applicable to dividends received by low-income shareholders. The maximum amount of tax-free dividends that can be paid to a shareholder with no other sources of income and the related benefit are summarized in appendix table 2.

Shareholders who are family members may be introduced either on incorporation or subsequently through an estate freeze.

1. *Introducing Shareholders on Incorporation*

Since newly incorporated entities typically have nominal value, it should be possible for family shareholders to subscribe for shares from treasury for a nominal amount.\(^{34}\) The authorized share capital and attributes of any particular class of shares acquired by the non-professional family member must comply with the relevant professional body’s regulations and profession-specific legislation. Typical share restrictions relate to votes and governance of the PC. Growth or non-growth shares can be issued. Income-splitting shares typically are designed to be “dividend-sprinkling” shares, with no participation in growth but allowing for the payment of an unlimited amount of discretionary dividends.\(^{35}\)

Where the professional has been practising as a partner before incorporation, it is likely that his or her share of professional practice assets, goodwill, or interest in the partnership will be transferred to the PC. Where property is transferred to the PC, the corporate attribution rules must be considered and the transferred property must be carefully valued. In certain professions, there may be little or no goodwill or other incremental value to the business beyond book value. In other cases, there may be a predetermined valuation formula (common in partnerships). It will be important

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\(^{34}\) Conferral-of-benefit issues are generally limited at the incorporation stage owing to the nominal value of the entity.

\(^{35}\) Corporate law may supersede and limit or prohibit the amount of dividends that can be paid, for example, under solvency test provisions.
to properly establish value in order to avoid any conferral-of-benefit rules that would impute income or proceeds of disposition to the transferring professional. This could occur, for example, where the value of consideration received (for example, cash, debt, and/or shares) by the professional in exchange for the practice assets, goodwill, or partnership interest is less than the value of the transferred asset.

Corporate attribution could apply whether the professional is transferring assets to the PC on a taxable or a tax-deferred basis. Since the consideration received from the PC will be some combination of shares and debt, it will fall within the definition of “excluded consideration” and thus will not reduce the calculation of the outstanding amount at the time of transfer.

Where family members subscribe for shares in the PC, there will be a “designated person” as a specified shareholder and corporate attribution could apply. However, if the PC is an SBC on formation and maintains that status subsequent to the transfer of assets, the corporate attribution rules will not apply because one of the conditions for corporate attribution is that the transferee corporation “was not a small business corporation” throughout the relevant period.

If the PC is used for its intended purpose of saving and accumulating wealth, it will likely fail the SBC test at some point subsequent to incorporation as non-business assets begin to exceed 90 percent of the PC’s aggregate value. Assuming that the other aggregate conditions are met, corporate attribution will apply from the time the SBC test is breached until one or more of the other conditions are established not to apply.

2. Introducing Shareholders After Incorporation

If family members are to be included in the PC subsequent to its formation, there will likely be an accumulation of corporate surplus and perhaps a potential increase in the value of the underlying partnership interest related to goodwill. Typically, an estate freeze will be used in order to avoid any adverse issues associated with conferral of benefits on new shareholders. The same tax considerations will apply as discussed above regarding the introduction of shareholders on incorporation, followed by a contribution of the partnership interest. Specifically, the primary issues relate to determination of the value of the transferred property and the impact of corporate attribution.

3. Practical Implications

The corporate attribution rules should not be a concern in the early stages of the PC since it will likely qualify as an SBC. This will change over time with the accumulation of investment assets.

36 These rules are contained in subsection 56(2) and paragraph 85(1)(e.2), respectively.
37 Defined in subsection 74.4(1).
38 Paragraph 74.4(2)(c).
39 Pursuant to the definition of “small business corporation” in subsection 248(1).
Establishing a properly structured family trust as shareholder should preclude the application of the corporate attribution rules to minors. Neither the corporate attribution nor the split-income rules will apply once the non-arm’s-length minors are of adult age.

The corporate attribution rules can also be managed by paying sufficient dividends on the outstanding amount (as measured at the time of transfer). Given the integration of active business income summarized in appendix table 1, the overall compensation package of the professional from the PC can include dividends without a material financial penalty (and may generate an absolute saving when paying out SBD-eligible income in the form of dividends in certain provinces). The receipt of taxable dividends from the PC on shares taken back from the transfer of a practice or partnership interest may mitigate the impact of imputed income. Additionally, a redemption of shares paid in cash, resulting in a deemed dividend, will reduce and ultimately eliminate the outstanding amount.

Similar to the payment of ordinary dividends, a deemed dividend resulting from the redemption of shares should produce the same integration result. The low corporate tax rates on a PC’s active business income would likely provide a sufficient source of surplus cash to fund the share redemption. Accordingly, elimination of the outstanding amount could also be part of the professional’s overall compensation package.

Therefore, a professional can split income with a spouse either by eliminating the outstanding amount (as described above) or by paying the necessary amount of dividends as part of the overall compensation package. Given the current low prescribed rate, the payment of dividends to a high-income professional may represent a nominal cost of income splitting.

If corporate attribution applies and is not managed by the payment of dividends or interest, or by reduction of the outstanding amount, the professional will be taxed on imputed income, and thereafter taxed on the eventual extraction of corporate surplus. That is, the professional will be subject to double taxation.

**Income Splitting When Non-Professionals Are Not Permitted as Shareholders**

To the extent that family members are not permitted to be shareholders in the PC, an alternative tax structure is required. One such structure uses a secondary investment corporation (“Investco”) in which the family members will invest.

Generally, the shareholders of Investco could include the spouse and children of the professional either directly or through a family trust. PC would loan its corporate surplus to Investco so that the funds could be invested by Investco instead of PC.

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40 Based on the calculations in subsection 74.4(2).

41 Subsection 84(3). Dividends deemed to be paid pursuant to section 84 are not considered taxable dividends for the purposes of reducing corporate attribution income pursuant to paragraph 74.4(2)(f).
Control of Investco could remain with the professional by using a special class of “super-voting” preferred shares. While common control would result in PC and Investco being associated corporations, most professionals would invest family wealth in non-business assets. Therefore, the SBD would continue to be available to PC to the extent that PC’s and Investco’s aggregate “taxable capital employed in Canada” did not exceed $10 million to $15 million.

With the Investco plan, the accumulated earnings and surplus of PC would translate into the principal amount of the loan to Investco, and only accumulated investment income would accrue to the benefit of the non-professional shareholders. Depending on the corporate law governing Investco, solvency tests could preclude a distribution of assets if asset values were equal to or less than the loan owing to PC. While this is a limitation in the value of the plan, there is a benefit as compared with direct investment in PC by family members. Whereas corporate attribution requires a transfer of funds or property by an individual to a corporation, the loan for Investco’s investment capital would be made by PC from its accumulated corporate surplus; accordingly, the use of Investco may prevent the application of corporate attribution.

**PC Income-Splitting Plans Versus Traditional Prescribed-Rate Loans**

Both direct PC shareholder and Investco income-splitting plans impose a practical limitation on the allocation of income. Whereas a prescribed-rate loan arrangement allows for the annual allocation of income to family members regardless of age, the distribution of earnings from PC or Investco is limited to spouses and adult children. This practical limitation arises from the direct application of the kiddie tax rules, even if PC or Investco invests in publicly traded securities, the income from which would normally not be subject to kiddie tax if paid directly.

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42 The CRA acknowledged at the 2009 British Columbia Tax Conference that no value premium would be assigned to super-voting shares when used in the context of an estate freeze to control the underlying business to preserve the freeze share value. Consideration would need to be given to the value of the super-voting shares in other non-estate freeze contexts. See “Questions and CRA Responses,” in the 2009 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2009), 16:1-15.

43 Pursuant to subsection 256(1).

44 Even in the absence of control or any element of cross-ownership by the professional in Investco, consideration would always need to be given to the de facto control provision of subsection 256(5.1). While Investco might truly be independently managed by the professional’s spouse, Investco would be fully funded by debt from PC, and therefore PC could be regarded as exerting influence on Investco.

45 As defined in subsection 181.2(1).

46 Based on the business limit reduction formula in subsection 125(5.1).

47 By virtue of the exclusionary component in subparagraph (a)(i) of the definition of “split income” in subsection 120.4(1): “taxable dividends received by the individual in respect of shares of the capital stock of a corporation (other than shares of a class listed on a designated stock exchange or shares of the capital stock of a mutual fund corporation).”
On the other hand, there is no requirement for loans between two Canadian corporations to bear interest. Accordingly, by using an Investco for income splitting, there is incrementally more after-tax investment income available to accrue to the family than there would be with a prescribed-rate loan that required interest to be paid to the family creditor.

There are several other features of the Investco structure that make it beneficial to an overall tax-planning strategy and minimize the impact of the limitation on distributions to minors.

Earning income in PC and loaning it to Investco provides a larger pool of capital to invest relative to the same income being earned personally. Once the after-tax corporate surplus is invested, there may be little difference between earning investment income in the corporation and earning such income personally. As shown in appendix table 3, the taxation of interest income and capital gains of a Canadian-controlled private corporation (CCPC) on a predistributed basis results in a nominal (less than 1 percent absolute value) prepayment or small deferral savings in 5 out of 10 provinces, resulting in very little difference in the taxability of investment income in corporate or personal form. The corporate taxation of non-connected dividends, however, generally results in a prepayment of tax because the part IV rate of 33.33 percent typically exceeds the equivalent rate of personal tax on dividend income. Therefore, sufficient dividends should be paid from Investco annually (not to minors, to avoid the kiddie tax) to recover the part IV tax applicable to non-connected dividends received by Investco.

However, the material benefit of the Investco structure relates to the interaction between the taxation of the investment income in the CCPC and its eventual distribution to low-income shareholders. Whereas the CCPC rates of tax on investment income approximate the top marginal personal rates, the accumulation of investment income in a CCPC also accumulates refundable dividend tax on hand (RDTOH), being 26.66 percent of “aggregate investment income.” The accumulation of RDTOH produces a future source of “balloon cash” in the form of a dividend refund that is accessed when taxable dividends are paid. Accumulated investment income can be distributed to shareholders with low or no income (see the previous discussion on streaming tax-free dividends), generating absolute income-splitting tax savings, and at the same time generating a large corporate cash dividend refund that can be used for further distributions. There are ultimately two benefits. There will be a larger pool of invested capital from PC because of the lower tax rates on its earnings. As well, dividends can be streamed to lower-income shareholders, triggering a tax refund in Investco that exceeds the tax payable by the recipient. This results in less overall tax, even though distributions to minors must be delayed until they become adults.

A number of factors should always be considered in deciding whether any income-splitting structure is appropriate, including projected rates of return and willingness

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48 As defined in subsection 129(4).
to have a slightly more complex operating structure. A financial model that uses expected rates of return and expected rates of tax should be prepared to assist in analyzing whether savings can be achieved using a particular structure.

**WHY WAIT? THE CASE FOR SETTING UP A PC EARLIER IN ONE’S CAREER**

One might argue that a PC should not be used until the professional has reached the point where lifestyle/consumption needs do not require all of the earnings and a significant amount can be left to accumulate in the PC. Until then, the costs of establishing and maintaining the structure would likely exceed the small tax-deferral benefits (if any). However, as previously illustrated, there are several absolute tax-saving opportunities that relate to non-deductible expenses, self-funding capital requirements, and the ability to arbitrage provincial rates of tax, the benefits of which may outweigh the additional costs of compliance complexity.

The longer that a professional waits to establish a corporate structure, the more likely it is that he or she will have accumulated valuable professional assets. In the context of income-splitting structures, this may result in a larger corporate attribution exposure on transferring assets to a PC with a greater prescribed-rate interest income inclusion. Where fixed-value preferred shares must be used to reflect the higher-value assets transferred to the PC, dividends will have to be paid on those shares before dividends can be paid to family members, thereby delaying or reducing the tax benefits of the structure.

There are also significant benefits to accumulating wealth in corporate form from the perspective of the professional’s overall estate plan; a delay in establishing a PC may therefore result in lost tax benefits and opportunities. Subject to any future developments on the *MacDonald* case as it relates to surplus extraction at capital gains rates, the accumulation of undistributed savings in a PC (see the discussion below on retirement considerations) will leave the professional’s estate with a funded investment corporation. There will be a large capital gain on the death of the professional, and consequently a higher ACB to the estate (assuming no spousal rollover). It may be possible to extract the accumulated surplus of the PC (now an investment corporation) on a tax-free basis by accessing the ACB of the shares now held in the estate. This would be accomplished by having the estate transfer its investment in the former PC to a new holding corporation in exchange for a note or shares with paid-up capital (PUC) equal to the new higher ACB. The former PC could pay tax-free intercorporate dividends to the holding corporation, which in turn would repay the note (or return share PUC) to the estate on a tax-free basis. Accordingly, the

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49 *Canada v. MacDonald*, 2013 FCA 110; rev’g. 2012 TCC 123.

50 Assuming that the shares were not acquired from a related person that claimed the capital gains exemption or a V-day valuation to increase the ACB.

51 Assuming that section 84.1 does not apply.
professional may leave a larger estate than would have been available had a corporation not been used.

**CONSIDERATIONS FOR RETIRING WITH A PC**

As a professional nears retirement or is making an estate plan, consideration must be given to how an exit from professional services will be accomplished. The partnership agreement will need to be reviewed to determine whether transfers of partnership interests or PC shares are permitted.

The most likely scenario for a PC's exit from professional practice is that the partnership interest is redeemed or transferred to a new partner at an amount specified in the partnership agreement. This may occur as a direct disposition of the partnership interest held by the PC, or through a supplemental mechanism in the case of a PC billing a partnership for professional services. In the latter scenario, the PC is not a partner of the partnership, and therefore any payouts on retirement must take into account the particular PC structure. In the case of a direct partnership interest, the accumulation of non-deductible partnership income allocations may result in a significant partnership interest ACB to the PC.\(^{52}\) Depending on the quantum of the proceeds of disposition, if any, for the partnership interest, it is likely that the PC will realize a capital loss. This loss may be used to shelter corporate tax on future, or the past three years of, capital gains. However, personal tax will be payable when the proceeds are distributed in the form of taxable dividends. Because the corporate gains were sheltered with the loss on the disposition of the partnership interest, there would be no addition to the CDA and thus no ability to pay a tax-free capital dividend. In addition, in the year in which the professional retires from the partnership, the PC will be required to pay income tax on the prior-year work-in-progress deferral available to professionals.\(^{53}\)

Once a PC has exited the practice (and completes the necessary regulatory deregistration processes), it continues to be a private corporation, and the retired professional may find it advantageous to maintain the operating structure. For example, there may be opportunities for income splitting and deferral of tax on active income earned through the business.

**ADMINISTRATIVE CONSIDERATIONS:**

**UNDERSTANDING SETUP AND OPERATING REQUIREMENTS OF A PC**

Professional partnerships will often handle the ongoing operational and administrative functions on behalf of the partner. These may include periodic distributions, payment of professional membership dues, payment of liability and disability insurance

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52 Paragraph 53(2)(e).

53 Section 34.
premiums, technology reimbursements, charitable donations, and tax preparation and financial advisory services. Certain expenses (such as automobile and entertainment expenses) are often incurred by the partners personally. Thus, very little financial and administrative engagement is required by the partner to operate the practice and render professional services.

On the other hand, consider the following items extracted from a typical CRA ruling to represent a backdrop to the administrative requirements of establishing and operating a PC structure:

Each [PC] will be responsible for the following expenses:

i. professional membership fees in respect of the Partner;
ii. professional liability insurance (to the minimum coverage level required by the Professional Requirements) and/or disability insurance for the particular Partner;
iii. continuing education costs;
iv. travel expenses, including car, accommodation and meal expenses;
v. communication expense, including cellphone and Blackberry device;
vi. office equipment and supplies; and
vii. additional business expenditures relating to personal practice preference of the particular [PC].

The discussion that follows sets out a selection of requirements for establishing and operating a PC, based on criteria specified in various CRA rulings.

**Setting Up a PC**

**Organizational Considerations**

The broader partnership must permit the use of a PC by the individual partners. Where PCs are permitted, there may be supplemental restrictions beyond regulatory and professional bodies’ rules regarding permitted shareholders and operating structures.

**Incorporation and Professional Registration**

Subject to organizational, statutory, and regulatory restrictions, decisions must be made about who will be the shareholder(s) of the PC. As discussed above in the section on income splitting, it may be advantageous to include a spouse or other family members, or a family trust, as shareholders.

Each professional body has its own unique requirements for professional registration. Certain professions may mandate that specific clauses be included in the articles and bylaws of the PC.

Additionally, minute books and other records will have to be maintained, at the expense—in terms of money and perhaps time—of the incorporated professional.

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Establishing an Employee-PC Relationship

Generally, a professional will render services as an employee of the PC, and it is recommended that there be some formal documentation of the relationship. The codification of the required employee-PC relationship may be reflected in an amended partnership agreement or a service contract between the PC and the original professional partnership.

Banking

The PC will maintain its own bank accounts. While it is conceivable that a professional could manage the flow of cash relating to the PC exclusively by way of direction and/or shareholder loan accounting, this alternative form of operating may fail to adhere to the factual assumptions discussed in the CRA rulings and in respect of the recommended operating structure. For example, the direct receipt of partnership draws by the professional is feasible. However, to support the integrity of the structure, it would be best if draws were deposited into the PC's corporate account and thereafter distributed to the employee/shareholder professional in a separate transaction. The same sequential depositing recommendation would apply to fees for services rendered by the PC to the partnership.

Another important consideration is the source of funds for the acquisition of shares by a spouse or family trust (where permitted) and the importance of avoiding application of the various attribution rules. Given that a newly incorporated PC will have nominal fair market value, the subscription price for new shares will also be nominal, typically ranging from $10 to $100. The subscription funds should come from independent sources in order to benefit from income-splitting opportunities and avoid the attribution rules previously discussed. These sources could include employment income earned by the spouse, gifts to the spouse (other than gifts from the professional), and investment income earned on independent funds.55 Funds in joint accounts or otherwise commingled should not be used to purchase shares even if the funds originate from acceptable non-attributeable sources.

Financial Records and Tax Administration

The PC will be required to maintain separate books and records, prepare financial statements, and file corporate income tax returns. Accurate financial records will also be required to monitor and report compliance with respect to the various tax rules applicable to shareholder loans, non-deductible expenses, and tax attribute balances, such as RDTOH, CDA, and ACB.

Various federal and provincial tax accounts will also need to be opened immediately following the incorporation of the PC. These may include the following:

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55 Investment income, regardless of whether the principal represents an attribution issue, should constitute “second-generation” income and therefore not lead to attribution issues.
1. corporate income tax accounts with the CRA for federal and applicable provincial income taxes;
2. corporate income tax accounts with the governments of Alberta and Quebec if the PC or partnership will render services from provincial permanent establishments in those provinces;\footnote{See part IV of the regulations for considerations relating to corporate permanent establishments.}
3. goods and services tax (GST), harmonized sales tax (HST), or Quebec sales tax (QST), as applicable, in the case of a PC that renders services to a partnership; and
4. payroll tax remittance accounts if the PC will be paying salary or bonus, specifically including
   a. CRA payroll accounts for remittance of employee source withholdings and Canada Pension Plan (CPP) premiums;
   b. employer health tax accounts with certain provinces; and
   c. workers’ compensation remittance accounts for the nominal premiums payable on a professional’s salary.

**Claiming Expenses in the PC and Other Administrative Matters**

Certain expenses should be incurred by the PC in order to maintain the integrity of the structure. Alternatively, they can be paid by the professional and the PC can reimburse him or her for the expenditures. Such expenses may include the cost of professional insurance, meals and entertainment, travel, and technology/communications. In the case of disability insurance, it is important for the individual to pay the premiums to ensure that future benefits are received tax-free.

Business cards, stationery, and e-mail signatures will need to be updated to indicate that services are being rendered through the PC. The change in name and appearance is often not discretionary, since many professional bodies mandate that the professional disclose that services are being rendered through a PC.

**Operating a PC**

With the formation of a PC, there may be an increased focus on cash flow management for the remittance of tax and the payment of expenses that are now to be borne by the PC.

In the case of a PC that will render services to a partnership, it is recommended that invoices be routinely issued to the partnership and collected to support the factual determination that the PC is an independent entity rendering services to the partnership. Routine fluctuating quantum and properly documented invoices describing the specific services rendered (for example, identifying clients and hours spent) by the PC will be preferable to fixed loan draws that are cleared once or twice annually through a generic invoice. Although both examples produce the same cash flow to the PC, the former is advisable to maintain the integrity of the structure.
Additionally, GST, HST, or QST (as applicable) will be exigible when a PC invoices the partnership for services rendered. The PC will be required to collect and remit the tax and make the required filings.

In the case of a PC that holds a partnership interest, the key cash flow operating consideration will be to ensure that draws are deposited into the PC’s corporate bank account.

The single most important consideration in operating a PC, as compared with professional practice as a direct partner, is determining how to access corporate funds given the particular corporate operating structure. Once the earnings are in the PC, funds can be drawn by the professional in the form of a wage, dividend, loan, or return of ACB, or not drawn at all. Factors such as marginal tax rates, contributions to a registered retirement savings plan, CPP eligibility, and cash flow requirements must be considered to determine an optimal remuneration package. Regardless of how corporate funds are accessed, it will be important to accurately administer and manage income tax accounts, payroll tax accounts, sales tax accounts, and annual tax filings.

**Employer/Personal Tax Issues**

With the exception of employment income, draws from a PC are generally not subject to source withholding rules. For example, the payment of dividends, returns of PUC, repayment of shareholder loans, and the payment of interest do not require the PC to withhold or remit funds to the CRA. On the other hand, the payroll remittance rules apply to the payment of wages, salary, and or bonuses to the employee-professional, as well as to family-member employees.

Personal income tax and CPP premiums must be calculated for each payment characterized as employment income. Commercial payroll providers are available to provide this calculation service for a fee; however, professionals may use the CRA’s free “payroll deductions online calculator,” which provides the requisite remittance amounts based on inputs the professional provides. If the professional resides in Quebec, additional Quebec remittance and filing requirements apply.

The PC must also file T4 (“Statement of Remuneration Paid”) and T5 (“Statement of Investment Income”) information returns where it has paid employment income and dividends, respectively, during the year. These returns are due no later than the last day of February of the next year following the taxation (calendar) year.

Remuneration by way of salary does not give rise to quarterly personal tax instalments. The source withholding rules, if applied correctly, should take care of the

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57 Subsection 153(1), regulation 100, section 21(1) of the Canada Pension Plan Act (RSC 1985, c. C-8, as amended), and section 82(1) of the Employment Insurance Act (SC 1996, c. 23, as amended).


59 See subsection 156(3), the definition of “instalment base,” and regulation 5300(1).
income tax and CPP related to salary paid in the year. However, if the professional has drawn corporate funds in the form of dividends or interest on shareholder loans, personal quarterly tax instalments may be applicable for the year following the year in which the amounts without source withholdings were drawn.

A planning technique of paying dividends and employment remuneration in alternating years can be used to eliminate the requirement to remit personal tax instalments. Where an individual is otherwise required to pay personal tax through instalments, the instalments are computed as the least of three items, one of which is based on the preceding year’s balance of tax owing.60 To the extent that no tax was owing in the prior year, there will be no requirement to make current-year personal tax instalments. The professional can plan for this result by receiving salary in one year (say, 2013), subject to source withholdings, and dividends in the following year (2014) that are not subject to source withholdings. The dividend income received in 2014 will not be taxed until April 30, 2015. A continued alternating pattern of receiving wages/bonus and dividends in this manner will eliminate quarterly instalments in relation to professional income.

**Corporate Requirements**

Corporations are also required to remit tax in instalments. If the partnership operates in Alberta or Quebec, supplementary instalment payments to those provinces are required in addition to CRA remittances. Balances of corporate tax payable, if any, are due two months after the PC’s year-end (or three months after if the PC claims the SBD in the current or preceding year and income of the preceding year was at or below the SBD threshold).

A newly incorporated PC will not be required to remit instalments until, at the earliest, March 31 of the year following the year in which it reports taxes payable.61 Regardless whether the PC will be required to make monthly or quarterly tax instalment payments (depending on whether the corporate income is fully subject to the SBD or not), the key consideration for the professional is to ensure that the instalments are paid when due in order to avoid the assessment of interest or penalty on late or deficient instalments. On the other hand, projections and/or management of the instalment calculations should also be considered, to avoid the overpayment of instalment remittances to the CRA or to the Alberta or Quebec tax authorities.

In addition to the information return requirements discussed above regarding the payment of employment income and dividends, annual filings will be due for combined federal-provincial returns, as well as separate tax returns for Alberta and/or Quebec if the PC is operating in or receiving partnership allocations from those provinces.

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60 Paragraph 156(1)(a).

61 Assuming that the PC’s taxes payable exceed the minimum threshold for instalments.
CONCLUSION
There are substantial tax benefits to professional incorporation, including certain opportunities that are applicable to professionals who may not be saving or investing substantial amounts of money. The key consideration in using a PC is determining whether the potential benefits of tax deferral and tax savings outweigh the cost of setup and administration and the ongoing effort required to maintain the structure. Additional tax implications such as attribution and kiddie tax must be considered. Given the administrative considerations that arise in creating and operating a PC, it is important that the professional, the PC, and the partnership work together in planning the transition and maintaining an effective relationship.
## APPENDIX TABLE 1  
Cost/Savings and Tax Deferral on Income Distributions Through a Professional Corporation, at 2014 Rates

<table>
<thead>
<tr>
<th>Eligible for small business deduction up to $500,000</th>
<th>General rate active business income (ABI)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cost/(savings)</td>
</tr>
<tr>
<td>percent</td>
<td></td>
</tr>
<tr>
<td>Newfoundland and Labrador</td>
<td>(0.94)</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>1.95</td>
</tr>
<tr>
<td>Nova Scotia(^a)</td>
<td>(2.40)</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>(0.91)</td>
</tr>
<tr>
<td>Quebec</td>
<td>1.36</td>
</tr>
<tr>
<td>Ontario(^b)</td>
<td></td>
</tr>
<tr>
<td>Income up to $509,000</td>
<td>(1.41)</td>
</tr>
<tr>
<td>Income in excess of $509,000</td>
<td>(1.42)</td>
</tr>
<tr>
<td>Manitoba(^a)</td>
<td>0.89</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>(0.27)</td>
</tr>
<tr>
<td>Alberta</td>
<td>0.69</td>
</tr>
<tr>
<td>British Columbia(^c)</td>
<td>0.56</td>
</tr>
</tbody>
</table>

Notes: Calculations based on all rate proposals announced up to May 31, 2013. It is assumed that the individual is taxed at the top federal-provincial marginal personal tax rate (except for the calculations for Ontario income up to $509,000 that is subject to the top federal marginal tax rate and the second-highest Ontario marginal tax rate) and that the corporation has a December 31 year-end. Payroll taxes at the corporate level (such as Canada Pension Plan [CPP] and employer health taxes) and CPP contributions and provincial health premiums at the individual level are ignored. It is also assumed that the after-tax amount of ABI not eligible for the small business deduction is distributed as eligible dividends on the basis that the income results in a sufficient general rate income pool balance (GRIP).

\(^a\) Ignores the impact of income between $400,000 and $500,000 since the small business limit in this province is $400,000.

\(^b\) It is assumed that the 2013 provincial income tax brackets will remain unchanged.

\(^c\) It is assumed that commencing January 1, 2014, there will be a temporary two-year increase in the personal income tax rate applicable to individuals earning more than $150,000 a year. The tax rate will increase by 2.1%, from 14.7% to 16.8%, for 2014 and 2015 only, before reverting to 14.7% in 2016.

Source: Adapted from 2014 integration tables by province (based on all rate proposals announced up to May 31, 2013): Table 1: Integration on Active Business Income and Table 2: Integration on Investment Income Earned Through a CCPC, first published online in July 2013 by Ernst & Young Electronic Publishing Services Inc.
### APPENDIX TABLE 2  Maximum Tax-Free Dividends and Associated Tax Savings from Income Splitting, at 2013 Rates

<table>
<thead>
<tr>
<th>Province</th>
<th>(A) Maximum eligible dividend</th>
<th>(B) Top marginal rate on eligible dividends</th>
<th>(A x B) Income-splitting tax savings on maximum dividend</th>
<th>(C) Maximum non-eligible dividend</th>
<th>(D) Top marginal rate on non-eligible dividends</th>
<th>(C x D) Income-splitting tax savings on maximum dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newfoundland and Labrador</td>
<td>48,845</td>
<td>22.47</td>
<td>10,975</td>
<td>19,280</td>
<td>29.96</td>
<td>5,776</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>44,680</td>
<td>28.70</td>
<td>12,823</td>
<td>11,655</td>
<td>38.56</td>
<td>4,494</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>30,510</td>
<td>36.06</td>
<td>11,002</td>
<td>28,340</td>
<td>36.21</td>
<td>10,262</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>48,845</td>
<td>24.91</td>
<td>12,167</td>
<td>21,905</td>
<td>33.05</td>
<td>7,240</td>
</tr>
<tr>
<td>Quebec</td>
<td>34,735</td>
<td>35.22</td>
<td>12,234</td>
<td>22,390</td>
<td>38.54</td>
<td>8,629</td>
</tr>
<tr>
<td>Ontarioc</td>
<td>48,845</td>
<td>29.54</td>
<td>14,429</td>
<td>40,140</td>
<td>32.57</td>
<td>13,074</td>
</tr>
<tr>
<td>Manitoba</td>
<td>23,860</td>
<td>32.26</td>
<td>7,697</td>
<td>9,440</td>
<td>39.15</td>
<td>3,696</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>48,845</td>
<td>24.81</td>
<td>12,118</td>
<td>19,160</td>
<td>33.33</td>
<td>6,386</td>
</tr>
<tr>
<td>Alberta</td>
<td>48,845</td>
<td>19.29</td>
<td>9,422</td>
<td>21,650</td>
<td>27.71</td>
<td>5,999</td>
</tr>
<tr>
<td>British Columbia</td>
<td>48,845</td>
<td>25.78</td>
<td>12,592</td>
<td>25,060</td>
<td>33.71</td>
<td>8,448</td>
</tr>
</tbody>
</table>

- **a** Assumes that the individual recipient has no other sources of income.
- **b** Assumes that the individual is taxed at the top marginal rate for his or her province unless otherwise noted.
- **c** Assumes that the individual is a high-income professional making less than $509,000 annually.

Source: Adapted from calculations of Maximum Dividend Income Before Incurring Income Tax for 2013, first published online in July 2013 by Ernst & Young Electronic Publishing Services Inc.
APPENDIX TABLE 3  Cost/Savings and Tax Deferral on Investment Income Earned Through a Canadian-Controlled Private Corporation, at 2014 Rates

<table>
<thead>
<tr>
<th>Province</th>
<th>Interest income (eligible for RDTOH treatment)</th>
<th>Non-eligible dividends (subject to part IV tax)</th>
<th>Eligible dividends (subject to part IV tax)</th>
<th>Capital gains (eligible for RDTOH treatment)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cost/(savings) Deferral</td>
<td>Cost/(savings) Deferral</td>
<td>Cost/(savings) Deferral</td>
<td>Cost/(savings) Deferral</td>
</tr>
<tr>
<td>Newfoundland and Labrador</td>
<td>3.89 (6.37)</td>
<td>nil (2.32)</td>
<td>nil (10.87)</td>
<td>1.95 (3.18)</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>7.05 (3.30)</td>
<td>nil (6.69)</td>
<td>nil (4.63)</td>
<td>3.53 (1.65)</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>3.70 (0.67)</td>
<td>nil (5.74)</td>
<td>nil (2.73)</td>
<td>1.85 (0.33)</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>1.97 0.17</td>
<td>nil (2.68)</td>
<td>nil (5.98)</td>
<td>0.99 0.09</td>
</tr>
<tr>
<td>Quebec</td>
<td>1.90 0.34</td>
<td>nil (6.57)</td>
<td>nil (1.89)</td>
<td>0.95 1.70</td>
</tr>
<tr>
<td>Ontario</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income up to $509,000</td>
<td>1.20 0.24</td>
<td>nil (1.58)</td>
<td>nil (3.79)</td>
<td>0.60 0.12</td>
</tr>
<tr>
<td>Income in excess of $509,000</td>
<td>1.04 3.36</td>
<td>nil (5.26)</td>
<td>nil (0.51)</td>
<td>0.52 1.68</td>
</tr>
<tr>
<td>Manitoba</td>
<td>6.22 (0.27)</td>
<td>nil (7.44)</td>
<td>nil (1.07)</td>
<td>3.11 (0.13)</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>4.26 (2.67)</td>
<td>nil (1.99)</td>
<td>nil (8.52)</td>
<td>2.13 (1.33)</td>
</tr>
<tr>
<td>Alberta</td>
<td>3.49 (5.67)</td>
<td>nil (3.46)</td>
<td>nil (14.04)</td>
<td>1.75 (2.83)</td>
</tr>
<tr>
<td>British Columbia</td>
<td>3.97 0.13</td>
<td>nil (4.65)</td>
<td>nil (4.66)</td>
<td>1.98 0.07</td>
</tr>
</tbody>
</table>

Notes: Based on all rate proposals announced up to May 31, 2013. It is assumed that the individual is taxed at the top federal-provincial marginal personal tax rate (except for the calculations for Ontario income up to $509,000 that is subject to the top federal marginal tax rate and the second-highest Ontario marginal tax rate) and the corporation has a December 31 year-end. It is also assumed that there are sufficient funds in the corporation to allow dividends to be paid to fully recover refundable dividend tax on hand (RDTOH).

- It is assumed that the 2013 provincial income tax brackets will remain unchanged.
- It is assumed that commencing January 1, 2014, there will be a temporary two-year increase in the personal income tax rate applicable to individuals earning more than $150,000 a year. The tax rate will increase by 2.1%, from 14.7% to 16.8%, for 2014 and 2015 only, before reverting to 14.7% in 2016.

Source: Adapted from 2014 integration tables by province (based on all rate proposals announced up to May 31, 2013): Table 1: Integration on Active Business Income and Table 2: Integration on Investment Income Earned Through a CCPC, first published online in July 2013 by Ernst & Young Electronic Publishing Services Inc.
**Planification fiscale personnelle**

Directrices de chronique : Pearl E. Schusheim* et Gena Katz**

**Certaines considérations sur l’utilisation d’une société professionnelle**

*Gabriel Baron**

Les sociétés professionnelles (SP) permettent à certains professionnels, c'est-à-dire des membres de professions libérales, d'avoir accès aux mêmes avantages fiscaux que les propriétaires d'une petite entreprise. De nombreux professionnels ne se sont toutefois pas constitués en SP parce qu'ils n'étaient pas sûrs des avantages fiscaux qui se rattachent à cette forme de société ni du fardeau associé à la satisfaction des exigences administratives et opérationnelles qu'elle impose. Les SP offrent toutefois la possibilité de faire des économies fiscales bien plus grandes que ce n'est généralement le cas lorsque le même revenu est gagné et imposé en tant que revenu personnel. Elles peuvent procurer également d'autres avantages aux professionnels qui commencent leur carrière et peuvent ne pas faire beaucoup d'économies, notamment le financement des besoins en capitaux initiaux et l'optimisation des taux d'imposition sur la rémunération personnelle. Combinée à une stratégie de fractionnement du revenu, la SP peut permettre d'augmenter grandement les avoirs. Cet article décrit comment obtenir ces avantages fiscaux en structurant et en exploitant la SP de manière à réduire le risque de contestation de la part de l’Agence du revenu du Canada et le refus d’accorder les avantages fiscaux connexes.

**Mots-clés : Sociétés professionnelles ■ Fractionnement du revenu ■ Intégration**

**Sommaire**

Introduction 1194

Considérations structurelles : Comment la SP s’intégrera-t-elle dans le cabinet du professionnel? 1195

Pourquoi utiliser une SP? 1196

Principal avantage : Report de l’impôt des particuliers 1196

Autres avantages fiscaux 1197

Exigences relatives aux besoins en capitaux et dépenses non déductibles 1197

Économies d’impôt absolues par l’arbitrage du taux d’imposition provincial 1199

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* De Couzin Taylor LLP, Toronto (affilié à Ernst & Young LLP).

** De Ernst & Young LLP, Toronto.
INTRODUCTION

Les sociétés professionnelles (SP) sont devenues un élément populaire de la planification fiscale des professionnels, c’est-à-dire des membres de professions libérales. Bien que la constitution en société puisse procurer une certaine protection de responsabilité et des avantages quant au report de l’impôt, de nombreux professionnels continuent de gagner un revenu d’entreprise substantiel en tant que revenu personnel. Cet article examine diverses considérations pratiques initiales, certains avantages de planification fiscale pour les professionnels débutants, la question du fractionnement du revenu à l’aide d’une SP et les considérations relatives à l’exploitation. Il donne un aperçu des points dont discuterait un conseiller avec un client se demandant s’il est judicieux d’opter pour une SP ainsi que des exigences administratives sous-tendant l’exploitation efficace d’une SP. La discussion se concentre sur les professionnels qui fournissent généralement leurs services par l’intermédiaire d’une société de personnes plutôt qu’à titre individuel, et présume que les sociétés actionnaires ne sont pas permises (c’est-à-dire que la SP n’est pas une société de portefeuille).
CONSIDÉRATIONS STRUCTURELLES : COMMENT LA SP S’INTÉGRERA-T-ELLE DANS LE CABINET DU PROFESSIONNEL?

Les conseillers ne doivent pas présumer que la simple constitution d’une SP permettra d’obtenir les avantages fiscaux de société escomptés. Comme il est souligné dans un rapport de conférence de 2006, l’Agence du revenu du Canada (ARC) a rendu des décisions anticipées en matière d’impôt sur le revenu relativement à certaines structures de SP en « [traduction] présumant simplement que les faits nécessaires existent pour qu’il soit possible de rendre des décisions et d’exprimer des opinions favorables » relativement, entre autres choses, à la détermination de l’existence d’une entreprise de prestation de services personnels (EPSP) et du revenu de société de personnes déterminé (RSPD)¹. L’ARC ne fournit toutefois pas de conseils ou de faits dans ses décisions anticipées pouvant aider à se conformer à ces décisions. Par conséquent, une fois qu’un professionnel et son conseiller ou sa conseillère ont établi qu’une SP pouvait être très avantageuse au point de vue fiscal, il faut ensuite examiner comment gérer l’administration de la SP pour s’assurer qu’elle procure les avantages escomptés. Si la SP ou le cabinet ne respecte pas les exigences administratives, en particulier les exigences fiscales, elle ou il court le risque de porter atteinte à la réputation du professionnel et du cabinet. Les dommages pourraient ainsi dépasser le coût d’observation des exigences.

Les deux structures d’exploitation habituelles d’une SP sont les suivantes :

1. Un particulier qui est membre d’une société de personnes de professionnels transfère sa participation dans la société de personnes à une nouvelle SP. La société de personnes attribue un revenu et effectue des distributions à la SP.
2. Le particulier demeure un associé de la société de personnes de professionnels en ce qui a trait aux fonctions ou aux services administratifs. La nouvelle SP fournit des services professionnels à la société de personnes et facture ces services à la société de personnes.

Dans les deux cas, le particulier est un employé de la SP.

Il existe deux grandes différences entre ces structures, soit la capacité de demander la déduction accordée aux petites entreprises (DAPE) en vertu de l’article 125 de la Loi de l’impôt sur le revenu² et la complexité de l’exploitation et de l’administration.

En ce qui a trait à la DAPE, comme il a été mentionné précédemment, dans la première structure, la SP reçoit une attribution du revenu de la société de personnes. En l’absence d’autre planification ou d’une restructuration, la DAPE pouvant être

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² Loi de l’impôt sur le revenu, LRC 1985, c. 1 (5e suppl.), telle que modifiée (ci-après « la Loi »). À moins d’indication contraire, les renvois législatifs dans cet article sont à la Loi.
obtenue relativement à ce revenu est limitée par le RSPD en fonction de la participation sous-jacente de l’associé dans la société de personnes3. Par contre, dans la deuxième structure, la SP est considérée comme une entreprise exploitée activement — qui fournit des services à la société de personnes en contrepartie d’honoraires — et, par conséquent, elle devrait généralement pouvoir demander le plein montant de la DAPE (qui s’applique actuellement à la première tranche de 500 000 $ de revenus de la société pour l’année, aux fins de l’impôt fédéral et de la plupart des impôts provinciaux)4 jusqu’à concurrence de son revenu net. Compte tenu du plafond de 500 000 $ pour la DAPE et d’un écart moyen hypothétique de 10 pour cent entre le taux d’imposition général des sociétés et le taux d’imposition des petites entreprises, il devient possible de reporter une somme additionnelle de 50 000 $ lorsque la DAPE peut être demandée. Comme il est précisé ci-après, le taux de la DAPE et les taux d’impôt général sur le revenu sont intégrés lorsqu’il y a distribution des bénéfices. Si, toutefois, la distribution des bénéfices a lieu chaque année, la perte du report d’impôt peut être coûteuse sur la durée de vie à long terme d’une structure de SP, surtout compte tenu du coût de l’observation et de l’administration.

La complexité administrative (également abordée ci-après) constitue le second aspect à prendre en considération. Le transfert de la participation dans la société de personnes à une SP peut être relativement simple et nécessiter peu de changements sur le plan de l’exploitation de la société de personnes. La société de personnes peut, par exemple, continuer de distribuer de la même façon ses retraits de la société sans effet sur la préparation de la déclaration de renseignements annuelle T5103 (« État des revenus d’une société de personnes »), sauf pour le remplacement du nom de la SP par celui de l’associé. Par contre, un changement de modèle d’entreprise où la SP est responsable de facturer ses services professionnels nécessite un changement fondamental dans l’information financière et l’évaluation. Comme il est précisé ci-dessus, il est important de préciser la structure du modèle des honoraires pour les services afin de prévenir l’application des règles sur les EPSP/RSPD.

POURQUOI UTILISER UNE SP?

Principal avantage : Report de l’impôt des particuliers

Les avantages du report d’imposition que procure la constitution en société peuvent être substantiels lorsqu’un professionnel économise une partie de son revenu et ne le retire pas de la société (voir le tableau 1 en annexe présenté après la conclusion de l’article). L’impôt sur le revenu des particuliers reporté peut être soit investi pour gagner un revenu excédant le coût global de la distribution, soit transféré par l’intermédiaire d’un véhicule de fractionnement du revenu qui

3 Alinéa 125(1)a) et paragraphe 125(7), la définition de « revenu de société de personnes déterminé ».
4 Paragraphe 125(2). Le plafond des affaires s’établit à 500 000 $ dans toutes les provinces, sauf au Manitoba et en Nouvelle-Écosse, qui ont toutes les deux adopté un plafond de 400 000 $.  

convertit le coût de la distribution en une économie absolue. Fondamentalement, une SP permet de constituer une plus grande réserve de capitaux d’entreprise investissables provenant du revenu d’une entreprise exploitée activement comparativement aux sommes après impôt qui sont disponibles lorsque le même revenu est gagné en tant que revenu personnel. Ainsi, un revenu de société de personnes de 400 000 $, qui est imposé au taux d’impôt moyen des particuliers de 41 pour cent, laisse au membre d’une profession libérale un revenu de 236 000 $ après impôt. Le même revenu, s’il est gagné par une SP, laisserait au professionnel environ 336 000 $, ou 292 000 $ après l’impôt des sociétés, en présumant de l’application d’un taux de DAPE et d’un taux d’impôt général de 16 pour cent et de 27 pour cent, respectivement. Le report d’impôt permis par une SP augmente grandement les sommes que peut investir un professionnel.

Comme il est indiqué dans le tableau 1 en annexe, il peut y avoir un coût global à procéder à la distribution du revenu d’entreprise d’une SP sous la forme de dividendes. Il est toutefois souvent possible d’éponger ce coût sur deux ou trois ans si la société gagne un taux de rendement du marché raisonnable sur la partie du revenu dont l’imposition a été reportée. Par exemple, en Ontario, le coût global est de 1,8 pour cent à la distribution du revenu d’une entreprise exploitée activement imposé au taux général sous la forme de dividendes. Cependant, avec un report d’impôt du revenu des particuliers de 19,91 pour cent, il est possible de couvrir le « coût » global si les impôts reportés sont investis à un taux de rendement après impôt de 4,5 pour cent pour deux ans.

**Autres avantages fiscaux**

Les professionnels qui doivent dépenser la totalité ou presque de leur revenu peuvent tout de même trouver à la SP des avantages fiscaux et financiers, notamment les exigences plus flexibles concernant les flux de trésorerie et le versement de l’impôt, les exigences relatives aux besoins en capitaux et la monétisation du prix de base rajusté (PBR) de la participation dans la société de personnes. En outre, tarder à utiliser une SP peut être une source de désavantages importants si le fractionnement du revenu est l’objectif final. Cependant, pour savoir s’il est avantageux de former une SP étant donné les coûts additionnels associés à son maintien et à son exploitation, il est important de calculer les économies d’impôt absolues et la valeur de placement du report d’impôt comparativement à ces coûts.

**Exigences relatives aux besoins en capitaux et dépenses non déductibles**

Certaines sociétés de personnes établissent qu’une partie du capital investi ne peut pas être empruntée de la société ni donnée en gage d’un emprunt bancaire. Cet

5 Les taux de 16 et de 27 pour cent représentent la moyenne estimative de la DAPE et du taux d’impôt général, respectivement, selon les taux d’impôt fédéral et provinciaux prévus par la loi en vigueur pour 2013.
investissement est généralement financé au moyen de retraits ou de distributions sur une période fixe, ou il peut être formé des économies personnelles des associés individuels. De plus, les cabinets professionnels peuvent avoir d’importantes dépenses non déductibles, généralement les frais de repas et de représentation, où 50 pour cent des dépenses représentent un revenu imposable pour lequel aucune distribution n’est reçue pour payer le montant équivalent en impôt.

Comme l’accroissement de capital et le paiement des dépenses non déductibles doivent être financés au moyen de la trésorerie après impôt, la constitution en une SP pourrait permettre d’affecter à ces fins le revenu de société qui a été imposé à des taux plus bas, plutôt que les dollars personnels après impôt, et produire ainsi des économies d’impôt absolues. Par exemple, si un associé a des besoins en capitaux de 50 000 $ qu’il doit autofinancer au moyen du revenu tiré de la société, il aura besoin de 94 000 $ environ de revenu. Par contre, en présumant que le taux d’imposition pour les petites entreprises et le taux d’impôt général des sociétés s’établissent à 16 et à 27 pour cent respectivement, le même investissement autofinancé au moyen de la trésorerie de la société nécessitera environ 59 000 $ de revenu admissible à la DAPE ou 68 000 $ de revenu imposé au taux général. Si le revenu excédentaire est distribué sous la forme d’une rémunération (c’est-à-dire qu’il dépasse les besoins de financement de la société), le professionnel se retrouvera avec un montant de trésorerie supplémentaire après impôt de 18 000 $ ou 13 000 $ environ (pour le revenu admissible à la DAPE et celui assujetti au taux d’impôt général, respectivement).

Le même principe s’applique à la répartition des dépenses non déductibles. Compte tenu des taux d’imposition susmentionnés, la trésorerie personnelle nécessaire pour financer le coût aux fins de l’impôt de 20 000 $, par exemple, de dépenses non déductibles réparties annuellement s’établirait à 9 200 $ comparativement à un impôt des sociétés variant de 3 200 $ à 5 400 $. Ce chiffre représente une économie d’impôt annuelle absolue de 3 800 $ à 6 000 $, qui pourrait dépasser les coûts administratifs associés à l’exploitation de la SP.

L’assurance-vie est l’une des dépenses non déductibles les plus importantes que doivent engager les professionnels. Si un professionnel est titulaire de la police et paie les primes annuelles, il aura besoin d’un revenu personnel plus élevé pour payer les primes non déductibles. Si, par contre, c’est la SP qui est titulaire de la police et qui paie les primes non déductibles, le taux d’imposition moins élevé pour les sociétés signifie qu’un revenu avant impôt moins élevé sera nécessaire pour financer cette dépense. Lorsque la SP est le bénéficiaire de la police, il est généralement possible, au décès, d’ajouter le produit au compte de dividendes en capital (CDC) de la société, lequel peut être distribué en franchise de l’impôt.

Par conséquent, le financement bien structuré d’une police d’assurance-vie non déductible avec la trésorerie de la société peut permettre d’obtenir des économies d’impôt annuelles absolues que la société pourrait distribuer en franchise de l’impôt.

6 L’alinéa d) de la définition de « compte de dividendes en capital » au paragraphe 89(1), et paragraphe 83(2).
déductible au moyen d’une société peut permettre d’obtenir des économies d’impôt substantielles.

Économies d’impôt absolues par l’arbitrage du taux d’imposition provincial

Une SP peut permettre de réaliser des économies d’impôt annuelles lorsque le taux marginal d’impôt sur le revenu des particuliers le plus élevé du professionnel est inférieur au taux pondéré s’appliquant au revenu de profession libérale fondé sur les pourcentages d’attribution provinciale du revenu.

En vertu du Règlement de l’impôt sur le revenu7, un associé individuel est réputé gagner un revenu d’entreprise dans les diverses provinces où la société de personnes a un établissement stable. Le particulier peut être assujetti aux taux d’imposition de plusieurs provinces, quelle que soit la province où il ou elle réside8, et le taux pondéré provincial peut être supérieur au taux le plus élevé dans la propre province du professionnel.

Une SP permet à un professionnel de se soustraire à l’effet des taux d’imposition de plusieurs provinces et territoires pour que son revenu soit imposé au taux qui s’applique à la province où il réside, pourvu qu’il ou elle travaille dans cette province9. En payant un salaire déductible au professionnel, la SP peut convertir un revenu d’entreprise en un revenu d’emploi pour le particulier qui sera imposé au taux d’imposition de la province de résidence du particulier le dernier jour de l’année civile10.

Pour obtenir ce résultat, un professionnel peut, mais n’est pas tenu de, retirer un salaire de la SP. Lorsque l’employé professionnel qui fournit les services à la SP est également son principal actionnaire actif, l’ARC appliquera sa politique de longue date de renonciation à l’exigence que la rémunération soit raisonnable11. Ainsi, le professionnel est totalement libre de choisir et de répartir le revenu qu’il ou elle tire de la SP en tant que revenu d’entreprise ou revenu personnel, ce dernier étant versé en tant que salaire déductible.

La stratégie de recaractérisation du taux provincial peut être appliquée à une partie du revenu de la SP. Elle peut par exemple être limitée au résultat en trésorerie de l’entreprise de sorte que tous les montants non déductibles (ou le

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7 Partie XXVI du Règlement.
8 Article 2601(2) du Règlement.
9 Il est présumé que le professionnel fournit des services en tant qu’employé de la SP, qui à son tour gagne un revenu d’entreprise directement (ou indirectement par l’entremise d’une société de personnes) et, ainsi, le critère de déductibilité générale à l’alinéa 18(1)a) est satisfait.
10 Article 2601(1) du Règlement.
résultat en trésorerie non réparti par l’entreprise) ne sont pas répartis par la société et sont imposés aux bas taux d’imposition des sociétés.

Cette stratégie avantage probablement uniquement les professionnels qui sont membres d’une société de personnes exerçant ses activités dans plusieurs provinces et qui résident en Alberta ou à Terre-Neuve, où les plus hauts taux marginaux d’impôt sur le revenu ordinaire des particuliers sont plus bas que ceux des autres provinces.

Emprunt fiscalement efficace pour financer une dette personnelle tout en simplifiant la conformité fiscale relative à l’impôt des particuliers

Un professionnel qui a une dette personnelle (une hypothèque ou une marge de crédit) peut contracter un emprunt à court terme auprès d’une SP (au moyen d’un prêt d’actionnaire) à un taux généralement inférieur au coût actuel de la dette personnelle.

L’impôt des particuliers applicable aux retraits d’une SP dépendra de la nature des paiements. Les salaires et les dividendes sont imposables l’année de leur réception tandis que les prêts et avances aux actionnaires ne sont pas immédiatement imposables. Afin d’éviter l’inclusion éventuelle du montant total des avances dans le revenu personnel, ces prêts doivent être remboursés à la SP avant la fin de l’année civile suivant l’année d’imposition du retrait des fonds12. Pendant cet intervalle, le professionnel est réputé avoir reçu un avantage égal aux intérêts13 si les intérêts payés sur le prêt sont inférieurs au taux prescrit14.

Une SP peut simultanément comptabiliser par régularisation les salaires ou primes payables à ses employés et déduire le paiement de son revenu net aux fins de l’impôt. Le montant comptabilisé par régularisation doit être payé dans les 179 jours suivant la fin de l’année d’imposition de la SP où le montant a été comptabilisé15. Cette stratégie est pratique parce qu’elle permet de n’avoir à faire les retenues à la source et le versement des impôts qu’une fois par année plutôt que pendant toute l’année, comme c’est le cas lorsque les salaires sont payés périodiquement.

Un professionnel qui utilise une SP peut retirer la totalité de la trésorerie gagnée par la SP pour rembourser progressivement sa dette et obtenir des économies par la réduction du solde du capital à rembourser. Aucun impôt ne sera prélevé si le professionnel paie le taux prescrit et que le prêt est remboursé dans le délai requis16. La SP comptabiliserait par régularisation un salaire à payer au

12 Paragraphes 15(2) et (2.6).
13 Paragraphe 80.4(2).
14 Le taux prescrit est défini au paragraphe 80.4(7) et par renvoi à l’article 4301(a) du Règlement.
15 Paragraphe 78(4).
16 En fait, le remboursement dans les 179 jours exigé au paragraphe 78(4) entraîne le remboursement du retrait par l’actionnaire environ six mois avant la date de remboursement exigée au paragraphe 15(2.6).
professionnel et paierait le montant comptabilisé au plus tard le 179e jour suivant la fin de son année d’imposition. Le paiement du salaire et le remboursement du prêt à l’actionnaire se feraient au moyen d’une entente de compensation. Le professionnel serait tenu de rembourser en espèces un montant suffisant pour financer le versement des déductions à la source ainsi que l’impôt-santé des employeurs dans le cas d’une prime élevée, le cas échéant. Le résultat pratique de ce plan est qu’il sera possible d’avoir accès aux flux de trésorerie bien avant la date à laquelle les acomptes provisionnels trimestriels du particulier auraient été exigibles si le revenu avait été versé sous la forme d’attributions de la société de personnes gagnées à titre personnel. Le coût d’accès à ce financement est limité à l’impôt des particuliers sur l’avantage imposé au taux prescrit. Les économies réalisées grâce à ce plan pourraient diminuer dans l’avenir lorsque les taux d’intérêt prescrits augmenteront. L’effet dépendra de l’écart entre le taux prescrit et le taux d’intérêt sur la dette personnelle.

**Monétisation du PBR de la société de personnes**

Lorsque le PBR de la participation du professionnel dans la société de personnes a augmenté — par exemple, de l’accumulation de dépenses non déductibles — le professionnel a une occasion de monétiser et de convertir le PBR en un prêt à un actionnaire libéré d’impôt en transférant sa participation dans la société de personnes à la S.P et en souscrivant un billet représentant le montant du PBR. La juste valeur marchande de la participation dans la société de personnes transférée doit être au moins égale ou supérieure au PBR. Ce peut ne pas être le cas si la participation dans la société de personnes n’est pas transférable et qu’il n’y a aucun remboursement de capital ou prestation de retraite garanti.

La S.P pourrait payer le billet dû à l’actionnaire avec la trésorerie après impôt sans que l’actionnaire ait à payer d’impôt sur le revenu des particuliers. L’économie d’impôt serait égale à l’écart entre le taux d’impôt des sociétés applicable et le taux marginal d’impôt des particuliers, multiplié par le montant du PBR. Transférer la participation dans la société de personnes au moment où le PBR est à son maximum procure encore plus d’avantages17.

**Fractionnement du revenu**

Fractionner le revenu à l’aide des fonds après impôt accumulés dans une S.P permet de réaliser des économies d’impôt. Toutefois, dans cette situation, il est important de tenir compte des diverses règles d’attribution ainsi que de celles contre le fractionnement du revenu18.

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17 Alinéa 53(2)e) et, peut-être, le paragraphe 96(1.01).

Attribution entre conjoints
Pour éviter les diverses règles d’attribution du revenu qui s’appliquent aux transactions entre époux\textsuperscript{19}, il est crucial que l’époux utilise ses propres fonds pour acquérir le bien visé par la structure de fractionnement du revenu. Si un prêt est consenti à un des conjoints pour acquérir le bien, ce prêt doit être au taux prescrit\textsuperscript{20}.

Attribution avec des mineurs
Les règles d’attribution qui s’appliquent à certains mineurs\textsuperscript{21} s’appliqueront seulement jusqu’au début de l’année où un mineur atteint l’âge de 18 ans\textsuperscript{22}. Il n’y a pas d’attribution de gains ni de pertes en capital réalisés par les mineurs concernés sur le bien prêté ou transféré, sauf dans certaines transactions avec lien de dépendance\textsuperscript{23} décrites ci-après relatives à « l’impôt sur le revenu fractionné avec des mineurs ». Les distributions effectuées par fractionnement du revenu envisagées par les SP sont généralement visées par les règles de l’impôt sur le revenu fractionné avec des mineurs et, par conséquent, la règle d’attribution « ordinaire » qui s’applique aux mineurs ne devrait pas s’appliquer\textsuperscript{24}.

L’attribution résultant d’une restructuration avec les actionnaires familiaux
La formation d’une SP ou une restructuration du capital-actions d’une SP établie comportera généralement le transfert d’un bien d’un particulier à une société par actions. Il faudra par conséquent tenir compte des règles d’attribution des sociétés\textsuperscript{25} pour déterminer si le fractionnement du revenu sera permis. Ces règles réduiront souvent les avantages du fractionnement du revenu avec des « personnes désignées », sauf si la SP conserve son statut de société exploitant une petite

\textsuperscript{19} Paragraphes 74.1(1) et 74.2(1).
\textsuperscript{20} Paragraphe 74.5(2). L’attribution de revenu et de gains ne s’appliquera pas à un bien (ou à un bien qui y est substitué) acquis par un conjoint au moyen d’un prêt portant intérêt au moins élevé du taux prescrit (tel qu’il est prescrit à l’article 4301(c) du Règlement) et du taux équivalent dont les parties n’avaient aucun lien de dépendance, pourvu que le montant des intérêts sur le prêt soit payé annuellement, au plus tard le 30 janvier après la fin de l’année donnée.
\textsuperscript{21} En général, une personne âgée de moins de 18 ans qui a un lien de dépendance avec le prêteur/cédant, ou est une nièce ou un neveu de ce dernier.
\textsuperscript{22} Paragraphe 74.1(3).
\textsuperscript{23} Paragraphe 120.4(4).
\textsuperscript{24} Les paragraphes 74.1(1) et (2), 74.3(1) et 75(2) ne s’appliquent pas à tout montant inclus dans le calcul du revenu fractionné donné d’un particulier pour une année d’imposition.
\textsuperscript{25} Paragraphe 74.4(2).
entreprise (SEPE)26. Une « personne désignée » désigne l’époux ou le conjoint de fait d’un particulier, une personne de moins de 18 ans qui a un lien de dépendance avec le particulier ou qui est le neveu ou la nièce du particulier27.

L’un des avantages à utiliser une SP consiste à reporter l’impôt des particuliers en laissant les revenus dans la société par actions, mais cette accumulation de fonds empêchera la SP de conserver son statut de SEPE. Selon la valeur sous-jacente de la participation dans la société de personnes, une SP ne sera plus admissible en tant que SEPE si l’accumulation d’actifs de placement représente plus de 10 pour cent de la valeur globale des actifs de la société.

Dans le cas d’une attribution à une société, le montant du revenu attribué à l’actionnaire cédant est calculé en appliquant le taux prescrit au « montant non remboursé »28 du bien transféré, et est déduit de tout intérêt ou dividende imposable payé à ce particulier et du montant imposable des dividendes qui sont un revenu fractionné reçu par la personne désignée. Il est possible de réduire ou d’éliminer les effets de l’attribution à la société en mettant en place un arrangement adéquatement structuré pour le remboursement futur du montant non remboursé. Dans le but d’éviter l’application des règles d’attribution des sociétés, la participation que possède toute personne désignée dans la SP peut être structurée sous la forme d’une fiducie dont les conditions limitent les distributions de revenu et de capital29. Bien que toutes les personnes désignées seront empêchées de recevoir des distributions de la fiducie (dans la pratique, la SP) pendant qu’elles demeurent des personnes désignées, le fractionnement du revenu avec des mineurs ayant un lien de dépendance sera permis une fois que ces personnes seront devenues adultes.

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26 Le paragraphe 248(1) définit en partie une « société exploitant une petite entreprise » comme [une société donnée qui est une] société sous contrôle canadien et dont la totalité, ou presque, de la juste valeur marchande des éléments d’actif est attribuable, à un moment donné, à des éléments qui sont :
   a) soit utilisés principalement dans une entreprise que la société ou une société qui lui est liée exploite activement principalement au Canada;
   b) soit constitués d’actions du capital-actions ou de dettes d’une ou de plusieurs sociétés exploitant une petite entreprise rattachées à la société au moment donné, au sens du paragraphe 186(4) selon l’hypothèse que les sociétés exploitant une petite entreprise sont, à ce moment, des sociétés payantes au sens de ce paragraphe;
   c) soit visés aux alinéas a) et b).

27 Paragraphe 74.5(5).

28 Défini au paragraphe 74.4(3).

29 Paragraphe 74.4(4).
Impôt sur le revenu fractionné avec des mineurs

Le « revenu fractionné » comprend, entre autres choses, les dividendes imposables et les avantages conférés à un actionnaire reçus par des « particuliers déterminés » relativement aux actions d’une société privée. Les distributions de la SP à des mineurs seront assujetties à l’impôt sur le revenu fractionné avec des mineurs, lequel imposera les flux de rentrées fractionnés au taux marginal d’impôt des particuliers le plus élevé et limitera généralement l’admissibilité à la plupart des crédits d’impôt personnels. L’impôt sur le revenu fractionné avec des mineurs ne s’appliquera toutefois que jusqu’à la fin de l’année où le particulier déterminé est âgé de 17 ans.

Règles s’appliquant à une fiducie avec droit de retour

En général, une planification fiscale impliquant des mineurs nécessite l’utilisation d’une fiducie. Il faut dans ce cas tenir compte des règles visant une fiducie avec droit de retour au paragraphe 75(2). De façon très générale, ces règles s’appliqueront lorsqu’un bien est transmis à une fiducie et détenu par elle à la condition qu’il revienne au contribuant, qu’il soit transféré à des personnes devant être désignées par le contribuant, ou qu’il ne puisse en être disposé qu’avec le consentement ou suivant les instructions du contribuant. Bien que l’effet immédiat de ces règles sera l’attribution et l’imposition du revenu ou des gains sur le bien contribué dans les mains du contribuant, il peut être plus préoccupant de savoir si une règle complémentaire limite le transfert avec report d’imposition de tout bien de la fiducie.

Ces règles peuvent représenter un piège pour les personnes qui souhaitent conserver le contrôle sur la fiducie tout en étant le contribuant d’un bien. Par conséquent, le contribuant d’un bien ne devrait pas également être le bénéficiaire du capital de même qu’il ne devrait pas être le seul fiduciaire ni le fiduciaire contrôlant. Si le constituant ou autre contribuant à la fiducie doit être un fiduciaire, la fiducie devrait compter minimalement trois fiduciaires et les décisions devraient être prises à la majorité simple. Ainsi, le contribuant pourrait être mis en minorité sur des décisions concernant la distribution et la disposition des biens de la fiducie.

Structures de fractionnement du revenu

Deux structures possibles de fractionnement du revenu tenant compte des obstacles susmentionnés sont présentées ci-après.

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30 Défini au paragraphe 120.4(1).
31 Tel que défini au paragraphe 120.4(1).
32 Par suite de l’utilisation de l’expression « au moins égal à » au paragraphe 120.4(3), le calcul de l’impôt sur le revenu fractionné ne tient compte que du crédit d’impôt pour dividendes et du crédit pour impôt étranger.
33 Paragraphe 107(2).
Fractionnement du revenu lorsque les actionnaires peuvent être des membres non professionnels

Lorsque les membres non professionnels de la famille peuvent être actionnaires de la SP, il est alors possible de tirer profit des taux d’impôt des particuliers plus faibles qui s’appliquent aux dividendes reçus par les actionnaires à faible revenu. Le montant maximal de dividendes exonérés d’impôt pouvant être payé à un actionnaire sans autre source de revenus et l’avantage connexe sont résumés dans le tableau 2 en annexe.

Les membres de la famille peuvent être nommés actionnaires au moment de la constitution en société ou par la suite, au moyen d’un gel successoral.

1. Nomination d’actionnaires à la constitution en société

Comme les entités nouvellement constituées ont généralement une valeur nominale, les actionnaires familiaux peuvent souvent souscrire des actions autodétenues de la société à un montant nominal\textsuperscript{34}. Le capital-actions autorisé et les attributs de chaque catégorie d’actions acquises par le membre non professionnel de la famille doivent se conformer aux règlements pertinents de l’ordre professionnel et aux lois s’appliquant à cette profession. Les restrictions touchant les actions concernent généralement les droits de vote et la gouvernance de la SP. La société peut émettre des actions de croissance ou d’autres action. Les actions de fractionnement du revenu sont généralement des « actions à versement sélectif de dividendes », sans participation à la croissance, mais qui permettent le paiement d’un montant illimité de dividendes discrétionnaires\textsuperscript{35}.

Lorsqu’un professionnel travaillait à titre d’associé avant la constitution en SP, il est probable que sa part des actifs ou de la survaleur du cabinet, ou sa participation dans la société de personnes sera transférée à la SP. Lorsqu’un bien est transféré à la SP, il faut examiner si les règles d’attribution de sociétés s’appliquent et évaluer attentivement le bien transféré. Dans certaines professions, la survaleur ou autre valeur supplémentaire de l’entreprise peut ne pas dépasser ou dépasser seulement légèrement la valeur comptable. Dans d’autres cas, il peut exister une formule d’évaluation prédéterminée (courante dans les sociétés de personnes). Il sera important de bien établir la valeur afin d’éviter les règles sur l’octroi d’avantages qui imputeraient le revenu ou le produit de la disposition au professionnel effectuant le transfert\textsuperscript{36}. Cela pourrait se produire, par exemple, si la valeur de la contrepartie reçue (par exemple, argent, titre de créance et/ou action) par le professionnel en échange d’actifs, de survaleur ou d’une participation dans la société, est inférieure à la valeur du bien transféré.

\textsuperscript{34} Les questions d’octroi d’avantages se limitent généralement à l’étape de la constitution en société en raison de la valeur nominale de l’entité.

\textsuperscript{35} Le droit des sociétés peut remplacer et limiter ou interdire le montant de dividendes pouvant être payé, par exemple, en vertu des dispositions d’évaluation de la solvabilité.

\textsuperscript{36} Ces règles sont contenues au paragraphe 56(2) et à l’alinéa 85(1)e.2), respectivement.
L’attribution des sociétés pourrait s’appliquer que le professionnel transfère des actifs à la SP sur une base d’imposition ou de report d’imposition. Comme la contrepartie reçue par la SP sera composée d’actions et de titres de créance, elle entrera dans la définition de « contrepartie exclue » et ne réduira donc pas le calcul du montant non remboursé au moment du transfert.

Lorsque les membres de la famille souscrivent des actions de la SP, il y aura une « personne désignée » en tant qu’actionnaire déterminé et l’attribution des sociétés pourrait s’appliquer. Si la SP était toutefois une SEPE à sa formation et conserve ce statut après le transfert des actifs, les règles d’attribution des sociétés ne s’appliqueront pas parce que la condition sous-jacente à l’attribution des sociétés est que la société cessionnaire « n’est pas une société exploitant une petite entreprise » tout au long de la période pertinente.

Si la SP sert aux fins prévues d’économiser et d’accumuler un avoir, il est probable qu’à un moment donné, après la constitution en société, elle ne satisfera plus le critère de la SEPE lorsqu’elle conserve son statut après le transfert des actifs non commerciaux commenceront à excéder 90 pour cent de la valeur totale de la SP. En présumant de la satisfaction des autres conditions, l’attribution des sociétés s’appliquera à partir du moment où le critère de la SEPE n’est plus respecté, jusqu’à ce qu’il soit établi qu’une ou plusieurs autres conditions ne s’appliquent pas.

2. Nomination d’actionnaires après la constitution en société

Si des membres de la famille sont inclus dans la SP après sa formation, il est probable qu’il y aura une accumulation du surplus de la société et, peut-être, une augmentation de la valeur de la participation du solde de la société de personnes liée à la survaleur. Un gel successoral est généralement utilisé pour éviter les effets néfastes pouvant découler de l’octroi d’avantages à de nouveaux actionnaires. Les mêmes considérations fiscales que celles abordées précédemment s’appliqueront concernant la nomination d’actionnaires à la constitution en société, suivie de l’apport d’une participation à la société. Les principaux points à surveiller sont la détermination de la valeur des biens transférés et l’effet de l’attribution des sociétés.

3. Conséquences pratiques

Les règles d’attribution des sociétés ne devraient pas être une préoccupation aux premières étapes de la SP puisque cette dernière sera vraisemblablement admissible en tant que SEPE. La situation changera au fil du temps avec l’accumulation d’actifs de placement.

37 Défini au paragraphe 74.4(1).
38 Paragraphe 74.4(2).
39 Conformément à la définition de « société exploitant une petite entreprise » au paragraphe 248(1).
L’établissement d’une fiducie familiale bien structurée devrait empêcher l’application des règles d’attribution des sociétés aux mineurs. Ni les règles d’attribution des sociétés ni les règles du fractionnement du revenu ne s’appliqueront une fois que les mineurs qui ont un lien de dépendance ont atteint l’âge adulte.

Il est aussi possible de gérer les règles d’attribution des sociétés en payant suffisamment de dividendes sur le montant non remboursé (tel qu’il est mesuré au moment du transfert). Selon l’intégration du revenu provenant d’une entreprise exploitée activement présentée au tableau 1 en annexe, le régime global de rémunération offert par la SP au professionnel peut comprendre des dividendes sans pénalité financière importante (et peut générer une économie absolue en versant le revenu admissible à la DAPE sous forme de dividendes dans certaines provinces). Recevoir des dividendes imposables de la SP sur des actions rachetées après le transfert d’un cabinet ou d’une participation dans une société de personnes peut réduire l’effet du revenu fictif\(^40\). En outre, un rachat d’actions payé en argent, qui donne lieu à un dividende réputé\(^41\), réduira et éliminera ultimement le montant non remboursé.

Tout comme pour le paiement de dividendes ordinaires, un dividende réputé résultant du rachat d’actions pourrait donner le même résultat d’intégration. Les bas taux d’imposition sur le revenu d’une SP provenant d’une entreprise exploitée activement fourniraient probablement suffisamment de fonds excédentaires pour financer le rachat d’actions. En conséquence, l’élimination du montant non remboursé pourrait également faire partie du régime global de rémunération du professionnel.

Ainsi, un professionnel peut fractionner son revenu avec son conjoint en éliminant le montant non remboursé (comme il est décrit ci-dessus) ou en payant le montant de dividendes nécessaire dans le cadre du régime global de rémunération. Compte tenu du bas taux prescrit actuel, le paiement de dividendes à un professionnel gagnant un revenu élevé peut représenter un coût nominal du fractionnement du revenu.

Si l’attribution des sociétés s’applique et n’est pas gérée par le paiement de dividendes ou d’intérêts, ou par la réduction du montant non remboursé, le professionnel sera imposé sur le revenu fictif et, par la suite, sur le montant prélevé sur le surplus de la société, c’est-à-dire que le professionnel sera assujetti à une double imposition.

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40 Selon les calculs au paragraphe 74.4(2).
41 Paragraphe 84(3). Les dividendes réputés être payés en vertu de l’article 84 ne sont pas considérés comme des dividendes imposables aux fins de la réduction du revenu d’attribution des sociétés en application du sous-alinéa 74.4(2)b)(ii).
Fractionnement du revenu lorsque les membres non professionnels ne sont pas admis comme actionnaires

Si les membres de la famille ne sont pas admis comme actionnaires de la SP, il faut établir une autre structure fiscale. Une possibilité consiste à créer une société de placement secondaire (« Spla ») dans laquelle les membres de la famille investiront.

En général, les actionnaires de la Spla peuvent comprendre le conjoint et les enfants du professionnel, soit de façon directe ou par l’entremise d’une fiducie familiale. La SP prêterait son surplus de société à la Spla afin que les fonds puissent être investis par la Spla plutôt que par la SP. Le professionnel pourrait conserver le contrôle de la Spla au moyen d’une catégorie spéciale d’actions privilégiées « à vote multiple »42. Alors que le contrôle commun ferait en sorte que la SP et la Spla soient des sociétés associées43, la majorité des professionnels investirait le patrimoine familial dans des actifs non commerciaux. Ainsi, la SP serait toujours admissible à la DAPE44 dans la mesure où le total du « capital imposable utilisé au Canada45 » de la SP et de la Spla atteint au plus 10 millions à 15 millions de dollars46.

Dans le contexte du plan de la Spla, les gains accumulés et le surplus de la SP se traduiraient par le montant du capital du prêt à la Spla, et seul le revenu de placement s’accumulera au profit des actionnaires qui sont des membres non professionnels. Selon le droit des sociétés qui gouverne la Spla, des examens de la solvabilité peuvent empêcher une distribution des actifs si leur valeur est égale ou inférieure au montant du prêt dû à la SP. Bien que cet aspect limite la valeur du plan, ce dernier comporte tout de même un avantage par rapport à un investissement direct dans la SP par les membres de la famille. Alors que l’attribution des sociétés exige un transfert de fonds ou de biens par un particulier à une société par actions, le prêt pour l’investissement en capital dans la Spla serait fait par la SP à partir de son surplus accumulé; par conséquent, l’utilisation de la Spla peut empêcher l’application des règles d’attribution des sociétés.

43 Au sens du paragraphe 256(1).
44 Même en l’absence de contrôle ou de tout élément de participation croisée du professionnel dans la Spla, il est toujours nécessaire de tenir compte de la disposition de contrôle de fait au paragraphe 256(5.1). Bien que la Spla puisse être réellement gérée de façon indépendante par le conjoint du professionnel, la Spla serait entièrement financée par la dette de la SP et la SP serait considérée comme exerçant une influence sur la Spla.
45 Au sens du paragraphe 181.2(1).
46 Selon la formule de réduction du plafond des affaires au paragraphe 125(5.1).
Plans de fractionnement du revenu versus prêts traditionnels au taux prescrit de la SP

Tant le plan d’actionnariat direct que celui de fractionnement du revenu au moyen de la Spla imposent une limite pratique à l’attribution du revenu. Alors qu’un arrangement de prêt au taux prescrit permet de faire une attribution annuelle du revenu aux membres de la famille quel que soit leur âge, la distribution des bénéfices d’une SP ou du revenu d’une Spla est limitée aux conjoints et aux enfants adultes. Cette limite pratique résulte de l’application directe des règles de l’impôt sur le revenu fractionné avec des mineurs, même si la SP ou la Spla investit dans des titres cotés en bourse, dont le revenu ne serait habituellement pas assujetti à l’impôt sur le revenu fractionné avec des mineurs s’il était payé directement.47

Les prêts entre deux sociétés par actions canadiennes n’ont pas à porter intérêt. Ainsi, l’utilisation d’une Spla pour fractionner le revenu produit progressivement un montant plus élevé de revenu de placement après impôt à verser à la famille que ce serait le cas avec un prêt au taux prescrit exigeant que l’intérêt soit payé au créancier de la famille.

La structure de la Spla offre plusieurs autres avantages intéressants dans une stratégie de planification fiscale globale et minimise l’effet de la limitation des distributions aux mineurs.

Gagner un revenu dans la SP et le prêter à la Spla fournit une plus grande réserve de capitaux à investir que si le même revenu est gagné à titre personnel. Une fois que le surplus après impôt de la société est investi, il peut y avoir très peu de différence entre le revenu de placement gagné dans la société par actions et le revenu gagné à titre personnel. Comme il est présenté au tableau 3 en annexe, l’imposition du revenu d’intérêt et des gains en capital d’une société privée sous contrôle canadien (SPCC) sur la base d’une distribution antérieure donne lieu à un remboursement anticipé nominal (valeur absolue de moins de 1 pour cent) ou à de petites économies de report dans 5 des 10 provinces. Il y a ainsi très peu de différence entre l’assujettissement à l’impôt du revenu de placement d’une société ou d’un particulier. L’imposition des dividendes de sociétés non rattachées, toutefois, entraîne généralement un paiement anticipé d’impôt parce que le taux de 33,33 pour cent de la partie IV dépasse généralement le taux d’impôt des particuliers équivalent sur le revenu de dividendes. Suffisamment de dividendes devraient ainsi être payés par la Spla chaque année (mais pas aux mineurs pour éviter l’application de l’impôt sur le revenu fractionné avec des mineurs) pour recouvrer l’impôt de la partie IV applicable aux dividendes de sociétés non rattachées reçus par la Spla.

47 En vertu de l’élément d’exclusion au sous-alinéa a)(i) de la définition de « revenu fractionné » au paragraphe 120.4(1) : « dividendes imposables reçus par le particulier relativement à des actions du capital-actions d’une société (sauf des actions d’une catégorie cotée à une bourse de valeurs désignées et des actions du capital-actions d’une société de placement à capital variable). ».
Toutefois, le grand avantage de la structure de la Spia est qu’elle permet une interaction entre l’imposition du revenu de placement dans la SPCC et sa distribution éventuelle aux actionnaires à faible revenu. Alors que les taux d’imposition de la SPCC sur le revenu de placement se rapprochent des taux marginaux supérieurs d’impôt sur le revenu des particuliers, l’accumulation d’un revenu de placement dans une SPCC permet aussi d’accumuler de l’impôt en main remboursable au titre de dividendes (IMRTD), soit 26,66 pour cent du « revenu de placement total48 ». L’accumulation de l’IMRTD produit une source future de « trésorerie gonflée » sous la forme d’un remboursement au titre de dividendes reçu au moment du paiement de dividendes imposables. Le revenu de placement accumulé peut être distribué aux actionnaires à faible revenu ou sans revenu (voir la discussion précédente sur la répartition des dividendes en franchise de l’impôt), pour produire des économies d’impôt absolues découlant du fractionnement du revenu tout en produisant un remboursement élevé au titre des dividendes en espèces qui peut être affecté à d’autres distributions. Cette mesure procure ultimement deux avantages. La SP aura une plus grande réserve de capitaux en raison des taux d’imposition plus bas sur ses gains. Aussi, les dividendes peuvent être répartis aux actionnaires à plus faible revenu, procurant ainsi un remboursement d’impôt dans la Spia qui est supérieur au montant d’impôt à payer par le bénéficiaire. L’impôt total est ainsi moins élevé, même si les distributions aux mineurs doivent être reportées jusqu’à ce qu’ils atteignent l’âge adulte.

Certains facteurs sont à examiner au moment de choisir une structure de fractionnement du revenu, notamment les taux de rendement prévus, et il faut être prêt à avoir une structure de fonctionnement un peu plus complexe. La préparation d’un modèle financier à l’aide des taux de rendement et d’imposition prévus sera utile pour analyser les économies pouvant être réalisées au moyen d’une structure donnée.

POURQUOI ATTENDRE? LES ARGUMENTS EN FAVEUR DE LA CRÉATION D’UNE SP TÔT DANS LA CARrière

D’aucuns pourraient alléguer qu’un professionnel ne devrait pas avoir recours à une SP avant d’avoir atteint l’étape où son mode de vie et ses besoins de consommation ne nécessitent plus tous ses revenus et où il ou elle peut laisser une somme importante s’accumuler dans la SP. Avant cette étape, les coûts associés à l’établissement et au maintien de la structure dépasseraient sûrement les petits avantages tirés du report d’imposition (s’il y en a). Toutefois, comme il a été déjà illustré, les dépenses non déductibles, les exigences en matière d’autofinancement des besoins en capitaux et la capacité d’arbitrer les taux des impôts provinciaux offrent plusieurs occasions de réaliser des économies d’impôt absolues, créant ainsi des avantages pouvant dépasser les coûts additionnels associés à la complexité de l’observation des règles fiscales.

48 Au sens du paragraphe du paragraphe 129(4).
Plus longtemps un professionnel attend avant d’établir une structure de société, plus il est probable qu’il ou elle aura accumulé des actifs professionnels précieux. Dans le contexte des structures de fractionnement du revenu, cette situation peut entraîner une exposition à une attribution des sociétés plus élevée au transfert d’actifs à une SP avec une inclusion du revenu d’intérêt à un taux prescrit plus élevé. Lorsque des actions privilégiées à valeur fixe doivent être utilisées pour refléter le transfert d’actifs de valeur plus élevée à la SP, des dividendes devront être payés sur ces actions avant que des dividendes puissent être versés aux membres de la famille, ce qui retardera ou réduira les avantages fiscaux de la structure.

Il y a aussi plusieurs avantages à accumuler un patrimoine sous la forme d’une société dans le contexte de la planification successorale globale du professionnel; tarder à établir une SP peut donc entraîner une perte d’avantages et d’occasions au point de vue fiscal. Sous réserve des développements futurs dans l’arrêt MacDonald49 se rapportant à l’extraction du surplus aux taux des gains en capital, l’accumulation dans une SP d’économies non distribuées (voir la discussion ci-après sur les considérations relatives à la retraite) laissera la succession du professionnel avec une société de placement financée. Un important gain en capital sera réalisé au décès du professionnel et, par conséquent, un PBR plus élevé pour la succession (en présumant qu’il n’y a pas de transfert au conjoint). Il peut être possible d’extraitre le surplus accumulé de la SP (à présent une société de placement) en franchise de l’impôt au moyen de l’évaluation du PBR des actions maintenant détenues par la succession. Pour ce faire, la succession transférerait son placement dans l’ancienne SP à une nouvelle société de portefeuille en échange d’un billet ou d’actions dont le capital versé (CV) serait égal au nouveau PBR plus élevé50. L’ancienne SP pourrait payer des dividendes intersociétés en franchise de l’impôt à la société de portefeuille, qui à son tour rembourserait le billet (ou le CV des actions) à la succession en franchise de l’impôt51. Par conséquent, le professionnel peut laisser une succession plus importante que ce n’aurait été le cas si il ou elle n’avait pas utilisé une société.

CONSIDÉRATIONS SUR LA SP AU MOMENT DE LA RETRAITE

Lorsqu’un professionnel approche de la retraite ou prépare un plan successoral, il ou elle doit se demander comment quitter les services professionnels. Il faudra alors examiner le contrat de société pour déterminer s’il permet le transfert des participations dans la société de personnes ou des actions de la SP.

Selon le scénario le plus probable, la participation de la SP dans la société de personnes sera rachetée ou transférée à un nouvel associé à un montant précisé

49 Canada c. MacDonald, 2013 CAF 110; inf. 2012 CCI 123.
50 En présumant que les actions n’ont pas été acquises d’une personne liée qui a demandé l’exemption pour gains en capital ou une évaluation le jour d’évaluation pour augmenter le PBR.
51 En présumant que l’article 84.1 ne s’applique pas.
dans le contrat de société. Cela peut être fait au moyen d’une disposition directe de la participation détenue par la SP ou par un mécanisme supplémentaire dans le cas d’une SP qui facture ses services professionnels à la société de personnes. Dans le second scénario, la SP n’est pas un associé de la société de personnes et, par conséquent, tout dividende payé au moment de la retraite doit tenir compte de la structure de la SP. Dans le cas d’une participation directe dans la société de personnes, l’accumulation des attributions de revenu non déductibles de la société de personnes peut faire en sorte que la participation de la SP dans la société de personnes ait un PBr élevé. Selon le quantum du produit de la disposition, le cas échéant, de la participation dans la société de personnes, il est probable que la SP réalise une perte en capital. Cette perte peut servir à payer les impôts des sociétés sur les gains en capital futurs ou ceux des trois dernières années. L’impôt des particuliers sera toutefois payable à la distribution du produit sous la forme de dividendes imposables. Parce que les gains de société ont été compensés par la perte subie à la disposition de la participation dans la société de personnes, il n’y aurait pas d’augmentation du PBR et donc aucune possibilité de payer un dividende en capital libre d’impôt. De plus, l’année où le professionnel prend sa retraite, la SP devra payer l’impôt sur le revenu du travail en cours qui a été reporté de l’année précédente, comme ont droit de le faire les membres de professions libérales.

Une fois que la SP quitte le cabinet (et a pris les mesures réglementaires nécessaires pour révoquer son statut), elle demeure une société privée, et il peut être avantageux pour le professionnel retraité de conserver la même structure d’exploitation. Par exemple, il peut tirer avantage d’occasions de fractionnement du revenu et de report d’impôt sur le revenu d’activité gagné par l’entreprise.

CONSIDÉRATIONS ADMINISTRATIVES :
COMPRENDRE LES CONDITIONS DE CONSTITUTION ET D’EXPLOITATION D’UNE SP

Une société de personnes de professionnels s’occupe souvent des fonctions d’exploitation et d’administration au nom de l’associé. Elle peut ainsi faire les distributions périodiques, payer les cotisations de membre et les primes d’assurance responsabilité civile et invalidité, payer les remboursements de technologie, verser les dons de bienfaisance ainsi que préparer les déclarations de revenus et obtenir les services de conseillers financiers. L’associé paie souvent lui-même certaines dépenses, comme les frais d’automobile et de représentation. L’exploitation du cabinet et la prestation des services professionnels imposent donc très peu d’obligations financières et administratives à l’associé.

Il est toutefois utile d’examiner les éléments suivants, qui sont tirés d’une décision type de l’ARC et représentent les exigences administratives sous-jacentes à l’établissement et à l’exploitation de la structure d’une SP :

52 Alinéa 53(2)e).
53 Article 34.
Chaque [SP] sera responsable des dépenses suivantes :
   i. les cotisations professionnelles de l’associé;
   ii. l’assurance responsabilité civile (au niveau de garantie minimal requis par les exigences professionnelles) et/ou l’assurance invalidité pour l’associé visé;
   iii. les frais de formation continue;
   iv. les frais de déplacement, y compris les frais d’utilisation d’une automobile, et les frais d’hébergement et de repas;
   v. les frais de communications, y compris de cellulaire et Blackberry;
   vi. le matériel et les fournitures de bureau ; et
   vii. autres dépenses commerciales liées aux préférences personnelles en matière de pratique du particulier [SP]54.

La discussion qui suit présente diverses exigences visant la constitution et l’exploitation d’une SP, fondées sur des critères précisés dans diverses décisions de l’ARC.

**La constitution d’une SP**

**Considérations organisationnelles**

La société de personnes doit permettre aux associés individuels de constituer une société professionnelle. Le cas échéant, les associés doivent s’assurer de respecter les restrictions additionnelles pouvant s’appliquer au nombre d’actionnaires et aux structures d’exploitation en plus des règles des organismes de réglementation et des ordres professionnels.

**Constitution en société et inscription au tableau de l’ordre**

Sous réserve des restrictions organisationnelles, législatives et réglementaires, il faut décider qui sera actionnaire de la SP. Comme il a été discuté dans la section sur le fractionnement du revenu, il peut être avantageux de nommer comme actionnaire un conjoint, d’autres membres de la famille ou une fiducie familiale.

Chaque ordre professionnel a ses propres exigences en matière d’inscription à son tableau. Certaines professions peuvent rendre obligatoire l’inclusion de clauses particulières dans les actes et règlements administratifs de la SP.

De plus, les registres des procès-verbaux et autres documents devront être tenus, aux dépens — au point de vue de l’argent et peut-être de temps — du professionnel constitué en société.

**Établissement d’une relation employé-SP**

modifié ou dans un contrat de service entre la SP et la société de personnes de professionnels initiale.

**Services bancaires**
La SP aura ses propres comptes bancaires. Bien qu’il soit envisageable qu’un professionnel gère le flux de la trésorerie liée à la SP exclusivement par des directives ou la comptabilisation des prêts d’actionnaire, cette forme de fonctionnement peut ne pas être conforme aux hypothèses factuelles abordées dans les décisions de l’ARC ni à la structure d’exploitation recommandée. Par exemple, le professionnel peut recevoir directement les retraits de la société de personnes. Cependant, pour assurer l’intégrité de la structure, il est préférable que les retraits soient déposés dans le compte de société de la SP puis distribués séparément à l’employé/professionnel actionnaire. La même recommandation quant à la séquence des dépôts s’appliquerait aux honoraires versés pour les services fournis par la SP à la société de personnes.

Une autre considération importante est la source des fonds servant à l’acquisition des actions par un conjoint ou une fiducie familiale (là où c’est permis) et l’importance d’éviter l’application des diverses règles d’attribution. Étant donné qu’une SP nouvellement constituée aura une juste valeur marchande nominale, le prix de souscription des nouvelles actions sera aussi nominal, généralement entre 10 $ et 100 $. Les fonds de souscription devraient venir de sources indépendantes pour pouvoir tirer profit des occasions de fractionnement du revenu et éviter l’application des règles d’attribution mentionnées précédemment. Ces sources peuvent comprendre le revenu d’emploi du conjoint, les dons au conjoint (autres que les dons faits par le professionnel) et le revenu de placement gagné sur des fonds indépendants. Les fonds qui sont dans des comptes conjoints ou autrement amalgamés ne doivent pas servir à acheter des actions, même s’ils proviennent de sources non attribuables acceptables.

**Documents financiers et administration fiscale**
La SP devra tenir des livres et documents distincts, préparer les états financiers et produire les déclarations de revenus des sociétés. Des documents financiers adéquats seront également exigés pour surveiller et communiquer l’observation des diverses règles fiscales applicables aux prêts d’actionnaire, aux dépenses non déductibles et aux soldes des attributs fiscaux, comme l’IMRDT, le CDC et le PBR.

Il faudra également ouvrir certains comptes fiscaux fédéral et provinciaux immédiatement après la constitution en société de la SP, par exemple :

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55 Le revenu de placement, que le capital représente ou non un problème d’attribution, devrait constituer un « revenu de deuxième génération » et, par conséquent, ne pas donner lieu à des problèmes d’attribution.
1. des comptes d’impôt sur le revenu des sociétés avec l’ARC pour l’impôt fédéral et les impôts provinciaux applicables;
2. des comptes d’impôt sur le revenu des sociétés avec les gouvernements de l’Alberta et du Québec si la SP ou la société de personnes fournira des services à partir d’un établissement stable dans ces provinces;
3. la taxe sur les produits et services (TPS), la taxe de vente harmonisée (TVH) ou la taxe de vente du Québec (TVQ), selon le cas, lorsqu’une SP fournit des services à une société de personnes;
4. des comptes de paiement des cotisations sociales si la SP paiera les salaires ou les gratifications, y compris en particulier
   a. des comptes de paie de l’ARC pour le paiement des retenues à la source et des primes du Régime de pensions du Canada (RPC);
   b. des comptes d’impôt-santé des employeurs dans certaines provinces; et
   c. des comptes de paiement de l’indemnisation des accidentés du travail pour les primes nominales payables sur le salaire d’un professionnel.

**Paiement des dépenses par la SP et autres questions administratives**

Certaines dépenses devraient être engagées par la SP afin de maintenir l’intégrité de la structure. Par contre, elles peuvent être payées par le professionnel et la SP peut les lui rembourser. Ces dépenses comprennent par exemple le coût de l’assurance responsabilité professionnelle, les frais de repas et de représentation, les frais de déplacement et les frais de technologie et de communications. Dans le cas de l’assurance invalidité, il est important que le particulier paie les primes pour assurer que les avantages futurs sont reçus en franchise de l’impôt.

Il faut mettre à jour les cartes de visite, les articles de papeterie et les signatures des courriels pour indiquer que les services sont dorénavant fournis par la SP. Souvent, le changement de nom et d’apparence n’est pas discrétionnaire; de nombreux ordres professionnels obligent leurs membres à indiquer que leurs services sont fournis par l’entremise d’une SP.

**Exploitation d’une SP**

La formation d’une SP peut augmenter l’accent mis sur la gestion des flux de trésorerie pour le versement de l’impôt et le paiement des dépenses qui sont dorénavant prises en charge par la SP.

Dans le cas d’une SP qui fournit des services à une société de personnes, il est recommandé de facturer la société de personnes et de recouvrer les paiements de façon systématique pour étayer le fait que la SP est une entité indépendante qui fournit des services à la société de personnes. Des quantas modifiés régulièrement et des factures bien documentées détaillant les services qui ont été fournis (en

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56 Voir la partie IV du Règlement pour les considérations liées aux établissements stables de société.
précisant, par exemple, le nom des clients et le nombre d’heures facturées) par la SP sont préférables à des retraits fixes d’un prêt qui sont résorbés une ou deux fois par année au moyen d’une facture générique. Bien que les deux exemples produisent le même flux de trésorerie pour la SP, il est conseillé d’avoir recours au premier pour conserver l’intégrité de la structure. De plus, la SP devra facturer la TPS, la TVH ou la TVQ (le cas échéant) à la société de personnes pour les services qu’elles lui fournissent. Elle devra aussi recouvrir et verser les taxes et produire les déclarations exigées.

Dans le cas d’une SP qui possède une participation dans la société de personnes, la principale considération quant aux flux de trésorerie consistera à assurer que les retraits sont déposés dans le compte de banque de société de la SP.

La considération la plus importante en ce qui a trait à l’exploitation d’une SP, comparativement à l’exercice de la profession en tant qu’associé direct, est de déterminer comment avoir accès aux fonds de la société en tenant compte de sa structure d’exploitation particulière. Une fois que les revenus sont dans la SP, le professionnel peut les retirer sous la forme d’un salaire, d’un dividende, d’un prêt ou d’un remboursement du PBR, ou ne pas les retirer du tout. Il faut examiner les facteurs comme les taux marginaux d’imposition, les cotisations à un régime enregistré d’épargne-retraite, l’admissibilité au RPC et les besoins de liquidités pour établir le régime de rémunération le plus avantageux. Quelle que soit la façon dont le professionnel obtient les fonds de la société, il sera important de bien administrer et gérer les comptes d’impôt sur le revenu, les comptes de cotisations sociales, les comptes de taxes de vente et les déclarations fiscales annuelles.

**Impôt de l’employeur/impôt des particuliers**

À l’exception du revenu d’emploi, les retraits d’une SP ne sont généralement pas assujettis aux règles de retenue à la source. Par exemple, le paiement de dividendes, les remboursements du CV et des prêts d’actionnaire, et le paiement des intérêts n’exigent pas que la SP retienne des fonds ou les verse à l’ARC. Par contre, les règles du versement des retenues à la source s’appliquent au paiement des traitements, salaires ou gratifications à l’employé qui est un membre professionnel, ainsi qu’aux employés qui sont des membres de la famille.

Il faut calculer l’impôt sur le revenu personnel et les primes du RPC pour chaque paiement classé en tant que revenu d’emploi. Les fournisseurs commerciaux de services de paie offrent contre rémunération des services de calcul; toutefois, les professionnels peuvent utiliser le service gratuit de l’ARC, le « calculateur en direct de retenues sur la paie » qui établit le montant des retenues selon les données

57 Paragraphe 153(1), article 100 du Règlement, article 21(1) du Régime de pensions du Canada (LRC 1985, c. C-8, telle que modifiée) et article 82(1) de la Loi sur l’assurance-emploi (LC 1996, c. 23, telle que modifiée).

fournies par les membres. Si le professionnel réside au Québec, il doit également se conformer aux exigences de versement et de déclaration de cette province.

La SP doit aussi produire les feuillets T4 (« État de la rémunération payée ») et T5 (« État des revenus de placement ») lorsqu’elle paie un revenu d’emploi et des dividendes, respectivement, pendant l’année. Ces feuillets doivent être produits au plus tard le dernier jour du mois de février de l’année suivant l’année (civile) d’imposition.

La rémunération par voie de salaire n’entraîne pas d’acomptes provisionnels trimestriels pour les particuliers. Les règles de retenues à la source, si elles sont appliquées adéquatement, devraient s’occuper des retenues de l’impôt sur le revenu et du RPC pour le salaire payé pendant l’année. Si toutefois le professionnel a retiré des fonds de la société sous forme de dividendes ou d’intérêts sur un prêt d’actionnaire, il peut devoir payer des acomptes trimestriels pour l’année suivant celle pendant laquelle les montants ont été retirés sans retenue à la source.

Une technique de planification consistant à payer des dividendes une année et une rémunération d’emploi l’année suivante peut permettre d’éliminer les acomptes provisionnels pour le particulier. Lorsqu’un particulier doit autrement payer l’impôt des particuliers par acomptes, les acomptes sont calculés selon le moins élevé de trois éléments, dont l’un correspond au solde d’impôt à payer de l’année précédente. Si le particulier n’avait pas d’impôt à payer l’année précédente, il n’aura pas d’acomptes provisionnels à payer pour l’année en cours.

Exigences visant les sociétés

Les sociétés par actions sont également tenues de verser l’impôt par acomptes provisionnels. Si la société de personnes exerce ses activités en Alberta ou au Québec, elle doit payer des acomptes provisionnels supplémentaires à ces provinces en plus de ceux versés à l’ARC. Le solde d’impôt des sociétés exigible, le cas échéant, doit être payé deux mois après la fin de l’exercice de la SP (ou trois mois si la SP demande la DAPE l’année courante ou l’année précédente, et le revenu de l’année précédente était égal ou inférieur au plafond de la DAPE).

Une SP nouvellement constituée n’aura pas à verser d’acomptes provisionnels avant, au plus tôt, le 31 mars de l’année suivant l’année où elle déclare des impôts.

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59 Voir le paragraphe 156(3), la définition de « base des acomptes provisionnels » et article 5300(1) du Règlement.

60 Alinéa 156(1)a).
à payer\textsuperscript{61}. Que la SP soit tenue de payer des acomptes provisionnels mensuels ou trimestriels (selon que le revenu de société est entièrement assujetti à la DAPE ou non), la considération clé pour le professionnel consiste à s’assurer que les acomptes provisionnels sont payés à l’échéance pour éviter d’avoir à payer de l’intérêt ou une pénalité pour acomptes provisionnels payés en retard ou insuffisants. Par contre, il est aussi important de prévoir ou gérer les calculs des acomptes provisionnels de manière à éviter de payer des acomptes provisionnels trop élevés à l’ARC ou à l’administration fiscale de l’Alberta ou du Québec.

Outre les feuillets à produire dont il a été question précédemment pour le paiement d’un revenu d’emploi et de dividendes, il faut produire des déclarations combinées fédérale-provinciale ainsi que des déclarations de revenus distinctes pour l’Alberta et/ou le Québec si la SP exerce ses activités dans ces provinces ou reçoit des attributions de société de personnes dans ces provinces.

**CONCLUSION**

La constitution en société professionnelle procure d’importants avantages fiscaux, y compris diverses occasions pour les professionnels qui ne peuvent pas économiser ou investir beaucoup d’argent. Le principal aspect à considérer dans la décision de former une SP consiste à établir si les avantages potentiels du report et des économies d’impôt dépassent le coût d’établissement et d’administration ainsi que l’effort continu nécessaire pour maintenir la structure de la SP. Il faut aussi tenir compte d’autres répercussions fiscales comme l’attribution et l’impôt sur le revenu fractionné avec des mineurs. Étant donné les considérations administratives découlant de la création et de l’exploitation d’une SP, il est important que le professionnel, la SP et la société de personnes travaillent de concert pour planifier la transition et maintenir une relation efficace.

\textsuperscript{61} En présument que les impôts à payer de la SP dépassent le seuil minimum des acomptes provisionnels.
ANNEXE TABLEAU 1 Coût/économies et report d’impôt sur les distributions du revenu d’une société professionnelle, aux taux de 2014

<table>
<thead>
<tr>
<th>Province/Locality</th>
<th>Coût/( économies) Report pour cent</th>
<th>Coût/( économies) Report pour cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terre-Neuve-et-Labrador</td>
<td>(0,94) 27,30 2,65 13,30</td>
<td>Terre-Neuve-et-Labrador</td>
</tr>
<tr>
<td>Île-du-Prince-Édouard</td>
<td>1,95 31,87 3,44 16,37</td>
<td>Île-du-Prince-Édouard</td>
</tr>
<tr>
<td>Nouvelle-Écossea</td>
<td>(2,40) 36,00 5,88 19,00</td>
<td>Nouvelle-Écossea</td>
</tr>
<tr>
<td>Nouveau-Brunswick</td>
<td>(0,91) 31,34 0,13 19,84</td>
<td>Nouveau-Brunswick</td>
</tr>
<tr>
<td>Québec</td>
<td>1,36 30,97 2,68 23,07</td>
<td>Québec</td>
</tr>
<tr>
<td>Ontario</td>
<td>0,89 35,40 4,15 19,40</td>
<td>Ontario</td>
</tr>
<tr>
<td>Ontario</td>
<td>(1,41) 30,91 1,80 19,91</td>
<td>Ontario</td>
</tr>
<tr>
<td>Ontario</td>
<td>(1,42) 34,03 1,85 23,03</td>
<td>Ontario</td>
</tr>
<tr>
<td>Manitoba</td>
<td>0,27 31,00 1,11 17,00</td>
<td>Manitoba</td>
</tr>
<tr>
<td>Alberta</td>
<td>0,69 25,00 0,47 14,00</td>
<td>Alberta</td>
</tr>
<tr>
<td>Colombie-Britannique</td>
<td>0,05 23,00 0,45 14,00</td>
<td>Colombie-Britannique</td>
</tr>
</tbody>
</table>
| Notes : Les calculs sont fondés sur les propositions de taux annoncées jusqu’au 31 mai 2013. Il est présumé que le particulier est imposé au taux marginal d’impôt sur le revenu fédéral-provincial le plus élevé (sauf dans le cas des calculs pour le revenu gagné en Ontario jusqu’à concurrence de 509 000 $ qui est assujetti au taux marginal d’impôt fédéral le plus élevé et le deuxième taux marginal d’impôt le plus élevé en Ontario) et que la fin d’exercice de la société par actions est le 31 décembre. Il n’est pas tenu compte des cotisations sociales des sociétés (comme le Régime de pensions du Canada [RPC] et l’impôt-santé des employeurs) ni des cotisations au RPC et des primes versées aux régimes provinciaux d’assurance-maladie des particuliers. Il est aussi présumé que le montant après impôt du REEA non admissible à la déduction accordée aux petites entreprises est distribué en tant que dividendes déterminés sous réserve que le revenu procure un solde du compte de revenu à taux général (CRTG) suffisant.
| a Ne tient pas compte de l’effet d’un revenu entre 400 000 $ et 500 000 $ puisque le plafond des affaires dans cette province est de 400 000 $.
| b Il est présumé que les fourchettes d’imposition provinciales de 2013 demeureront les mêmes.
| c Il est présumé qu’à compter du 1er janvier 2014, il y aura une hausse temporaire de deux ans du taux d’impôt sur le revenu applicable aux particuliers gagnant plus de 150 000 $ par année. Le taux d’impôt augmentera de 2,1 %, passant de 14,7 à 16,8 %, pour 2014 et 2015 seulement, avant d’être rétabli à 14,7 % en 2016.

Source : Adapté des tableaux d’intégration de 2014 par province (selon les propositions de taux annoncées jusqu’au 31 mai 2013) : Tableau 1 : Intégration du revenu provenant d’une entreprise exploitée activement et Tableau 2 : Intégration du revenu de placement gagné par une SPCC, publiés initialement en ligne en juillet 2013 par Services d’édition Ernst & Young Inc.
## ANNEXE TABLEAU 2  Dividendes exonérés d’impôt maximums et économies d’impôt connexes découlant du fractionnement du revenu, aux taux de 2013

<table>
<thead>
<tr>
<th>Province</th>
<th>Dividende déterminé maximuma</th>
<th>Taux marginal le plus élevé sur les dividendes déterminés</th>
<th>Économies d’impôt par fractionnement de revenu sur le dividende maximumb</th>
<th>Dividende déterminé maximumb</th>
<th>Économies d’impôt par fractionnement de revenu sur le dividende maximumb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terre-Neuve-et-Labrador</td>
<td>48 845</td>
<td>22,47</td>
<td>10 975</td>
<td>19 280</td>
<td>29,96</td>
</tr>
<tr>
<td>Île-du-Prince-Édouard</td>
<td>44 680</td>
<td>28,70</td>
<td>12 823</td>
<td>11 655</td>
<td>38,56</td>
</tr>
<tr>
<td>Nouvelle-Écosse</td>
<td>30 510</td>
<td>36,06</td>
<td>11 002</td>
<td>28 340</td>
<td>36,21</td>
</tr>
<tr>
<td>Nouveau-Brunswick</td>
<td>48 845</td>
<td>24,91</td>
<td>12 167</td>
<td>21 905</td>
<td>33,05</td>
</tr>
<tr>
<td>Québec</td>
<td>34 735</td>
<td>35,22</td>
<td>12 234</td>
<td>22 390</td>
<td>38,54</td>
</tr>
<tr>
<td>Ontarioc</td>
<td>48 845</td>
<td>29,54</td>
<td>14 429</td>
<td>40 140</td>
<td>32,57</td>
</tr>
<tr>
<td>Manitoba</td>
<td>23 860</td>
<td>32,26</td>
<td>7 697</td>
<td>9 440</td>
<td>39,15</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>48 845</td>
<td>24,81</td>
<td>12 118</td>
<td>19 160</td>
<td>33,33</td>
</tr>
<tr>
<td>Alberta</td>
<td>48 845</td>
<td>19,29</td>
<td>9 422</td>
<td>21 650</td>
<td>27,71</td>
</tr>
<tr>
<td>Colombie-Britannique</td>
<td>48 845</td>
<td>25,78</td>
<td>12 592</td>
<td>25 060</td>
<td>33,71</td>
</tr>
</tbody>
</table>

a Il est présumé que le particulier bénéficiaire n’a pas d’autre source de revenus.
b Il est présumé que le particulier est imposé au taux marginal le plus élevé de sa province, sauf indication contraire.
c Il est présumé que le particulier est un professionnel à revenu élevé qui gagne moins de 509 000 $ par année.

Source : Adapté des calculs du revenu de dividendes maximum avant impôt pour 2013, publié initialement en ligne en juillet 2013 par Services d’éditique Ernst & Young Inc.
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Terre-Neuve-et-Labrador</td>
<td>3,89</td>
<td>(6,37)</td>
<td>néant</td>
<td>(2,32)</td>
<td>néant</td>
<td>(10,87)</td>
<td>1,95</td>
<td>(3,18)</td>
</tr>
<tr>
<td>Île-du-Prince-Édouard</td>
<td>7,05</td>
<td>(3,30)</td>
<td>néant</td>
<td>6,69</td>
<td>néant</td>
<td>(4,63)</td>
<td>3,53</td>
<td>(1,65)</td>
</tr>
<tr>
<td>Nouvelle-Écosse</td>
<td>3,70</td>
<td>(0,67)</td>
<td>néant</td>
<td>5,74</td>
<td>néant</td>
<td>2,73</td>
<td>1,85</td>
<td>(0,33)</td>
</tr>
<tr>
<td>Nouveau-Brunswick</td>
<td>1,97</td>
<td>0,17</td>
<td>néant</td>
<td>2,68</td>
<td>néant</td>
<td>(5,98)</td>
<td>0,99</td>
<td>0,09</td>
</tr>
<tr>
<td>Québec</td>
<td>1,90</td>
<td>3,40</td>
<td>néant</td>
<td>6,57</td>
<td>néant</td>
<td>1,89</td>
<td>0,95</td>
<td>1,70</td>
</tr>
<tr>
<td>Ontarioa</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenu jusqu’à 509 000 $</td>
<td>1,20</td>
<td>0,24</td>
<td>néant</td>
<td>1,58</td>
<td>néant</td>
<td>(3,79)</td>
<td>0,60</td>
<td>0,12</td>
</tr>
<tr>
<td>Revenu supérieur à 509 000 $</td>
<td>1,04</td>
<td>3,36</td>
<td>néant</td>
<td>5,26</td>
<td>néant</td>
<td>0,51</td>
<td>0,52</td>
<td>1,68</td>
</tr>
<tr>
<td>Manitoba</td>
<td>6,22</td>
<td>(0,27)</td>
<td>néant</td>
<td>7,44</td>
<td>néant</td>
<td>(1,07)</td>
<td>3,11</td>
<td>(0,13)</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>4,26</td>
<td>(2,67)</td>
<td>néant</td>
<td>1,99</td>
<td>néant</td>
<td>(8,52)</td>
<td>2,13</td>
<td>(1,33)</td>
</tr>
<tr>
<td>Alberta</td>
<td>3,49</td>
<td>(5,67)</td>
<td>néant</td>
<td>(3,46)</td>
<td>néant</td>
<td>(14,04)</td>
<td>1,75</td>
<td>(2,83)</td>
</tr>
<tr>
<td>Colombie-Britanniqueb</td>
<td>3,97</td>
<td>0,13</td>
<td>néant</td>
<td>4,65</td>
<td>néant</td>
<td>(4,66)</td>
<td>1,98</td>
<td>0,07</td>
</tr>
</tbody>
</table>

Notes : Les calculs sont fondés sur les propositions de taux annoncées jusqu’au 31 mai 2013. Il est présumé que le particulier est imposé au taux marginal d’impôt sur le revenu fédéral-provincial le plus élevé (sauf dans le cas des calculs pour le revenu gagné en Ontario jusqu’à concurrence de 509 000 $ qui est assujetti au taux marginal d’impôt fédéral le plus élevé et le deuxième taux marginal d’impôt le plus élevé en Ontario) et que la fin d’exercice de la société par actions est le 31 décembre. Il est également présumé que la société par actions a suffisamment de fonds pour payer des dividendes donnant droit au recouvrement de la totalité de l’impôt en main remboursable au titre de dividendes (IMRTD).

a Il est présumé que les fourchettes d’imposition provinciales de 2013 demeureront les mêmes.

b Il est présumé qu’à compter du 1er janvier 2014, il y aura une hausse temporaire de deux ans du taux d’impôt sur le revenu applicable aux particuliers gagnant plus de 150 000 $ par année. Le taux d’impôt augmentera de 2,1 %, passant de 14,7 à 16,8 %, pour 2014 et 2015 seulement, avant d’être rétabli à 14,7 % en 2016.

Source : Adapté des tableaux d’intégration de 2014 par province (selon les propositions de taux annoncées jusqu’au 31 mai 2013) : Tableau 1 : Intégration du revenu provenant d’une entreprise exploitée activement et Tableau 2 : Intégration du revenu de placement gagné par une SPCC, publiés initialement en ligne en juillet 2013 par Services d’éditique Ernst & Young Inc.
INTRODUCTION

In a recent decision involving two private equity funds managed by the Florida-based Sun Capital investment adviser group (“the Sun funds”),¹ the First Circuit Court of Appeals held that at least one of those funds, Sun Capital Partners IV, LP (“Fund IV”), was a “trade or business” on which pension withdrawal liability may be imposed under the Employee Retirement Income Security Act of 1974 (ERISA).² Although the issue in the Sun Capital case was not a tax issue, the characterization

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¹ Sun Capital Partners III, LP; Sun Capital Partners III QP, LP; Sun Capital Partners IV, LP v. New England Teamsters & Trucking Industry Pension Fund, docket no. 12-2312 (1st Cir., July 24, 2013).
² 29 USC section 1001 et seq.
of a private equity fund as a trade or business could potentially be relevant to the US federal tax treatment of foreign investors in US private equity funds or their offshore feeder funds. The case could also have implications for foreign governmental investors that qualify for the section 892 exemption under the Internal Revenue Code. This article explores the implications of *Sun Capital* for foreign investors in such funds and attempts to assess whether it would be prudent for such investors to take any steps to mitigate tax risks arising from the court’s holding.

**FACTUAL BACKGROUND**

Scott Brass, Inc. (“SBI”), a leading producer of high-quality brass, copper, and other metals, was acquired by Fund IV together with its sister fund, Sun Capital Partners III (“Fund III,” which was also managed by the Sun Capital adviser group). SBI was a participating employer in a multi-employer pension fund known as the New England Teamsters and Trucking Industry Pension Fund (“TPF”), and until 2008 SBI made contributions to the TPF on behalf of its employees pursuant to a collective bargaining agreement. In 2008 SBI ceased making contributions to the TPF, and shortly thereafter SBI entered a chapter 11 bankruptcy. The TPF filed a lawsuit against SBI under ERISA section 1381. That section provides that if an employer withdraws from a multi-employer pension plan, the employer is liable to the plan for the employer’s allocable share of the unfunded vested benefits accrued under the plan (subject to certain adjustments). The TPF also sued Fund III and Fund IV, claiming that they were also liable for SBI’s pension withdrawal liability. The claim against those funds was based not merely on their ownership of SBI, but rather on a special rule contained in ERISA section 1301 pursuant to which trades or businesses under common control are treated as a single employer upon which pension withdrawal liability can be imposed. In order for this rule to apply, the TPF had to show that Fund III and Fund IV each constituted a “trade or business.”

The District Court held that the two funds were not trades or businesses and that the management activities of the funds’ general partner could not be attributed to the Sun funds. However, the First Circuit Court of Appeals reversed the District Court on the trade or business issue and concluded that Fund IV’s activities (or at least the activities of its general partner) were sufficient for Fund IV to be treated as a “trade or business” for the purposes of ERISA section 1301. The court applied a

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3 Internal Revenue Code of 1986, as amended (herein referred to as “the Code”).
4 Sun Fund III actually comprises two different partnerships, Sun Capital Partners III, LP and Sun Capital Partners III QP, LP. The court described these as “parallel funds” and treated them as a single fund.
5 ERISA section 1301(b)(1).
7 The court did not reach a conclusion on whether Fund IV was under common control with SBI and remanded the case back to the District Court for a conclusion on that issue.
standard that has come to be known as the “investment plus” test, which was first advanced by the agency charged with enforcing ERISA (the federal Pension Benefit Guaranty Corporation, or PBGC) in a 2007 ruling involving a private equity fund that foreshadowed the Sun Capital case.8

**US TAX TREATMENT OF FOREIGN INVESTORS IN PRIVATE EQUITY FUNDS**

The issue addressed in the Sun Capital case is potentially significant from a US tax perspective for foreign investors in private equity funds, since the determination of whether income that is effectively connected to an activity is subject to US federal income tax depends on the characterization of the activity as a trade or business conducted in the United States. More generally, a foreign investor may be subject to US federal income taxation under one of two regimes. One regime applies to fixed, determinable, and periodic (FDAP) income from US sources.9 Such income is subject to a 30 percent gross tax, which is enforced through withholding at source. The second regime, relevant here, imposes tax on a net basis at the same rates applicable to US taxpayers and applies to income that is effectively connected to a US trade or business.10 The term “trade or business” is not defined in the Code, and does not necessarily have the same meaning each time it appears within the Code, but is frequently defined in the manner adopted by the US Supreme Court in Commissioner v. Groetzinger11 as including any activity that is (1) engaged in for the primary purpose of profit and (2) conducted with sufficient continuity and regularity. Under longstanding and well-established authorities commencing with Higgins v. Commissioner,12 a taxpayer whose activities are limited to acting as a passive investor is not treated as being engaged in a trade or business. Consistent with those authorities, the courts and the Internal Revenue Service (IRS) have ruled that a foreign taxpayer that invests in securities is not treated as being engaged in a US trade or business, no matter how extensive the investment activities and regardless whether the activities are conducted through a US office.13 At one time, the courts distinguished foreign taxpayers that engaged in active and regular securities trading activities from passive investors and held that traders are engaged in a US trade or business.14 However, the Code was subsequently amended to specifically exempt securities traders from such treatment.15

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8 PBGC Appeals Board Decision, September 26, 2007.
9 Code sections 871(a) and 881.
10 Code sections 871(b) and 882.
12 312 US 212 (1941).
13 *Scottish American Investment Co., Ltd.*, 12 TC 49 (1949); and Rev. rul. 55-182, 1955-1 CB 77.
14 *Chiang Hsiao Liang*, 23 TC 1040, at 1042 (1955); acq., 1995-1 CB 4.
15 Code section 864(b)(2).
Private equity funds commonly undertake to their foreign investors that they will apply best efforts to ensure that they are not engaged in a US trade or business. Such funds typically acquire investments with an intent to hold them for extended periods of time, and they generally do not trade with sufficient frequency to be characterized as traders. Accordingly, in *Sun Capital*, the court did not entertain the characterization of the Sun funds as traders. Rather, the *Sun Capital* case focused on a different issue, namely, whether the activities of a fund’s general partner with respect to managing corporations in which the fund invests can cause the fund to be treated as being engaged in a trade or business of “corporate management.” Prior to *Sun Capital*, most tax practitioners thought that this issue had been favourably put to rest by the US Supreme Court in *Whipple v. Commissioner*, where the court stated:

Devoting one’s time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profits or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation’s business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.17

**THE APPELLATE COURT’S DISCUSSION OF THE TRADE OR BUSINESS ISSUE**

In its analysis of the trade or business issue, the appellate court in *Sun Capital* discussed both *Higgins* and *Whipple*. Although the court indicated that its holding was addressed to the ERISA definition of a trade or business and that it was therefore not required to conclude that Fund IV’s activities were sufficient for the fund to be treated as being engaged in a trade or business for tax purposes, the court nevertheless insisted that its conclusions were consistent with *Higgins* and *Whipple*. Indeed, the PBGC ruling that developed the investment plus standard applied by the court was itself based on the *Groetzinger* case, which was a tax case. The *Sun Capital* case

16 A footnote to the court’s opinion indicates that the TPF argued that the Sun funds should also be viewed as trades or businesses because they are engaged in the development, promotion, and sale of companies. Such “promoters” have been held to be engaged in a trade or business for tax purposes. See *Carroll L. Deely*, 73 TC 1081 (1980); *Frank L. Farrar*, 55 TCM 1628 (1988); and *Todd A. Dagres*, 136 TC 263 (2011) (which involved the slightly different issue of whether the general partner of a venture capital fund is engaged in a trade or business by reason of its management of the fund). However, none of those cases considered whether a promoter who is otherwise engaged in a trade or business can nevertheless rely on the Code section 864(b)(2) securities trading exemption to avoid being treated as engaged in a US trade or business for the purposes of determining the taxability of the promoter. The answer to this question probably depends on whether the promoter is acting as a “dealer” with regard to the activity.

thus represents a challenge to foreign investors in private equity funds who rely on the Higgins and Whipple cases and their progeny for the position that such funds are not engaged in a US trade or business.

The court in Sun Capital referred to several facts that supported the conclusion that Fund IV was a trade or business. These facts included

1. statements made in the Sun funds’ private placement memorandums to the effect that each fund would be actively involved in the management and operation of the companies in which it invested;
2. similar statements appearing in the Sun funds’ partnership agreements, which also empowered the general partner of each fund to make decisions about hiring, terminating, and compensating agents and employees of the fund and its portfolio companies; and
3. actions taken by the Sun funds to replace directors and provide consultants who were immersed in details involving the management and operation of the bankrupt portfolio company.

However, the fact to which the court seems to have attached the most weight was that management fees paid by Fund IV’s portfolio companies to its general partner entitled Fund IV to an offset against the management fees that it would otherwise have been obligated to pay to its general partner. The court considered this fact to be so significant that it declined to hold that Fund III was a trade or business absent a finding that Fund III had received a benefit similar to the benefit received by Fund IV from the offset of the management fees paid to its general partner by the bankrupt portfolio company; instead, the court remanded the case to the lower court for a determination on that factual point. In addition, the court found that this fee offset represented a significant difference between the facts in the case before it and those addressed by the tax cases on the trade or business issue. In the court’s view, the fact that Fund IV derived an economic benefit from the management activities of its general partner in the form of the fee offset meant that the general partner was performing those management activities as an agent of the private equity fund.18

**ANALYSIS**

Sun Capital is troubling in part because most private equity funds provide for an offset of fees that the manager earns from the portfolio companies against the fund’s proportionate share of the general partner’s management fee. However, the relevance of this fact to the issue of whether the fund is engaged in a trade or business seems questionable. From an economic perspective, the offset can be justified as compensating

18 Interestingly, in a rehearing petition subsequently filed by the Sun funds (which petition was denied by the court), Fund IV asserted that it had in fact waived its right to benefit from the fee offset during the years at issue and that the offset should therefore not have been given any weight by the court. It may be that the court believed that the mere existence of a right to claim the offset was sufficient to support its agency finding.
the funds for the cost to the general partner of devoting some of its resources to an activity other than managing the fund itself; or, putting it differently, the general partner is compensating the fund for providing the general partner with the opportunity to earn fees from the management company. The court thus seems to have got it backward. In effect, the court seems to be treating what is in substance a payment by the general partner to the fund (in the form of a fee offset) as if it were a payment by the fund to the general partner for acting as the fund’s agent. Furthermore and perhaps more importantly, as a technical matter the fee offset should not cause recognition of gross income to the fund at all, so the attribution of the management fees to the fund lacks any sound basis in the tax law. One can only hope that the latter point will serve to dissuade courts and the IRS from concluding that a private equity fund should be treated as being engaged in a trade or business for tax purposes by reason of its entitlement to a general partner management fee offset.

The Sun Capital case also has potential implications for foreign governmental investors that rely on the Code section 892 governmental exemption. The section 892 exemption is not available for income derived from a partnership that is engaged in a commercial activity. In addition, an otherwise exempt subsidiary (or “controlled entity”) of a foreign government may be disqualified entirely from the section 892 exemption if it is viewed as being indirectly engaged in a commercial activity through a partnership. The same logic that led the First Circuit court to conclude that Fund IV was a trade or business could potentially support an argument that the fund was engaged in a commercial activity within the meaning of section 892. Proposed regulations under section 892 would protect a governmental entity from being disqualified by reason of engaging in a commercial activity inadvertently or as a result of an investment in a partnership as a limited partner if the governmental entity does not have rights to participate in the management and conduct of the partnership’s business. However, the income earned from such an investment is still not eligible for the section 892 exemption.

CONCLUSION

It appears unlikely that the Sun Capital case will cause any changes in the operation of the industry, but in the event that the decision is viewed as changing the legal landscape, then consideration should be given to the use of special-purpose blocker corporations for investments in private equity funds, especially if the fund features a general partner management fee offset like the one present in Sun Capital. While fund investors probably will not complain about management fee offsets, from which they benefit, it is possible that concern about the trade or business risk could lead to resistance to general partners and their affiliates earning management fees directly from portfolio companies.

19 Code section 892.

20 Prop. reg. sections 1.892-5(a)(2) and (b)(5)(1)(iii).

This book, written by an experienced Canadian tax litigator, provides a comprehensive review of the relevance of the concept of economic substance in tax-avoidance law. It is a well-written and thoroughly researched work that tax practitioners, judges, administrators, policy makers, and academics should have on their shelves as an invaluable resource. Many readers will find the book most useful for its thorough and thoughtful presentation and its doctrinal synthesis of the relevant case law, not only in Canada but also in the United States, Australia, New Zealand, South Africa, and the United Kingdom. McMechan, however, goes beyond doctrinal analysis to present an important normative case for the incorporation of a concept of economic substance into anti-avoidance law. Given the reluctance of Canadian courts (as well as the courts in many other countries) to take this step, such incorporation must be effected through legislation.

The first three chapters together provide some necessary conceptual background. Chapter one reviews the accepted, but ill-defined, distinction between abusive tax avoidance, which is subject to prohibition, and acceptable tax minimization, which is not. In particular, on the basis of various secondary sources, McMechan suggests that the distinction is focused squarely on the notion of economic substance, with abusive tax avoidance very often occurring in circumstances where any such substance is lacking. Chapter two consists of an enumeration of the range of consequential attributes that make tax avoidance problematic as a tax policy matter. Chapter three argues that standards, rather than more narrowly specified rules, are required to control tax avoidance. In making the latter argument, McMechan reviews a well-known body of academic legal literature supporting the development of standards by the judiciary as an overlay to rules. But although the development and application of standards in combatting tax avoidance is closely associated with the development and application of judicial anti-avoidance doctrines, general anti-avoidance rules

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(GAARs) employ the same approach to perform the same function, the formal difference being that they are articulated in legislation.

Chapters four, five, and six can also be grouped together conceptually. Chapter four summarizes the truncated development of judicial anti-avoidance doctrines in Canada. McMechan concludes, not surprisingly, that these doctrines, which still have effect alongside the GAAR in section 245 of the Income Tax Act,1 are inadequate to control tax-avoidance transactions lacking economic substance. Chapter five then follows with an interesting account of the Supreme Court of Canada’s treatment of the concept of economic substance in tax-avoidance cases, characterizing the thread of relevant case law as following “a very winding road.”2 The court’s general rejection of economic substance in favour of the concept of legal substance is contrasted with an unquestioned acceptance of the relevance of economic realities in a broad range of non-tax contexts. An appendix summarizes a range of tax-law issues, in a non-avoidance context, that similarly turn on a perception of economic and commercial realities. Perhaps somewhat contentiously, McMechan argues that denying the availability of tax benefits for transactions that lack economic substance is no different in kind than denying the availability of tax benefits for transactions that are considered to be “shams”; yet Canadian courts have tended to refuse to do so in the former instance, while accepting what is arguably their responsibility to do so in the latter instance. Chapter six provides an obvious contrast to the Canadian experience, detailing the development of the economic substance doctrine by US courts, the application of the doctrine in a series of corporate tax shelter cases, and its recent legislative codification.

Chapters seven, eight, and nine (which are followed by a brief concluding chapter) are not as tightly linked conceptually as chapters one to three and four to six, and tend therefore to be stand-alone accounts of the relevant topics. Chapter seven provides accounts of the experiences with GAARs in South Africa, Australia, and New Zealand, as well as the recently enacted GAAR in the United Kingdom and the concept of abuse of law in continental European countries. It is actually quite difficult to draw common threads in the experiences of each of the selected countries regarding the relevance of economic substance to the application of the particular GAARs and the abuse-of-law concept. The account of the experience of each country primarily offers an understanding of that experience that is invariably unique to the particular country, and it is difficult to draw much in the way of broader policy lessons. Chapter eight provides an account of the development in some selected countries of information and reporting regimes for aggressive tax-avoidance transactions. McMechan argues that the adoption of such regimes, including that in Canada, is insufficient to combat abusive tax avoidance unless those regimes are accompanied by the legislative incorporation of a requirement to take economic substance into account in applying GAARs. To make this point somewhat more concretely,

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1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”).
2 McMechan, at 83.
in chapter nine McMechan details five Canadian case studies and suggests that the result in each one would be changed by a legislative requirement that economic substance be accounted for in interpreting and applying section 245.

T.E.


This consultation paper follows up on an undertaking in Canada’s 2013 federal budget to open up a consultative process on the contentious subject of treaty shopping. More particularly, the 2013 budget stated the government’s intention “to consult on possible measures that would protect the integrity of Canada’s tax treaties while preserving a business tax environment that is conducive to foreign investment.” The release of a consultation paper was to be the basis for consultation. Although it is at least arguable that the Canada Revenue Agency (CRA) already has sufficient means to address treaty shopping, recent case law has tended to undermine confidence in that proposition and may well be the motivation for the current consultative process on the subject.

The consultation paper commendably addresses directly the need for a working concept of treaty shopping that may or may not require a response by tax policy makers and tax administrators. In the first instance, a broad concept is posited, extending to any “situation under which a person who is not entitled to the benefits of a tax treaty uses an intermediary entity that is entitled to such benefits in order to indirectly obtain those benefits.” This overinclusive concept is refined, however, by the inclusion of four more specific factors, including an important focus on the absence of the intermediate entity’s engagement in real and substantial business activities in its country of residence as a proxy for tax-driven structuring. It is suggested that Canada would be justified in denying otherwise available treaty benefits associated with such fact patterns, since there would be strong evidence that one of the main purposes for creating the intermediate entity was to access those benefits.

After providing a working concept of targeted transactions that should be subject to denial of treaty benefits, the next three sections of the consultation paper review briefly

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3 Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013, at 373.
4 Ibid.
5 For an earlier and thorough review of the subject, see David A. Ward, Access to Treaty Benefits, research report prepared for the Advisory Panel on Canada’s System of International Taxation (Ottawa: Department of Finance, September 2008).
6 See, for example, MIL (Investments) SA v. The Queen, 2006 TCC 460; aff’d. 2007 FCA 236. See also Velcro Canada Inc. v. The Queen, 2012 TCC 57; and Prevost Car Inc. v. The Queen, 2008 TCC 231; aff’d. 2009 FCA 57.
7 Finance consultation paper, at 4.
Canada’s position on treaty shopping,
relevant Canadian case law considering treaty-shopping transactions,
some indirect empirical evidence of treaty shopping, and
some unintended consequences of treaty shopping.

The empirical evidence consists of aggregate statistics comparing inbound and outbound foreign direct investment with trade data. As a measure of the scale of treaty shopping, this comparison is obviously based on a coarse-grained data set. The consultation paper concedes this point, admitting that unusually high levels of inbound and outbound direct investment can be an indicator of the use of conduit entities but may not be indicative in all instances of treaty shopping. The discussion of unintended consequences is very brief but it is important, since there is a defensible position that treaty shopping does not necessarily present a policy problem simply because of the fact that a resident in a third country gains access to the benefits of a tax treaty between Canada and another country. With one notable exception, the list of unintended consequences of treaty shopping does not provide an especially compelling policy case for anti-treaty-shopping responses. The notable exception is the fact that a person who is resident of a third country gains access to treaty benefits while being insulated from exchange-of-information provisions that would otherwise apply if that person were resident in a treaty country. Such provisions would, of course, apply to an intermediate entity used to access treaty benefits, but that would not necessarily expose the resident of the third country to the same range of information exchange requirements if that person were resident in a treaty country.

At the core of the consultation paper are two sections that, respectively, outline possible approaches to preventing treaty shopping and discuss the perceived need to strike a balance between general and specific anti-treaty-shopping responses. Although the consultation paper does not indicate a clear preference for any particular approach, the indication is that the Department of Finance is leaning toward an anti-treaty-shopping response that is articulated at a relatively general level. All of the seven questions that are set out as the focus for submissions relate to the issues of choice of approach and specification of an anti-treaty-shopping response.

T.E.

John Lester, “Tax Credits for Foreign Location Shooting of Films: No Net Benefit for Canada” (2013) 39:3 Canadian Public Policy 451-72

The federal and provincial governments have a long history of providing subsidies for film, video, and television production in Canada. While there may be some cultural benefits to subsidizing production by Canadian firms that produce material on Canadian themes, subsidies for foreign producers should be justified on their economic merits as job creation or industrial development programs. In this article, John Lester provides a cost-benefit analysis of the $470 million in tax subsidies that federal and provincial governments provided to foreign filmmakers in 2010. The total tax subsidy represents about 25 percent of the foreign filmmakers’ expenditures.
in Canada; three-quarters of the subsidy is provided by the provinces, with most coming from British Columbia, Ontario, and Quebec.

One of the stated motivations for the tax credits is to increase employment in the film production industry by attracting productions that would otherwise be shot in other countries, principally the United States. However, as Lester points out, the increase in employment in the film production industry is not a net benefit because the labour that is drawn into the industry would generally have been employed elsewhere in the economy. It is a standard assumption in cost-benefit studies (or at least the reputable ones) that there is full employment in the relevant labour markets, and any additional employment from a project or policy will be offset by a loss of employment in other sectors of the economy.

So, what are the benefits of the subsidies for foreign film production? Lester identifies two potential benefits. First, the foreign actors, directors, and other staff pay taxes on the income that they earn while working in Canada. However, CRA data indicate that this is likely a very minor benefit (amounting to only $5.6 million in 2010). The other potential benefit is the gain to Canadian film industry from increases in the scale of activities, leading to lower unit costs for other film productions. Lester surveys the literature on the economies of scale in the film production literature and the closely related literature on agglomeration effects, and concludes that the foreign film tax credits would have reduced the Canadian industry’s production costs by only 1 percent or $40.6 million in 2010.

Stacked up against the aggregate benefits of $46.3 million in 2010 are five categories of cost that Lester also measures. The largest cost is the transfer of $217.3 million from Canadian taxpayers to foreigners. Foreign film companies increase their productions in Canada only to the extent that they are made better off by doing so; Lester estimates that over $200 million is captured by the foreign producers. The second major cost to Canadian society is the cost of imposing additional taxes to make up for the revenues that are lost through the foreign film tax credit. On the basis of estimates of the distortionary effects of taxes as calculated by Dahlby and Ferede, Lester calculates this loss at $106.6 million in 2010. The third major cost to the Canadian economy is the loss from the transfer of resources from other sectors of the economy to the film production industry. Resources will flow from the rest of the economy to the film industry until the after-tax returns are equalized; consequently, at the margin resources in the film industry are 25 percent less productive than in their alternative use. The total cost of this distortion in resource allocation, which is in addition to loss incurred in financing the subsidy through higher taxes, is $49 million in 2010. The administration and compliance costs of the tax subsidy program are the remaining costs that are included in the

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analysis, and they were found to be relatively minor at $2.9 million and $1.3 million, respectively. Thus, subtracting the $377.1 million in costs from the $46.3 million in benefits indicates that the foreign film production tax credits imposed a net loss on the Canadian economy of $330.8 million in 2010.

Although widespread misperceptions of the benefits of such tax credits may be one reason for their continued existence, perhaps stronger underlying reasons are provincial tax competition (which can lead to excessive subsidies to a highly mobile industry) and the strength of the lobbying by the Canadian film industry. The foreign film industry credit is yet another example of government intervention that concentrates benefits on a small well-organized interest group at the expense of Canadians generally. It is hoped that the exposure of the losses that such programs impose on Canadians will at least help to curtail the expansion of these programs.

B.D.


The mobility of high-income taxpayers has been in the news in recent months. The threat of a 75 percent marginal tax rate in France prompted Gérard Depardieu to take out Russian citizenship, and one of France’s richest men moved to a Belgian city just over the border with France. While these high-profile individuals make news, it is not clear how important tax rates are in the decisions of high income earners regarding where they choose to live and earn their incomes. This study by Kleven, Landais, and Saez provides empirical evidence on the degree to which one group of high income earners—European football players—are influenced by taxation in making these decisions.

The authors use data on the first division football players in 14 European countries from 1996 to 2008 to estimate how the top marginal income tax rate in a country affects the location decisions of the top players and the composition of the teams in each league in terms of domestic and foreign players. They hypothesize that if a country reduces its tax rate on the earnings of foreign players, the fraction of foreign players on teams in the country will increase and the number of domestic players will decline. Their empirical analysis indicates a high degree of mobility and sensitivity to top marginal tax rates in the location decisions of top European football players. The authors estimate that in the current open labour market for football players, the elasticity of the fraction of foreigners on teams in a country with respect to the net of tax rate, which is one minus the marginal tax rate, is 1.22 and that the elasticity of the fraction of footballers playing in their home countries is lower at 0.29. To put these elasticities in perspective, they imply that a reduction in a country’s top marginal tax rate from 60 percent to 50 percent would add one foreign player to each of the country’s first division football teams. Perhaps most interesting for football fans, the authors show that since 1996 the quality of a country’s football teams, as measured by the total number of points earned by all of the country’s clubs in the Union
of European Football Associations (UEFA) Champions League, is inversely related to its top marginal tax rate. It seems that if countries want to achieve success on the field, they should pay as much attention to tax reform as to tactics and coaching.

Kleven, Landais, and Saez also analyze the effect of the so-called Beckham law in Spain, which was a special tax provision that reduced the tax rate on all foreign workers to a flat rate of 24 percent from the normal rate of 45 percent. Their study shows that the share of foreign-born players increased and the share of top players, defined as individuals who play for their countries’ national teams, also increased. Perhaps this tax measure explains why Real Madrid has been able to attract so many top players over the years (as witnessed by its recent hiring of Gareth Bale) and continues to be a contender in the UEFA Champions League each year.

Although we should not assume that the degree of tax-induced mobility of European soccer players can be generalized to all high income earners, it is likely that in some fields, such as finance and information technology, taxes affect career location decisions and should be taken into account in setting policies regarding top marginal rates.

B.D.


Some of the more complicated and creative tax-avoidance transactions involve financing arrangements and/or the use of derivative financial instruments. This OECD paper focuses on a transactional type that is certainly evidence of this proposition. With this type of transaction, derivatives are used to provide offsetting short and long positions for a corporate taxpayer or members of the same corporate group; however, the positions are offsetting on an after-tax basis only. The pre-tax positions are adjusted to take into account different tax rates applicable to the offsetting positions such that the pre-tax cash flows do not offset but the after-tax cash flows do. This feature of the transactions considered in the OECD paper is nothing more than the technique involved with after-tax hedging transactions generally. It differs, however, from standard after-tax hedging techniques and is labelled “aggressive tax planning” because the transaction is implemented either to generate or transfer a tax benefit or to realize a premium return while eliminating any market risk for the relevant taxpayers; instead, the risk is effectively borne by government. Although there is virtually no literature on these transactions, they represent a significant revenue risk for many governments. The OECD paper suggests that hundreds of millions of US dollars are at stake. These transactions apparently originated in the financial

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sector but, as the paper indicates, are now being used in other sectors and by medium-sized enterprises. Despite the absence of literature, a number of tax administrations have identified such transactions under audit and have responded with administrative positions intended to deny any tax benefit. In the United Kingdom, tax policy makers have introduced legislation realizing the same result.

After a brief presentation of the basics of after-tax hedging, the OECD paper describes some representative transactional examples of aggressive tax planning based on after-tax hedging. The examples illustrate that these transactions can be implemented in an entirely domestic context, taking advantage of asymmetric treatment of gain and loss on offsetting positions, or in a cross-border context, taking advantage of different tax rates in different tax jurisdictions applicable to members of the same corporate group effecting offsetting positions. The paper then reviews the detection strategies and responses used by tax administrations and policy makers. Responses include the application of GAARs (Australia) or judicial anti-avoidance doctrines, as well as the adoption of specific anti-avoidance rules (the United Kingdom) and transfer-pricing adjustments. It is recognized that a particular difficulty involved in crafting a response is the need to draw a line between acceptable and unacceptable after-tax hedging transactions. Detection difficulties arise primarily in the cross-border context because of the lack of any explicit linkage of offsetting positions implemented in different tax jurisdictions.

The OECD paper concludes with a set of recommendations for governments concerned with aggressive tax-planning transactions based on after-tax hedging. The recommendations include the following:

- Focus on detection of these transactions, in particular by staffing tax administrations with individuals who have expertise in financial markets.
- Introduce rules to eliminate asymmetric treatment of offsetting positions.
- Consider whether existing general or specific anti-avoidance rules are sufficient to address these transactions.
- Maintain a balanced position, recognizing that not all transactions involving after-tax hedging present a tax policy problem.
- Continue to exchange information spontaneously and share relevant intelligence regarding these transactions.

T.E.


This book consists of 10 papers presented at a conference held at Oxford University in April 2010. They provide a first-rate account of the policy issues associated with the range of exempt treatment under value-added tax (VAT) and goods and services tax (GST) systems. Broadly, the motivation for exempt treatment is either technical design problems in applying the invoice/credit method to inputs and outputs, or perceptions of social or public policy. The different sectors of an economy that fall within either of these categories are somewhat diverse. Nonetheless, the same consequence of exempt treatment applies: the value of outputs is not subject to tax but the tax paid on related inputs cannot be claimed as an input tax credit.

The authors and titles of the papers are as follows:

- Rita de la Feria and Richard Krever, “Ending VAT Exemptions: Towards a Post-Modern VAT”
- Joachim English, “The EU Perspective on VAT Exemptions”
- Pierre-Pascal Gendron, “VAT Treatment of Public-Sector Bodies: The Canadian Model”
- Rebecca Millar, “Smoke and Mirrors: Applying the Full Taxation Model to Government Under the Australian and New Zealand GST Laws”
- Walter Hellerstein, “Comparing the Treatment of Charities Under Value Added Taxes and Retail Sales Taxes”
- Yoram Margalioth, “VAT on Gambling”
- Sijbren Cnossen, “A Proposal To Improve the VAT Treatment of Housing in the European Union”
- Rebecca Millar, “VAT and Immovable Property: Full Taxation Models and the Treatment of Capital Gains on Owner-Occupied Residences”
- Harry Grubert and Richard Krever, “VAT and Financial Services: Competing Perspectives on What Should Be Taxed”
- Howell H. Zee, “Further Thoughts on Reforming the VAT: Treatment of Financial Intermediation Services”

A common theme of most of the papers is the extent to which exemption can be rejected in favour of full taxable treatment. In this respect, de la Feria and Krever contrast European VATs with what they label the “modern VAT” systems adopted later by Australia, Canada, and New Zealand. The point of contrast is the much more limited range of exemptions under these latter systems, although as Gendron highlights, it may be a bit of a stretch to include Canada in this grouping if the criterion is a reduction in the range of exemptions as compared with European systems.

Readers may recognize many of the names listed above; most of the authors are leading academic experts on VAT/GST and consumption tax systems more generally. Although all of the papers are of the highest quality, readers may find the paper by Millar on the ostensibly full taxation treatment of government under the Australian
and New Zealand systems especially interesting for its discussion of the unique approach in each of these countries. The paper by Cnossen, as well as Millar’s paper, on possible approaches to the treatment of owner-occupied housing is also notable for the author’s thoughtful analysis of this most difficult of subjects under VAT/GST systems. The last two papers, by Grubert and Krever and by Zee, respectively, review the well-worn subject of the VAT/GST treatment of financial services. Although there is a relatively comprehensive literature on this subject and there have been notable attempts by some countries to erode exempt treatment, the two papers are worth reading if only because the subject has gained some notoriety in the wake of the 2007-2009 financial crisis.


The author of this article is an economist and one of Canada’s leading academic experts on the GST. The article is a thoughtful and thorough analysis of tax expenditure reform relating to the GST. Gendron argues that the range of tax expenditures embedded in the GST must be addressed primarily for revenue-raising reasons, although elimination of a number of non-neutrality associated with some of the expenditures would also be desirable as a secondary matter. Reform would allow for better targeting and delivery of a range of social programs, as well as a reduction in administrative and compliance complexity attributable to the interpretation and application of the GST tax expenditure provisions.

Gendron categorizes the various tax expenditures in terms of their formal attributes as either exemption, zero-rating, or rebating. He provides a complete descriptive accounting of the various exemptions with these formal attributes, including cost estimates based on Department of Finance tax expenditure accounts. The most important part of the article presents the case for reform of selected tax expenditures in both the short and the medium term. In the short term, Gendron would eliminate the following tax preferences:

- zero-rating of basic groceries, prescription drugs, medical devices, and agricultural and fish products and purchases;
- rebates for new housing and new residential property; and
- exemptions for water and garbage collection and municipal transit, for child care and personal services, and for ferry, road, and bridge tolls.

To compensate for the distributional effect of the elimination of these tax expenditures, Gendron would increase the GST income tax credit available to low-income households. He would also increase the small suppliers’ threshold for exemption to $100,000. In the medium term, Gendron would like to see the Department of Finance commission a study of the GST treatment of public sector bodies, non-profit organizations, and charities. Although exempt treatment of the financial sector is
motivated by technical design issues and not tax expenditure considerations, Gendron suggests that the exempt status of this sector also should be studied. The goal of the studies in both cases would be to provide a menu of reform alternatives for the treatment of these two sectors.

T.E.


The parol evidence rule is a rule of contract law intended to protect the integrity of written agreements by prohibiting the contracting parties from adducing oral evidence that would contradict, vary, add to, or subtract from the written terms. The rule is, however, subject to a set of well-accepted exceptions. This article considers whether the parol evidence rule can be used by or against tax authorities in tax litigation to alter the terms of a written agreement between a taxpayer and another party, and thereby alter the tax consequences associated with that agreement. As Pichhadze explains, this question has been considered by Canadian courts, and there are conflicting authorities; yet no reasoning is given by the courts in the relevant cases. By contrast, in the United States, there is a deep case law that provides lines of reasoning to be followed regarding the status of the parol evidence rule in a tax litigation context. On the basis of an extensive review and consideration of this US jurisprudence, Pichhadze suggests that the status of the parol evidence rule in this context depends critically on the status of substance over form as an approach to the characterization of private-law arrangements for tax purposes, and on whether a particular written agreement represents a complete integration of all the terms of an agreement.

T.E.


In the wake of the financial crisis of 2007-2009, a tax literature has grown speculating on the link between particular tax system rules and the crisis. One of the more prominent of these rules is the well-known bias of most corporate income tax systems in favour of debt finance. The important public policy issue is to what extent this bias, which obviously undermines the goal of prudential regulatory regimes governing banks, increases levels of leverage in the banking sector and thereby increases the probability of banking-led financial crises. With one notable exception, the existing tax literature provides no empirical evidence of either of these critical links. The exception is an earlier paper by two of the authors testing empirically the link between
a tax-debt bias and levels of bank leverage. This latest working paper builds on the earlier paper to test empirically the second important link, between tax-induced increases in the levels of bank leverage and increases in the probability of banking crises.

Using aggregated financial data covering 29 countries over the period 2001-2009, the authors estimate that a 1 percentage point reduction in the corporate income tax rate results in a reduction in the aggregate leverage ratio of banks ranging between 0.08 and 0.11 percentage points. However, because the estimate is slightly smaller when inferred from macro data, the authors consider the range of sensitivity to be somewhere between 0.04 and 0.15 percentage points. Not surprisingly, they find that the impact of a marginal increase in leverage on the likelihood of crisis depends on the initial leverage ratios, which they assume, for illustrative purposes, to be 90 percent, 93 percent, or 96 percent of assets. Estimates of increases in the probability of crisis are derived for these different leverage levels using the lower and upper bounds of the tax-sensitivity estimates for increases in leverage, as well as a mid-point between these two bounds. In general, they conclude that the increase in the probability of crisis attributable to an increase in leverage associated with a tax-debt bias is not inconsiderable, especially at higher initial levels of leverage.

In a relatively brief concluding section, the authors provide some estimates of the welfare gains associated with three different tax policy choices: (1) a 10-point reduction in the corporate tax rate, (2) a bank leverage tax on wholesale or uninsured liabilities, and (3) an allowance for corporate equity (ACE). They estimate that an ACE would provide the greatest welfare gains, attributable to its consistent tax treatment of debt and equity. Gains associated with a 10-point reduction in the corporate tax rate would also be sizable, especially at higher levels of bank leverage. The authors find that a bank leverage tax applied at a rate of 10 basis points, consistent with the rates adopted in many countries, would yield the smallest welfare gains, although such gains would be considerable at high levels of tax responsiveness and initial levels of leverage. They acknowledge that either an ACE or a reduction in the corporate income tax rate applied exclusively to the banking sector would be problematic for technical tax policy reasons and political reasons. More realistically, therefore, the policy suggestion is for the use of bank leverage taxes at rates higher than those observed in existing country practice.

T.E.

Are governments that do not need to raise most of their revenues from their taxpayers, because they receive substantial resource revenues or grants from senior levels of government, less responsive to voters? This is an important question given the poor economic performance of many resource-rich countries. It should also affect the design of federal systems of government in terms of the allocation of taxing powers and provision of intergovernmental grants. Clearly, both of these issues are relevant for Canada.

This study uses data from municipalities in Brazil to examine the effects of intergovernmental transfers on the quality of local government officials. According to the political economy model developed by the authors, transfer dependence weakens the link between government performance and accountability to the voters, leading to increased corruption and a decline in the “quality” of local politicians. The authors used data from two electoral periods, January 2001 to December 2004 and January 2005 to December 2008, to generate 2,877 observations on municipal officials’ performance. They found that a 10 percent increase in federal transfer to small municipalities in Brazil increased the total corruption cases by 6 percent and severe corruption cases by 16 percent. A 10 percent increase in transfers also reduced the degree of political competition by increasing the probability of an incumbent mayor’s re-election by 7 percent, while the fraction of political contenders with a college degree declined by 6 percent.

How relevant are these results for Canada? The Brazilian municipalities in this study are all small, with fewer than 50,000 residents, and they are highly dependent on grants to finance their spending. Local taxes represent only 6 percent of their total revenues. Clearly, the Brazilian federal system violates in practice the principle of “no representation with taxation.” In contrast, all Canadian provinces and municipalities raise substantially higher fractions of their total revenues through taxes levied on their residents. Furthermore, the authors caution that increases in a government’s non-tax revenues may not have the same effect in “societies with a long tradition of good government and with abundant social capital.” Still, the results suggest that the links between levying taxes, responding to voters’ concerns, and providing good government should not be overlooked in any country.

B.D.
The article by Brollo et al. reviewed above highlights the low level of tax effort by municipal governments in Brazil. In particular, the property tax provides relatively little revenue for local government in Brazil (and many other less-developed countries), and property transfer taxes are often used instead. Taxes on immovable property have been endorsed by the OECD as the revenue-raising method that is the least damaging to economic growth, followed in order of increasing impact by broad consumption taxes, personal income taxes, and corporate income taxes. The property tax is the major source of own-tax revenue for local government in Canada and a handful of other countries (France, Israel, Japan, New Zealand, the United Kingdom, and the United States). While economists have generally supported the property tax as a source of government revenue, particularly for local governments, it is the most unpopular of taxes for the very reasons that economists cite in its defence—namely, the property tax burden is largely unavoidable, and the tax is relatively transparent.

Norregaard’s paper provides an overview of the issues in levying property taxes and discusses in particular the policy and administrative issues associated with enhancing the role of property taxes, especially in developing countries. For OECD countries as a whole, property tax revenues have increased from an average of 1.24 percent of gross domestic product (GDP) in the 1970s to 2.12 percent in the 2000s, but have declined as a percentage of total tax revenue because of the buoyant growth of consumption and income taxes. Although the case for increased reliance on property taxes is strong in many countries, some of the strengths of the property tax need to be considered with care. While land is generally fixed in supply, capital is highly mobile at the local government level in the long run. Non-residential property taxes can discourage investment in industrial and commercial building, and hamper growth. The salience of the property tax is perhaps more apparent than real because the property tax burden may be capitalized in property values, such that the current property owner, while liable for paying the tax, may have been sheltered from the burden to the extent that the purchase price of the property took the tax levy into account. Also, the burden of the property tax depends on whether we are discussing the average burden across an entire country or province, or the burden that arises when one municipality or city decides to raise its property tax to finance additional spending.

The property tax is less buoyant, or from another perspective less volatile, than the other major sources of tax revenue that are available for local governments. Local politicians have despaired at the low elasticity of the property tax. While it is true that the property tax base does not increase as fast as population and income when cities are growing and facing increased demands for services, it also does not decline during economic downturns. Norregaard\textsuperscript{15} shows that state and local income and sales tax revenues plunged in the United States during the 2002 and 2008 recessions, while property tax revenues have grown at a fairly constant rate over the last 20 years. That property taxes are less volatile than other sources of revenue is often considered a virtue for local governments with limited ability (in law or in practice) to finance operating deficits, but the fixity of the property tax burden during economic downturns may strain household budgets.

Norregaard admits that the administrative costs of running a property tax system, especially in countries without well-developed property rights and a cadastral of property ownership, may be quite high. While he claims that the high collection costs arise in part because property taxes do not lend themselves to self-assessment to the same degree as income and sales taxes, he notes that the city of Bogotá used self-assessment in its 1993 property tax reform, and this led to a 77 percent increase in property tax revenues in 1994. The assessment of property values for tax purposes is one of the difficulties in applying a property tax, as a recent book on Ontario property taxes\textsuperscript{16} has shown, but the possibility of using self-assessment of property values should be investigated.

For Canadian policy makers, the conclusion to be drawn from Norregaard’s paper is that improving assessment procedures would be a better way of reforming municipal finances than introducing new sources of tax revenue for municipal governments.

B.D.


Canada remains an outlier among OECD countries in its failure to include a formal method of group reporting in its corporate income tax system. The latest consultation initiative of the federal government on this issue\textsuperscript{17} appears to have stalled, and corporate taxpayers in Canada continue to implement, with the blessing of the CRA, accepted restructurings to realize the same result as consolidated reporting, at least

\textsuperscript{15} Norregaard, at 21.


\textsuperscript{17} Canada, Department of Finance, \textit{The Taxation of Corporate Groups: Consultation Paper} (Ottawa: Department of Finance, November 2010).
in terms of loss offsets. For readers who continue to have an interest in formal consolidated reporting regimes, this book is a comprehensive resource on the subject. The author has published some of his related work previously, including an article in this journal. The book, however, brings all of the different threads of earlier published work together as a single research resource. Ting draws on the consolidated reporting regimes in nine selected countries: Australia, France, Italy, Japan, the Netherlands, New Zealand, South Korea, Spain, and the United States. As with all good comparative law analyses, the book is organized around key design issues and draws on the experience in the selected countries to illustrate possible rule choices along the relevant dimensions of the subject.

The book is divided into two parts. Part one, which consists of three chapters, provides some necessary conceptual and theoretical background material. Part two, which consists of seven chapters, provides the country-comparative analysis of the key design issues that all systems of consolidated reporting must address. These include

- the definition of an eligible corporate group,
- the treatment of losses,
- the treatment of assets,
- the treatment of intragroup shareholdings, and
- interactions between the consolidation regime and other parts of the corporate income tax system.

The final chapter draws together all of the comparative material on these design issues in an analysis of what might best serve as a model system of consolidated reporting.

T.E.


Canada’s 2013 federal budget included a proposal for a specific anti-avoidance rule addressing synthetic dispositions. A comparable provision addressing constructive sales was added to the US Internal Revenue Code in 1997. Because of the specified

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19 Budget Plan, supra note 3, at 341-43 and resolution (19). Draft legislation including the proposed legislative rule governing synthetic dispositions was released on September 13, 2013. See Canada, Department of Finance, News Release 2013-117, September 13, 2013 and Legislative Proposals Relating to the Income Tax Act, the Excise Tax Act, and the Income Tax Regulations (Ottawa: Department of Finance, September 13, 2013), at clause 24 (proposing new subsection 80.6) and clause 50 (proposing new subsection 248(1) definitions of “synthetic disposition” and “synthetic disposition period”).

level of risk reduction required for the application of the US rule in respect of a long position in an appreciated capital asset, it has been relatively easy to avoid constructive sale treatment under the rule. One such avoidance technique involves the use by high-wealth individuals of variable prepaid forward contracts written on an appreciated long share position. These contracts differ from a standard forward contract in that an upfront payment is received by the taxpayer writing the forward contract over the share position. On maturity of the contract, the taxpayer receives no additional payment and must pay an amount dependent on the value of the shares at that time. In Revenue ruling 2003-7,21 the Internal Revenue Service confirmed that a properly structured variable prepaid forward contract would not be considered a constructive sale. One of the stated conditions for an acceptable structuring is the absence of a securities lending agreement entered into by the taxpayer with the appreciated long position and the counterparty financial institution with the long position under the forward contract. Such agreements are desirable in allowing the financial institution facilitating the transaction to hedge its long position under the forward contract by selling the shares short. In 

Anschutz Co. et al. v. CIR,22 it was held that the presence of a securities lending agreement resulted in a constructive sale under a “benefit-and-burden” approach to the characterization of ownership, even though it was accepted that the specific anti-avoidance rule deeming a constructive sale to occur did not apply because of the required level of risk reduction.

Brennan’s article reviews the relevant US law and administrative positions regarding variable prepaid forward contracts and argues that the legislative anti-avoidance rule governing constructive sales fails to adequately account for financial considerations such as volatility of asset values and riskiness of dividend payments. Brennan illustrates how delta-based financial models account for such considerations and should be incorporated into a legislative constructive sale rule. Because the application of the proposed synthetic disposition rule applies only where there is a level of risk reduction comparable to that under the US constructive sale rule, the US experience with variable prepaid forward contracts is somewhat instructive for Canadian purposes. In the absence of a benefit-and-burden approach to the characterization of ownership that would ignore legal formalities in certain circumstances, the CRA would presumably be forced to rely on GAAR to address transactions designed to avoid the application of the proposed synthetic sale rule.

T.E.


Although anti-tax-avoidance laws in different countries address the same issues, and in many instances the same transactions, they invariably develop in different ways with their own unique interpretive pressure points. For example, Australia’s GAAR

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22 664 F. 3d 313 (10th Cir. 2011); aff’g. 135 TC 78 (2010).
does not include a misuse or abuse standard like that in subsection 245(4) of Canada’s Income Tax Act, and this seems to have resulted in an emphasis in the Australian GAAR jurisprudence on issues that are also apparent in the Canadian GAAR but have not received nearly as much attention as the interpretation of subsection 245(4). An especially curious aspect of the Australian experience is a focus on what the author of this article refers to as “the reconstruction step” in the application of any anti-tax-avoidance rule. The more familiar step, and the one that tends to garner most attention, is what he refers to as “the destruction step.” The destruction step permits the tax authority to undertake various actions necessary to deny the availability of a tax benefit where a GAAR applies. Contentiousness therefore arises in the interpretation and application of the conditions under which a GAAR applies. The reconstruction step involves determining how the relevant taxpayer should be taxed ignoring the prohibited tax-avoidance transaction that was implemented. This step has received considerable attention in Australia. The substitute that is to be taxed is commonly referred to as “the counterfactual” or “alternative postulate.”

As Cooper points out, there has been a debate in Australia as to whether there needs to be a reconstruction step distinct from the destruction step. The Canadian experience is certainly representative of the single-step approach, in which the destruction step is considered sufficient to realize the appropriate tax result. This single-step approach is embodied in subsection 245(2) of the Act, which provides that “the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction.” But Cooper also points out that the debate over a single-step or two-step approach is somewhat moot in Australia, with the jurisprudence following a path that requires a two-step approach. However, with the exception of some early case law, there was not much focus on the required reconstruction step until a recent spate of cases, which prompted the Australian Treasury to amend the Australian GAAR to ostensibly clarify the required reconstruction step.

Cooper reviews the relevant case law considering the reconstruction step and sets out a set of possible conceptual approaches to this step, some of which are reflected in the recent amendments. A brief concluding part of the article contrasts the Australian two-step approach with the single-step approach adopted in other GAAR jurisdictions (including Canada). Under the single-step approach, the tax

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23 See also subsection 245(5), which provides an illustrative, non-exhaustive list of the kinds of adjustments that may be made in order to deny the availability of a tax benefit.


authority has discretionary power to effect an appropriate reconstruction that incorporates denial of the relevant tax benefit. Cooper suggests that this approach is deficient in its reliance on administrative discretion, which leaves taxpayers with remedies of judicial review only in the event that they disagree with the reconstruction posited by the taxing authority. It appears that the preference would be for a rules-based reconstruction step, albeit not necessarily the one now incorporated in the Australian GAAR. Given the scope for argument over the interpretation and application of the misuse or abuse standard in subsection 245(4) of the Act, it is perhaps understandable that Canadian tax practitioners have seen no compelling need to challenge the discretionary approach to the reconstruction step in subsection 245(2). What is especially curious about the Australian experience is the perceived need to articulate this step in a rules-based manner that can be the subject of substantive dispute over the interpretation and application of the Australian GAAR.

T.E.


The incidence of the corporate income tax is an important public policy concern, but it is also a very controversial topic, because one’s view of the incidence of the corporate income tax is likely to influence one’s view of the appropriate corporate income tax rates. The Harberger model, which is based on a closed economy with fixed supplies of labour and capital, indicated that most of the burden would be borne by the owners of capital throughout the economy and not just the shareholders of firms in the corporate sector. Subsequent models based on the assumption of a small open economy, with perfectly mobile capital, predict that most of the burden of a tax on capital will be borne by the other inputs that are relatively inelastic in supply—labour and land. Finally, there is the view that to the extent that corporate profits represent pure profits or economic rents, the corporate income tax will fall on shareholders and managers of firms.

In recent years, a growing empirical literature has sought to move beyond these theoretical models of corporate tax incidence to provide econometrics-based estimates of the distribution of the burden of corporate tax. The authors of this article contribute to this literature by estimating the effects of German municipalities’ business taxes on employees’ earnings. Their data set covers the tax rates in 11,441 municipalities and administrative data on employee compensation over an 11-year

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26 Subsection 245(6) allows for a consequent reconstruction authority in determining the tax consequences to a taxpayer whose tax position is affected by the denial of a tax benefit to another taxpayer.

period (1998-2008). The underlying theoretical model is one in which workers bargain with an employer over the division of the economic rent that is earned by the firm. Workers are viewed as perfectly mobile within the integrated German economy while businesses and capital are assumed to be immobile because there are locational advantages associated with operating in a particular municipality.

The authors find that a €1 increase in a business’s municipal tax liability directly reduces its wage bill by 77 cents. They also estimate that the business tax indirectly reduces wages by 10 cents owing to the reduction in investment caused by the tax. However, they also find that if workers in a firm are not represented by a trade union, their wages do not decline with an increase in the municipality’s business income tax. Thus, the authors’ analysis indicates that most of the burden of the German municipalities’ business tax falls on the earnings of the workers in firms where collective bargaining takes place.

The authors also find that medium-skilled and highly skilled workers suffer relatively larger wage losses from a business tax increase than do low-skilled workers. They attribute this to the greater bargaining power of higher-skilled workers. This result is at variance with the experience in North America, where union wage bargaining tends to compress the wage distribution within a firm and collective bargaining tends to benefit low-skilled low-wage workers more than highly skilled workers. Thus, the organization of German unions and the distribution of power within and among unions may create distributional effects that are different from those that are generally observed in Canada and the United States.

B.D.


Measuring the distortionary effects of raising additional tax revenue is an important component of tax policy and benefit-cost analysis, as is apparent from John Lester’s study of Canada’s foreign film production tax credit, reviewed above. This study by Barrios, Pycroft, and Saveyn uses computable general equilibrium (CGE) models of 24 EU countries to calculate the marginal cost of public funds (MCF), which is a measure of the losses sustained by the private sector of an economy in raising an additional euro of tax revenue. Typically, although not always, the cost of raising one additional euro of tax revenue is more than €1 because of the distortions to the allocation of resources in the economy that are caused by a tax rate increase. The MCF therefore measures the cost at the margin of additional public revenue.

The authors measure the MCF from taxes on labour income and on energy consumption in the European Union. The motivation for comparing the MCF for these broad taxes is to provide a basis for deciding how fiscal adjustments in the European Union should be implemented if tax increases are contemplated. While the measurement of the MCF from taxing labour incomes has been implemented in a number
of other studies, this study is somewhat different in its focus on the distortions that are caused by labour market rigidities and the associated involuntary unemployment that currently plagues many EU countries (notably Spain). The authors use the Shapiro and Stiglitz efficiency wage theory\(^\text{28}\) to model the labour market distortion, although how the parameters of the model in the base-case scenario were chosen is not explained in the paper.

The authors chose to also calculate the MCF from energy taxes because of the public interest in green taxes and the so-called double dividend. However, it should be noted that the CGE models that they use do not incorporate any environmental benefits from pollution reduction, such as reductions in carbon dioxide emissions. Therefore, the MCF for the energy tax just reflects the distortion to the allocation of consumption spending from raising the price of energy to consumers in order to raise additional tax revenues. Another interesting feature of the analysis is the attempt to measure whether an individual country’s labour or energy tax either benefits or harms other EU countries through changes in trade flow. These cross-border effects could lead to biases in the choice of tax policy changes if governments ignore the impact of their decisions on other EU countries.

The CGE model, which was calibrated to 2005 data, indicated that the average MCF for the EU countries was 1.90 for the labour tax, whereas for the energy tax it was 1.08. These results are not surprising given that most EU countries already levy relatively high taxes on labour incomes and much lower taxes on energy consumption. There were also substantial differences in the magnitude of the MCF for labour taxes across countries, ranging from 1.30 in Estonia to 2.41 in France. Generally speaking, the MCF for a labour tax increases with the country’s tax-to-GDP ratio. The model indicates that when the ratio of government tax revenue to GDP increases by 10 percentage points, the MCF increases by approximately 33 cents. For energy taxes, the MCF ranged from 0.62 in Bulgaria to 1.42 in France. An MCF of less than 1 for Bulgaria indicates that increasing the tax on energy improved the allocation of resources in that country.

The model also indicates that raising additional tax revenues generally has negative impacts on a country’s EU trading partners, although the effects are relatively minor. For example, the MCF for a labour tax increase in Germany was 1.96 when only the impact of the tax on German residents and German tax revenues was considered, but it rose to 2.04 when the EU-wide effects were taken into consideration.

The results from this study will provide policy makers with measures of the distortionary effects of taxes and the potential gains from altering the tax mix. Perhaps most importantly, it indicates that additional public spending has to generate substantial social gains if it is to compensate for the economic losses sustained by raising additional taxes on labour in the European Union.

B.D.

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This book by two prominent US tax and public finance economists is a delightful read. The target audience is individuals with no tax expertise but an interest in the US tax system. In fact, the goal of the book is to educate Americans about their tax system. As the authors state, “there is a desperate need for a clear, concise explanation of how our tax system works, how it affects people and businesses, and how it might be made better.”

It is hard to think of any other publication that realizes these goals more effectively than this book. And perhaps as a pleasant surprise, Burman and Slemrod have a lighter side that shines through in their text, which is written with considerable humour and enhanced by the inclusion of political cartoons lampooning the US tax system. The cartoons alone are worth the purchase price of the book.

The target audience necessitates the delivery of very basic information in a simplified form. Nonetheless, there is more than enough in the book to engage tax experts in the United States, let alone in other countries. Part one of the book provides an overview of the tax system mix in the United States, as well as a review of the VAT—which, of course, is not part of the US system but probably should be. Part two reviews the economic effect of taxes, hidden spending through the tax system, and tax administration and enforcement. Part three concludes with a discussion of US tax politics and some of the basics of the tax reform debate.

T.E.

Ruth Mason, “Delegating Up: State Conformity with the Federal Tax Base”


Harmonization of the tax bases of national and subnational levels of government in federal states with significant tax and spending powers residing in the subnational levels of government seems to be one of those tax policy ideals that are an unquestioned first-best policy goal, the realization of which is sometimes undermined by messy politics. The Canadian experience with federal-provincial harmonization of income and consumption taxes arguably bears witness to this proposition. Mason’s article, however, provides a deep and thoughtful analysis of the benefits that motivate harmonization, as well as the costs that should be considered and minimized to the extent possible. Although the analysis focuses on the US federal-state income tax, much of the discussion is relevant for Canada and other federal jurisdictions.

The principal benefit of harmonization remains the compliance and administrative cost savings. Mason moves beyond this obvious benefit to consider some secondary benefits that, while not insubstantial, tend to pale in significance. Perhaps more importantly, she provides an account of the costs of harmonization, which otherwise

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29 Burman and Slemrod, at xix.
tend to be ignored. At a general level, a notable cost is a loss of political accountability and the regulatory diversity that would otherwise prevail. In this respect, the most significant particular manifestation of this general concern is the automatic adoption by harmonizing state governments of federal spending programs in the form of tax expenditures. As one possible means to address this significant cost of harmonization, Mason suggests that states incorporate the federal income tax base at the point of determination of adjusted gross income rather than taxable income. Doing so would avoid incorporation of many of the federal tax expenditure provisions that are delivered as taxable income deductions and would allow the states to make their own decisions without any need to take the step of formally deviating from the federal base. Much the same result is realized under the tax-collection agreements in Canada, with the harmonized base being federal taxable income. To the extent that tax expenditures are delivered in the form of tax credits rather than taxable income deductions, the provinces retain autonomy over their spending decisions.

T.E.


This article is part of a symposium issue of the Pepperdine Law Review titled “Tax Advice for the Second Obama Administration.” The authors, two tax professors at the University of California at Los Angeles law school, argue that the revenue imperative motivating future tax reform in the United States should require the American middle class to pay an increased level of tax, but in return for a deeper and more stable social safety net consistent with the experience in many other countries. They do not, however, suggest whether this revision of the social contract in the United States might include the adoption of a federal VAT consistent with the experience in most other countries.

The largest portion of the article is devoted to a statistical detailing of two accepted economic trends in the United States: the relative decline in the economic position of American middle-class households, and the relative decline of the share of the tax burden borne by American middle-class households. The latter is clearly linked to the former. In particular, a range of tax measures intended to reduce the tax burden of the American middle class have been motivated politically by the increased stagnation of this income group. Instead of continuing along this policy path, Stark and Zolt suggest that revenue imperatives will dictate tax increases for the American middle class and that these increases will make it more politically feasible to increase the relative burden on higher-income households. The practice of delivering tax relief for significant household expenditures such as health, education, and housing should be abandoned because of the pressure on prices that this kind of relief exerts, with rising prices offsetting any benefit for the American middle class. Elimination of the tax expenditures in these areas would increase effective tax rates, but direct spending relief could provide offsetting relief in an effort to buttress the social safety net.

T.E.