Canadian Tax Journal: The Third Decade—1973-1982

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THE FISCAL BACKGROUND

In terms of contemporary tax changes, the journal's third decade, from 1973 to 1982, began with the introduction of the tax reform legislation of 1972 and ended with Minister of Finance Allan MacEachen's budget of November 18, 1981. The substance and implementation of these tax reform exercises were undoubtedly greatly assisted by the research published in the journal. Many articles focused on aspects of the countless technical changes needed to correct anomalies, inconsistencies, and gaps left by the tax reform legislation of 1972. In 1973, in part to quell the continuing political opposition to tax reform, the government introduced major tax incentives for the manufacturing and processing industries, reduced the rates of personal income tax, and indexed the personal income tax exemptions and rate brackets. The journal carried numerous articles on these subjects and the many other tax initiatives that were undertaken throughout the 1970s.

The MacEachen budget of November 1981 proposed to eliminate or substantially reduce many personal and corporate income tax expenditures. At the same time, it proposed to reduce personal income tax rates for middle- and upper-income taxpayers and to repeal the manufacturers' sales tax and introduce a new wholesale sales tax. In many ways, the package of reforms suggested in the budget was at least as substantial as and more comprehensive than those proposed in Finance Minister Benson's white paper on tax reform 12 years earlier. The budget proposals included the elimination of the income-averaging provisions, a half-year convention for the capital cost allowance system in the year of purchase of an asset, the restriction of the interest deduction for money borrowed to make an investment, the taxation of many untaxed employee benefits, a substantial narrowing of the corporate rollover provisions, the taxation of accrued interest income every three years, and a reduction in the federal dividend tax credit. Almost all of these measures were either anticipated or analyzed in journal articles. After the budget was tabled in the House of Commons, the board of governors of the Foundation took the unprecedented step of writing to the minister of finance and expressing its

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concern about "first, the process by which major tax reform proposals were formulated and introduced without prior public consultation, discussion, and debate, and second, the inadequacy of the transitional measures."[1]

THE CONTINUING EVOLUTION AND EXPANSION OF THE JOURNAL AND ITS FEATURES

The editorship of the journal changed four times over the decade. In October 1973, Barbara Brougham resigned as editor. She was replaced the next month by John McHugh, who served as editor for two years. Catherine Frost joined the Foundation's staff in April 1976 and served as editor for more than three years, resigning in July 1979. She was succeeded in August 1979 by the inimitable Laurel Amalia. Laurel is well known, at least by reputation, for the efficient and meticulous manner in which she oversees all of the Foundation's ambitious publishing programs, and she is well respected by all those who have written for Foundation publications over the past 23 years.

During Laurel's tenure, the journal has undergone significant change. The first and most notable improvement she made was to formalize the practice of having papers reviewed by one or more outside readers. A number of changes were made in the appearance and format of the journal in the first issue of 1979. The introductory pages were modified to increase the clarity of the contents of the journal, and the features were grouped in the latter half of the journal rather than interspersed among the articles. Besides making it easier to find materials in the journal, the change in the distribution of articles and features helped expedite publication because features were often submitted later than articles and held up production. A new type of binding also made it possible to increase the number of pages published in each issue. In 1973 the journal ran to slightly fewer than 600 pages; by 1982 it ran to nearly 1,000 pages.

During this decade, some of the journal's features were altered and others were added. By the end of the decade, the format of the journal looked very much like it does today.

Gwyneth McGregor continued to write Around the Courts until the last issue of 1975, when she retired from the Foundation. Douglas Sherbaniuk noted in his annual report for 1974 that

> "Around the Courts" has flowed from the pen of Gwyneth McGregor for over twenty years. Many readers have told us that this feature is their main source of information on judicial decisions in the tax field. Written with perception and sometimes with humour, it deserves the following it has.[2]

In her last feature, Gwyneth McGregor thanked her readers "for the help, encouragement and appreciation they have shown me over the years. I depart with the most pleasant memories of the Foundation, its staff and its members. Vaya con Dios!"[3]

After Gwyneth's departure, the feature was renamed Current Cases and its editorship was taken over by Tom E. McDonnell, who at the time was a tax professor at the Faculty of Law, University of Toronto. It continued to be an extremely popular feature of the journal. In the tradition established by Gwyneth, the comments were analytical, thorough, insightful, and often critical. Tom wrote extensive comments on as many as 10 cases for each issue. From time to time he would invite other academics to write a comment, but in the main he wrote them all. In 1977 Tom joined the law firm of McMillan Binch. Near the end of this decade of the journal, colleagues at the firm, particularly Richard Thomas, began contributing comments.

David Perry continued to write Fiscal Figures throughout this period, providing unique and illuminating insights into many aspects of taxation and public expenditures.

In Checklist, which appeared in every issue, Millie Goodman kept readers posted on all recent developments in federal and provincial taxation. Beginning in 1974, the Foundation published in January of each year a Tax Memo setting out the changes reported in the six issues of Checklist in the preceding year so that members would have a convenient summary of all recent tax developments.

In the Library continued to serve the useful function of bringing new tax and public finance publications to the attention of journal readers.

One of the most popular features in the journal, Estate Planning in Canada, edited by Sheldon Silver and Stanley Taube, was regularly consolidated and reprinted as a booklet. It was frequently referred to by practitioners and regularly used in bar admission and continuing legal education programs. Commencing with the first issue of 1976, Sheldon Silver became the sole editor. The feature came to an end in the last issue of 1979 when Sheldon decided to discontinue it.

In 1975 the International Tax Planning feature was introduced. The coming into force of the foreign affiliate rules and regulations and the signing of several new tax treaties had made the tax implications of carrying on business abroad a matter of increasing importance to Canadian tax practitioners. The editor was Robert D. Brown, senior tax partner of Price Waterhouse.

In 1980 three more features relating to aspects of tax practice were added to the journal. Personal Tax Planning, edited by William E. Crawford and Paul Gratis, both of Clarkson Gordon, debuted in the first issue of 1980. In the next issue, Selected US Tax Developments, edited by Sidney I. Roberts, senior partner of the law firm of Roberts & Holland of New York, Washington, DC, and Miami, appeared for the first time. The Taxation of Corporate Reorganizations was introduced in the fourth issue of 1980. The original editors were David Timbrell of Coopers & Lybrand and Douglas Ewens, a partner in McCarthy & McCarthy; with the first issue of 1982, Jack Boultbee of Coopers & Lybrand replaced David Timbrell.

Finally, a feature called Current Reading appeared in the journal from time to time from issue no. 5, 1977 until issue no. 1, 1980. Edited by Richard M. Bird of the Department of Political Economy at the University of Toronto, the feature was "intended to be a hybrid of conventional book reviews of varying lengths and of more personal notes on current fiscal reading."[4] An interested reader could keep up with almost all of the major reports, books, and monographs on tax published in English around the world. Indeed, it now provides a fascinating archive of the intellectual currents in tax during the period. The feature also included Richard Bird's always insightful and often irreverent comments on the publications. For example, in reviewing a collection of research papers published in the United States, he commented digressively:

> A recent glaring example of the lamentable way in which tax policy questions are commonly "studied" in Canada occurs in the recent Ontario budget, where the Treasurer noted that "it is . . . difficult to estimate the revenue gains and employment gains that will occur in Ontario due to the elimination of succession duties." Since there is not a shred of evidence from any jurisdiction to suggest that there will by *any* such gains, it doesn't seem as difficult as all that! Similarly, when the budget goes on to say that ". . . on balance Ontario will profit in many ways from this decision," it is hard to avoid mentioning how very few (and wealthy) residents of the province seem likely *ever* to benefit from this policy in any significant way. Indeed, the virtually complete disappearing act of death taxes in this country at least in part probably reflects the state of tax research and tax policy in Canada.[5]

RANGE OF SCHOLARSHIP PUBLISHED IN THE JOURNAL

Because the Canadian Tax Foundation is a multidisciplinary association—bringing together lawyers, accountants, economists, business persons, and public administrators—the journal serves as an interdisciplinary forum for the expression of original ideas from a wide variety of perspectives. The goal of representing all forms of scholarship relating to tax and fiscal policy was evident from the beginning of the journal, but was pursued more self-consciously as the journal matured.[6] By the 1970s the journal aimed (and still aims) to publish articles that would serve one or more of several goals: to explicate, interpret, and apply current tax law to complex personal and commercial transactions; to synthesize and critique developing areas of tax law; to provide a comparative perspective on tax law issues; to provide an economic analysis of tax and public finance issues; and to address contemporary issues relating to tax reform and administration. There are doubtless many ways in which the total body of scholarship that appears in the journal could be divided. In the pages that follow I offer my own (somewhat conventional) categorization, both to provide an overview of the articles published in the journal in its third decade, and to facilitate a comparison of the methodology and subject matter of these articles with the methodology and subject matter of articles published in the journal in subsequent decades.

All published research should contribute to existing knowledge and have some importance for the real world. More to the point, it should be original and relevant. Beyond these general criteria, however, pure scholarship can take many forms. It is often divided into scholarship of discovery, integration, and application. Scholarship of discovery makes a direct contribution to the stock of human knowledge and at its best is perhaps the most exciting form of scholarship. The scholarship of integration draws apparently isolated facts together in a context that reveals new relationships or provides new interpretations of their significance. Scholarship of application applies knowledge in new ways that further the achievement of human ends and is perhaps the type of scholarship most commonly found in the journal.

Just as scholarship may be divided into three categories, knowledge itself may be usefully classified as one of three types. Empirical knowledge is based on systematic observations of the world; normative knowledge is based on reasoning about values and goals; and analytic knowledge is based on reflective thought about the methods we use in making judgments about facts and values, the grounds we have for asserting them, and the concepts we use in formulating them. Scholarship can involve the discovery, integration, or application of facts, values, or concepts. Although it is not fashionable to make strong claims about the significance of the distinction between these three types of knowledge, this categorization is useful in thinking about research and analysis. In the third decade of the journal, the majority of the articles in which the authors were pursuing new knowledge dealt with empirical issues. The authors were attempting to make discoveries about the way the world works, or at least that part of the world affected by taxes. Although I may have overlooked them, I did not notice any articles during this period that purported to add to our normative or conceptual knowledge of taxes.

Most articles published in the journal do not undertake what might be described as pure scholarship. Instead, they are characterized primarily by instrumental reasoning or policy analysis. That to say, they use knowledge developed by others instrumentally in the pursuit of certain goals. They are articles that advocate that the courts, administrators, or legislators adopt a particular tax or expenditure policy. They tend to be normative in purpose and pragmatic in nature. They are normative in purpose in that, almost invariably, they are attempting to justify a result in terms of its consequences. They are pragmatic in nature in that they employ a wide variety of forms of argumentation in advancing their preferred policy. The general criteria that are used in assessing these types of articles include whether they have increased the conceptual clarity with which the relevant issues are perceived, whether they have provided solid evidence for their empirical claims, and whether they have offered good reasons for their value-based arguments.

The types of policy or instrumental articles published in the journal during its third decade might be subdivided into doctrinal, tax planning, technical tax policy, tax expenditure, and other articles. The mission of the Foundation is not only to undertake original research but also to educate tax practitioners and, more generally, the taxpaying public. Thus the journal frequently publishes articles that might fairly be called descriptive in that they neither add to the store of knowledge nor recommend policy changes. The goal of these articles is to present knowledge about the tax system in a form accessible to a wide audience of lawyers, accountants, economists, business persons, and members of the public. They might describe a conceptually difficult area of tax law, or survey and synthesize the results of research and compare and evaluate different contributions.

Using the categories suggested above, I attempt in the following pages to provide an overview of the types of articles published in the journal in its third decade. Since the scope of this summary is necessarily limited, I refer to particular articles largely for illustrative purposes.

EMPIRICAL RESEARCH

Observation is perhaps the most important way in which we increase our knowledge of the world. Unfortunately, we cannot personally observe most of the important phenomena in the world, and to the extent that we can, we have learned from experience that we cannot safely generalize about the real world based on our individual experiences. Therefore, in advancing our empirical knowledge, we rely on the research of social scientists who have developed rigorous methodologies and guidelines for collecting and describing data and drawing inferences from them. In tax research, the data are invariably numerical and researchers use sophisticated statistical techniques and analysis in attempting to draw inferences from them to other, more relevant facts.

Although empirical research might involve amassing data for use by researchers and others, or summarizing data so that they can be easily comprehended, most empirical research involves drawing an inference from observable data to phenomena that we are interested in but cannot directly observe. That is to say, most empirical research simply attempts to determine the relationship between two variables: If A occurs, will B occur, and why? Almost all of our empirical knowledge about the world can be thought of as knowledge about relationships between data. The basic idea is straightforward. Only a difference or change can explain another difference or change: only variables can explain variables. In tax research, one variable (the independent variable) is usually some change in the tax system, such as a reduction in tax rates, and the empirical question is whether that change will affect some other variable (the dependent variable), such as the decision of individuals to work, save, or invest.

Before they begin to collect data that might assist them in inferring whether a relationship exists between two variables, researchers will have a theory that explains why there might be such a relationship. Since taxes affect relative prices, it was natural that economists were among the first group of social scientists to study the effect of taxes. On the basis of the precepts of basic price theory, economists hypothesized about the effect of taxes on such variables as labour supply, savings, risk taking, investment decisions, corporate financial policy, and the distribution of income. This kind of theorizing obviously yields empirically falsifiable propositions. A good deal of tax research by economists consists of attempts to test these theories about the economic effects of taxes.

One of the most basic and important ways that taxes might affect economic prosperity is by affecting the incentive of individuals to work. Beginning in the 1950s, there was a series of well-known studies on the effect of taxes on labour supply. As noted in the reviews of the journal's first two decades, studies on this issue were published in the journal. A further study by a group of three university students and two of their professors was published in the journal in 1978. The researchers attempted to determine whether the Canadian progressive income tax structure had any effect on the decision of UBC professors to earn extra income. They conducted telephone interviews with 46 randomly chosen economics and business professors about whether the professors' behaviour had changed in the past as a result of the effect of taxes. On the basis of the survey results, the researchers concluded that it had not: "In general, we feel that the personal income tax had relatively little effect on the work effort of our sample of professors. Other factors, particularly job satisfaction and professional recognition, appeared to be more important in determining the extent of their work effort."[7]

In the early 1970s, the Canadian government introduced several tax incentives to increase business investment and ultimately to increase employment, economic growth, and the competitive position of firms in Canada. Studying the likely effects of these incentives became a cottage industry among empirically oriented economists, and a number of these studies were published in the journal. R.M. Hyndman undertook one of the first studies to examine the effects of the 1972 reduction in tax rates for manufacturing and processing profits.[8] Using an econometric model of the economy, he simulated the effects of the rate reductions and concluded that they were relatively inefficient in achieving their objectives, in part because they resulted in such a small reduction in the cost of production. More specifically, he found that much of the revenues lost through the rate reduction would benefit not businesses operating in Canada, but instead the US treasury through reduced foreign tax credits claimed by the US parent corporations of American multinationals operating in Canada. This finding, which was confirmed in subsequent research, was an important contribution to knowledge about the likely effects of investment tax incentives in Canada. Hyndman also noted that even relatively minor changes in the exchange rate would be much more significant than rate reductions for the competitiveness of Canadian manufacturers. In a subsequent issue of the journal, his findings were vigorously contested by R.P. Simon, the director of taxes for Molson Companies Limited.[9]

An econometric study by F.J. Harmon and J.A. Johnson, published in 1978, analyzed the effects of the level and timing of investment of five different investment tax incentives: the 1963 acceleration of capital cost allowance (CCA), the 1966 deferral of CCA, the 1970 increase in the capital cost of the CCA base, the 1972 accelerated allowance and tax cut, and the investment tax credit introduced in 1975.[10] Their main conclusion was that "the effectiveness of investment incentive tax policies in bringing about changes in the overall level of investment or the timing of investment expenditures is not at all apparent."[11]

An indispensable concept in the analysis of the effects of taxation is the concept of tax incidence—the different effects on different taxpayers' real income when a tax is introduced or increased. To the extent that taxes induce changes in individual and firm behaviour, there will be associated changes in the price of goods and services and in the return to factors of production, and consequently the final burden or economic incidence of a tax is likely to be very different from its statutory incidence. Public finance economists use various approaches to analyze tax incidence, and a number of such studies were reported in the journal throughout this period. By considering the incidence of all taxes, researchers can estimate the overall distributional implications of the tax system. One of the best-known early attempts at such estimation, by Irwin Gillespie, was published in the journal in 1976.[12] Making the most plausible assumption about the incidence of each tax in the Canadian tax system, he allocated all government tax receipts to the individuals in various income groups. He then calculated what he called the broad income of each income group. The concept of broad income was meant to provide a much more accurate indication of the economic well-being of individuals in each income group than that derived from a simple observation of their money income. Broad income included various forms of imputed income, such as the imputed rental value of owner-occupied homes, individuals' share of corporate earnings, inheritances, and accrued capital gains. Finally, for each income group, Gillespie calculated the taxes paid as a percentage of broad income. On the basis of this analysis, he found that the tax system was regressive over most income groups. That is to say, high-income groups tended to pay a smaller percentage of their broad income in tax than did low-income groups. He also attempted to estimate the extent to which individuals in each income group benefited from government spending programs. He found that spending programs were generally more favourable to lower income groups, so much so, in fact, that the programs more than offset the regressivity of the tax system. Thus, the overall fiscal system was found to involve some redistribution from higher to lower income groups. Nevertheless, contrary to the myth that the Canadian government was increasingly redistributing larger shares of income from the rich to the poor, he found that from the early 1960s to the early 1970s the poor in fact had experienced no gain in their share of national income after government taxes and transfers, while the rich had benefited at the expense of the middle class.

The results of these kinds of incidence studies must, however, be treated with the greatest of caution. Among other things, they assume that government creation of property and contract rights does not affect the distribution of income; they are extremely sensitive to the assumptions that are made about the incidence of individual taxes and government spending programs; and they rely only upon annual income data. Of course, all attempts to learn about the real world have their frailties. For example, another type of empirical study that gained popularity in the early 1970s was the attempt to determine the compliance cost of taxes. Richard Bird, who seems always to have had a special interest in pointing out the limits of human knowledge, wrote an article for the journal in which he debunked many of the claims made in these studies.[13] He concluded, rather pessimistically, "There appears to be little reason either conceptually or empirically for tax policymakers to expect much help from cost-revenue studies, no matter how carefully they are done."[14] Given the conflicting results of the empirical studies conducted by economists, the same might be said of many kinds of tax policy research. Nevertheless, in spite of the difficulties, an important role of scholarship is its pursuit of the truth. By the 1970s, the journal was actively engaged in this collaborative enterprise by publishing the studies mentioned above and many others like them.

A quite different type of empirical research, of particular interest to lawyers, attempts to determine the variables, such as ideological beliefs, that influence judges in reaching their decisions. Despite widespread agreement among political scientists that an attitudinal model of judicial decision making would have a tremendous amount of explanatory power, few legal scholars have undertaken this type of empirical work. In 1982, the journal published an article by three accounting professors that attempted to explain the decisions of tribunals in cases involving the valuation of private businesses.[15] After coding and statistically analyzing 125 cases drawn from the period 1917 to 1979, their major discovery was that the tribunal was almost twice as likely to adopt the valuation contended by the tax department as to prefer the valuation contended by the taxpayer: in about 45 percent of the cases the tribunal adopted the department's valuation, while in about 26 percent of the cases it adopted the taxpayer's valuation. On the basis of these results, and noting that "taxpayers find it very difficult to discharge the onus of disproving the tax department's assessment," the researchers theorized that

> [t]his may be so because the tax department may be better able to assess the value of the business owing to greater resources at its disposal or because the department may have less of an incentive to be biased than the taxpayer who must pay the taxes associated with the valuation.[16]

In those cases in which the tribunal did not adopt the valuation contended by either party, it usually chose a value close to one of the values contended by the parties instead of a compromise value. The researchers found that none of the other explanatory variables they studied, such as the size of valuation, level of tribunal, member of the tribunal hearing the case, or time period, was helpful in predicting the results of the tribunal in valuation cases.

Instead of attempting to predict and explain judicial outcomes, empirical research might attempt to explain legislative outcomes. Hardly anyone thinks that the shape of the Canadian income tax system can be explained by reference to the rational application of tax policy criteria. Indeed, some contend that it does not even look like it was designed on purpose. Political scientists who study the public policy process have developed a number of theories or explanations to account for legislative outputs. Some emphasize the importance of prevailing ideas and ideologies; some argue that environmental factors, such as Canada's proximity to the United States, significantly influence policy outcomes; others argue that policy outputs are largely determined by the distribution of economic power in Canadian society (some of these analysts are of the view that economic power is widely dispersed in Canada, while others take the view that it is highly concentrated); some argue that policy outputs are determined, or at least severely constrained, by the structure of the economy and reliance on private investment; public choice theorists argue that policy outputs can largely be explained by examining the self-interest of the proximate decision makers—civil servants seeking to increase their power and prestige, politicians hoping to get re-elected, and interest group leaders attempting to satisfy their members. Although this type of empirical research was not reflected in the journal in the 1970s, Irwin Gillespie alluded to its importance in an article in which he surveyed research findings on the effectiveness of post-war federal countercyclical fiscal policy.[17] He found that federal budgetary countercyclical fiscal policy was not successful in achieving its normative goal of stabilizing the economy. In searching for an answer to the question "what factors have caused changes in budgetary taxes and expenditures?"[18] he speculated that the pursuit of normative goals could only ever provide a partial answer. Referring to empirical work in the United States on "the political business cycle," he suggested that the answer may have a lot to do with the government pursuing electoral gains[19] and noted that in his future research he intended to develop a more sophisticated positive theory of federal government budgetary behaviour.

DOCTRINAL SCHOLARSHIP

Whereas economists primarily undertake empirical scholarship, most legal scholars engage in doctrinal scholarship—namely, the exposition of the law. Legal scholars are experts at articulating the meaning of rules, mapping legal doctrine, and applying the rules across countless different sets of facts and circumstances. Doctrinal scholarship might be further subdivided, roughly, into writing that is primarily descriptive, prescriptive, or interpretive.

A good deal of doctrinal writing in the journal during the 1970s was primarily descriptive. Its goal was to organize, synthesize, and apply tax law. In addition to being concise and elegantly written, the best of this type of doctrinal writing is imaginatively structured; explains how the law attempts to solve the basic problems it has to deal with; reveals the conceptual relationship between complex sections in the income tax legislation; reflects a clear understanding of the principles underlying the law; articulates the similarities and contrasts among apparently diverse lines of doctrine; reconciles or distinguishes conflicting lines of precedent; situates the law in its historical, social, and economic context; and applies the law to novel and increasingly complex factual situations. Generally, however, this type of work treats the law as an autonomous discipline and is normative only in the sense that it prefers to approach the law as if it were internally coherent. Nevertheless, although this doctrinal writing is fairly described as primarily descriptive, neither the difficulty of doing it well nor the value it serves in the legal system should be underestimated.

Throughout its third decade, the journal published the very best of this kind of writing in Canada. Representative articles include Robert Couzin's "Of Arm's Length, and Not Dealing Thereat"[20]; John W. Durnford's "The Corporate Veil in Tax Law"[21] and "Goodwill in the Law of Income Tax"[22]; Howard J. Kellough's "The Business of Defining a Partnership Under the Income Tax Act"[23]; O.A. Pyrcz's "The Basis of Canadian Corporate Taxation: Residence"[24]; and Alan M. Schwartz's "A Practical Look at Section 80."[25]

Another type of doctrinal writing, instead of attempting to present the law and its rules in a coherent light, deals directly with the gaps, conflicts, and ambiguities in the law. This type of doctrinal writing is self-consciously prescriptive. Its goal is to improve the performance of legal decision makers such as judges and administrators.

At its best, it embodies a sophisticated form of practical reasoning, and applies the familiar technical tax policy criteria of equity, neutrality, and administrative practicality to the interstices of tax law. In arguing for a position, authors will often explore the origins and evolution of the relevant legal doctrine; evaluate the policy basis for the rule and explore its reach; compare how other jurisdictions have dealt with similar problems; relate the rules to the structural principles that underlie the tax system; and speculate on the effect of alternative formulations on the allocation of resources and the distribution of income.

A surprisingly large number of these types of doctrinal problems in the tax law arise at the boundaries between two concepts, often legal concepts. Examples of such problems are found in the distinction between business income and capital gains, business income and income from property, business income and a gift, an independent contractor and an employee, personal and business expenses, current and capital expenses, disposing of an asset and holding it, corporations and partnerships, partnerships and joint ventures, and debt and equity. All of these contrasting concepts, and the many more that form the bulk of income tax jurisprudence, have one characteristic in common. Although the concepts are easily recognizable in their pure form, they are joined by an almost infinite set of arrangements that form a continuum between them. Wherever the line is drawn separating the concepts for tax purposes, arrangements that are substantially similar will invariably be found on either side of the line. The challenge of tax jurisprudence, and the subject matter of much of the doctrinal writing on tax law that deals with these contested categories, is to draw a line across the continuum that can be defended rationally, that is difficult to manipulate, and that provides certainty and predictability in the application of the law.

Any number of strategies might be used in defining the boundaries of these concepts for tax purposes. If the concepts used in tax law have names similar to those of legal concepts used in private law, courts will often simply refer to the meaning of the concepts in private law and then analogically import the boundaries defined in private law cases into the tax cases at hand. And they will do this even though scholars, beginning at least with the legal realists in the 1930s, have repeatedly pointed out the absurdity of giving a legal concept that is developed in one area of law to achieve a particular policy objective the same meaning in another area where it is used to achieve an entirely different policy objective. For example, why would anyone think it sensible to give the concept of employee the same meaning in both tort law, where the concept was developed to limit the vicarious liability of employers, and tax law, where the concept is used, for among other purposes, to limit the deductibility of employment expenses? This kind of reasoning is so obviously fallacious that it even has a label in introductory logic books—the fallacy of the transplanted category, which in turn is a type of the more general "one word, one meaning" fallacy.

There is a strong normative basis for distinguishing between certain tax concepts. For example, personal and business expenses are distinguished for the ultimate purpose of ensuring that taxpayers pay tax on the value of the goods and services they consume for their personal benefit. Thus, even though considerations of efficiency, administrative practicality, and even social policy may dictate precisely where to draw the line between the two concepts, normative considerations can at least guide the exercise. Although there might be normative reasons for distinguishing between certain other tax concepts, the courts have never explicitly drawn their lines on normative grounds. For example, the normative reasons for giving preferential treatment to capital gains are presumably to encourage risk taking and to reduce the lock-in and bunching effect when unrealized gains are not taxed. A distinction between income, which is taxed at the normal rates, and capital gains, which are taxed at preferential rates, could be drawn on these normative grounds. However, the courts have not done so. Instead, for whatever reason, the courts continue to base the distinction on what J. Harvey Perry, a former director of the Canadian Tax Foundation, referred to as "the so-called English concept of income . . . a scheme that ideally suited the selfish designs of the ruling classes of England a century and a half ago."[26]

The task of line drawing is most difficult in those cases where there is no normative tax basis for distinguishing between two tax concepts. For example, there is no reason why, in principle, the return to debt should be taxed differently from the return to equity. Yet a fundamental structural characteristic of the Canadian income tax system is that interest is taxed differently from dividends. Given its lack of normative content, the distinction between debt and equity has bedevilled not only the courts but also the legislators. Similarly, there is no normative reason why taxpayers who sell their assets with accrued gains should be taxed differently from taxpayers who hold such assets. Under the Haig-Simons-Carter definition of income, from which the income tax derives its moral force, income is the sum of personal consumption plus the change in net wealth during the taxable period. This normative definition of income implies that taxpayers should value their assets at the end of each taxable period and include in their income any increase in the value of the assets and deduct any loss in value. However, since the realization requirement clearly underlies our income tax legislation, taxpayers generally do not have to report gains or losses on capital property until they dispose of the property. But what is a disposition? How should the courts distinguish between persons who have disposed of an asset and those who have not? Clearly, the normative concept of income is of no value in making this decision; the realization requirement cannot be justified by reference to the Haig-Simons-Carter definition of income. Furthermore, the reasons traditionally given for the realization requirement—if taxpayers were required to pay tax on gains accrued on capital property, it would be difficult for them to determine the value of their assets on an annual basis and they may not have funds available to pay tax owed on paper gains—do not support the line drawn under the present law. Most obviously, the traditional reasons do not suggest why publicly traded securities should not be taxed on an accrual basis. Thus, an answer to the question of when a taxpayer should be treated as having disposed of an asset cannot be deduced from the reasons behind the realization requirement.

Although line drawing in this area has become vastly more difficult with the development of sophisticated financial derivatives, it has always been perplexing. For example, when, if ever, should modification of the terms of a debt instrument be treated as a disposition of the original instrument for the modified one? This is the type of tricky line-drawing question that one of the articles we have republished from the journal's third decade grapples with. Co-authored by Brian Arnold and David Ward, "Dispositions—A Critique of Revenue Canada's Interpretation"[27] deals with what appears to be a relatively simply question: "In what circumstances, if any, where there is a change in the terms of attributes of a share or a debt receivable, is the holder of the share or debt receivable considered to have disposed of it for tax purposes?"[28] In June 1980, Revenue Canada released an interpretation bulletin[29] in which it described the modifications to debt obligations and shares that it would treat as a disposition. Basically, if the change altered the fundamental character of the holder's economic interest in the bond or stock, Revenue Canada proposed to treat the alteration as a disposition. That is, it would answer the question whether a disposition had occurred by focusing on the significance of the changes in the terms of the security. The article, as indicated by its title, was a critique of the line that Revenue Canada had drawn between disposing of a security and holding it in this context.

We have republished this article because the problem that it deals with is still with us and because the article is still frequently referred to as the leading piece on the issue. Moreover, it is an exemplar of this type of doctrinal scholarship. The authors state the precise issue that the article deals with; they clarify the conceptual issues; they explain the nature and importance of the fundamental principle—the realization requirement—at stake in the line-drawing exercise; they review the meaning the courts have given to the concept of disposition in other contexts in the legislation; they discuss the significance of related structural features of the legislation, such as the non-recognition provisions; they explain in great detail the anomalies that Revenue Canada's interpretation of disposition in this context will create; they signal the ways in which savvy tax planners might avoid most of the implications of the proposed interpretation and note the circumstances under which unwary taxpayers will be adversely affected; and they support their case for a different test by reference to the practice in the United Kingdom and the United States.

It is easy to imagine a series of line-drawing tests to distinguish between modifications of a debt instrument that will be treated as a disposition and those that will not: any modification, only modifications that are economically significant, only modifications that would amount to the discharge and substitution of a new contract in contract law, and no modifications (only transactions that result in the termination of the holder's entire interest would be treated as a disposition). Choosing among these tests, or some other test, in particular tax law contexts is the stuff of good prescriptive doctrinal tax writing. It involves sophisticated and nuanced policy analysis such as that undertaken in this article (even though one may disagree with the authors' conclusion). It is theoretically sophisticated in that it penetrates far into the existing legal materials in search of generalizations and animating principles. In discussing the consequences of different line-drawing tests, it explicitly states and supports its empirical assertions and normative values with the best evidence and compelling arguments. (Parenthetically, the article has been cited in several cases that have referred with approval to the authors' analysis.[30]) Although the interpretation bulletin that was critiqued in the article has not been reissued, the Canada Customs and Revenue Agency (formerly Revenue Canada) recently suggested that it is revising the bulletin, and it has modified its approach to determining whether a disposition of a debt obligation has occurred from one based on economic substance to one based on the contract law of the relevant jurisdiction.[31]

A third type of doctrinal writing, which might be characterized as interpretive analysis, aims to determine the meaning of specific words in a statute. At one extreme, some legal scholars, employing a form of reasoning very different from that used in tax policy analysis, assign meaning to words based on their use in other contexts, such as ordinary discourse, and perhaps rely upon well-known conventions that refer to the use of other words in the statute. At the other extreme, some legal scholars argue that there is only one way to make any sensible decision, whether or not it involves the interpretation of a statute, and that is by postulating a number of plausible, alternative policy options for each interpretive issue; considering the consequences of each in terms of tax policy principles; and choosing the option that in the light of its consequences leads to the best policy outcomes. Naturally, there is a range of approaches between these extremes. The appropriate approach to take to interpreting a tax statute has been a consistent theme in the journal, and the third decade was no exception.

One of the more interesting articles, written by Brian Hansen in 1976, dealt with the approach of judges to the interpretation of the word "transfer" in the context of the attribution rules, an approach he characterized as "Judicial Nonsense."[32] He noted, for example, that judges had interpreted the word transfer in section 74 as including a sale at fair market value but not an interest-free loan. Hansen pointed out how silly these interpretations are in the light of the provision's intended effect—namely, to prevent income splitting. On the one hand, a sale of property to a spouse at fair market value presents no issue of income splitting: the parties have simply exchanged properties and thus income-earning potential. On the other hand, an interest-free loan to a spouse is the paradigmatic case of an income-splitting transaction: the borrower has increased capacity to earn net income that the lender controls through the ability to call the loan. In effect, by holding that a loan was not a transfer of property for the purposes of the attribution rules, the judges wrote the rules out of the legislation. In a scathing review of this and other examples of the jurisprudence in this area, the author suggested that the judges' interpretation of the attribution provisions could not be sustained no matter what approach was taken to interpreting the statute, except one dedicated to making nonsense out of it. Another article that was published in this decade, David Ward's "Principles To Be Applied in Interpreting Tax Treaties,"[33] is still frequently referred to as an important work on the issue of the proper approach to interpretation.

It is useful to think of judges as potentially having three responsibilities in tax cases: to interpret the legislation, to characterize the party's transactions for tax purposes, and to minimize tax avoidance. In the 1970s the appropriate role of the court in discharging the latter two responsibilities appears to have caused much more concern than the court's role in interpreting the statute. Throughout the period, there was a proliferation of cases that raised the question of how the courts in tax cases should define and deal with ineffective transactions, artificial transactions, shams, transactions in which the legal form and economic substance differed, step transactions, and transactions that had no business purpose. Numerous articles in the journal attempted to delineate the reach of doctrines that might deal with each of these types of transactions. However, the issue that appeared to provoke the most concern was the suggestion in a number of tax cases that judges should apply a business purpose test in deciding whether to uphold the party's transactions. In a 1977 article entitled "The Business Purpose Test—Who Needs It?"[34] M.J. O'Keefe argued that a business purpose test should not be established either by the courts or by statute because of the uncertainty it would create. He concluded: "Hopefully the Supreme Court of Canada will set the record straight sometime in the near future and lay to rest once and for all any notion of a common law business purpose test."[35] In 1981, in a very well known article, which Justice Estey in *Stubart Investment Ltd. v. The Queen* referred to as "[p]erhaps the high water mark in the opposition to the introduction of a business purpose test"[36] and which the court relied upon in holding that there was no business purpose test in Canada, David Ward and Maurice Cullity thoroughly reviewed the development of the abuse of rights doctrine in civil law jurisdictions and the application of a business purpose test in common law jurisdictions.[37] Their main objection to the introduction of a business purpose test was that it "would inevitably create a significant degree of uncertainty and unpredictability in the application of Canadian income tax law."[38] Moreover—and this was the passage the Supreme Court relied upon in rejecting a business purpose test—

> [i]f taxes are minimized or postponed, more capital will be available to run the business and more profit will result. Surely, in the penultimate decade of the twentieth century it would be naive to suggest that businessmen can, or should, conduct and manage their business affairs without regard to the incidence of taxation or that they are not, or should not, be attracted to transactions or investments or forms of doing business that provide reduced burdens of taxation.[39]

TAX-PLANNING ANALYSIS

Tax planning has a number of dimensions that require scholarly treatment, but the one that dominated the tax-planning literature published in the journal in the 1970s was the comparison of after-tax values of different individual investment opportunities and management decisions. In a world with taxes, all decisions, whether personal investment decisions or management decisions such as appropriate compensation packages, financial structures, or the strategy to be used in a corporate reorganization, should take into consideration the after-tax cash flow of various alternatives. Effective after-tax decision making is not, however, a straightforward exercise, and the interaction of different tax provisions can often lead to counter-intuitive results.

Over the course of five years, Lawrence Gould and Stanley Laiken published a series of interesting articles in which they developed a framework and provided algebraic formulas for analyzing investment returns subject to different types of tax treatment on an equivalent after-tax basis.[40] Even though many tax-planning articles may reflect considerable ingenuity and the sophisticated application of difficult economic and finance concepts, they often have a limited shelf life because tax rules are so transitory, especially those that are subject to manipulation. Nevertheless, it is worth mentioning the subject matter of a few additional articles on tax planning that appeared in the journal during this decade, most of which involved the development of algebraic models for converting pre-tax cash flows to after-tax cash flows which could be applied to recurring tax-planning situations: the remuneration of owner-managers,[41] share redemptions,[42] the buyout of shares in a closely held corporation,[43] the donation of appreciated property to a charitable organization,[44] and the use of the general averaging provision when an income increase is anticipated.[45]

TECHNICAL TAX POLICY ANALYSIS

A good income tax system is one that functions as an effective instrument for achieving the goals the government wishes to pursue. In broad terms, these goals include raising the revenue required to finance government spending and to assist in stabilizing the economy, and achieving a more socially acceptable distribution of income than that which results solely from market forces. However, the design of the tax system must also satisfy the familiar criteria that are used in evaluating all government policy instruments. In tax policy analysis, these criteria are usually discussed under the headings of equity, neutrality, and simplicity. A good tax system treats similarly situated individuals the same, does not affect the personal choices individuals make, and is relatively convenient and inexpensive to administer and comply with. The application of these criteria to the full range of issues involved in designing the technical elements of the income tax system is the stuff of tax policy analysis. The journal published a wide range of articles on tax policy issues during its third decade.

One of the most intractable problems in income tax policy is determining the appropriate treatment of interest expenses. Although the general issue of the deductibility of interest has numerous dimensions, two problems that continue to plague the Canadian tax system are the need to distinguish between personal and business interest expenses and the appropriate treatment of interest expenses when the income to which they are related is given preferential tax treatment—for example, when the related income takes the form of a capital gain and hence the taxation of the income is deferred until it is realized and then only half of the income is taxed. These two issues were raised recently in cases before the Supreme Court of Canada, *Singleton v. The Queen*[46] and *Ludco Enterprises Ltd. et al. v. The*

Queen.[47] From a tax policy perspective, the court's decisions in these cases were unsatisfactory. In 1973, Gordon Bale, a professor on the Faculty of Law at Queen's University, wrote "The Interest Deduction Dilemma,"[48] which suggested a solution to both of the problems raised in these cases. In part because of the current interest in these problems, we decided to republish this article.

Until the time of Bale's article, not much had been written about the tax policy aspects of interest expenses. In more recent years, there has been a flood of articles dealing with the issue. Nevertheless, the solutions suggested by Bale are still worth considering. Most (but not all) analysts agree that it is necessary to distinguish between an interest expense that should be treated as a personal expense, and therefore non-deductible, and an interest expense that should be treated as a business or investment expense, and therefore deductible. The trick is in determining how the distinction should be made. Under the present law, the distinction is made by physically tracing the use of the borrowed money on which the interest expense is incurred. If the borrowed money can be traced to a personal purpose, the interest expense will be treated as personal and thus non-deductible; if the borrowed money can be traced to a business or investment purpose, the interest expense will be treated as a business expense and thus deductible. Although it is arguable that a tracing rule provides the correct tax result in principle, a physical tracing rule places a high premium on tax planning. As Bale illustrates with a detailed example, two taxpayers with the same assets and the same cash flows both before and after the purchase of an owner-occupied home will be in very different tax positions depending on how they finance the home. If one retains his or her investment assets and borrows money that is used directly to purchase the home, the interest paid on the borrowed money will not be deductible because the borrowed money has been used for a personal purpose. If the other, identically situated taxpayer sells his or her investment assets and uses that money to purchase the home and then borrows money to repurchase the investment assets, the interest on the borrowed money will be deductible because the borrowed money has been used for an investment purpose. Bale suggests that "[t]here must be something defective about a tax rule that results in such a capricious allocation of tax burden among . . . persons who are in substantially identical situations."[49] He points out that with proper tax planning the first taxpayer could achieve the same tax result as the second taxpayer, but even so,

> a tax rule that places a high premium on form and therefore on tax planning is inferior to a rule that achieves the same or a very similar result without the need for tax planning. This proposition is greatly fortified by the facts that awareness of tax planning is concentrated among those with higher incomes and the availability of expert tax advice is largely confined to such persons.[50]

Moreover, even if we could assume that both parties have access to tax-planning advice, the result is still unsatisfactory because "[t]he tax system should as a general rule be as neutral as possible as between different modes of achieving substantially identical results."[51]

In order to formulate an interest deductibility rule that would treat these two taxpayers the same, Bale considers six possible rules that allow (1) all interest payments to be deductible; (2) interest payments to be deductible to the extent that the value of the taxpayer's income-yielding assets is as great as the amount of his or her debt; (3) interest payments to be deductible up to the amount of the taxpayer's net income from property; (4) the same percentage of the taxpayer's interest payments to be deductible as the percentage of his or her income-yielding assets is to his or her total assets; (5) interest payments to be deductible to the extent that the amount of the taxpayer's debt exceeds the value of his or her non-income-producing assets; and (6) no interest payments to be deducted.

Having set out these six possible rules, Bale considers each in terms of the traditional tax policy criteria of equity, neutrality, and administrative practicality. He ultimately settles on a variation of rule 3. Taxpayers should be allowed to deduct the interest expenses they incur in a year from only their investment income. If their interest expenses exceed their investment income in any year and they can physically trace the borrowed money to the purchase of an income-earning asset, the interest expense should be allowed to be carried forward to be deducted from future income from that asset. When the asset is sold, any remaining undeducted interest expense should be allowed to be added to the adjusted cost base of the asset. Bale argues that, in addition to distinguishing between personal and business interest expenses in a way that is more equitable, neutral, and simple than any of the other possible rules, such a rule also neatly deals with the problem of interest expenses that have been incurred to earn preferentially taxed income such as capital gains. Under the present law, as illustrated in *Ludco Enterprises Ltd.*,[52] a taxpayer who borrows to purchase an investment asset that yields mainly a capital gain receives an implicit tax subsidy because the interest expense on the borrowed money can be used currently to shelter ordinary income from full tax rates while the related capital gain will be taxed only when realized and only at half rates. Thus, the present rule enables individual investors to borrow money and make an uneconomic investment but still earn an after-tax rate of return. Bale notes that his proposed rule solves this problem by ensuring that interest expenses are deductible only from fully taxed investment income, and to the extent that they are related to the earning of a capital gain, their effect is simply to reduce the pre-tax gain.

Although not everyone will agree with Bale's policy recommendations, his article is a fine example of tax policy analysis. The article deals with one of the most intractable problems in the tax system; it builds upon accumulated wisdom, such as it was at the time; it applies the tax criteria of equity, neutrality, and simplicity with sophistication; it carefully distinguishes between the technical and tax expenditure aspects of the problem; and, since a first-best solution to the problem was unattainable, the article engages in a search for the most appropriate second-best solution.

A tax policy issue that dominated technical and public discussions of the tax system throughout much of the 1970s was how the tax system should deal with the problems posed by inflation. The Carter commission did not deal with the issue at all. The conventional wisdom in the mid-1960s was that the tax system should take no account of inflation. However, the worldwide acceleration in the inflation rate in the late 1960s and early 1970s sparked immediate and intense interest in the issue. Inflation poses two completely separate problems for the technical tax system. First, as the price level rises, inflation erodes the real value of the tax brackets, exemptions, tax credits, and all other amounts expressed in dollar figures in the tax system. Although there are several technical issues to resolve, the obvious general solution to this problem is to index all dollar figures for inflation. Following a proposal in Finance Minister John Turner's budget of February 1973, this aspect of the Canadian tax system was fully indexed for inflation. Not surprisingly, the journal carried several articles on the problem of indexing the tax system's dollar figures for inflation.[53]

The second problem that inflation poses for the technical tax system is the mismeasurement of income from capital, interest deductions, and capital cost allowances. The tax system should account for the effect of inflation on asset prices. Although this issue did not receive the same amount of coverage in the journal as the indexing of dollar amounts in the tax legislation, Meyer Bucovetsky wrote an article that is still frequently cited on the issues involved in adjusting realized capital gains from both inflation and the advantages of deferral.[54] He concluded that an acceptable approximation of accrual taxation on real capital gains could be implemented, without prohibitive complexity, by allowing for the indexing of capital gains and imposing an interest charge to counterbalance the advantage of delayed payment. Near the end of the decade, in an article that was concerned primarily with the effect of inflation on the capital gains tax, John Bossons demonstrated the ways in which inflation acts as a hidden tax on wealth. In conjunction with other aspects of the tax system, in particular the non-taxation of the return realized on owner-occupied homes, he also showed how inflation distorts the economy's investment resources and reduces the incentive to save.[55] He recommended the introduction of a package of reforms to deal with the problem, including the indexing of the cost base of assets. Jonathan Kesselman also addressed the need to index assets in an article that was prompted by the reforms announced in the 1981 federal budget.[56] Many proposed reforms in that budget were aimed at reducing opportunities for tax deferral, particularly with respect to income from capital. Although the reforms would move the income tax base closer to the Haig-Simons-Carter ideal, and thus make it more equitable and less distortionary, Kesselman pointed out that, in the absence of capital indexation, such partial reforms were more likely to increase the adverse economic effects of the tax system. After examining six alternative tax bases, he concluded that the government should consider moving to an alternative tax base such as a "real receipts" tax base, because a tax on accrued income will be fair and neutral only if all major capital assets are taxed on an accrual basis and there is full capital indexation, both of which features pose administrative difficulties.

In addition to solving issues related to the definition of the tax base, technical tax policy analysis is used to solve the many timing and accounting issues raised by the imposition of an annual income tax. During the latter part of the 1970s, Brian Arnold was working on a comparative study of the relationship between income taxation and accounting concepts, particularly in the measurement of business income. His monograph, which is still highly regarded and frequently referenced, was published by the Foundation in 1983.[57] In the course of preparing this work, he published a number of articles for the journal on related subjects. In these articles he argued that Canada should consider allowing taxpayers to compute the flow of inventory costs using the last in, first out (LIFO) convention;[58] that the tax legislation should contain detailed rules dealing with the problems of conversions of property to and from inventory;[59] and that there is no reason why tax accounting should be required to conform to financial statement accounting.[60]

Besides carrying articles dealing with tax policy aspects of the personal income tax, the journal carried a number of articles dealing with tax policy aspects of taxing corporations and trusts.[61] One of the most durable problems in corporate tax—remaining even after the 1972 reforms—is the problem that arises if a distribution of corporate earnings is taxed at a rate different from (usually higher than) the rate applicable to a gain on a sale of shares. Whether and how the practice of surplus stripping, which exploits this differential treatment, should be dealt with has probably been the subject of more corporate tax policy articles in the journal than any other. One of the leading articles on this subject in the third decade of the journal was Robert Dart's "Designated Surplus—Why?"[62] It is a detailed and sophisticated critique of the longstanding "designated surplus" solution to this problem. This subject, and many others related to corporate distributions, was also dealt with in detail in an article by Tom McDonnell and Elinore Richardson.[63]

Another perennial issue in corporate tax policy is the treatment of losses. In an article published in 1977, Brian Arnold and David Poynton concluded that although the then recent amendments that allowed reorganized corporations to flow through losses in certain circumstances improved the law, "the amendments do not go far enough" and the government should consider allowing for "the consolidation of profits and losses for corporations within a related group."[64] The next year the journal published a thorough analysis of this very issue by Susan Hershberg, "Consolidated Returns: A Tax Policy Perspective."[65]

When should the tax legislation extend non-recognition treatment to transactions involving corporate reorganizations that would otherwise result in taxable capital gains? The November 1981 federal budget proposed to tighten up the Canadian rules so that only reorganizations in which there was no substantial change in economic interest would be allowed a rollover. Elinore Richardson and Robert Langlois wrote a thorough critique of the proposals.[66] They reviewed the legislative history of the non-recognition provisions relating to corporate reorganizations, attempted to explain the development of the rules by reference to related developments in prevailing business practices and economic conditions, speculated on the tax principles underlying the proposed changes, and reviewed the approaches taken to similar tax policy issues in the United Kingdom and the United States. Most significantly, they undertook an exhaustive examination of the anomalies and incongruities that would result from the implementation of the rules. In part because of this article, or at least its expression of the types of concerns it raised, the government withdrew the proposal to amend the corporate reorganization provisions.

TAX EXPENDITURE ANALYSIS

Tax expenditure analysis identifies the tax expenditure measures buried in tax legislation, determines the revenue losses attributable to them, explains the normative government purposes they serve, evaluates their design, and compares their effectiveness with that of alternative policy instruments. The journal has served as the principal publication in Canada for this type of analysis.

One of the first, if not the first, published attempts in Canada to determine the revenue losses attributable to corporate tax expenditures was a commentary by David Perry in his Fiscal Figures feature in 1976.[67] A year later, Jonathan Kesselman published a paper in which he estimated the revenue cost and the distribution by income class of various personal tax expenditures.[68] These studies, and others like them, contributed to a much better understanding of the tax expenditure concept in Canada and led to the publication of a tax expenditure account by the Department of Finance in 1979, in which the department estimated the cost of a large number of both personal and corporate tax measures that might be regarded as tax expenditures.[69] But the methodology for estimating the cost of tax expenditures was and still is contentious. For example, in a 1980 journal article, Samuel Rea took issue with how the department had estimated the cost of the registered retirement savings plan (RRSP) tax expenditure.[70] The amount of tax revenue forgone due to the RRSP tax expenditure is a function of three aspects of such plans: revenue is lost because RRSP contributions are deductible and because the investment income that is earned in the plan is not taxed as it accrues, but some of this lost revenue is eventually recouped because income is taxed on its withdrawal from the plan. In its 1979 tax expenditure account, the federal government accounted for the cost of RRSPs on a current cash flow basis: the revenue lost in the year due to contributions and accrued income was offset only by the tax on withdrawals in the year. Since withdrawals as a percentage of contributions would increase in future years, Rea argued that the revenue loss attributable to RRSPs should be calculated on a present-value basis, and he suggested the appropriate discount rate for making such a calculation.

The issue whether a particular tax measure should be classified as a tax expenditure is also contentious and has important consequences. On the one hand, if a tax measure can be justified on the grounds that it is necessary to refine the measurement of taxable income, it should take the form of a tax deduction. On the other hand, if the measure can only be justified on the grounds that it is designed to provide relief to certain taxpayers or to encourage them to engage in particular types of activities, it should take the form of a tax credit so that all qualifying individuals receive the same subsidy regardless of their marginal tax rate. In the late 1970s, when the tax expenditure concept was just emerging in Canadian tax policy analysis, there was a brisk debate over which tax measures should be treated as an integral part of the technical tax system and which should be regarded as tax expenditures. In an article published in 1980,[71] Wayne Thirsk argued, contrary to the position taken by some social policy groups at the time, that tax deductions for such items as union and professional dues, tuition fees, carrying charges on investments, moving expenses, child-care expenses, uninsured casualty losses, and medical expenses were all properly treated as an integral part of the technical tax system and thus should not be converted to tax credits. The tax deductions for registered home ownership savings plans, charitable contributions, and attendance at educational institutions, on the other hand, were properly considered tax expenditures and should be converted to tax credits. He went on to show, however, that even if these three deductions were converted to credits, the effect on the overall distribution of the tax burden would be minimal. Although many of the tax measures that he thought could not justifiably be treated as tax expenditures were in fact converted to tax credits in the reforms of 1987, a number were not and the debate over which measures should be treated as tax expenditures continues unabated.

One consequence of the increasing recognition throughout the 1970s of the importance of tax expenditures was that articles that dealt with major areas of public policy usually took them into account and emphasized the need to coordinate tax expenditures and direct spending programs.[72]

FEDERAL-PROVINCIAL RELATIONS AND THE BUDGET PROCESS

Tax may be its obvious focus, but the journal also publishes articles that deal with public finance issues more generally. Although many non-tax subjects received substantial coverage in the journal during the 1970s, including social security policy[73] and fiscal policy,[74] the two issues that received the most coverage were federal-provincial relations and the budget process.

A number of articles dealt with the changing arrangements during the 1970s for the financing of health and post-secondary education,[75] and Richard Simeon reviewed the state of play relating to federal-provincial arrangements in 1982.[76] In addition to addressing issues related to fiscal arrangements such as equalization grants and federal transfer programs, a federal system must establish rules for assigning tax bases among the various levels of government. In an article published in 1982, Charles McLure suggested that in a federal system the corporate income tax should ideally be assigned solely to the federal government. In the absence of this ideal, he argued, the corporate tax should be centralized as much as possible—for example, by having provincial corporate taxes "piggyback" on the federal tax.[77] He expressed concern about the sustainability of Canada's relatively uniform corporate tax systems as Alberta joined Quebec and Ontario in enacting its own corporate tax. In 1976, in what remains the definitive treatment of the issue, Ernest Smith reviewed comprehensively the development of the Canadian rules for allocating the taxable income of corporations to provinces.[78]

Finally, an issue that the Foundation raised and played an active role in during the 1970s was budget secrecy and the reform of the tax legislative process. In his report to the annual meeting of the Foundation for 1975, delivered on April 13, 1976, Douglas Sherbaniuk discussed the doctrine of budget secrecy, the justifications for it, and the problems that it creates by denying the public meaningful input into government budget policy, including proposed tax changes.[79] This report was subsequently published in the journal.[80] Between the date of the report's delivery to the Foundation and its publication in the journal, the minister of finance, Donald Macdonald, announced in the House of Commons that he would be undertaking a re-examination of aspects of the budget process and the doctrine of budget secrecy.[81] At the request of the minister, the Foundation organized a committee in the fall of 1976 for the purpose of studying and reporting on the budget process as it relates to tax changes. The committee completed its work in November 1977 and submitted it to the new minister of finance, Jean Chrétien. The report, which contained numerous detailed recommendations, was published in the journal.[82] Although widely cited, the committee's report did not result in any substantive changes in the budget process.

In the federal budget of November 12, 1981 tabled by Minister of Finance Allan MacEachen, the government proposed a substantial number of major tax reforms. In a move unprecedented in the history of the Foundation, the chair of the Foundation, Charles Pelletier, wrote to the minister of finance to express concern over the lack of public consultation preceding the announcement of such significant tax measures. In response to a request from the minister of finance early in 1982, the Foundation established a Committee on the Budget Process. Its report, "On Opening Up the Budget Process," was submitted to the minister on March 12, 1982. A little over a month later, the government tabled in the House of Commons a green paper dealing with the budget process that made extensive reference to the committee's report. The committee's report, with the green paper appended to it, was published in the journal.[83] The Department of Finance subsequently implemented a number of the committee's recommendations, including the use of advisory committees from the private sector to consider important tax changes, the publication of consultative documents outlining proposed amendments and inviting comments from the public, and the publication of a detailed explanatory memorandum to accompany draft income tax amendments.

RIGOUR AND RELEVANCE

This eclectic review of the articles published in the journal in its third decade does not do justice to the sophistication and originality of many of the articles. Nevertheless, it does reveal that by its third decade the journal was admirably fulfilling the Foundation's purpose, printed on the inside cover of every issue over decade, of providing "both the tax-paying public and the governments of Canada with the benefit of expert, impartial research into current problems of taxation and government finance" with a view to "the establishment of the best possible tax system."

NOTES

1 Charles Pelletier, "Report of the Chairman," in Canadian Tax Foundation, *Thirty-Sixth Annual Report*, for the year ending December 31, 1981 (Toronto: Canadian Tax Foundation, 1982), 8-21, at 16.

2 Douglas J. Sherbaniuk, "Report of the Director," in Canadian Tax Foundation, *Twenty-Ninth Annual Report*, for the year ending December 31, 1974 (Toronto: Canadian Tax Foundation, 1975), 14-25, at 21.

3 Gwyneth McGregor, Around the Courts feature (1975) vol. 23, no. 6 *Canadian Tax Journal* 520-35, at 520.

4 Richard M. Bird, Current Reading feature (1977) vol. 25, no. 5 *Canadian Tax Journal* 590-94, at 590.

5 Richard M. Bird, Current Reading feature (1979) vol. 27, no. 2 *Canadian Tax Journal* 238-42, at 242 (note omitted).

6 As the director, Douglas Sherbaniuk, explained in his annual report to the Foundation in 1974, supra note 2, at 21: "In the planning of each issue, an attempt is made to provide something of interest to all of the groups that make up our heterogeneous membership. Articles may deal with subjects ranging from highly technical analyses of particular sections of the Income Tax Act, which are of primary concern to practitioners, to evaluations of public expenditures or the economic effects of a Budget, which are likely to be of greater concern to public finance economists and government officials."

7 Margaret Babey, Robert G. Clark, Robert M. Clark, Larry Holm, and William T. Stanbury, "Effects of the Personal Income Tax on Work Effort: A Sample Survey" (1978) vol. 26, no. 5 *Canadian Tax Journal* 582-90, at 589 (original is italicized).

8 R.M. Hyndman, "The Efficacy of Recent Corporate Income Tax Reductions for Manufacturing" (1974) vol. 22, no. 1 *Canadian Tax Journal* 84-97.

9 R.P. Simon, "The Efficacy of Recent Corporate Income Tax Reductions for Manufacturing—An Unsimulated View" (1974) vol. 22, no. 2 *Canadian Tax Journal* 160-65.

10 F.J. Harman and J.A. Johnson, "An Examination of Government Tax Incentives for Business Investment in Canada" (1978) vol. 26, no. 6 *Canadian Tax Journal* 691-704.

11 Ibid., at 704.

12 W. Irwin Gillespie, "On the Redistribution of Income in Canada" (1976) vol. 24, no. 4 *Canadian Tax Journal* 419-40. Gillespie subsequently expanded this article into a monograph, *On the Redistribution of Income in Canada* (Toronto: Gage, 1980).

13 Richard M. Bird, "The Costs of Collecting Taxes: Preliminary Reflections on the Uses and Limits of Cost Studies" (1982) vol. 30, no. 6 *Canadian Tax Journal* 860-65.

14 Ibid., at 864.

15 Richard D. Rennie, George J. Murphy, and Jack G. Vicq, "The Judicial Approach to Private Business Valuation: An Empirical Inquiry into Canadian Tax Cases" (1982) vol. 30, no. 3 *Canadian Tax Journal* 389-95.

16 Ibid., at 391-92.

17 W. Irwin Gillespie, "Postwar Canadian Fiscal Policy Revisited, 1945-1975" (1979) vol. 27, no. 3 *Canadian Tax Journal* 265-76.

18 Ibid., at 275.

19 Ibid., at 276.

20 Robert Couzin, "Of Arm's Length, and Not Dealing Thereat" (1978) vol. 26, no. 3 *Canadian Tax Journal* 271-86.

21 John W. Durnford, "The Corporate Veil in Tax Law" (1979) vol. 27, no. 3 *Canadian Tax Journal* 282-326.

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The Interest Deduction Dilemma

[From Vol. XXI, No. 4 (1973), 317-36]

Gordon Bale*

After pointing out various deficiencies of the present rule for the deductibility of interest payments, the author of this article proposes a rule that would (1) be more equitable, not only as between investors, but also as between earners of investment income and earners of salaries and wages, and (2) do away with the need for involved financial manipulating. References to relevant cases serve to illustrate the inadequacy of the present rule and the superiority of the one proposed.

"There is no trusting appearances"[1]

The Income Tax Act provides that a taxpayer may deduct "an amount paid in the year . . . pursuant to a legal obligation to pay interest on (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy), . . . or a reasonable amount in respect thereof, whichever is the lesser".[2] Such a provision appears to embody logic and common sense. Nothing seems more reasonable than that interest paid by the taxpayer should be deductible provided the borrowed money is used to earn income. However, the initial attractiveness of this proposition fades on closer inspection, particularly in regard to property income.[3]

The Practical Problem of Tracing

There is first of all the practical problem that arises out of the phrase "borrowed money used for the purpose of earning income". It is necessary for the taxpayer to be able to trace the funds received from the lender into the income-earning process. However, it is not simply the first use of borrowed money that determines the deductibility of the interest paid, but its continued use. As Jackett P. stated in *Trans-Prairie Pipelines Ltd. v. M.N.R.*: "Surely, what must have been intended by section 11(1)(c) was that the interest should be deductible for the years in which the borrowed capital was

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[1] Sheridan, *The School for Scandal,* Act V, Sc. ii.

[2] S.C. 1970-71-72, c. 63, s. 20(1)(c). It also provides for a deduction of interest on an amount payable for property acquired for the purpose of earning income and of interest paid to the government on amounts paid to the taxpayer under an Appropriations Act for specified purposes.

[3] This statutory provision has previously received critical analysis. See Robert M. Turnbull and J. Kerr Gibson, "Is Ottawa Tight on Borrowed Money?", *Canadian Tax Journal*, XV, 1 (1968), p. 8. Their emphasis was primarily upon the deductibility of interest on funds used in a business. This article will be primarily directed towards the deductibility of interest on borrowed funds used to earn property income. The general topic of the deductibility of interest has not received a significant amount of attention. A short and stimulating analysis is to be found in Richard Goode, *The Individual Income Tax* (The Brookings Institution, 1964) at pp. 157-62. The article by D. A. Dixon, "A Consideration of the Theory of the Deductibility of Interest Payments from the Personal Income Tax Base", *National Tax Journal,* Vol. 23, 2 (1970), p. 168, in a large measure prompted the writing of this article.

employed in the business rather than that it should be deductible for the life of the loan as long as its first use was in the business."[4] In *Lakeview Gardens Corporation v. M.N.R.*,[5] the company borrowed money from a bank to acquire a large tract of land which it then sold in smaller parcels at a profit. The profit was reported and taxed as income and interest payments were claimed and allowed as a deductible expense. The company subsequently acquired shares in a subsidiary corporation, the dividends from which constituted exempt income. The Minister contended that, although the borrowed funds were initially used to purchase land which was inventory of the company, as the land was sold, the borrowed funds were used to purchase shares. The Tax Appeal Board held that "the onus was on the appellant to prove that the money which served to make the investment . . . came from money earned rather than from money borrowed and the appellant failed to do so."[6] Thus the onus is on the taxpayer to prove the continued use of the borrowed funds in the income-earning process.

This problem will not now be so serious for most companies because section 248(1) defines "exempt income" as not including a dividend on a share.[6a] Companies also benefit from an interpretational modification of the requirement that borrowed funds must be traced into the income-earning process for interest to be deductible. Borrowed funds used to redeem preferred shares are in one sense not used to earn income from a business because they are paid out to the shareholders to redeem their shares. This was so held by the Tax Appeal Board in *Trans-Prairie Pipelines Ltd. v. M.N.R.*,[7] but this was reversed by the Exchequer Court.[8] Jackett P. held that the interest on borrowed money used to redeem preferred shares was deductible provided the capital of the company continued to be used to produce income. Thus the change in the capital structure of the company which involved substituting debt capital for equity capital did not prevent the interest from being deductible, provided the capital of the company continued to be used for the purpose of earning income. Interest on borrowed funds used to pay dividends also appears to be deductible, provided the capital of the company is used to earn income, even though in one sense the funds are not used in the business.[9]

It is the individual who borrows money that still faces the full rigor of

[4] 70 DTC 6351 at 6354; [1970] C.T.C. 537 at 541.

[5] 71 DTC 281; [1971] Tax A.B.C. 394.

[6] *Ibid.*, at 285 and 399 respectively.

[6a] There is, however, an added complication for companies who have "outstanding debts to specified non-residents" as defined in s. 18(5). The thin capitalization rules contained in ss. 18(4) to (7) and s. 22 of the Income Tax Application Rules, 1971 provide for a proportionate disallowance of interest which is otherwise deductible. See Interpretation Bulletin IT-59 (15/8/72).

[7] 65 DTC 642; 39 Tax A.B.C. 243.

[8] N. 4 above.

[9] It was perhaps uncertain whether the deductibility of interest on funds used to pay dividends represented not only departmental policy but also the law. In *Modern Dairies Ltd. v. M.N.R.* 50 DTC 442, 3 Tax A.B.C. 66; *Boyles Bros. Drilling Company Limited v. M.N.R.* 51 DTC 70, 3 Tax A.B.C. 287; and *Savage Shoe Co. Ltd. v. M.N.R.* 51 DTC 79; 3 Tax A.B.C. 309, interest on borrowed funds used to pay dividends was held to be deductible. The primary issue before the Board in each case appeared to be whether a debtor/creditor relationship existed. No attention appears to have been directed to the issue of whether the funds were used for the purpose of earning income. By anology to the *Trans-Prairie Pipelines* case, the interest would now appear to be legally deductible provided the capital of the company is used to earn income. Interpretation Bulletin IT-80 (27/11/72) states that "it is not the Department's policy to disallow interest on money borrowed to pay dividends unless a substantial portion of the accumulated profits of a corporation immediately before the payment of the dividend has (a) not been used for the purpose of earning income, (b) been used to acquire property the income from which is exempt, or (c) been used to acquire a life insurance policy. This policy equates a corporation that used profits for expansion and then is required to borrow money to pay dividends with one that paid dividends out of profits and then is required to borrow to finance the expansion."

the onus of proving that the borrowed money not only was initially used but continues to be used for the purpose of earning income from a business or property. The tracing of borrowed funds may be an exceedingly difficult task. It may in fact be an impossible task, particularly where the taxpayer does not maintain different bank accounts for different purposes.[10] If the borrowed money is used to repay money previously borrowed, the new borrowing is deemed to be used for the same purpose as the previously borrowed money,[11] with the result that the tracing process may be very complex. However, even if the tracing of borrowed funds did not present a problem, it is suggested that the existing interest deductibility rule is unsatisfactory in regard to property income.

The Substantive Problem

The following example is intended to illustrate the defectiveness of the existing interest deductibility rule. Let us consider three individuals A, B and C, each of whom has a salary income of $20,000 and possesses $50,000 in common stock yielding a dividend income of 4.5% and no other asset or liability. Each of A, B and C decides to buy a $50,000 home. A sells $10,000 of securities to obtain the down payment and purchases a $50,000 house subject to a $40,000 mortgage at 9% interest. B sells $50,000 in securities and buys his house with cash. B then borrows $40,000 at 9% from his bank and purchases $40,000 in securities which he subsequently pledges as collateral for his loan. C sells $10,000 in securities and borrows $40,000 from his bank at 9%, using the remaining $40,000 of securities as collateral for his loan. C purchases his $50,000 house for cash.

If a personal balance sheet were prepared for A, B and C, the asset side would be the same. Each has $40,000 in securities which are assumed to be identical and a $50,000 house. On the liability side, A would have a $40,000 mortgage at 9% while B and C would each have a bank loan of $40,000 at 9%. Their cash flow positions would be identical, each having a salary income of $20,000 and an investment income of

ASSET POSITION

	A	B	C
Initial Personal Balance Sheet	$50,000 in securities 50,000 net worth.	$50,000 in securities 50,000 in net worth.	$50,000 in securities 50,000 in net worth.
Home Is Purchased.	$10,000 in securities are sold. $10,000 is used as a down payment on a $50,000 house which is purchased subject to a $40,000 mortgage at 9%.	$50,000 in securities are sold. $50,000 is used to purchase a house $40,000 is borrowed from a bank at 9% interest to purchase $40,000 in securities which are pledged as collateral	$10,000 in securities are sold. $40,000 is borrowed from a bank at 9% using $40,000 in securities as collateral $50,000 is used to purchase a house.
Personal Balance Sheet after House Purchase.	$40,000 in securities 50,000 house 40,000 mortgage at 9%. 50,000 of net worth.	$40,000 in securities 50,000 house 40,000 bank loan at 9%. 50,000 of net worth.	$40,000 in securities 50,000 house 40,000 bank loan at 9%. 50,000 of net worth.

[10] As merely one example of the many hopeless cases involving the onus of tracing borrowed funds see *No. 616 v. M.N.R.* 59 DTC 247; 22 Tax A.B.C. 31.

[11] S. 20(3).

TAX POSITION

Salary Income	$20,000	$20,000	$20,000
Investment Income $1,800 + 33⅓% of $1,800 (s. 82(1))	2,400	2,400	2,400
Less: Employment Expense Deduction (s. 8(1)(a))	150	150	150
and Interest Deduction (s. 20(1)(c))	—	3,600	—
Net Income	$22,250	$18,650	$22,250
Less: Personal Deduction for Married Person (s. 109(1)(a))	2,850	2,850	2,850
and Optional Standard Deduction (s. 110(1)(d))	100	100	100
Taxable Income	$19,300	$15,700	$19,300
Total Federal Tax on Taxable Income $3,415 + 35% of the amount in excess of $14,000 (s. 117(1))	$ 5,270	$ 4,010	$ 5,270
Less Dividend Tax Credit ⅘ × 33⅓% × $1,800 (s. 121) (or simply 20% of $2,400)	480	480	480
Basic Federal Tax	$ 4,790	$ 3,530	$ 4,790
Less 1972 Tax Reduction of 3% of Basic Federal Tax	144	106	144
Federal Tax Payable	$ 4,646	$ 3,424	$ 4,646

Note: It should be emphasized that the example does not take into account any capital gain which might become subject to tax on the disposition of the additional $40,000 in securities by B. The value of the tax deferral, assuming that the securities have appreciated in price, will reduce the tax advantage of obtaining the interest deduction of $3,600. However, even if 100% of the proceeds of disposition represented capital gain, there would still be a significant tax saving, because the interest deduction represents a continuing annual tax saving as compared to the single value of the tax deferral of the capital gain. This is illustrated in the following table in which it is assumed that the individual's life expectancy is 20 years and the rate of discount is 8%.

Percentage of proceeds of the additional disposition of $40,000 that represents capital gain	Amount of capital gain	Federal tax at 35% of ½ of capital gain	Present value of federal tax deferral $\frac{T}{1+i} \sim \frac{T}{(1+i)^n}$ T is the tax in preceding column	Present value of federal tax saving from interest deduction $\left(1{,}222 \times \frac{1-(1+i)^{-n}}{i}\right)$
10	4,000	700	498	11,998
25	10,000	1,750	1,245	11,998
50	20,000	3,500	2,490	11,998
75	30,000	5,250	3,735	11,998
100	40,000	7,000	4,980	11,998

This particular result does not simply flow from the selectrion of a long period such as 20 years. It also holds true for short periods. The present value of the tax saving from the interest will be much less for a short period, but the value of the tax deferral on the capital gain will be correspondingly less and the same relationship indicated by the table will prevail. In addition, if the proceeds of disposition do not exceed the adjusted cost base of the securities, the tax advantage of the immediate realization of a capital loss will reinforce that of obtaining the interest deduction.

At the time this article was written, Bill C-193, "An Act to amend the Statute Law Relating to Income Tax (No. 3)" had not been introduced in the House of Commons. This Bill, when it becomes law, will increase the personal deduction of a married persion to $1,600 plus $1,400, less the amount by which the dependant spouse's income exceeds $300. It also provides for future adjustment of personal deductions and tax brackets in accordance with changes in the Consumer Price Index. There is also to be an additional deduction from tax of the greater of $100 or 5% of the tax otherwise payable, but limited to $500. A and C would have $4,501 of federal tax to pay while B would have $3,304 to pay in 1973.

$1,800 (assuming a dividend yield of 4.5%). Each pays $3,600 of interest in the year (on the assumption that there is no repayment of capital). Their tax positions, however, are drastically different, as can be seen from the table. A and C would have net incomes subject to tax of $22,250.[12] This includes $20,000 of salary income and the $1,800 of dividend income which must be increased by the amount of the new dividend tax credit of 33⅓%.[13] Each would have an employment expense deduction of $150. However, B would have only $18,650 of net income because the $3,600 of interest which B pays will qualify as a deduction under section 20(1)(c). B carefully arranged that the proceeds of the bank loan should be used to purchase securities yielding an income. If A, B and C each has only his wife as a dependant and she earns less than $250 a year and each claims the optional standard deduction of $100 in lieu of medical expenses and charitable donations, it can be seen from the table that A and C have a federal tax liability of $4,646 while B's liability is $3,424. The federal tax liability of A and C is $1,222 or 35.7% greater than B's.

There must be something defective about a tax rule that results in such a capricious allocation of tax burden among three persons who are in substantially identical situations. They possess the same assets and B and C have an identical liability, a bank loan of $40,000 at 9% interest, while A has a mortgage of $40,000 at 9% interest. Each of A, B and C has a net worth of $50,000. In order to have a $50,000 house and $40,000 in securities, it is necessary to have an indebtedness of $40,000 whether it is in the form of a bank loan or a $40,000 mortgage. The mortgage just as much as the bank loan is required to finance the total asset holding, including the $40,000 in securities. It is arbitrary to assign a particular debt to a particular asset simply because the funds from the debt can be traced into the asset.

An apologist for the existing interest rule, that permits deduction only if the funds can be traced into an income-earning asset, might simply say that A and C should have sought tax advice before arranging the funds for the pur-

[12] By virtue of section 8, A, B and C would undoubtedly have other deductions such as Canada or Quebec Pension Plan contributions, registered pension plan contributions and unemployment insurance premiums. To simplify a comparison of their tax situations, these deductions have not been considered. As these deductions would be equally available to each of A, B and C, it does not alter the differential effect produced by the interest deduction. I have also used the term "net income". It is not used in the Income Tax Act, but it is a convenient term to apply to gross income minus the deductions permitted in the earning of gross income.

[13] S. 82(1). The mechanics of the new dividend tax credit are explained in Interpretation Bulletin IT-67 (13/9/72).

chase of the house.[14] Alternatively, he might say that there is no need for A and C to pay more tax than B and might recommend a course of action which would enable A and C to deduct interest with the result that their tax liability will be the same as B's. C could sell his $40,000 in securities and pay off the bank loan on which interest is not deductible because it is tainted through the use of the funds to purchase the house. C could then borrow the $40,000 back and repurchase $40,000 in securities, and the interest on the bank loan miraculously becomes deductible.[14a] Similarly, A could sell his $40,000 in securities, pay off the $40,000 mortgage and then borrow $40,000 from his bank to purchase $40,000 in securities which might be pledged to the bank as collateral. A would be in the same situation as B and the interest would be deductible. However, after selling the $40,000 in securities and paying off the mortgage A might simply mortgage the house back to the same mortgagee and take the $40,000 and purchase securities. The interest on the mortgage would be deductible because the borrowed money has been used to earn income. It is sometimes said that mortgage interest on a home is not deductible. This is an incorrect generalization. If the proceeds of the mortgage are used to earn income, the security for the loan is irrelevant.[15]

One must readily concede that through judicious channelling of funds in the first place A and C could have avoided a tax liability greater than B's. One must also concede that through judicious rechannelling of funds the initially greater tax burden which A and C assumed relative to B can be rectified. However, a tax rule that places a high premium on form and therefore on tax planning is inferior to a rule that achieves the same or a very similar result without the need for tax planning. This proposition is greatly fortified by the facts that awareness of tax planning is concentrated among those with higher incomes and the availability of expert tax advice is largely confined to such persons. However, the proposition would be true even if knowledge of planning techniques were equally disseminated. The tax system should as a general rule be as neutral as possible as between different modes of achieving substantially identical results. It would be difficult to contend that the tax system should endeavour to encourage the use of funds from particular loans for particular purposes. The rule about interest deductibility is designed simply to limit the deduction to situations in which it is considered to be warranted. It is my contention that it fails to achieve this desired end in regard to borrowing

[14] The apologist for the present interest deductibility rule which accords differing tax treatment to persons in virtually identical situations might simply parrot Lord Green M.R. who stated, "It frequently happens in Income Tax cases that the same result, in a business sense, can be secured by two different legal transactions, one of which may attract tax and the other not. There is no justification for saying that a taxpayer who has adopted the method which attracts tax is to be treated as though he had chosen the method which does not, or vice versa." *Henriksen v. Grafton Hotel Ltd.* (1942) 2 K.B. 184 at 193; 24 T.C. 453 at 460. This is a proper and necessary attitude for a judge who is charged with construing the existing tax legislation. It is not a justification anyone else can invoke. Where two differing modes of attaining an identical result elicit differing tax treatment, it represents a failure of our tax legislation. An ideal tax would mete out differing tax treatment only if there were a relevant economic difference between taxpayers. The ideal tax will never be attained but we cannot be satisfied when we fall so far short of the target as we do with the interest deductibility rule.

[14a] It would perhaps be advisable not to repurchase the same class of securities of the same companies because section 245 might be invoked on the basis that the transaction was such that it would "unduly or artificially reduce the income". This might apply equally to B in the example. However, because section 20(1)(c) specifically permits the interest to be deducted, I would doubt the applicability of section 245 to the examples given. It would be applicable were B to sell shares to someone on condition that the person should resell to B at a subsequent time.

[15] In *Auld v. M.N.R.* 62 DTC 27 at 29; 28 Tax A.B.C. 236 at 240, Mr. Boland stated, "The security given for a loan is never relevant in considering the application of section 11(1)(c) [the predecessor of s. 20(1)(c)]."

to obtain property income and, in addition, fails to treat taxpayers fairly.

In our example, A, B and C should pay the same tax without having to engage in financial manipulation. The debt of $40,000, whether in the nature of a bank loan or a mortgage, is necessary to finance the holding of a $50,000 house and $40,000 in securities, as each of A, B and C has a net worth of $50,000. It is unacceptably arbitrary to stipulate that interest may only be deductible if the proceeds of the borrowing may be traced into income-earning assets. A realistic assessment is that the total asset holding of each A, B and C is only possible through the indebtedness of $40,000. The nature of the collateral is irrelevant, and the fact that the proceeds of a loan can be traced into a particular asset should also be irrelevant, because such a flow can be easily contrived in order to obtain the interest deduction. A new interest deductibility rule is required in regard to property income. The existing interest deductibility rule may be appropriate where funds are borrowed for use in a business, but it is not adequate when used to determine net property income. Any attempt to match particular debts to particular assets will only promote financial manipulation by property owners, with the greatest gain accruing to the property owner who is most skilful in matching all his debts with assets that produce taxable income and matching his net worth with assets that do not produce taxable income.[16]

[16] Canadian taxation statistics are not compiled in a way that would enable a comparison to be made of the total interest deduction by income classes because rental income is reported on a net basis. It is also not possible to determine the interest deduction from investment income excluding rental property because the interest deduction is lumped together with other carrying charges. However, it seems probable that interest paid on money borrowed to earn investment income is the major component of the item entitled "deductions from investment income". The following table is interesting in that it reveals that although taxpayers with incomes of $25,000 and over claimed 54% of the deductions from investment income, they received only 22% of total investment income, and of the largest single component received by the $25,000-and-over income class, gross dividends, they received only 39% of the total gross dividends reported on all taxable returns. One explanation of this disparity is simply that higher-income persons have greater access to and make greater use of borrowed funds. Another explanation is that higher-income persons are more skilful in arranging their affairs and therefore obtain greater advantage from the interest deduction. It seems probable that the significantly greater percentage of total deductions from investment income taken by higher-income persons as compared to their percentage of total investment income stems from both these factors. However, their relative significance cannot be assessed.

	Amounts reported on taxable returns of $25,000 and over	Amounts reported on taxable returns of $25,000 and over as a percentage of amounts reported on all taxable returns	Amounts reported on all taxable returns
	($000)	(%)	($000)
Deduction from Investment income	40, 876	54	76,053
Gross dividends	273,305	39	699,726
Bond interest	57,804	15	389,153
Bank interest	135,574	12	1,110,794
Estate income	50,952	30	167,685
Mortgage interest	49,268	16	299,159
Other Canadian investment income	35,332	39	89,950
Foreign investment income	31,335	51	61,546
Total investment income	633,570	22	2,818,013

Source: *Taxation Statistics 1972* (Dept. of National Revenue, 1972) (for the taxation year 1970), Table 2 at p. 39.

Possible Interest Deductibility Rules

I shall now attempt to formulate interest deductibility rules that would treat A, B and C equally for tax purposes. However, such rules must be assessed from a wider perspective. Rules that treat A, B and C equally will only be acceptable if they also achieve a distribution of the tax burden among all taxpayers that is regarded as fair. Thus, in formulating an interest deductibility rule, one must be cognizant of the fact that of the approximately 8 million income taxpayers in Canada 6.5 million receive wage and salary income as their chief source of income. They also receive some investment but this constitutes only slightly more than 2% of the amount of their wage and salary income. Only about 350,000 or 4.4% of taxpayers had a chief source of income from investments.[17] This is a relevant consideration because wages and salaries are taxed on a basis that permits very few deductions. Therefore, to promote fair treatment between the great majority of taxpayers and investors, it is important to guard against formulating tax rules that would tend to underestimate net investment income. This underestimation will occur if the interest deductibility rule is unduly generous. Also, an overly generous interest deductibility rule will not accord fair treatment between those investors who utilize borrowed funds and those who do not.

There are six rules that would accord equal tax treatment to A, B and C. These will be considered in order of diminishing liberality to A, B and C. If two rules are equally liberal to them, the one that is more liberal to taxpayers making interest payments will be considered first. In order to simplify the analysis, it will initially be assumed that there are only two types of assets: houses yielding no taxable income and securities yielding fully taxable income. The problem of capital gains will be deferred to the latter part of this paper. At that time, the interest deductibility rule selected from the six possible rules will be considered with reference to capital gains in order to determine whether it can cope with the special problems arising out of gains only one-half of which is taxable.

Rule 1—All Interest Payments Are Deductible

The first rule is that all interest payments are deductible in determining net income subject to tax. In our example, A, B and C would each be permitted to deduct the $3,600 they paid in interest. Although according equal treatment to A, B and C, such a rule would enable mortgage interest payments to be deducted without limit. At the present time, the failure to include in taxable income the imputed rent of owner-occupied homes provides a tax subsidy to home-owners.[18] It is an absurdly structured tax subsidy, with the greatest benefit accruing to the highest bracket taxpayers possessing the most expensive homes in which they have the greatest

[17] *Taxation Statistics 1972* (Dept. of National Revenue, 1972) (for the taxation year 1970), Table 3, pp. 42-50.

[18] The Carter Report acknowledged that, "To ensure that all taxpayers bore their fair proportion of the total tax burden, it would be necessary to impute rental income . . . " (Vol. 3, p. 48). The British Royal Commission on The Taxation of Profits and Income considered the imputed rent of owner-occupied houses to be income. The Report states "His right of occupation could be made to produce a money income if he let or sub-let the property: he chooses, however, to enjoy the occupation himself and . . . by his own choice he shows that the enjoyment yields him an income in kind of a value equivalent to the rent foregone. . . . There can be taxable income which is not received in cash. Living accommodation is a necessity of life and the taxpayer who does not own it is obliged to rent it: consequently an owner-occupier with a given income, paying no rent, has a larger taxable capacity than a tenant with the same income out of which he must meet liability for rent." (*Final Report*, Cmd. 9474, 1955, pp. 249-50.) See also Richard Goode, "Imputed Rent of Owner-Occupied Dwellings under the Income Tax", *Journal of Finance*, Vol. 15 (1960), p. 504: "The Commission might have added that the homeowner has the alternative of investing his capital in other assets, and the choice of a house shows that he considers the return from it superior to the yield of other income-producing investments."

equity.[19] If all interest, including mortgage interest, were deductible, greater tax subsidies would be granted to homeowners. However, this would redress the inequity of the existing home-ownership subsidy as between an individual who owns his home outright and the person who owns an identical home but has very little equity in it because the mortgage or other indebtedness approaches the total value of the house.[20] On the other hand, it would exacerbate the existing tax discrimination against the tenant. Although recognizing that making all interest deductible would promote greater equity as between persons with varying equities in their homes, this rule should be rejected because it increases the tax discrimination against the tenant and because it suffers from a major defect. A mortgage interest deduction will always provide the greater tax subsidy to the person with the higher income. Assuming that a high priority is placed upon encouraging home-ownership, it should be possible to devise a sensible system of encouraging home-ownership directed toward persons who really do need assistance.[21]

The ideal solution to this problem would be to include the imputed rent of owner-occupied homes in income and then to permit mortgage interest to be deducted from the imputed rent. The Carter Report rejected this approach, but the rejection was based on the conviction that the determination of imputed rent would impose insuperable administrative problems.[22] The administrative problem has been considerably

[19] Harry Kitchen in "Imputed Rent on Owner-Occupied Dwellings", *Canadian Tax Journal*, XV, 5 (1967), p. 482 at 484, states, "the non-taxation of imputed rent is an important subsidy which is provided to encourage home ownership. However, if this is the case it appears to be an inefficient subsidy. First, it is designed to help the home owners with high incomes and high marginal tax rates more than people in the lower income strata." See also Henry Aaron, "Income Taxes and Housing" *The American Economic Review*, Vol. 60, 5 (1970), p. 789 at 803.

It should also be noted that the tax subsidy for owner-occupied homes has been increased in relative terms. While all other investments are subject to capital gains taxation, investment in one's principal residence together with up to one acre of land is not. The White Paper proposed that gains on a principal residence should be exempt up to $1,000 per year of occupation. If the average cost of a house is $20,000 and the average increase in the market value of a house is 5% per year of the original cost, the taxpayer with the average-cost house (or less) would not be subject to the tax. However, taxpayers who owned a house of greater value than the average would have been subject to some capital gains taxation. It is to be regretted that there is no limitation upon the tax subsidy in regard to capital gains on a principal residence. The limitation proposed by the White Paper may not have been sufficiently generous to exempt the average homeowner in view of inflationary trends, but some limitation is clearly warranted to prevent the greatest tax subsidy accruing to the highest-bracket taxpayers owning the most expensive homes. The Carter Report advocated a lifetime exemption of $25,000 for gains derived from the sale of a principal residence. The Report of the Senate's Banking, Trade and Commerce Committee on the White Paper recognized the need for some limitation but proposed a lifetime exemption of $50,000. See Horst G. Wolff, "The White Paper: Tax Treatment of Principal Residences", *Canadian Tax Journal*, XVIII, 4 (1970), p. 263.

[20] See Carl S. Shoup, *Public Finance* (1969) at pp. 45-7.

[21] The persons who need assistance most are those who are not able to obtain the required down payment on a house. Perhaps Central Mortgage and Housing Corporation should be authorized by the government to loan up to the full purchase price of a home. As it is often during the first few years that mortgage payments are most difficult to meet, CMHC might be authorized to forgo the interest on, for example, the first $5,000 of the amount of the mortgage for three years to a person purchasing his first home. Assuming a rate of interest of 10%, the cost of forgoing interest on $5,000 for three years would be $1,500. To diminish the cost of such a program and to restrict it to persons who need assistance, the amount of the interest-free loan might be scaled down as income rises. The amount of interest forgone might even be made recoverable when the house is sold. It would be a once-in-a-lifetime grant, available to persons who need assistance, whereas the present tax subsidy is an annual subsidy of considerable magnitude accruing in the largest measure to those who need it least.

[22] Carter Report, Vol. 3, p. 49. However, Harvey E. Brazer in "Review of the Report", *Canadian Tax Journal*, XV, 3 (1967), p. 273 at 283 concludes that the Carter Report overemphasized the problems involved, the Commission being influenced by unsatisfactory experience of the U.K. prior to 1962 when the taxation of imputed rent was abandoned. Brazer regards this as irrelevant because "it may fairly be said that the British tax authorities, at least in recent years, never tried to enforce the provisions of their income tax law relating to imputed rental income".

diminished since 1966. Ontario and New Brunswick have moved towards a provincewide uniformity of real property assessments and in all provinces there have been substantial improvements in the technique of real property assessment.[23] It should be possible in the relatively near future to move toward nationwide uniformity of real property assessment from which the imputed rent of owner-occupied homes could be derived. Until such time as imputed rent is included in income, it would, I believe, be a retrograde move to permit mortgage interest to be deductible without limit.[24] Rule 1, which would permit all interest payments to be deducted, should be rejected.

Rule 2—Interest Payments Are Deductible to the Extent that the Value of the Income-Yielding Assets Is as Great as the Amount of the Debt

The second rule is that all interest payments should be deductible provided that the amount of the debt does not exceed the value of the income-yielding assets and, if the debt is greater, the proportion of interest payments deductible should be equal to the ratio that the value of the income-yielding assets bears to the amount of the debt. In our example, A, B and C each owe a debt of $40,000 and as this does not exceed the value of the income-yielding assets, which is also $40,000, this rule would permit each to deduct the full interest payment of $3,600.[25] This rule simply matches the debt obligation with the income-yielding assets up to the value of those assets. The rule eliminates the need to trace the borrowed money into the income-yielding assets in order to obtain the interest deduction. It suffers from an administrative disadvantage in that it involves valuation problems, restricted to income-yielding assets. The rule provides very favourable treatment to investors who borrow money by assuming that debt is matched with income-earning assets and that net worth is matched with non-income-earning assets, to the extent that this is possible. This liberal interest deduction rule would tend to underestimate the true income of many investors relative to taxpayers whose source of income is wages and salary and who are permitted exceedingly few deductions. This rule should therefore be rejected because it accords a differentially favourable tax treatment to some investors as compared with the great majority of taxpayers.

Rule 3—Interest Payments Deductible up to the Net Income from Property

The third possible rule is that interest payments are deductible up to the net income from the assets held. In our example, A, B and C each held $40,000 in common stocks with an assumed dividend yield of 4.5%. They will each receive $1,800 in dividends, but they must also include in income the new dividend tax credit of 33⅓% and thus

[23] Frederic H. Finnis, *Property Assessment in Canada* (Canadian Tax Foundation, Tax Paper No. 50, 1970).

[24] The status quo cannot, however, be defended. We must either include imputed rent of owner-occupied homes in income with a deduction for mortgage interest, or we must make mortgage interest deductible in order to achieve fair treatment between persons with differing equities in their home. If the latter course is followed, it would be necessary to correct the tax discrimination against the tenant by permitting him to deduct a portion of his rent. The Carter Report argued that the inequity resulting from a failure to impute rental income to owner-occupiers is less in Canada than in the United States where mortgage interest is deductible (Vol. 3, p. 49). This neglects the problem that the non-deductibility of mortgage interest in Canada, while equitable as between owners and renters, is inequitable as between the owner with a clear title and the owner with a mortgage. See John G. Head, "Henry Simons Regained", *Finanzarchiv*, N.F. Bd. 29 (1970), p. 198 at 205 and footnote 4.

[25] If A, B and C had the same net worth of $50,000 but possessed a $60,000 house, $30,000 in securities and $40,000 in debt on which the interest was 9%, the interest deductible, according to rule 2, would be $\frac{30{,}000}{40{,}000} \times 3{,}600 = \$2{,}700$.

$2,400 of income is derived from the securities. Rule 3 would permit each of A, B and C to deduct $2,400 of the $3,600 of interest which they paid. It is perhaps overly generous because, like rule 2, it implicitly first matches the debt obligation with the income-producing assets, but it does limit the interest deduction to the net income from the assets held. The rule tends to be generous to taxpayers possessing high income-yielding assets.[26] This rule does avoid valuation problems.

Rule 4—Interest Payments Deductible in the Ratio of Income-Yielding Assets to Total Assets

A fourth possible rule is that interest payments are deductible in the ratio that the value of the income-yielding assets bears to the total assets. In our example, A, B and C have $40,000 in income-yielding assets and total assets of $90,000. This rule would permit A, B and C each to deduct $1,600 in interest payments $(\frac{40,000}{90,000} \times 3,600)$. This rule in effect allocates debt and net worth on a proportional basis to both the income-yielding assets and the non-income-producing assets. This rule seems to provide a very reasonable allocation of that part of the interest payments which should be regarded as deductible. However it gives rise to more difficult valuation problems than rule 2 does. Rule 2 required a valuation of income-yielding assets; rule 4 requires a valuation of all assets. Rule 4 involves cumbersome administrative problems.[27]

Rule 5—Interest Payments Deductible to the Extent that the Amount of the Debt Exceeds the Value of Non-Income-Producing Assets

A fifth possible rule is that interest is only deductible if the amount of the debt exceeds the value of the non-income-producing assets and the interest payment is deductible in the ratio that the excess of the debt over the value of such assets bears to the amount of the debt. In our example, rule 5 would not permit A, B and C to deduct any interest because the amount of the debt is $40,000 and this does not exceed $50,000, the value of the non-income-producing asset, the house.[28] Rule 5 is the converse of rule 2: rule 5 allocates the debt to the assets in a way most favourable to the Revenue, while rule 2 matches debts and assets in the way most favourable to the taxpayer who makes interest payments. Rule 4 is intermediate in that it makes a proportional allocation of the debt among the assets. Rule 2 was rejected because it was unduly generous to an investor who makes interest payments and therefore would tend to underestimate his net

[26] D. A. Dixon, *op. cit* (n. 3), at p. 174 states "If tax-payers receive a taxable yield on their assets greater than the rate of interest, this will increase the amount of debt which will be eligible for interest payments deductions above that which is necessary to permit the continued holding of assets yielding taxable income".

[27] It should, however, be noted that the Department does, at times, adopt an analogous approach. In *Lakeview Gardens Corporation v. M.N.R.* 71 DTC 281, [1971] Tax A.B.C. 394 the taxpayer was not able to establish that the shares of a subsidiary corporation had been purchased out of the earnings of the company rather than with borrowed funds. The Department disallowed a proportion of the interest payment. The portion disallowed was the ratio of the shares yielding exempt income to all assets of the company, computed on a cost basis. The technique produces the same result as permitting interest to be deducted in the ratio that the value of assets yielding taxable income bears to the value of total assets, computed on a cost basis. However, the issue before the Board was whether the company was entitled to a full deduction of the interest expense and not the allocation technique adopted by the Department. The technique is presumably authorized by the concluding words of s. 20(1)(c) "or a reasonable amount in respect thereof, whichever is the lesser".

[28] If A, B and C had the same net worth of $50,000 but possessed $60,000 in securities and a $30,000 house and had an indebtness of $40,000 at 9%, the interest deductible would be

$$\frac{40,000 - 30,000}{40,000} \times 3,600 = \$900.$$

income. Rule 5 must be rejected because it treats the investor who makes interest payments in too niggardly a fashion and would tend to overestimate his net income.

Rule 6—No Interest Payments Are Deductible

The sixth rule would not permit the deduction of any interest payments in the calculation of net income for tax purpose. This rule would treat A, B and C equally by prohibiting each of them from deducting the $3,600 they pay in interest. This is the polar extreme of rule 1, which would permit the deduction of all interest payments, and it is stated merely to complete the spectrum of possible interest deductibility rules. It must be rejected as unreasonably harsh. If a person pays interest on a debt and holds only income-earning assets, he is obviously entitled to deduct some interest in determining his net income.

The Proposed Interest Deductibility Rule

All six interest deductibility rules accord equal treatment to A, B and C. Having regard only to A, B and C, any of the six rules are preferable to the present interest deductibility rule which permits only B to deduct the $3,600 he pays in interest. All six rules are based on the realistic premise that an individual's asset holding regarded in its totality is dependent on his indebtedness and his net worth. All six rules eliminate the need to trace borrowed money into income-earning assets in order that interest may be deducted. In so doing, they nullify the premium that the existing interest deductibility rule places on financial manipulation. Of the six rules, only rules 3 and 4 would appear to hold an even hand between investors who use borrowed funds and the great majority of taxpayers who have wage or salary incomes. Rules 1 and 2 are too favourable to the investor who uses borrowed funds and rules 5 and 6 are too unfavourable to him. Rule 4, which makes interest payments deductible in the ratio that the income-yielding assets bear to the total assets, would be eminently fair, but it involves valuation difficulties. One must therefore settle for rule 3, that interest is deductible up to the net income from the assets held.

This is a rule that can and should apply to all types of interest payments. No distinction should be made as between interest paid on a loan to purchase consumer durables, on a residential mortgage, on a student's loan to pay tuition fees or on a loan to purchase income-earning assets. However, the interest deduction is limited to the net amount of income from his assets. Previously, we considered only two types of assets, income-producing assets and an owner-occupied home. Let us now consider a person who decides that he requires a home freezer. Let us assume that he holds securities equal in value to the cost of the home freezer. If he wishes to continue to hold the securities, the interest on the additional debt necessary to finance his larger asset holding would only be currently deductible provided he sold the securities and bought the home freezer and subsequently borrowed the same amount and repurchased the securities. However, according to the rule proposed in this paper, all interest is deductible up to the net income from the assets. There would be no need to engage in any wasteful financial manœuvres simply for tax reasons.

The proposed rule for interest deductibility would not result in any significant decrease in the tax base through a large increase in the amount of interest that

[29] Richard Goode, *op. cit.* (n. 3), at p. 161, states: "If individuals had been allowed to deduct interest payments only up to the amount of their taxable income from property, seven-tenths or more of the deductions actually taken in 1960 would have been ruled out." It must be noted that Goode is speaking about the United States where the general rule is "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness". (s. 163 I.R.C.)

would be deducted.[29] Many persons who pay substantial amounts of mortgage interest and interest on loans to purchase consumer durables do not have income and would obtain no benefit from the proposed rule. Some have small amounts of bank interest, and interest on Canada Savings Bonds and other securities, and if they also make interest payments, they will derive some benefit from the proposed rule by being allowed to deduct interest up to the amount of their investment income. There will be other persons, such as B in our example, whose interest deduction will decline from $3,600 to $2,400 under the proposed rule.

The proposed rule will assuage some taxpayers who have been greatly annoyed by the present interest deductibility rule. *Dubois v. M.N.R.*[30] involved a taxpayer who had had his home expropriated. There was a delay in the payment of compensation. As a result, Mr. Dubois had to borrow money to build a new home. When he did receive the compensation, he also received interest for the period during which the compensation payment had been delayed. Mr. Dubois sought to deduct the interest he paid on the money borrowed in connection with his new house from the interest he received on the delayed compensation payment. He was told that the interest was not deductible because it was not used for the purpose of earning income. It is easy to appreciate that Mr. Dubois would be exasperated by first having his house expropriated and then having this compounded by a tax blow. The Tax Appeal Board member stated that "The appellant, in his argument had harsh words for the unjust treatment he allegedly received at the hands of the officers responsible for applying the Act."[31] Mr. Dubois's anger was misdirected: it should have been directed at Parliament, for enacting a faulty interest deductibility rule. The proposed rule would permit Mr. Dubois to deduct any interest he paid up to the amount of interest he received on the delayed compensation payment and any other property income he might have. The proposed interest rule will also accord fair treatment to those persons who sell one home and take back a mortgage on some other security from the purchaser and then pay interest on indebtedness related to the acquisition of a new house. In *Hopkins v. M.N.R.*,[32] *Pellman v. M.N.R.*[33] and *Davis v. M.N.R.*[34] taxpayers have unsuccessfully sought to set off interest paid on the indebtedness incurred in acquiring a new home from interest received from the purchaser of their former home on a mortgage or other security which they received from him. By not permitting a deduction for interest paid in such circumstances, the existing interest deductibility rule often results in a totally artificial increase in income subject to tax. The proposed rule would only result in an increase in income if the interest payments they received were greater than the interest payments they made.

A Possible Modification of the Proposed Rule

The proposed rule would probably be criticized for being insufficiently generous in some circumstances. For example, a person might borrow money to purchase an asset even though the rate of interest he had to pay was more than the current rate of return on the asset, in the expectation that the rate of return would soon rise above the rate of interest. If he had no other source of investment income, his net investment income will be negative. However, our proposed interest deductibility rule

30 66 DTC 512; 41 Tax A.B.C. 351.
31 *Ibid.* at 514 and 359 respectively.
32 62 DTC 579; 30 Tax A.B.C. 269.
33 64 DTC 19; 34 Tax A.B.C. 194.
34 71 DTC 242; [1971] Tax A.B.C. 314.

would limit the interest that could be deducted to the amount of his investment income. The effect of this rule is to prevent a taxpayer from claiming for tax purposes that he has a negative source of income from investments caused by the interest deduction. This suggestion is not without precedent. From 1923 until 1952, income was deemed to be not less than the income from the taxpayer's chief source of income.[35] If a person had only two sources of income, for instance, salary income and investment income, up until 1952, his interest deduction would have been limited to his investment income. However, if he had more than two sources of income, he could deduct his negative source of investment income from another source of income provided that it was not his chief source of income.

It may be thought that there should be a carry-forward of interest that cannot be currently deducted because of the proposed interest rule. However, if there is to be a carry-forward of currently non-deductible interest, it appears that one is compelled to return to the technique of tracing the borrowed money into the particular asset. The currently non-deductible interest would have to be allocated to the particular assets and carried forward against subsequent income from these assets that exceeds the interest paid on the money borrowed to obtain the asset and other costs deductible from the income of the asset. The tracing-of-funds technique of matching liabilities and assets is to be denigrated, but if a carry-forward of currently non-deductible interest is to be permitted, there appears to be no other alternative. In some cases, tracing will not be necessary because investment income will be greater than interest payments. In many cases, where interest payments on funds borrowed to obtain consumer durables and homes exceed investment income, a carry-forward of currently non-deductible interest would be nugatory because the assets do not produce income that is subject to tax.

In order to illustrate the carry-forward of currently non-deductible interest, let us consider A, B and C once again. Each pays $3,600 in interest, but because his investment income is only $2,400 ($1,800 plus the new dividend tax credit of 33⅓%), each may only deduct $2,400 in interest payments under the proposed rule. As the interest carry-forward requires a tracing of the borrowed funds into the income-producing asset, only B will be able to carry the $1,200 of currently non-deductible interest forward — which is not consistent with the criterion I stated above, that my proposed rules would treat A, B and C equally for tax purposes. This equality of treatment will not be achieved if a carry-forward of currently non-deductible interest is permitted. However, B will never benefit from the interest carry-forward as long as his current interest payment exceeds his investment income. Permitting a carry-forward means only that there is a potentiality for unequal tax treatment between A, B and C. The carry-forward of currently non-deductible interest does place some premium on financial manipulation, but not the very large premium placed on it by the present interest deductibility rule.

The proposed rule to limit interest deductions to investment income would totally eliminate the need to trace borrowed funds into income-yielding assets. However, if a carry-forward of currently non-deductible interest payments is considered necessary, one must return to the technique of tracing borrowed money into particular income-producing assets. Fortunately, this need for tracing will arise only in some cases rather than in

[35] S.C. 1923, c. 52, s. 1. This became s. 13(1) of the Income Tax Act, S.C. 1948, c. 52 and stated "The income of a person for a taxation year shall be deemed to be not less than his income for the year from his chief source of income." This was changed by S.C. 1952, c. 29, s. 4.

all cases as under the present rule, and the advantage to be derived from financial manipulation will be much diminished. The adoption of the proposed rule, even if it is considered necessary to have a carry-forward of currently non-deductible interest payments, would represent a significant improvement in the tax treatment of interest payments.

The Problem Imposed by the Inclusion of Only One-Half of Capital Gains in Income

The interest deductibility rule has so far been assessed on the basis that assets yield either fully taxable income or no income. However, there is the additional complication that only one-half of capital gains is included in income. This is made more complex by the fact that some assets—notably common shares—yield substantial but varying amounts of fully taxable income and half-taxable capital gains.

Before considering the proposed interest deductibility rule, I shall attempt to assess the adequacy of the present interest rule. Let us assume that the taxpayer has a marginal rate of tax of 50%, that all his income is initially derived from salary, that he borrows $10,000 at a rate of interest of 10%, and purchases $10,000 of common stock in a company that does not yet pay a dividend. (It is a manufacturing company that has substantial earnings per share and there are good prospects for future dividends, but because funds are required to finance the rapid growth of the company, no dividend is currently being paid.) Let us assume that the shares are purchased on 1 January, that at the end of three years no dividend has yet been paid, and that the taxpayer sells for $15,000 the shares that originally cost $10,000. What are the tax implications of these transactions? The major problem is to determine whether the $1,000 in interest is deductible from his salary income. If the borrowed money has been used for the purpose of earning income, it is deductible according to our present rule.

In *Moore v. M.N.R.*,[36] it was held that the interest on borrowed money used to purchase speculative mining stock that did not pay a dividend was not deductible. However, the fact that the stock does not yield dividend income is not decisive, as indicated by *Haig v. M.N.R.*[37] Mr. Haig, who had no investment income, borrowed extensively to buy shares in a steel company of which he was a key employee and subsequently a director. In the years from 1964 to 1968, he deducted the interest he paid on the funds borrowed to purchase the shares from his salary income. In each of those years the company earned a substantial profit, but it was not until 1970 that a dividend was declared. The Minister added back to Mr. Haig's income the interest deducted in the years 1964 to 1968. However, the Chairman of the Tax Review Board found the interest to be deductible, stating: "There is nothing in the evidence that might indicate that he placed himself in such an indebted position for the purpose of obtaining capital accretion only."[38] He came to this conclusion after first finding that the "appellant's first hope was that the share value would appreciate and increase, and his second was that the company would declare a dividend and he would thus benefit from both aspects".[39] The Chairman of the Tax Review Board did not even find it necessary to consider whether the interest paid bore a reasonable relationship to the amount of dividend income that the shares might reasonably have been

[36] 71 DTC 543; [1971] Tax A.B.C. 817. He held one income-producing stock and the Minister allowed an interest deduction of $247.50 out of a total interest payment of $628.88.

[37] 72 DTC 1465.

[38] *Ibid.* at 1476.

[39] *Ibid.* at 1471.

expected to yield.[40] If the *Haig* case represents the appropriate test for determining the deductibility of interest on funds borrowed to purchase common stock, it would appear that interest will always be deductible provided that the shares are of a company that pays a dividend or might reasonably be expected to pay a dividend. In that case, it would not be possible to say that the shares were purchased solely for capital accretion, even though that may be the primary purpose.

Returning to our example, the $1,000 of interest would be deductible in each of the three years. Although no income was earned, the borrowed money was used at least in part for the purpose of obtaining dividends. The fact that the objective was not realized is, according to the *Haig* case, immaterial. As the taxpayer was assumed to be paying tax at a marginal rate of 50%, his tax liability would be reduced by $1,500, $500 in each of the three years in which he deducts $1,000 in interest payments. From 1952 up to 1972,[41] the taxpayer was in an extremely favourable situation in that he could reduce his tax payable by $1,500 and the $5,000 gain on the sale of the stock was not taxable. However, even if all the transactions were to occur after 1972, the results would still be very favourable. Tax payable is reduced by $1,500 in total, while only one-half of the gain of $5,000 is taxable. If the taxpayer is not pushed into a higher tax bracket by the inclusion of $2,500 in his income, he will pay only $1,250 in tax when he realizes a gain of $5,000. The net result for the Revenue is a loss of $250. Prior to 1972, the net result would have been a loss of $1,500 in tax revenue because nothing would have been recouped when the taxpayer realized the $5,000 gain.

It is difficult to contend that one-half of capital gains is being taxed effectively if interest on funds used in part to produce capital gains may be deducted from fully taxable income. In the example above, in which $10,000 was borrowed for three years at a rate of interest of 10% and the asset appreciated by $5,000, there is a net gain of $2,000: $5,000 minus the $3,000 of interest payments. At a 50% marginal rate a taxpayer should pay $500 on a capital gain of $2,000, because one-half of the gain is included in income. However, when the $1,000 interest payment for each of the three years may be deducted from taxable income, there is a loss of $1,500 in tax revenue, and when one-half of the $5,000 gain is taxed at 50%, the gain in revenue is only $1,250. The Revenue, instead of obtaining $500 in tax, suffers a net loss of $250. Instead of one-half of capital gains being taxed, the present interest deductibility rule may even cause a tax subsidy to be granted to a person who realizes a capital gain with borrowed funds.

The existing interest deductibility rule is definitely defective when borrowed funds are used to purchase an asset such as common stock, which does or may yield both fully taxable dividends and half-taxable capital gains. The proposed interest rule, which would limit the deductible interest to the amount of

[40] *In Fallis v. M.N.R.*, 66 DTC 233, 40 Tax A.B.C. 370, the taxpayer in 1960 borrowed funds at 6 to 7% interest in order to purchase at a substantial premium 5½% convertible income notes of a company which were not convertible until 1964. Mr. Fordham stated (at 235 and 374 respectively) that "the appellant's conduct throughout was inconsistent with his assertion that he bought the notes because of their income feature" and concluded that the interest payments were not deductible because "a capital gain, rather than any income benefit, was what he had in mind". Mr. Flanigan's approach in the *Haig* case does not seem to be reconcilable with the *Fallis* case. They may be distinguished on the basis that in the *Fallis* case it was indisputable that the income from 1960 until the date of conversion in 1964 could not possibly exceed the interest on the borrowed funds while in the *Haig* case it was possible that a large dividend might have been paid and some net income earned. This distinction is very artificial. There was no reasonable prospect that the shares would yield a net return after the deduction of interest. A capital gain rather than an income benefit was what Mr. Haig had in mind just as much as Mr. Fallis.

[41] See footnote 35.

investment income, with a carry-forward of the currently non-deductible interest provided that the borrowed funds could be traced into income-yielding assets, would cope more effectively with such situations. In the example above, in which the taxpayer with no investment income borrowed $10,000 at 10% interest and purchased common stock that yielded no dividend, no interest would be deductible in each of the three years. However, since the borrowed money may be traced into the common stock, the taxpayer would be permitted a carry-forward of currently non-deductible interest. When the securities are sold in three years' time for $15,000, the taxpayer should be permitted to add the total carry-forward of currently non-deductible interest of $3,000 to the cost base of the securities, with the result that he would realize a capital gain of $2,000 of which one-half would be included in income. The proposed rule would produce the appropriate result; the present rule does not. The proposed rule would also cope with the situation in which the taxpayer continued to hold the securities and paid off the loan. If a dividend were received on the stock, the carry-forward of currently non-deductible interest could be applied against the dividend and his tax liability would not be increased until the carry-forward of interest was exhausted. If the securities were sold before the carry-forward of interest was reduced to zero, the balance of the carry-forward should be added to the cost base of the securities. In that way, the appropriate amount of capital gain will be taxed.

The present interest deductibility rule may result in a failure to tax one-half of capital gains effectively. In addition, it may result in effectively taxing more than one-half of some capital gains. Although one-half of capital gains is included in income by virtue of section 3, the murky distinction between income and capital gains is definitely maintained by the new Act. Therefore it is reasonable to argue that when section 20(1)(c) refers to borrowed money used for the purpose of earning income, the term "income" is being employed in its traditional sense and does not refer to the one-half of capital gains which is simply included in income by section 3. If this is the case, let us again consider the taxpayer who borrows $10,000 at 10% but this time he purchases speculative mining shares of a company that not only does not pay a dividend but does not yet have any net earnings. Let us assume that he buys them on 1 January for $10,000, holds them for three years, during which time no dividend is paid, and sells them for $15,000. If the word "income" in section 20(1)(c) is construed in the way I have suggested, the case of *Moore v. M.N.R.*[42] would still be relevant. The interest payments would not be deductible because the money was borrowed to obtain capital accretion rather than ordinary income. Half the amount of $5,000 would be taxable, even though the gain is only $2,000, because $3,000 has been paid in interest which is not deductible from income and there is no authorization to add the $3,000 to the cost base of the asset.

The proposed interest deductibility rule with a carry-forward of currently non-deductible interest would produce the appropriate result. If the taxpayer has no investment income, the interest payments would not be currently deductible. However, since the borrowed funds may be traced into the speculative mining stock, there will be a carry-forward of currently non-deductible interest. If no dividend is received before the stock is sold, the interest carry-forward of $3,000 would be added to the cost base. The total gain is $2,000, and one-half would be included in income. The proposed interest deductibility rule with the carry-forward of currently non-deductible interest would be much more effective in taxing one-half of capital gains.[43] The present inter-

42 71 DTC 543; [1971] Tax A.B.C. 817.

est deductibility rule may result in under- or over-taxation of capital gains in a very capricious manner.

Conclusion

It is proposed that interest payments of any kind whatsoever should be deductible up to the net income from property. This would eliminate the need for taxpayers to arrange that borrowed funds should be traceable into income-earning assets and thus eliminate the need for much financial manipulation. In *De Zwirek v. M.N.R.*[44] the taxpayer, obliged to honour her guarantee of a loan, was confronted with the alternative of selling her apartment building or obtaining a loan. She obtained a loan and argued that the interest should be deductible because obtaining the loan enabled her to avoid selling her apartment building. The Tax Appeal Board found that the interest was not used directly for the purpose of earning income. However, if Mrs. De Zwirek's response was that "The Law is a ass", many persons, in this instance, would probably concur. If Mrs. De Zwirek had sold her apartment, used the part of the proceeds to satisfy her guarantee and then repurchased the apartment building, financing it in part with increased borrowing, all the interest on borrowed funds would be deductible. This sort of wasteful and costly financial manipulation is encouraged by our present interest deductibility rule. The proposed interest rule would permit Mrs. De Zwirek to deduct the interest she paid up to the amount of the net income from her apartment building. The proposed rule is grounded on the realistic premise that all debts contribute to the asset holding in its totality and therefore the net return from assets may only be determined after deducting the interest paid on all debts.[45]

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[43] If the taxpayer has investment income, the exact capital gains taxation treatment previously outlined will not be attained by the proposed rule. The person with some net worth and high-yield income-producing assets will be in an advantageous position in that he will be able to deduct the full amount of interest on funds borrowed, up to his net property income, even if his sole aim is to obtain a capital gain. He will obtain a full deduction for interest paid, but when he sells the appreciated asset only one-half the gain will be taxable. However, it has been emphasized that it is arbitrary to pair a debt and an asset in this way. The interest payment should be associated with his total asset holding. A person with little net worth will be able to deduct the full amount of interest payments only if his holding of assets is directed towards both income and capital appreciation. If it is primarily aimed at capital appreciation, little of the interest payments will be currently deductible and most will have to be carried forward. The proposed rule is far superior to the present rule, but the only fully satisfactory solution to the problem is to tax capital gains in the same way as any other gain.

[44] 69 DTC 140; [1969] Tax A.B.C. 121.

[45] There are a great many other cases in which the proposed interest deductibility rules would make for more sense than the existing rule. In *No. 185 v. M.N.R.*, 54 DTC 395; 11 Tax A.B.C. 173, the argument on behalf of the estate being taxed was that the interest on money borrowed to pay the old Dominion succession duty should be deducted from the income of the estate because, if the estate had not borrowed, some of the income-producing assets would have had to be sold and income of the estate would have been correspondingly less. Mr. Fabio Monet stated (at 400 and 181 respectively): "There must be a direct relationship of cause and effect between the borrowing of money and the earning of income. In other words, in order to qualify under the section, the borrowed money must enter into the income-earning process of the property; it must be put to work to earn income. In the present case, the borrowing was merely used to pay succession duties . . . as an indirect result, the loan might have allowed the appellant to retain certain income-producing assets which he would have had to dispose of otherwise: this is only an indirect result of the loan and this result, in addition, has nothing to do with the income-earning power of these assets." Section 11(1)(c) (now section 20(1)(c)) requires this direct tracing technique. It must, however, be acknowledged that it is a patently artificial approach. The argument made in this case is so reasonable that its rejection should cause us to reject the present interest deductibility rule. The proposed rule would permit a deduction of the interest paid. A similar argument was made and was rejected in the following cases: *No. 228 v. M.N.R.*, 55 DTC 39, 12 Tax A.B.C. 83; *No. 253 v. M.N.R.*, 55 DTC 217, 12 Tax A.B.C. 369; *Cutten v. M.N.R.*, 56 DTC 454, 16 Tax A.B.C. 1; and *Shields v. M.N.R.* 68 DTC 668, [1968] Tax A.B.C. 909. In each of these cases a more reasonable result would have been reached if the proposed rule had been applied. An analogous argument was made in *Carswell v. M.N.R.*, 51 DTC 414, 5 Tax A.B.C. 194. In this case, money was borrowed to purchase a house to be used as the owner's residence. It was argued that because the borrowing saved her from selling income-producing securities, the interest should be deductible. Our proposed rule would permit the interest to be deductible up to the net income from the securities. The present interest deductibility rule provides a tax incentive for Mrs. Carswell to dispose of her securities and pay off the loan. But there is no reason for the tax system to encourage the sale of her securities.

If the interest deductibility rule were simply that interest may be deducted up to the net income from all assets, the matching of indebtedness with particular income-earning assets could be totally avoided. The rule would mean that a taxpayer would be prevented from having a negative source of income from property through the interest deduction. This might be regarded as too stringent a rule. For instance, a person with no other property income might borrow funds to purchase income-producing property which currently does not yield as much income as the amount of interest paid but which is expected to yield greater income in the future. It would seem that a carry-forward of currently non-deductible interest might be permitted if the borrowed funds can be traced into particular assets. The interest carry-forward could be used to offset net income from the asset in subsequent years. If the asset is sold, the balance of the interest carry-forward could be added to the cost base of the asset in order to determine the appropriate amount of capital gain.

The inadequacy of the present interest deductibility rule has been recognized in regard to one particular asset, land. Section 18(2) prevents the deduction of interest on borrowed money used to acquire land and also property taxes except to the extent that the income earned by the property exceeds the aggregate of all other amounts deducted in computing income from the land.[46] Rules formulated to apply to one particular asset should be avoided unless the problem is actually confined to that particular asset and unless it is impossible to formulate a general rule that will cope with all assets effectively. The purpose of section 18(2) is to prevent interest in excess of the net income from land being deducted from fully taxable income while, when the land is sold, only half the gain is included in income. The interest and property taxes which cannot be deducted is by virtue of section 53(1)(h) added to the cost base of the land. This appears to be unduly harsh. If the land does subsequently produce net income, it would seem that the interest that has not been deducted should first be available as an offset against such income. Only if the land never produces sufficient net income should the non-deductible interest be added to the cost base.

A problem admittedly exists in regard to land. However, since a few transactions or even a single transaction in land has often resulted in a finding that the taxpayer has engaged in "an adventure in the nature of trade", section 18(2) may not have very broad application because it applies only if the land cannot reasonably be considered to be included in the inventory of the taxpayer's business. Probably a more serious problem arises from permitting a full deduction of interest on money borrowed to purchase some common stock while including only one-half of the gain on the sale of such stock. The problem is clearly not confined to land. It is therefore a mistake to wage a tax war on such a narrow front when a general offensive is warranted.

The interest deductibility rule found in section 20(1)(c) should be amended in regard to property income so that interest may be deducted only up to the net income from property. Section 18(1)(h) which prohibits the deduction of personal or living expenses should be

[46] This provision seems to be a legislative reversal of the Tax Appeal Board decision in *Mettarlin v. M.N.R.*, 69 DTC 26, [1968] Tax A.B.C. 1247, in which interest charges and municipal taxes were permitted in regard to a small farm which was rented for $500 per year. The deduction of interest and municipal taxes produced a substantial loss from the particular property. The taxpayer had a considerable amount of real estate, but the Minister admitted that the taxpayer was an investor and not a trader in real estate. The case is in many regards confusing, as Gwyneth McGregor has emphasized in "Around the Courts", *Canadian Tax Journal,* XVII, 2 (1969), p. 98 at 112-13.

amended so as not to prohibit any interest payment which is otherwise deductible according to the amended section 20(1)(c). Without this amendment, interest on mortgages and loans for the purchase of consumer durables which might otherwise be deductible under the amended section 20(1)(c) would be prohibited as a deduction of personal or living expenses.[47] If borrowed funds may be traced into particular assets, any interest which is not currently deductible might be carried forward and applied against net income from that asset in a subsequent period. If the asset is sold, the balance of the interest carry-forward should be added to the cost base in order to determine the amount of capital gain or loss. The sections dealing with the interest on funds borrowed to purchase land should be eliminated because they would be superfluous with an adequate general interest deductibility rule.[48]

[47] *Couture v. M.N.R.*, 72 DTC 1013; *Davis v. M.N.R.*, 71 DTC 242, [1971] Tax A.B.C. 314; *Child v. M.N.R.*, 69 DTC 489, [1969] Tax A.B.C. 674.

[48] The proposed interest deductibility rule will not achieve precisely the same result as section 18(2). The interest payment would be deductible up to the net income from all assets and not limited to the net income from each property. Precisely what a per-property limitation is intended to achieve remains doubtful. It would appear that all it will do is to promote financial manipulation. It will result in the adjustment of the amount of debt related to each property so that the interest payments per property will not exceed the net income per property, to the extent that this is possible. This seems to be an absurd type of financial manipulation to encourage. The general interest deduction limitation which I have proposed seems much more reasonable.

Dispositions — A Critique of Revenue Canada's Interpretation

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The authors review the consequences to shareholders and creditors of changes to the payment terms of debts and to the provisions attaching to shares. They comment upon Revenue Canada's views on these matters as expressed in Interpretation Bulletin *IT-448 and examine the possible extension of these views to transactions involving property other than shares and debts.*

It is a fundamental principle that income must be realized before it is subject to tax. The concept of realization finds statutory expression in the provisions of the Income Tax Act that tie capital gains, recaptured depreciation, and certain other income inclusions to a "disposition" of property and that tie business income to property "sold." This article, which is intended as a response to the position taken by Revenue Canada in *Interpretation Bulletin* IT-448, dated June 6, 1980, deals with the question whether a "disposition" occurs where the provisions attaching to shares and the terms of payment of principal and interest on debt obligations are altered.

The question to be dealt with can be simply stated: In what circumstances, if any, where there is a change in the terms or attributes of a share or a debt receivable, is the holder of the share or debt receivable considered to have disposed of it for tax purposes? If the property is considered to have been disposed of, the taxpayer may realize a capital gain or capital loss, one-half of which will be taken into account in computing his income for the year unless some rollover provision is applicable.[1] The disposition of a share or debt obligation as a result of an alteration in its terms may occur even though there is no corresponding acquisition of the property by any other taxpayer.[2]

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[1] Note that a wide variety of related tax consequences may be triggered by a disposition. For example, where the shares or debt obligations are denominated in a foreign currency, gains or losses in respect of fluctuations in the value of such foreign currency will be realized upon the disposition of such shares or debt obligations. Where the share or debt obligation constitutes taxable Canadian property owned by a nonresident, the certificate procedures of subsection 116(3) become applicable upon the disposition.

Even more surprising results may occur. For example, section 84.1 does not apply to shares acquired after 1971 from a person with whom the taxpayer was dealing at arm's length (subsection 84.1(3)). A disposition of shares within the circumstances set out in IT-448 would literally deprive the shares of the relief provided by subsection 84.1(3).

[2] The destruction of property is another example of a disposition of property with no corresponding acquisition.

The Meaning of "Disposition"

A "disposition" of property is defined by paragraphs 13(21)(c) (dealing with capital cost allowances on depreciable property) and 54(c) (dealing with gains and losses on capital property) to include "any transaction or event entitling a taxpayer to proceeds of disposition of property." The term "proceeds of disposition" is extensively defined in paragraphs 13(21)(d) and 54(h). Dealing with capital property, paragraph 54(c) specifically provides that the following transactions, involving shares or bonds, debentures, notes, certificates, mortgages, hypothecs, agreements of sale, and similar property (which we refer to herein collectively as "debt obligations"), are considered to be dispositions—namely:

1) the redemption of a share or debt obligation,[3]

2) the cancellation of a share or debt obligation,

3) the settlement or cancellation of a debt, and

4) the conversion of a share by virtue of an amalgamation.

Paragraph 54(c) specifically provides that:

1) the issue of debt or shares by a corporation,

2) the transfer of property by a debtor for the purpose of securing a debt, and

3) the return of such property by the creditor to the debtor

are not dispositions of the property.

The term "disposition" is also used in several other provisions of the Act.[4] In interpreting the word "disposition" in those other provisions, however, the definitions in paragraphs 13(21)(c) and 54(c) may not be applicable because they are specifically applicable only for purposes of sections 13 and 20 (and the regulations dealing with capital cost allowances) and subdivision c of Division B, respectively.

Although the courts have indicated that the term "disposition" is to be given a broad meaning, the jurisprudence concerning the application of the term "disposition" to particular transactions is not extensive. In an early case dealing with the recapture of capital cost allowance, the Exchequer Court stated that:

> . . . it is not unreasonable to give the words "disposed of" their widest meaning which would be "to part with", "to pass over the control of the thing to someone else" so that the person disposing no longer has the use of the property.[5]

Other cases have affirmed that the term "disposition" should be given a broad interpretation. The Supreme Court of Canada recently confirmed[6] that the words "disposed of" in the capital cost allowance provisions of the Act should be given their broadest possible meaning. The Court made reference to the definition of the phrase "to dispose of" in *The Oxford English Dictionary*:

> To put or get (anything) off one's hands; to put away, stow away, put into a settled state or position; to deal with (a thing) definitely; to get rid of; to get done with, settle, finish. In recent use sometimes *spec.* to do away with, "settle", or demolish

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[3] A disposition is also considered to occur where an interest in a share or debt obligation is redeemed in part.

[4] For example, see section 14 (the disposition of an eligible capital property), section 59 (the disposition of resource property), and paragraph 106(2)(a) (the disposition of an income interest in a trust).

[5] *Victory Hotels Ltd. v. MNR*, 62 DTC 1378, 1385; [1962] CTC 614, 626 (Ex. Ct.).

[6] *The Queen v. Compagnie Immobilière BCN Ltée*, 79 DTC 5068, 5073; [1979] CTC 71, 78 (SCC).

> (a claim, argument, opponent, etc.); also *humorously,* to make away with, consume (food).

Specifically, the Supreme Court held that the termination of a leasehold interest upon the merger of the leasehold interest with the fee simple interest in the property resulted in the extinction of the leasehold interest and therefore its disposition. The term "disposition" was therefore held to be broad enough to include the destruction or extinguishment of property.[7] In a subsequent case the Supreme Court held that the demolition of a building was the disposition of the building, although the taxpayer did not receive any proceeds of disposition in respect of the building.[8]

In another recent case the Trial Division of the Federal Court considered the meaning of the term "disposition" in relation to the capital cost allowance provisions and the meaning of the term "sale" in relation to the provisions dealing with business income under the Act.[9] The case involved an agreement to sell a building under which the purchaser took immediate possession of the building but legal title was not to pass to the purchaser until most of the purchase price had been paid and a deed delivered. With respect to the term "sale," Mr. Justice Addy stated:

> Since there is no special definition of the word "sale" or any special meaning to be attached to it in the *Income Tax Act,* one must consider that word in the light of the law of the Province of Quebec as applied to the relationship created by the agreement . . . .

According to Mr. Justice Addy, however, the term "disposition" was broader than a sale and, following the Supreme Court's view, he confirmed that it should be given its broadest possible meaning. He concluded, in the particular circumstances of the case, that while there was not a "sale" of the property under the law of the province of Quebec, there was a "disposition" of the property for purposes of section 13 because the taxpayer:

> . . . completely divested itself of all of the duties, responsibilities and charges of ownership and also all of the profits, benefits and incidents of ownership, except the legal title.[10]

Even with this broad approach to the interpretation of the term "disposition," the fundamental requirement is that there must be a cessation, divestiture, alienation, or transfer of the incidents of ownership of property. In other words, the taxpayer's interest in the property must be substantially, even if not completely, terminated[11] whether or not such interest is acquired by any other person.

The general approach of the Canadian cases to the meaning of the term "dis-

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[7] See also *In Re Leven,* [1954] 3 All ER 81 (Ch.); *Interpretation Bulletin* IT-460, dated October 6, 1980.

[8] *The Queen v. Malloney's Studio Limited,* 79 DTC 5124; [1979] CTC 206 (SCC).

[9] *Olympia & York Developments Ltd. v. The Queen,* 80 DTC 6184, 6187, [1980] CTC 265, 269 (FCTD).

[10] Id., at DTC 6193, CTC 278. Mr. Justice Addy based this approach to the meaning of "disposition" on the meaning of the acquisition of property adopted in *MNR v. Wardean Drilling Ltd.,* 69 DTC 5194, [1969] CTC 265 (Ex. Ct.), and *The Queen v. Henuset Bros. Ltd.* [*No. 1*], 77 DTC 5169, [1977] CTC 227; [*No. 2*] 77 DTC 5171, [1977] CTC 228 (FCTD). See too, *Interpretation Bulletin* IT-170R, dated August 25, 1980, in which Revenue Canada sets out its views concerning the timing of a "disposition" where property is disposed of by means of a sale.

[11] For example, as in the *Olympia & York* case, supra note 9, the taxpayer may dispose of property even though he retains title.

position" is consistent with English and Australian jurisprudence.[12]

It is clear that where one property is exchanged for another property, there is a disposition of the former property, with proceeds of disposition equal to the fair market value of the property received. The Act, however, provides rollover treatment for the following exchanges of shares and debt obligations:

1) Section 51 provides that where capital property that is a share, bond, debenture, or note of a corporation is exchanged for shares of one class, no disposition is considered to occur if the terms of the security provided for its conversion. Where the security does not confer upon the holder the right to convert it into shares of the corporation, Revenue Canada has ruled[13] and has stated in *Interpretation Bulletin* IT-448 that the amendment of the terms of the original property to provide such a right to convert will not constitute the disposition of the security.

2) Section 77 provides a tax-free rollover where a taxpayer exchanges a bond for another bond of the same debtor with the same principal amount if the terms of the original bond authorized the exchange. This rollover applies both to bonds that are capital property and to bonds that are included in inventory.

3) Section 86 provides a tax-free rollover where, in the course of the reorganization of the capital of a corporation, a taxpayer disposes of all his shares of one class and property is receivable from the corporation for such shares which includes other shares of the corporation. As is the case with section 51, this rollover is only available for capital property.

4) Subsection 87(4) provides a tax-free rollover where, upon an amalgamation of two or more corporations, a shareholder disposes of shares, which constitute capital property, of a predecessor corporation and receives shares in the amalgamated corporation in consideration therefor. A similar rollover is provided in subsections 87(6) and (7) where a taxpayer disposes of a debt obligation of a predecessor corporation and receives no consideration therefor other than a debt obligation of the amalgamated corporation with the same principal amount.

It should be noted that the Minister of Finance has proposed amendments to sections 51, 86, and 87 that would deny full rollover treatment where a transaction otherwise subject to section 51, 86, or 87(4) carried out after December 11,

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[12] For example, in *Henty House Property Limited v. Federal Commissioner of Taxation* (1953), 88 CLR 141, 151, the Australian High Court commented upon the meaning of the term "disposition" in the context of depreciable property as follows:

> The entire expression "disposed of, lost or destroyed" is apt to embrace every event by which property ceases to be available to the taxpayer for use for the purpose of producing assessable income, either because it ceases to be his, or because it ceases to be physically accessible to him, or because it ceases to exist. . . . the words "is disposed of" are wide enough to cover all forms of alienation . . . and they should be understood as meaning no less than "becomes alienated from the taxpayer", whether it is by him or by another that the act of alienation is done.

See also *Rose v. Federal Commissioner of Taxation* (1951), 84 CLR 118 (H.Ct.), and *Gorton v. Federal Commissioner of Taxation* (1965), 113 CLR 604 (H.Ct.). See D. S. Ewens, "When is a 'Disposition'?" in *Report of Proceedings of the Twenty-sixth Tax Conference*, November 11, 12, 13, 1974 (Toronto: Canadian Tax Foundation, 1975), 515, for a more complete discussion of this jurisprudence. See also *Worcester Works Finance Ltd. v. Cooden Engineering Co. Ltd.*, [1971] 3 All ER 708 (CA).

[13] Income Tax Ruling TR-66, dated July 11, 1977.

1979 results in the conferral of a benefit on a related person.[14] In such circumstances, under the proposed amendments to sections 51 and 87, the taxpayer would be deemed to receive proceeds of disposition equal to the lesser of the fair market value of the original shares and the adjusted cost base of such shares plus the amount of the benefit conferred on the related person. Therefore, where these amended provisions apply, the capital gain deemed to be realized will usually be measured by the amount of the benefit conferred. However, where the benefit is conferred in circumstances where the proposed amendments to section 86 would apply, the taxpayer would be deemed to receive proceeds of disposition equal to the amount of the benefit plus the fair market value of any nonshare consideration. Therefore, an immediate capital gain will not arise if the amount of the benefit and the fair market value of the nonshare consideration do not exceed the adjusted cost base of the shares. Any capital loss arising on the exchange will be deemed to be nil under all three provisions.

Interpretation Bulletin IT-448

The general test adopted by Revenue Canada in *Interpretation Bulletin* IT-448 in determining whether a change in the terms of a security has resulted in the disposition of the security is "whether or not it is reasonable to regard the amended security being the same property as that which underwent the change."

Revenue Canada's approach focusses on the significance of the changes in the terms of the security and not on the method adopted to accomplish the change although the method adopted may be crucial in determining whether the taxpayer can claim the benefit of a full or partial rollover. The issuance of a new share certificate in substitution for an old share certificate, for example, does not necessarily indicate that the shares have been disposed of. While the bulletin indicates Revenue Canada's general approach, its contents are intended as guidelines. Therefore the bulletin may not be applicable in any particular set of circumstances and, in fact, may not describe all circumstances where Revenue Canada would claim that a disposition has taken place.

In dealing with debt obligations, IT-448 states that the following changes are "so fundamental to the holder's economic interest in the property that they almost invariably precipitate a disposition":

1) an interest bearing debt becomes non-interest bearing or vice versa;[15]

2) the repayment schedule or maturity date of an obligation is altered significantly;[16]

3) the principal amount of the obligation is altered;[17]

4) the addition of a premium payable upon the repayment of the obligation or, if the obligation originally was repayable only at a premium, the alteration or elimination of such premium;

[14] Draft Amendments to the Income Tax Act, August 28, 1980, sections 17, 41, and 42.

[15] A change in the rate of interest, even a substantial change, apparently does not result in the disposition of a debt. This distinction is difficult to understand. In Income Tax Ruling TR-63, dated July 4, 1977, Revenue Canada ruled that a change of ½ of 1 per cent in the rate of interest paid on debentures did not result in a disposition.

[16] Revenue Canada does not, however, indicate what types of changes will be considered to be significant.

[17] It is assumed that neither a decrease in the principal amount of a debt as a result of a partial repayment nor an increase in the principal amount as a result of additional money loaned would result in a disposition of a debt obligation.

5) any change in the debtor except where an amalgamated corporation assumes the debt obligation of a predecessor corporation under subsection 87(6) (where a third party agrees to discharge the debtor's liability but the debtor remains liable to the creditor, no disposition of the debt is considered to occur);

6) the conversion of a fixed interest obligation into an obligation with interest variable with the profit of the debtor or vice versa.

If the terms of the original obligation authorize any of the above changes, however, such a change will not be considered to be the disposition of the obligation. Changes in the security underlying a debt are not considered to result in the disposition of the debt itself. The addition of a right to convert a debt obligation into another security does not generally result, in Revenue Canada's opinion, in the disposition of the original debt.[18]

In dealing with changes in the terms of shares, Revenue Canada's approach is based upon the proposition that a share "consists of a bundle of rights and privileges attached to the shares by the articles of incorporation or the directors in accordance with the corporate law of the particular jurisdiction." From this fundamental proposition Revenue Canada indicates that the following changes are ordinarily considered to result in a disposition of the shares:

1) a change in voting rights that causes a change in the voting control of the corporation;

2) a change in the amount that a preferred shareholder is entitled to receive upon the winding up of the corporation;

3) the addition or elimination of a preferential right to share in the assets of the corporation upon winding up;

4) the addition or elimination of a right to participate in dividends beyond a fixed preferential rate or amount;[19] and

5) the conversion of a cumulative right to dividends into a noncumulative right to dividends or vice versa.

If the above changes are made with respect to authorized but unissued share capital, no disposition is considered to have occurred since no taxpayer holds the unissued shares.[20] Similarly, if the changes made in the terms of the shares do not result in any change in the relative interest in the corporation of the shareholders, no disposition is considered to have occurred.[21]

Revenue Canada has ruled previously[22] and has repeated its view in IT-448 that the addition of a right to convert a share

[18] This might be done as a preliminary step to the later use of a rollover under section 51 or 77. In *Interpretation Bulletin* IT-146R3, dated August 25, 1980, Revenue Canada in effect confirmed that the addition to a share of a right to convert it into a share of another class is not a disposition.

[19] As with changes in the rate of interest, a change in the dividend rate or amount apparently is not considered to result in the disposition of the share. However, see infra note 25.

[20] However, if a corporation makes changes to its authorized but unissued shares by, for example, creating a class of preference shares ranking prior to an issued class of shares, does the subsequent issue of shares of the new class alter the bundle of rights of the existing shareholders so that they will be considered by Revenue Canada to have disposed of such shares?

[21] For example, Revenue Canada indicates in paragraph 10 that where there is only one class of shares outstanding or where the shareholders have the same proportionate ownership of the shares of each class, any change in the terms of the shares will not be considered to result in the disposition of the shares.

[22] Supra note 13. See also *Interpretation Bulletin* IT-146R3, dated August 25, 1980.

of one particular class into a share of another class with different terms and conditions does not result in the disposition of the share. As long as the actual conversion of the share into a share of another class complies with the requirements of section 51 or section 86 of the Act and (assuming the proposed amendments to those provisions are enacted) the transaction does not result in a reduction in value of the share which it is reasonable to consider to be a benefit conferred on a related person, the conversion of the share will not result in the realization of any capital gain. Where the terms and conditions of a particular class of shares provide for the amendment of the provisions attaching to such shares, no disposition is considered to have occurred upon the actual amendment of the terms because the bundle of rights that constitutes the shares always contemplated the possibility of such an amendment.[23]

Interpretation Bulletin IT-448 indicates that each of the following changes in the terms of a share, per se, will not result in the disposition of the share:

1) the addition of a right to elect a majority of the directors of the corporation if the class of shares has sufficient voting power to control the election of the board of directors at that time;

2) any change in the number of votes per share unless the influence of any particular shareholder over the day-to-day affairs of the corporation is enhanced or impaired thereby;

3) the elimination of contingent voting rights unless such rights, if exercised, would carry control of the corporation;

4) any change in restrictions on the transfer of shares;

5) the addition of a right to redeem the shares at the option of the corporation;

6) a stock split or consolidation;[24]

7) the conversion of par value shares to no par value shares or vice versa unless such a change results in a change in the amounts to which the shares are entitled with respect to dividends or distributions upon winding up;[25]

8) a change in the ranking of preference features; and

9) any change, other than the addition or deletion of the right itself, in the amount or rate of a fixed dividend.

While each of the above changes is not considered to give rise to a disposition of the shares in itself, a combination of such changes, either simultaneously or in a series, may be considered to result in the disposition of the shares.

Interpretation Bulletin IT-448 recognizes that the reduction of the paid-up capital of a corporation may or may not result in the disposition of the shares.

[23] Because Revenue Canada is of the view that the addition to the rights attaching to a security of the right to convert it into shares of another class does not generally result in a disposition, would it also be of the view that the addition of a right to amend the terms and conditions of the security is not a disposition? If the answer is affirmative, any disposition of shares as a result of alterations in their terms could be avoided by first adding a right to amend.

[24] See *Interpretation Bulletin* IT-65, dated September 8, 1972. A split or consolidation of a class of voting shares will either multiply or diminish the number of votes exercisable by the holders of the class of shares. Quaere: If this affects the voting control of the corporation, will such a split or consolidation result in a disposition?

[25] See Income Tax Ruling TR-2, dated June 24, 1974. It is puzzling why Revenue Canada has added the caveat that there be no change in the shareholder's entitlement to dividends in light of the notable absence from the list of changes that Revenue Canada deems to be a disposition of a change in the rate of preferential dividends.

Where the paid-up capital of a preferred share[26] is reduced, the amount of the share's participation in the assets of the corporation upon winding up is ordinarily reduced and therefore Revenue Canada regards the reduction in the paid-up capital of such shares as the disposition of the shares.[27] Where the paid-up capital in respect of common shares is reduced, the entitlement of such shares to participate in the assets of the corporation upon winding up is not altered and therefore no disposition of the shares is considered to have occurred.[28]

If a disposition, within the meaning of the bulletin, does not produce any tax consequences (that is, there is no gain or loss), the taxpayer is not required to report the disposition. However, where a taxpayer does not report in his return a disposition within the meaning of the bulletin and no assessment on the basis of the disposition is made within the statutory limitation period, Revenue Canada takes the position that the tax consequences of a subsequent disposition will be computed as if the previous disposition did not occur. It is sort of a "heads Revenue Canada wins, tails the taxpayer loses" situation which Revenue Canada is unlikely to be able to maintain while adhering to its view set out in IT-448.

If the taxpayer takes the position that Revenue Canada's views in *Interpretation Bulletin* IT-448 are incorrect or if the amendment to the shares or the debt obligation took place before the publication of the bulletin or if the taxpayer is simply not aware of the bulletin and for any of these reasons does not report any disposition of the property, Revenue Canada may not discover the fact of the alleged disposition. If a sale of such property subsequently takes place at a time when the year of the earlier transaction has become time-barred for reassessment and the taxpayer then takes the position that there was a prior disposition of the property that resulted in a step-up of the cost of the property, the gain arising from that prior disposition would not be subject to tax.

If Revenue Canada wishes to avoid this result, it would have to argue in contradiction of its stated position in *Interpretation Bulletin* IT-448 that the prior change in the terms of the security was not a disposition. If it succeeded, Revenue Canada would presumably withdraw IT-448 and would then have the problem of dealing with what might be a militant group of taxpayers who voluntarily paid tax on the basis that IT-448 represented the applicable law.

It should be noted that the bulletin does not deal with the determination of the proceeds of disposition of securities that are considered to be disposed of as a result of alterations in their terms. Presumably, however, the value of the new bundle of rights represents the proceeds of disposition of the old bundle

[26] A "preferred share" is defined in subsection 248(1) to be any share other than a common share, and a "common share" is defined in the same subsection to be a share that is not precluded from participating in the assets of the corporation upon a reduction of capital or a redemption of shares beyond the paid-up capital in respect of such share, a fixed premium, and a defined rate of dividend.

[27] This could have particularly disastrous tax consequences where the preferred shares were issued in a subsection 85(1) rollover transaction and, by virtue of the election filed, their adjusted cost base is a nominal amount. The disposition of the shares on a reduction of their paid-up capital could result in the realization of the full fair market value of the shares as a capital gain. In our view, it would be preferable to treat a reduction in capital as a partial disposition of the shares for proceeds of disposition equal to the amount, if any, paid to the shareholder on the reduction of capital.

[28] See Income Tax Rulings TR-9, dated January 27, 1975, and TR-71, dated April 17, 1978.

of rights. If this is the correct analysis, the fair market value of the shares or debt obligation, as amended, would represent the proceeds of disposition. Also, Revenue Canada does not deal in IT-448 with any of the more subtle tax consequences where share or debt obligations are disposed of in the circumstances described in the bulletin.[29]

Alteration in the Terms of Debt Obligations

At first glance, the basic approach used by Revenue Canada to determine whether changes in the terms of a debt obligation result in its disposition (that is, whether it is reasonable to regard the changes as resulting in the creation of different property) may seem to be sensible. This approach, however, is not consistent with the case law interpreting the term "disposition," the gist of which is the notion of the alienation or extinguishment of property. It is suggested that since a debt obligation is in legal terms a contract between the debtor and the creditor, whether the alteration in the terms of the debt is in substance an exchange of one property for another property should be resolved by reference to the applicable contract law. If, in accordance with the relevant contract law, the changes in the terms of the original debt obligation have resulted in the discharge of that obligation and the substitution of a new obligation, it is probably appropriate to view the original obligation as having been disposed of for income tax purposes.

The clearest example of a disposition under this approach occurs where the creditor accepts the obligation of a new debtor in complete satisfaction of the contractual obligation of the original debtor. Such a novation of the contract essentially involves the cancellation of one debt and the creation of a substituted debt in its place.[30] It is also pos-

[29] For example, where a debt obligation is disposed of at a loss, the loss is deemed to be nil if (1) the debt is personal-use property, or (2) the debt was not acquired for the purpose of earning income or as consideration for capital property disposed of to a person with whom the taxpayer was dealing at arm's length (subparagraphs 40(2)(g)(ii) and (iii)).

Where the terms of a debt obligation that was acquired to earn income are altered and the debt obligation is considered to be disposed of, a capital loss will be realized to the extent that the fair market value of the amended debt is less than the adjusted cost base of the original debt. However, if the amended debt is then disposed of (either because its terms are altered again or because it becomes a bad debt), the resulting capital loss may be deemed to be nil because the amended debt was not acquired in an arm's length transaction or for the purpose of earning income. It is hoped that Revenue Canada would be prepared to regard the amended debt as having been acquired for the same purpose as the original debt.

Further, the disposition of a debt as a result of an alteration in its terms (perhaps because of the financial difficulties of the debtor) would appear technically to result in the disallowance of a reserve under subparagraph 40(1)(a)(iii) where the original debt was part of the consideration for the disposition of capital property. It is thought that Revenue Canada did not intend this result and may allow the creditor to continue to claim the reserve because, despite the disposition of the debt obligation upon the change in its terms, an amount is still owing to the creditor. See, too, supra note 1.

[30] See Cheshire and Fifoot, *Law of Contract*, 9th ed. (1976), 508, and Fridman, *The Law of Contract in Canada* (1976), 471. In *Herold v. B.A. Oil Company* (1954), 12 WWR 333 (Alta. SC), the following four requirements of a novation were established: (1) the substituted debtor must accept all the liabilities of the original debtor under the contract; (2) the creditor must accept the substituted debtor as the principal debtor and not as a guarantor; (3) the creditor must accept the new contract in full satisfaction and complete discharge of the old contract; and (4) the original debtor must consent to the transaction.

See, however, Income Tax Ruling TR-3, dated July 8, 1974, where Revenue Canada ruled that the creditors of a predecessor corporation did not dispose of the debts held by them when the corporation amalgamated with another corporation and the debt became a debt owing by the amalgamated corporation. A specific statutory rollover is now provided in subsection 87(6) for the disposition of obligations of predecessor corporations upon an amalgamation.

sible under contract law to have a novation of part of a debt.[31] Clearly, therefore, an analysis of the legal effect of the substitution of a new debtor by way of novation provides support for the proposition that the creditor has disposed of the original debt obligation in whole or in part for income tax purposes.

While novation involves the introduction of a new party and the substitution of a new agreement for the original agreement, there are other circumstances in which the original agreement may be terminated and replaced by a subsequent agreement between the original parties. In any particular case, whether a subsequent agreement between the same parties is intended to replace an earlier agreement and release the parties from their obligations under that agreement depends upon the intentions of the parties. In most situations the crucial issue is whether the parties intended to abrogate the original contract completely or merely to vary it in some way. In order to be effective under the common law, an agreement varying the terms of an earlier agreement must itself be an enforceable agreement supported by consideration or made under seal.[32] The effect of a variation of a contract is that the parties have by mutual agreement altered their rights and obligations under the original agreement, with the original agreement remaining in effect and governing the rights and obligations of the parties, as amended.

The terms of a contract may also be altered where one party waives some or all of his rights under a contract for the benefit or convenience of another party. Unlike a variation of the contract, a waiver may operate to alter the terms of the original agreement even though it is not an enforceable obligation itself. There is a good deal of controversy concerning the distinction between a variation of a contract and a waiver of rights under a contract.[33] For our purposes, however, the crucial point is that under both a variation and a waiver, the terms of the original agreement remain in effect except insofar as altered by the subsequent variation or waiver.

An agreement under which one party has completely performed his obligations but the other party has not may be discharged by way of an accord and satisfaction. An accord and satisfaction involves the purchase by the party who has not performed his obligations under the contract of his release from those obligations by way of giving some valuable consideration. Because an accord and satisfaction results in the termination of the original agreement, it would appear to be appropriate to regard a debt so discharged as disposed of by the creditor for income tax purposes.

Applying this contract law to the situations described in IT-448 in relation to debt obligations, it is difficult to support Revenue Canada's position except with respect to a change in the debtor as a result of a novation. In each of the other situations (a change in the repayment schedule, maturity date, or principal amount; the addition, elimination, or alteration of any premium; and certain changes involving interest), it is unlikely that the parties would intend

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[31] Fridman, supra note 30, at 473.

[32] However, a subsequent agreement that completely terminates an original agreement apparently does not have to be an enforceable agreement itself. See Cheshire and Fifoot, supra note 30, at 535; Fridman, supra note 30, at 474, and Waddams, *The Law of Contracts*, 146-7.

[33] Cheshire and Fifoot, supra note 30, at 538, and Fridman, supra note 30, at 477.

the original contract to be terminated and replaced by a new contract; rather, the changes will ordinarily be made by way of a variation of the original agreement. Therefore, where the original debt has not been discharged or cancelled but only varied, even though varied substantially, the foregoing analysis of the underlying relationships between the parties indicates clearly that the creditor has not disposed of the debt.

Revenue Canada's position, however, is not based upon an analysis of the legal relationships between the parties but, rather, seems to be based upon an analysis of the creditor's economic interest in the property. In our view, this test for determining when a disposition of a debt obligation has occurred is unjustified. It is clear from the jurisprudence concerning the term "disposition" that a disposition of property must involve the alienation or extinguishment of the property. There is no notion of alienation or extinguishment in Revenue Canada's concept that a disposition occurs whenever there is a substantial change in the holder's economic interest in the property. The irony is that a change in the economic value of the holder's interest in the property is clearly not a disposition of the property until, in Revenue Canada's view, there is some amendment of the debt obligation (which may not itself further change significantly the economic value of the property) at which time Revenue Canada considers that and all prior changes in value to be realized.

Alterations in Share Terms

WHAT IS A SHARE?

It appears from *Interpretation Bulletin* IT-448 that Revenue Canada regards any change in the terms of a share that results in a substantial change in the holder's economic interest in the corporation to be a disposition of the share for income tax purposes. As with debt obligations, however, it is our view that this approach is not consistent with the jurisprudence concerning the meaning of a "disposition." As with the analysis of changes in the terms of debt obligations, it is necessary, initially at least, to analyse the nature of a share and the legal relationships between shareholders and the corporation. Revenue Canada has in fact recognized the necessity of this approach with the following statement:

> A shareholder's interest in a corporation consists of a bundle of rights and privileges attached to the shares by the articles of incorporation or the directors in accordance with the corporate law of the particular jurisdiction.[34]

The precise legal nature of a share has never been clear, however. In *Bradbury v. English Sewing Cotton Company Limited,*[35] an often quoted judgment as to the meaning of a share, it was stated:

> A share is, therefore, a fractional part of the capital. It confers upon a holder a certain right to a proportionate part of the assets of the corporation, whether by way of dividend or of distribution of assets in winding up. It forms, however, a separate right of property. The capital is the property of the corporation. The share, although it is a fraction of the capital, is the property of the corporator . . . the share is a property in a fractional part of the capital.

34 Compare Grover and Ross, *Materials on Corporate Finance* (1975), 39: "Shares constitute a bundle of legal and equitable rights, mainly in favour of but sometimes against the registered owner." See also *Hunt Estate v. The Queen*, 66 DTC 5322; [1966] CTC 474 (Ex. Ct.).

35 [1923] AC 744, 767 (HL).

In another often quoted case, *Borland's Trustee v. Steel*,[36] a share was defined as:

> . . . the interest of a shareholder in a company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second place, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se* . . . . A share is not a sum of money . . . but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.

This emphasis upon the contractual nature of a share was repeated in a subsequent case, *In Re Sir William Thomas Poulin*:[37]

> It is impossible to treat a share as being an interest in the company's assets or an aliquot share in the company's capital and to regard the contract arising from and contained in the company's articles of association as a separate and independent thing. That contract and the rights and liabilities that flow from it are of the very essence of the share.

Notwithstanding the preceding references to the contractual nature of a share, it is clear this analysis of the relationship of a shareholder to the corporation can be applied only to corporations incorporated by memorandum of association or comparable means and not to letters patent corporations.[38] With the adoption of the concept of articles of incorporation under the Canada Business Corporations Act and the requirement that all corporations incorporated under prior federal company law statutes be continued by articles under the new Act, it remains an open question whether and to what extent a contractual analysis may now be applicable to those corporations incorporated or continued by articles under the Canada Business Corporations Act.

In Ontario, corporations incorporated by letters patent under prior company law legislation were not required to be continued by articles under The Business Corporations Act (Ontario). Therefore, although it has not been determined whether the contractual analysis is appropriate to deal with the rights or interests of shareholders in corporations incorporated or continued by articles of incorporation under the federal or Ontario legislation, it would seem clear that the analysis cannot be applied to older Ontario corporations that were incorporated by letters patent.

The position in the other provinces is equally diverse; some continue to incorporate companies by memoranda of association, some by letters patent, and some by articles of incorporation. In *Interpretation Bulletin* IT-448, Revenue Canada does not discuss this range of possibilities but appears to deal with shares in all corporations on the assumption that they represent "bundles of rights and privileges."

The concept of a share is a unique legal creation in which notions of property, rights, privileges, and sometimes contractual rights have been intermixed and synthesized. In light of the rather obscure legal nature of a share, Revenue Canada's view of a share as a "bundle of rights and privileges" is not particularly objectionable. Nor is it particu-

[36] [1901] 1 Ch. 279, 288. While approving of this analysis for company law purposes, for purposes of estate duty a share was described as "one indivisible piece of property," per Lord Blanesburgh in *IRC v. Crossman*, [1937] AC 26 at 51.

[37] [1935] 1 KB 26, 57 (CA).

[38] See Wegenast, *The Law of Canadian Companies* (1931), 477.

larly helpful since any property can be viewed from a theoretical perspective as a bundle of rights. Halsbury,[39] for example, states in relation to property generally:

> Ownership consists of innumerable rights over property, for example, the rights of exclusive enjoyment, of destruction, alteration, and alienation, and of maintaining and recovering possession of the property from all other persons. Such rights are conceived not as separately existing, but as merged in one general right of ownership.
> . . .
> Ownership is nevertheless divisible to some extent. For example, one or more of the *fasciculus* of rights constituting ownership may be detached. Thus an owner is *prima facie* entitled to possession or to recover possession of his goods against all the world, a right which a dispossessed owner may exercise by peaceable retaking. He may, however, voluntarily or involuntarily part with possession, for example, by pledging, lending, hiring out, bailment, theft, or loss of his goods, in any of which cases he is left with a right of ownership without possession, accompanied or not accompanied, as the case may be, with the right to possess.

This same type of analysis—namely, that the ownership of any property can be analysed from the point of view of a bundle of rights—has essentially been adopted for tax purposes in various ways. In determining whether property has been disposed of or acquired, for example, the courts have examined the "incidents of ownership" in order to determine whether the previous owner has given up sufficient rights and obligations in respect of the property that he can no longer be said to be the owner of it and whether the new owner has acquired sufficient rights and obligations in respect of the property that he can be said to have become the owner.[40]

CHANGES IN SHARE PROVISIONS[41]

According to Revenue Canada, where the terms of shares are amended, there may be a disposition. Where the terms of shares specifically provide for their amendment, however, the amendment of the terms is not considered to be a disposition of the shares "because the possibility of such a change was always inherent in its bundle of rights."[42] But, even where the terms of a class of shares do not specifically provide for their amendment, it would appear that it is inherent in the nature of a share that its terms may be altered by the corporation by special resolution in the manner provided by statute or by the

[39] *Halsbury's Laws of England*, vol. 29, 3rd ed. (1960), paragraph 736 ff. Salmond, *On Jurisprudence* 11th ed. (1957), 303, in reference to tangible property, says: "It is always possible to express corporeal ownership in terms of incorporeal ownership. Ownership as a particular kind of right can be translated into ownership as a particular kind of relation to rights of all descriptions. . . . Strictly speaking, however, corporeal ownership is not so much one right as a bundle of rights, liberties, powers and immunities." Similarly, in Brown, *The Law of Personal Property*, 3d. ed., 6, it is stated: "In the strict legal sense, however, property means not the thing itself, but the rights which inhere it. Ownership, or the right of property is, moreover not a single indivisible concept but a collection or bundle of rights, of legally protected interests." See also, Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning* (1919).

[40] See the *Olympia & York Developments* case, supra note 9; *Wardean Drilling* and *The Queen v. Henuset* [No. 1], supra note 10; paragraph 2(b) of *Interpretation Bulletin* IT-50R, dated February 13, 1978; paragraphs 7 and 8 of *Interpretation Bulletin* IT-170R, dated August 25, 1980, and paragraph 1 of *Interpretation Bulletin* IT-460, dated October 6, 1980.

[41] See, generally, D. S. Ewens, "Company Law Considerations Relating to Corporate Actions and Reorganizations," *Report of the Proceedings of the Twenty-eighth Tax Conference*, November 22, 23, 24, 1976 (Toronto: Canadian Tax Foundation, 1977), 224 at 254-57.

[42] IT-448, paragraph 11.

articles of the corporation.[43] Therefore, extending Revenue Canada's bundle of rights theory, it could be argued that the alteration of the terms of a share should not generally result in a disposition since the possibility of amendment is inherent in every share.

An exchange of shares in a corporation for other shares of the same corporation is clearly a disposition of the shares for income tax purposes. Such a transaction, however, would probably be subject to one of a number of specific statutory provisions that provide tax-free rollovers for such share exchanges.[44] Where shares of a corporation are redeemed or cancelled, in whole or in part, the shares are considered to have been disposed of by virtue of the statutory definition of "disposition."[45]

To these transactions, which clearly constitute dispositions for income tax purposes, Revenue Canada purports to add those changes in share attributes set out in paragraph 14 of *Interpretation Bulletin* IT-448. The changes that Revenue Canada regards as resulting in the disposition of the shares can be divided into two general categories for purposes of analysis:

1) changes in voting rights that result in a change in the control of the corporation; and

2) changes in rights to participate in the assets of the corporation, by way of distributions upon liquidation, or dividends beyond a fixed preferential rate or amount.

All the changes outlined in paragraph 14 of the bulletin would involve, in most circumstances, amendments to the articles of incorporation of the corporation. The amendments, however, would not necessarily involve the cancellation of the old shares and their replacement by new shares.[46] The relevant corporate statute may provide that any changes with respect to the rights, privileges, or conditions of a particular class or series of shares must be approved by a two-thirds or three-fourths majority of the holders of that class or series of shares voting separately.[47]

It is clear that for corporate law purposes the amendment of the terms of a particular class of shares does not result in the cancellation of those shares and the issuance of new shares with altered terms. The shares remain outstanding and the provisions attaching to them continue to govern the legal rights and privileges of the holder except insofar as those legal rights and privileges are amended in accordance with the corporate law of the particular jurisdiction.

CHANGES IN CONTROL AS A RESULT OF CHANGES IN VOTING RIGHTS

Revenue Canada's position that a change in voting rights that results in a change in control of the corporation is a dispo-

[43] See subsection 167(1) of the Canada Business Corporations Act and subsection 189(4) of The Business Corporations Act (Ontario). See also *Allen v. Gold Reefs of West Africa*, [1900] 1 Ch. 656 (CA), and *In Re Welsbach Incadescent Gas Light Co.*, [1904] 1 Ch. 87 (Ch.).

[44] See, for example, sections 51 and 86.

[45] Subparagraph 54(c)(ii)(A).

[46] See, for example, subsection 167(1) of the Canada Business Corporations Act which permits the articles of a corporation to be amended by special resolution, *inter alia*, to change the designation of all or any of its shares, and add, change, or remove any rights, privileges, restrictions, and conditions, including rights to accrued dividends, in respect of all or any of its shares, whether issued or unissued. See also subsection 189(1) of The Business Corporations Act (Ontario).

[47] See, for example, section 170 of the Canada Business Corporations Act and subsection 189(4) of The Business Corporations Act (Ontario).

sition of the shares gives rise to a number of difficulties. Revenue Canada may have legitimate reasons to be concerned that a change in the control of a corporation (for example, to avoid Part IV tax in respect of intercorporate dividends or to transfer value to the next generation) may be accomplished either by a transfer of shares or by an alteration in the voting rights attached to shares. Where the shares are transferred, whether in an arm's length or a non-arm's length transaction, a disposition occurs and the transferee may realize a capital gain on the transfer[48] unless one of the rollover provisions of the Act applies.[49] The same result can be achieved by altering the voting rights attached to shares. Even if, contrary to IT-448, no disposition of the shares is considered to have occurred as a result of the alteration in the voting rights, a disposition may be deemed to have occurred pursuant to subsection 245(2) if the alteration in the share terms results in the conferral of a benefit on another taxpayer.

It is not apparent from *Interpretation Bulletin* IT-448 whether Revenue Canada considers that when voting control of a corporation changes because the voting rights attaching to a class of shares are amended, a disposition occurs only of those shares whose voting rights are changed. Assume, for example, that a corporation has an equal number of Class A and Class B shares, each of which carries equal voting rights — namely, two votes per share. If the votings rights attached to the Class A shares are changed so that each Class A share has four votes, the holders of the Class A shares will control the corporation by virtue of holding two-thirds of the votes. The holders of the Class B shares, on the other hand, will have their voting power reduced from one-half to one-third of all the votes in the aggregate.

If Revenue Canada takes the position that only the Class A shares have been disposed of because only the provisions attaching to those shares have been altered, the holders of the Class B shares will be unaffected by the change. The same change in the control of the corporation could be accomplished by reducing the voting rights of the Class B shares to one vote per share and in this case only the Class B shares might be considered to be disposed of.

In more general terms, since any increase in the rights attaching to one class of shares results in the reduction of the rights attaching to the other class of shares, it is illogical, in our view, to regard only the shares whose provisions are amended to be disposed of. The inevitable conclusion to be drawn is that where the voting rights of a particular class of shares are changed and control of the corporation is thereby altered, Revenue Canada may take the view that all the shareholders of the corporation must be considered to have disposed of their shares.

If this is a correct interpretation of Revenue Canada's position, then the further question arises whether the holders of shares of a particular class that control a corporation may be considered to have disposed of those shares upon the issuance by the corporation of shares of another class (or perhaps even more shares of the same class) where the

48 In these circumstances, the proceeds of disposition may reflect a control premium.

49 Where the amendment has been made for the purpose of transferring some of the value in the shares to related persons, the rollover provisions of sections 51, 86, and 87 (as these sections are proposed to be amended) will only be partially achieved since a gain will be deemed to be realized equal to the amount of the benefit conferred.

holders of the new shares or new class of shares acquire voting control of the corporation. If Revenue Canada's position, which is derived from the bundle of rights theory, is correct, then surely the bundle of rights held by the former controlling shareholders is diminished equally, whether or not rights attaching to another class of shares are altered or new shares are issued or a new class of shares is issued.[50]

It is thought, however, that Revenue Canada does not intend to treat outstanding shares as disposed of upon the issuance of new shares or upon the redemption or cancellation of other shares. It is our view that there is no logical reason why the fundamental principles upon which Revenue Canada has based its position in IT-448 should not be extended to these transactions, and the danger is that they may be so extended at some time in the future.

The effect of Revenue Canada's position is that shareholders who acquire control of corporations and perhaps other shareholders whose voting rights are reduced as the result of the change in the voting rights will be considered to have disposed of their original shares for proceeds of disposition equal to the fair market value of the shares held by them after the alteration of voting rights has been made.[51] As a result, the shareholder who acquires control of the corporation will be considered to have realized a capital gain in the amount of any accrued appreciation in respect of the shares plus any relevant control premium.[52]

The determination of the cost to the shareholder of the shares that are considered to be acquired by him by virtue of the amendment of the terms of his original shares presents an interesting question. Ordinarily, one would expect that the cost would be equal to the fair market value of the shares after the amendment has been made.[53] There is, however, no statutory provision that deems the taxpayer to have acquired the amended shares at a cost equal to their fair market value. It might reasonably be argued that the cost of the amended shares is the price paid (that is, the fair market value of what the taxpayer gave up) in order to acquire the amended shares whereas the proceeds of disposition would be the value of the amended shares. If this is the result, an element of double taxation will arise when the taxpayer disposes of the amended shares.

[50] See *Greenhalgh v. Arderne Cinemas Ltd.*, [1945] 2 All ER 719, aff'd [1946] 1 All ER 512 (CA), for a discussion of this kind of alteration of share provisions. The same reasoning, of course, could apply in circumstances where shares are redeemed or cancelled, with the result that control shifts to the continuing shareholders of the corporation. The shares that are redeemed or cancelled clearly are disposed of by virtue of the statutory definition of a disposition. On Revenue Canada's theory, it would seem that the shares held by the continuing shareholders may also be considered to be disposed of.

[51] This result would apply even if the shareholders are not dealing with one another at arm's length. Paragraph 69(1)(b) would not appear to have any application to the disposition since the shares cannot be said to be disposed of to a person with whom the shareholder was not dealing at arm's length. Paragraph 251(5)(c), which deems a shareholder to be related to himself, applies only where a shareholder owns shares of two or more corporations.

[52] In contrast, where control of a corporation is acquired by means of an acquisition of shares by one shareholder from another, the transferee is not considered to have disposed of any shares he previously held, nor is the transferor considered to have disposed of any shares that he continues to own.

[53] See, for example, section 45 where the deemed disposition of property upon a change in its use for proceeds equal to the fair market value of the property is deemed to give rise to an immediate reacquisition of the property at a cost equal to the same amount.

CHANGES IN DISTRIBUTION ENTITLEMENTS

In *Interpretation Bulletin* IT-448, Revenue Canada has indicated that any change by way of increase or decrease in the rights of a share to participate in the assets of the corporation upon liquidation or by way of dividend beyond a fixed preferential rate or amount is considered to be a disposition of the share. Many of the points made previously with respect to changes in the voting rights attached to shares are equally applicable to changes in the distribution entitlements in respect of shares.

Changes in the distribution entitlement with respect to one class of shares will result in corresponding inverse changes in the distribution entitlements of other shares of the corporation. For example, assume that a corporation has two classes of shares that are substantially equal in all respects and that one class of shares is amended to provide that the shares are entitled to receive a fixed preferential amount upon liquidation and then to share equally with the other class of shares. It is clear in Revenue Canada's view that the addition of the preferential right to share in the assets of the corporation upon liquidation results in the disposition of the shares that acquire this preferential right. It is not clear, however, whether the other shares of the corporation, the terms of which are not altered but whose economic interest in the corporation is diminished by the addition of the preferential right to the other shares of the corporation, are considered to be disposed of.

If Revenue Canada intends to consider that a disposition of a class of shares takes place only when the terms attaching to such shares are amended, its approach would appear to be too formalistic in focussing only on the class of shares subject to amendment. If Revenue Canada considers that there will be a disposition of any shares in the corporation whose economic interest is significantly altered by any change in the distribution entitlement of any shares of the corporation, Revenue Canada may be going too far. Where rights to an increased participation in the assets of a corporation are added to shares, Revenue Canada's position appears to be that the acquisition of additional property rights adds to the shareholder's bundle of rights, that the new bundle of rights is different from the old one, and therefore that there is a disposition of the shares, the underlying property.

It is hoped that stating this proposition may be sufficient to evidence its absurdity. To extrapolate from Revenue Canada's position, and there is no logical reason why one should not do so, the alteration of the distribution entitlements attaching to shares of any class affects the economic interest of the holders of shares of that class and the holders of shares of any junior ranking class and would result in the disposition of the shares of each such class. It also seems that if Revenue Canada's position is correct, the issuance of additional shares or the redemption of issued shares of a particular class or any senior ranking class could result in the disposition of the shares of the particular class and any junior ranking class.[54]

[54] See, however, *White v. Bristol Aeroplane Co. Ltd.*, [1953] Ch. 65, and *In Re John Smith's Tadcaster Brewery Co. Ltd.*, [1953] Ch. 308, where the Court of Appeal held, for English corporate law purposes, that although the issuance of preference shares affected the ordinary shareholders as a matter of business and thereby affected the enjoyment by the ordinary shareholders of their rights, it did not affect the rights themselves.

Policy Considerations

It is difficult to discern from the text of *Interpretation Bulletin* IT-448, either directly or by implication, any reason or policy objective for Revenue Canada's position. Most of the changes in the terms of securities, which in Revenue Canada's view result in the disposition of the securities, have the effect of shifting some value or voting control from one taxpayer to another and, if voting control has value in itself, in every case it may be said that there has been a shift in value.

This is not a satisfactory explanation, however, since if the value is shifted to a related person in transactions covered by sections 51, 86, 87 or subsection 245(2), the deemed disposition under those provisions (assuming that the proposed amendments to sections 51, 86, and 87 are enacted) will result, in substance, in the realization of a capital gain equal to not more than the amount of the benefit. In contrast, under IT-448 any disposition is a disposition of the entire share or debt for proceeds equal to the full fair market value of the amended security.

It may be that Revenue Canada is simply stating its administrative interpretation of the term "disposition" in order to provide guidelines to taxpayers and to reduce the number of advance ruling applications on these issues. The principles underlying Revenue Canada's position in IT-448, however, are so far reaching that the possibility now exists that transactions that previously were entered into without much, if any, concern that a disposition was involved, may be considered by Revenue Canada now, or in the future when its theories have become fully developed, to constitute dispositions. As a result, there may be a significant increase in the number of advance ruling applications on these questions.

We would suggest that there are substantial policy objections to Revenue Canada's approach to the meaning of the term "disposition." The concept of a disposition is the statutory description of the realization requirement for income tax purposes. As stated earlier, it is a fundamental principle of income tax law that income must be "realized" before it is subject to tax. If property increases in value, the amount of the increase is not subject to tax until it is realized by means of a sale or some other similar transaction.

There are three basic reasons for the realization requirement for income tax purposes.[55] First, in the absence of a realization, the taxpayer may not have any funds with which to pay the tax. Second, the realization requirement provides a determinable amount to be included in the taxpayer's income. In the absence of the realization requirement, periodic valuations of the taxpayer's property would have to be made in order to determine the amount to be included in his income. Finally, the realization requirement involves a final termination of the taxpayer's interest in the property so that further fluctuations in the value of the property are irrelevant to the particular taxpayer.

These three factors underlie the realization requirement and, we suggest, also underlie the concept of a disposition. Revenue Canada's position in IT-448 with respect to the disposition of shares and debt obligations is in large part inconsistent with the fundamental prin-

[55] D. J. Sherbaniuk, "Receipt and the Time of Recognition of Income: A Historical Conspectus of the Income Tax Laws of the United Kingdom, the United States, and Canada" (1963), 15 *U. of T.L.J.* 62.

ciple of realization and the reasons supporting that principle.

A more theoretically acceptable approach would be to treat the changes in the terms of a share or debt obligation, which Revenue Canada believes result in a disposition, as only a partial disposition. Each of the rights and privileges of a creditor in respect of a debt obligation and each right of the bundle of rights of a shareholder in respect of a share of a corporation would appear to constitute "property" within the broad meaning of that term in subsection 248(1). The provisions of the Act certainly contemplate the disposition of part of a property.[56]

In addition, the legal analysis of a share in a corporation and a contract between the parties in respect of a debt obligation indicates that the changes (with the exception of a novation) in most instances will constitute a variation of the terms of the original share or debt obligation and not the termination of the original security and its replacement by a new security. Where the terms of a share or debt obligation are only varied, it is appropriate, at most, to view the holder as disposing of the relevant part of the rights and privileges attached to the property rather than the entire property.

As a practical matter, there would appear to be difficulties in determining the adjusted cost base of that part of the property that is disposed of (that is, the particular right or rights of the total bundle of rights that ceases to exist) and in determining the amount of the proceeds of disposition (that is, the fair market value of the new right or rights received in exchange). In many cases, the taxpayer disposing of rights and privileges attached to property may not receive any proceeds of disposition and therefore would realize a capital loss upon the disposition.[57] It should also be noted that where the terms of a share or debt obligation are altered by the addition of new rights or privileges without any of the old rights or privileges being terminated, no disposition would be considered to have occurred under this approach.

Where the parties are dealing at arm's length, the proposed amendments to sections 51, 86, and 87 would not apply. In fact, each party will presumably acquire rights and privileges equal in value to the rights and privileges equal in value to the rights and privileges he gives up. Arguably, there would be a disposition by each party of certain rights and privileges in exchange for other rights and privileges of equal value. In many circumstances, however, a tax-free rollover may be available for these dispositions.[58] Where such a rollover is not available, in our view it is inappropriate to accelerate the payment of tax on the accrued capital gain.

The result of Revenue Canada's position is that transactions tailored to qualify as rollovers under section 51, 77, 86, or 87 will avoid tax, except that (if the proposed amendments are enacted) in the case of shares, most transactions that involve benefits conferred on related persons will give rise to a capital gain limited to the amount of the benefit so conferred. It is difficult to justify the imposition of tax on all unrealized capital gains whenever a share amendment takes place that fails to qualify as a rollover, that may confer no measurable benefit on anyone,

[56] See, for example, section 43.

[57] If the transaction is covered by section 51, 86, or 87, no capital loss will arise.

[58] The transaction might be planned to come within one of sections 51, 77, 86, or 87.

and that takes place in arm's length circumstances without the intention of conferring benefits.

In *Interpretation Bulletin* IT-453, dated July 31, 1980, Revenue Canada indicated that it will consider a disposition by way of gift to occur under paragraph 245(2)(c) where a controlling shareholder confers a benefit on a related person in either of the following ways:

1) by causing a corporation to issue to all shareholders rights to acquire shares at a price below fair market value and then refraining from acquiring any such shares; or

2) by causing a corporation to issue shares at a price below fair market value.[59]

In these circumstances, the controlling shareholder is considered to have disposed of "an economic interest in the company." According to Revenue Canada, the shareholder's "economic interest" is "his interest in the total of all the rights and privileges that are inherent in the shares that he owns" and by diluting his holding of shares "he disposes of a part of these rights and privileges." In other words, the taxpayer is considered to have made a partial disposition of his shares by way of a gift.

The proceeds of disposition are deemed by paragraph 69(1)(b) to be equal to the fair market value of the rights and privileges given up by the taxpayer. Presumably, in computing his capital gain or loss, the taxpayer must compute the adjusted cost base of the rights and privileges disposed of and deduct this amount from their fair market value. This position is in sharp contrast to Revenue Canada's position in IT-448 that an alteration of the voting rights attached to shares that results in a change in the control of the corporation or in the distribution entitlements of the shares is a disposition of the shares and not just a partial disposition of some of the rights and privileges attached to the shares.

The result seems to amount to a combined statutory and administrative trilogy of inconsistencies. In a transaction with related shareholders where a benefit is conferred on a related person but the transaction otherwise qualifies under section 51, 86, or 87 (as they are proposed to be amended), the deemed disposition will result in a gain limited to the amount of the benefit. In a non-arm's length transaction that does not come within section 51, 86, or 87, but to which subsection 245(2) can be applied, the taxpayer's capital gain would seem to be measured by the fair market value of the rights and privileges disposed of less the adjusted cost base of such rights and privileges. In other circumstances, including all those between persons dealing with one another at arm's length and carried out bona fide, Revenue Canada seeks to tax the full amount of the unrealized gain on the shares or debt obligation.

As has already been stated, the significance to a taxpayer of Revenue Canada's position in IT-448 depends in large part on whether a disposition, which Revenue Canada considers to occur, qualifies for one of the tax-free rollovers provided by the Act. Following are the points that should be noted with respect to the possible rollovers.

[59] The proposed amendments to sections 51, 86, and 87 presumably will reinforce this position. Previously, it might have been argued that the rollover provisions overrode subsection 245(2) so that the disposition would be considered to take place at the adjusted cost base of the shares.

1) With respect to debt obligations, other than those converted into shares, the only rollover available is section 77, which applies only to exchanges of bonds where the old bond was convertible by its terms into the new bond. It would appear to be possible to bring any disposition of a bond that results from an alteration in the terms of the bond within the scope of section 77 by first adding to the terms of the bond the right to convert it into another bond of the same debtor with the same principal amount. In all other circumstances, however, the disposition of a debt obligation by virtue of a change in its terms will not be subject to any tax-free statutory rollover.

2) With respect to shares, section 51 provides that an exchange of shares (which are capital property) is not a disposition if the terms of the old shares confer upon the holder the right to make the exchange. Since the addition of a right to convert shares of one class into shares of another class is not considered by Revenue Canada to result in the disposition of the shares, it would appear that a disposition of shares in the circumstances described in IT-448 can be avoided by structuring the amendment of the shares in the following manner:

a) the creation of a new class of shares with the desired rights and privileges,

b) the addition of a right to convert the old shares into shares of the new class, and

c) the conversion of the old shares into shares of the new class.[60]

3) Section 86 provides a tax-free rollover for exchanges of shares in the course of a reorganization of the capital of a corporation, but it applies only if "property is receivable from the corporation" in exchange for the taxpayer's old shares, which includes other shares of the corporation. There is no case law as to the meaning of the phrase "in the course of a reorganization of the capital of a corporation." Even if the phrase was interpreted to include alterations in the terms of shares, however, section 86 probably would not apply because no property is receivable from the corporation upon an alteration of the terms of shares.[61] As with section 51, the rollover protection of section 86 can probably be made to apply by amending the share terms in a more complicated way. Where the shares are cancelled with the consent of the shareholder, for example, and new shares with the desired rights and privileges are agreed to be issued by the corporation in consideration

[60] Obviously, this alternative method of amending the terms of the shares is less convenient and more expensive from a corporate viewpoint. However, Revenue Canada's position in IT-448 seems to require taxpayers to use artificial and indirect transactions in order to accomplish legitimate objectives. See, too, supra note 23. Quaere: would Revenue Canada attempt to apply the sham or step transaction doctrines or the provisions of subsection 55(1) in this situation?

[61] It might be argued that the basis on which the shares are considered to have been disposed of is that the shareholder has given up his old bundle of rights in exchange for a new bundle of rights and therefore the new bundle of rights is property receivable from the corporation. In our view this argument is unlikely to be accepted by a court because legally the shareholder does not receive anything from the corporation. Although Revenue Canada would say that the shareholder's shares have been disposed of when significant amendments have been made to their terms, it is questionable that section 86 could be made to apply for the additional reason that it requires that *the taxpayer* must have disposed of the shares. If the disposition occurs because of the changes of the bundle of rights by operation of the relevant corporation law and the vote of shareholders, can it be said that the taxpayer has done an act by which he has disposed of his shares?

therefor, section 86 would appear to be applicable.

4) Where it is not possible to obtain a rollover under section 51 or 86, a rollover may be accomplished by an amalgamation of the corporation with another corporation. The disposition of the shares of the predecessor corporation in exchange for shares of the amalgamated corporation that have the desired rights and privileges is entitled to tax-free rollover treatment under subsection 87(4).[62]

Treatment in the United Kingdom and the United States

UNITED KINGDOM

The U.K. capital gains tax legislation applies to the "disposal" of "all forms of property."[63] While a number of specific transactions are defined by the statute to be disposals, generally the term "disposal" is considered to mean "any form of transfer or alienation of the beneficial title to an asset (whether legal or equitable) from one person to another."[64]

One of the specific situations in which the statute deems a disposal of property to occur is where a capital sum is received in return for the forfeiture or surrender of rights or for refraining from exercising rights.[65] The House of Lords recently held that a sum received by an employer in consideration for releasing an employee from his service contract was a capital gain realized by the employer from the disposal of an asset (the contract) even though the asset was not assignable and therefore did not have a market value.[66] It should be noted that on the facts of the case the taxpayer disposed of all its rights under the contract; in other words, the contract was completely discharged. In addition, the taxpayer received a cash payment in consideration for the disposal of the contractual rights and, indeed, the U.K. statute requires that an amount be received in order for there to be a disposal of property.

With respect to debts, no chargeable gain arises from the disposal of a debt unless the debt is a "debt on a security."[67] The disposal of a debt generally occurs only upon the satisfaction, in whole or in part, of the debt and not upon an alteration in its terms.[68]

With respect to the shares of a corporation, the U.K. legislation deems a disposal at fair market value to occur where a taxpayer who controls a corporation exercises that control so that value in respect of shares owned by him passes to other shares of the corpora-

[62] As with section 51, under the proposed amendments to section 87(4), if the amalgamation has the effect of reducing the fair market value of the shares and conferring a benefit on a related person, the rollover will only be partially effective since the amount of the benefit will be deemed to be a capital gain.

[63] Finance Act 1965, section 22.

[64] Wheatcroft and Whiteman, *Capital Gains Tax*, 2d ed. (1973), 73.

[65] Finance Act 1965, subsection 22(3)(c).

[66] *O'Brien v. Benson's Hosiery (Holdings) Ltd.*, [1979] TR 335 (HL).

[67] Finance Act 1965, Schedule 7, paragraph 11(1). The meaning of the term "debt on a security" is unclear but includes loan stock and similar securities. For a further discussion of the meaning of the term "a debt on a security," see: *W. T. Ramsay Ltd. v. CIR*, [1979] STC 267 (CA), and the critique of this case in (1979), no. 4 *British Tax Rev.* 251.

[68] Finance Act 1965, Schedule 7 paragraph 11(2).

tion.[69] Such a statutory provision is considered to be necessary, in the view of one commentator, because otherwise there would be no disposition of any property.[70] This deemed disposition provision has apparently left many unanswered questions and its application can produce unsatisfactory results.[71]

Where the rights attached to the shares of a corporation are altered, the alteration is considered to be a reorganization of the corporation's share capital and, by a specific statutory provision, no disposal of the shares is considered to have occurred.[72] The amended shares are considered to be the same property as the original shares. If a shareholder receives nonshare consideration as a result of the alteration in the rights attached to his shares, a partial disposition of the shareholder's original shares is considered to have occurred. The determination of the portion of the cost base of the property disposed of is made by reference to the fair market value of the property at the date of the disposition.[73] Where the taxpayer pays an amount pursuant to the alteration in the rights attached to his shares, such amount will be added in computing the cost base of the amended shares.[74]

Although the relief provided where share rights are altered is extremely broad, it is not clear that the relief provision will override the deemed disposal that occurs where a person controlling a corporation uses that control to transfer value to other shares of the corporation.

In summary, the U.K. treatment of alterations in the terms of shares and debt obligations produces more sensible results than Revenue Canada's position in *Interpretation Bulletin* IT-448. The U.K. position in respect of shares is based on a specific statutory enactment which will be closely paralleled by sections 51, 86, and 87 of the Canadian Income Tax Act if the proposed amendments to those provisions are enacted. Neither statute goes as far as Revenue Canada has gone on an administrative basis in IT-448. The U.K. legislation provides specifically that alterations in the rights attached to shares are not con-

69 Finance Act 1965, Schedule 7, paragraph 15. This seems analogous to the proposed amendments to sections 51, 86, and 87 and the present provisions of subsection 245(2) of the Canadian Income Tax Act. For the purpose of capital transfer tax, section 39(5) of the Finance Act 1975 provides that where there has been an alteration in the share or loan capital of a close company, the alteration is treated as if it was made by a disposition. In this way, if the alteration has the effect of reducing value, the reduction is considered as a gift subject to tax.

70 Tiley, *Revenue Law,* 2d ed., 570.

71 See, for example, Wheatcroft and Whiteman, supra note 64, at 93-94 and 150, where it is said: "The authors regard this provision as being most unsatisfactory. There are many obscurities as to its precise scope; it may be entirely inadequate to deal with a skilled tax avoider, but it is quite likely to trap some unwary person with no tax avoidance intention in mind." A similar situation exists in Australia where paragraph (1)(f) of the Gift Duty Assessment Act 1941-1957 (Cmmw.) defines disposition to mean "any conveyance, transfer, assignment, settlement, delivery, payment or other alienation of property" and to include, *inter alia* "any transaction entered into by any person with intent thereby to diminish, directly or indirectly, the value of his own property and to increase the value of the property of any other person." It is clear that in the absence of this specific statutory definition, such transactions would not be covered by the ordinary meanings of the term "disposition." See *Gorton v. Federal Commissioner of Taxation* (1965), 113 CLR 604 (H.Ct.).

72 Finance Act 1965, Schedule 7, subparagraph 4(1)(a)(ii).

73 Id., paragraph 4(5).

74 Id., paragraph 4(3).

sidered to result in dispositions of the shares except where the shareholder receives nonshare consideration and even then only a partial disposition of the shares occurs.

UNITED STATES

The U.S. comparison is less helpful since under the Internal Revenue Code, gains are realized only when there has been a "sale or exchange" of a capital asset.[75] While the U.S. jurisprudence has construed the sale or exchange requirement broadly, it is clear that not all dispositions of property are sales or exchanges of property.[76] Under the U.S. tax system, if property is not the subject of a sale or exchange, any gain realized upon its disposition cannot qualify for capital gains treatment.

With respect to the variation of rights under a contract, the U.S. jurisprudence is not clear whether the extinguishment or termination of a contractual right is equivalent to the sale or exchange of the right.[77] It is important to note, however, that in these cases there was no question that a gain had been realized; the only difficulty was the characterization of the gain as a capital gain or as ordinary income.

There are apparently no clear rules for U.S. tax purposes governing the tax consequences of modifications in the terms of a share or debt obligation. In some circumstances, the substance over form doctrine may be applied to treat a substantial variation in terms as a disposition of the property. A disposition of the share or debt is more likely to be considered to have occurred where the alteration in the terms of the share or debt results in a transfer of valuable rights from one taxpayer to another and where the alteration in terms is so substantial that new and different property is created.

The Internal Revenue Code, however, provides broad nonrecognition provisions where securities are exchanged pursuant to a recapitalization of the capital of a corporation[78] and where common shares are exchanged for other common shares of the same corporation or preferred shares are exchanged for other preferred shares of the same corporation.[79]

Conclusion

It is our view that Revenue Canada's position as stated in *Interpretation Bulletin* IT-448, that certain alterations in the terms of shares and debt obligations are sufficiently significant to result in the disposition of the shares or debt obligations, is untenable. The juris-

[75] Internal Revenue Code, section 1222.

[76] Feld, "Capital Gains and Losses—Sale or Exchange Requirement," Tax Management Portfolio no. 344, at 1-3. For example, the destruction of property is not considered to be the disposition of the property by sale or exchange. See *Helvering v. Flaccus Oak Leather Co.,* 313 U.S. 248 (S.C. 1941). This result has been changed in part as a result of the enactment of section 1231 of the Internal Revenue Code.

[77] See, for example, *Commissioner Internal Revenue v. The Pittston Company,* 252 F. 2d 344 (2d Cir. 1958) and *Commissioner v. Ferrer,* 304 F. 2d 125 (2d Cir. 1962).

[78] Internal Revenue Code, section 368(a)(1)(E). Such recapitalizations are commonly referred to as "Type E Reorganizations." The Internal Revenue Service has taken the position on at least one occasion that an alteration in the distribution entitlement of certain shares was, in substance, an exchange of shares. In Revenue Ruling 56-654, 1956-2 C.B. 216, the amount to which preferred shares were entitled upon redemption and liquidation was substantially increased in order to reduce the value of the common shares of the corporation to facilitate the purchase of such shares by an officer of the corporation. Consequently, the exchange qualified as a tax-free exchange pursuant to a recapitalization of the corporation.

[79] Internal Revenue Code, section 1036.

prudence in Canada, the United Kingdom, and Australia is clear that a "disposition" necessarily involves some alienation or extinguishment of the taxpayer's interest in the property. In virtually all the cases outlined in *Interpretation Bulletin* IT-448 in which Revenue Canada considers a disposition to occur, no such alienation or extinguishment of the taxpayer's interest in the debt or shares can be said to take place.

While there is no question that the taxpayer has either given up certain rights or acquired certain rights, Revenue Canada's position is not that the taxpayer has disposed of such rights but rather that the taxpayer has disposed of the entire underlying property to which the rights attach. In this respect we are of the view that Revenue Canada has gone too far on an administrative basis in adopting, without any specific statutory authority, an interpretation that is unjustified by the existing jurisprudence.

Parliament and the legislative draftsman have been generous in providing a large number of rollover provisions applicable to transactions that would otherwise clearly constitute taxable dispositions of property.[80] It is curious, therefore, that Revenue Canada has apparently attempted to accelerate the realization of gains by taking the position that a disposition of property may occur in circumstances in which, in our view, such a disposition is not supportable by the provisions of the Act, by the jurisprudence, or by policy considerations.

Many of the situations where Revenue Canada considers a disposition to occur were probably never contemplated by Parliament or the draftsman. It is understandable therefore that the Act omits rollover treatment for these newly discovered "dispositions" because, properly viewed, the alteration of contractual or shareholder's rights would not normally be considered to result in a disposition of the property to which the rights attach.[81]

Currently, however, the combination of the legislative provisions and Revenue Canada's administrative interpretation presents the taxpayer with the curious result that many transactions that are clearly dispositions may take place on a rollover basis, while some transactions where benefits flow to related persons may be partial rollovers and an indeterminate number of more subtle transactions, which Revenue Canada views as dispositions, result in the full realization of gains or losses.

Therefore, Revenue Canada's new policy will act as a trap for the less sophisticated taxpayer and his advisers. It is hoped that sophisticated taxpayers and their advisers will be able to anticipate these problems and deal with them either through the advance ruling process or by structuring otherwise simple transactions to fit the more complex framework required to bring them into the ambit of one of the statutory rollover provisions.[82]

80 The Carter Commission recommended broad tax-free rollover provisions with respect to exchanges of securities. See Royal Commission on Taxation, *Report*, vol. 3 (Ottawa: Queen's Printer, 1966), 374-5.

81 There may be special circumstances in which it is appropriate to view modifications to property as resulting in the partial disposition of the property. See, for example, the proposed amendments to sections 51, 86, and 87 and paragraph 245(2)(c) of the Act.

82 For example, by attaching a right to convert a share into other shares of the corporation prior to the actual conversion of the share, section 51 may be made applicable. Similarly, many amendments to share provisions may be accomplished pursuant to a reorganization of the capital of the corporation or in the course of a statutory amalgamation with another corporation pursuant to sections 86 and 87 respectively.

The effect of Revenue Canada's new policy will only add, and in our opinion unjustifiably so, to the already unnecessarily complex mystique of Canadian income tax law. It will result in more expense and delay to taxpayers and it will furnish further support to the growing number of critics of the Canadian income tax system and its intricacies, subtleties, and complexities. Certainly we expect the result to be anything but a reduction in ruling requests submitted to Revenue Canada.

Perhaps the most striking aspect of *Interpretation Bulletin* IT-448 is the fact that the principles on which Revenue Canada relies with respect to shares and debt obligations can be extended to many other types of property.[83] For example, any significant variation in the terms of such intangible property as a licence agreement, a franchise agreement, a partnership agreement, or other contract[84] would appear to result in a disposition not just of the particular varied rights under the contract but also perhaps of the entire bundle of contractual rights. Similarly, the principles in the bulletin could be extended to tangible property. The granting of a lease, for example, or the variation of rent or the term of an existing lease could be considered as modifications of the bundle of rights of both the fee simple owner and the tenant and could result in the disposition of the underlying property by the lessor and the disposition of the leasehold interest by the tenant.[85]

It is our hope, however, that Revenue Canada can be persuaded to reconsider its position as reflected in *Interpretation Bulletin* IT-448 or, if it is determined to adhere to its position, that the Department of Finance will provide relief through appropriate statutory amendments.[86] We submit that it is not acceptable to leave the interpretation and application of the law in the state of confusion that flows from the examples outlined in the bulletin and the extrapolation of the principles stated therein to other transactions.

[83] It is thought that Revenue Canada did not consider this matter and may not intend at this time to extend the principles of IT-448 to property other than shares or debt obligations. However, it is difficult to distinguish shares and debt obligations from other contractual rights or other intangible property for these purposes.

[84] Such contractual rights may constitute capital property; *O'Brien v. Benson's Hosiery (Holdings) Ltd.,* supra note 66.

[85] Compare section 25(4) of the U.K. Capital Gains Tax Act, 1979.

[86] In light of the recently proposed amendments to sections 51, 86, and 87, however, it is unlikely that the Department of Finance would provide rollover relief except in cases involving unrelated taxpayers.