

I believe that, as Sir Richard Livingstone is constantly reminding us, the main task of education is the formation of character, and that the desirable democratic character is marked by independence of mind, a sense of values, and a broad (but not complete) toleration of opinions other than one's own. Such a character is only achieved in those who have had some experience of personal responsibility, who understand others, and who have always before them that "habitual vision of greatness" whose existence depends upon a study of the past as well as the present.

### The Teachers

It is obvious that these qualities cannot be produced in our young people except by the very best of teachers. It is a sad fact that the educational and professional qualifications of Nova Scotian teachers as a whole are at a lower ebb now, as a result of the war, than they have been since 1933. But the tide is about to turn, indeed may already have turned. Therein lies hope for the future. For a new and better qualified generation of teachers imbued with the spirit of an improved curriculum could not fail to raise the whole standard of education in our schools.

## Tax Avoidance in Canada

JOHN WILLIS

CANADA'S new Income Tax Act<sup>1</sup> provides, in Section 216, that "where the Treasury Board has decided that one of the main purposes for a transaction . . . was improper avoidance" of income tax, "the Treasury Board may give such directions as it considers appropriate to counteract the avoidance." The same Section states further that "an avoidance of taxes may be regarded as improper . . . although it is not illegal." This means, in plain English, that a man who has hired a lawyer or accountant to devise a scheme which is within the spirit but outside the words of the Income Tax Act can nevertheless be told by a committee of the Federal Cabinet that he must still pay the taxes he put out good money to dodge; or, in equally plain English, be forced by the government to pay a tax which is not imposed on him by law. What is the reason for this drastic provision?

There are only two ways of escaping income tax. The first, which is generally

regarded as dishonest, is to omit items from your return, charge as deductions payments you never made, and so forth. This is called evasion; it offends directly against specific provisions of the Act and the government maintains an enforcement division in the income tax department to catch and prosecute offenders. The second is so to arrange your affairs that what is in substance taxable is in form non-taxable. This is called avoidance and is entirely respectable. Unfortunately you do not know enough about the legal mysteries to do it yourself and you have to pay someone else to do it for you.

The fundamental principle of any tax avoidance scheme which your tax expert thinks up is always the same. It is to apply to situation "B" a principle of law which grew up to deal with situation "A" and has no relevance to situation "B".

Take first the principle that a man pays tax on his own income and not on someone's else's income—a principle so obvious that it requires no explana-

1. "The Income Tax Act," 11-12 George VI, Chapter 52, assented to 30 June, 1948.

tion. Suppose you are a married man and live on the \$250,000 a year which your investments bring in. If you transfer half of those investments to your wife, there are now in law two incomes—your income of \$125,000 and your wife's income of \$125,000—and because of the graduated rates the tax on two incomes of \$125,000 each is less than the tax on one income of \$250,000. But placed against the background of the facts of family life, the principle however sound in law does not here make sense for tax purposes. Before you made the transfer, the \$250,000 was in substance as much hers as yours and yet you paid tax on it as yours. The transfer has made no change in substance; the change has been in form merely. And a man's duty to contribute his share to the community in which he lives should not depend on the accident of form alone. This obvious gap, and other inter-family transfer gaps, has of course been plugged by specific and detailed provisions in the Act.<sup>2</sup>

Or, passing now to the less obvious, take the principle that permits a company to charge the interest on its bonds as a deductible expense.<sup>3</sup> The normal realistic way for a small businessman to incorporate his business is, of course, to sell the assets of his business to the new corporation for shares; he is the owner of the enterprise and it is shares which give ownership. But that isn't the way it is done to-day. He sells for a small amount of shares and a large amount of bonds, and the reason why he does it that way is that while he still receives the profits of the enterprise—in the guise of interest—the corporation, which could not have deducted those profits from its income if it paid them out as dividends, may now deduct them because it pays them out as interest on

its bonds. The result is that a man who is in substance the owner of the enterprise may, by making himself in form its creditor, reduce the tax payable by the corporation and so the total tax payable by him on the profits. This method of tax avoidance has even got, it seems, the blessing of Mr. Abbott, the present Minister of Finance, for in reply to a question in the Banking and Commerce Committee he treated it as falling outside even Section 126: "It is not a transaction for the purpose of avoiding taxation. It is a transaction for the purpose of incorporating the business and one of the main purposes of it is not the avoidance of taxation."<sup>4</sup>

Now take as a final illustration the principle that gains realized from an isolated transaction of purchase and sale of property are not taxable, i.e., the absence of a tax on so-called capital gains. Suppose you are a well-known professional actor or acrobat. It seems quite possible that you could, leaving aside the possible application of Section 126, avoid income tax on your earnings by incorporating a company, agreeing to work for five years for a small salary for the company and then selling your shares in the company to your sponsor for a lump sum. In substance you would be receiving your five years' salary from your sponsor in advance, but in law you would, the Courts might hold, be receiving no more than the sale price of your shares in the company. This is the kind of thing that Jack Benny was after in the recent much-publicized dealings with the United States Treasury.

#### "Substance" Versus "Form"

The reason why transparent devices like these are successful—to the perpetual astonishment of the bewildered ordinary man in the street—is that the courts have allowed themselves to become hampered by a defective method of statute interpretation. "It is the

2. See Sections 21-23 of the Act.

3. It is assumed that the change in wording of the interest section in the new Act does not change this principle which was certainly the law under the old Act. See *Canadian Chartered Accountant, Tax Review*, January, 1949, pp. 6-9.

4. Standing Committee, Banking and Commerce, House of Commons, 1948, p. 707.

letter of the law, and not its assumed or supposed spirit that governs. The intention of the legislature to impose a tax must be gathered only from the words by which it has been expressed and not otherwise." So Mr. Justice Thorson, the President of the Exchequer Court, in the course of a recent summary of previous authorities.<sup>5</sup> This stern rule, an open invitation to tax avoiders, was at one time believed to be tempered by the doctrine that in analyzing what the taxpayer did the court was entitled to regard the substance of the matter and disregard the form. In 1936, however, the House of Lords gave the supposed doctrine its quietus and stated that "every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so order his affairs that the amount of tax sought from him is not legally claimable."<sup>6</sup> The attitude of the Courts, in a word, is, to recall the well known remark of Mr. J. P. Morgan, that a man is a fool to pay taxes the government does not know enough to collect.<sup>7</sup>

The recent war, however, brought about a change in public attitudes to tax avoidance. "In the Victorian period the avoidance of taxation was a polite gentlemanly game. Taxation was low, and if a taxpayer could find a hole in the law and crawl through it, everyone laughed about it and tried to block up the hole . . . But when taxation becomes

as heavy as it is to-day, when to a very great extent the people of this country are working for the state . . . then it is not an amusing matter and is beyond the realms of a game. It becomes something—well, perhaps not exactly treason, but something most unpatriotic and unsocial." That was what Mr. Ilsley, then Minister of Finance, said in the House of Commons in 1943.<sup>8</sup> The Lord Chancellor, also in 1943, had this to say of tax avoiders in England: "There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matters, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is of course to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."<sup>9</sup>

There were a number of ways theoretically open to the government of translating into law the changed public attitude towards tax avoidance. They could, as in the past, wait until a new device appears, treat it as valid in respect of all previous transactions but insert a new section in the Act to plug the gap for the future; a very large number of sections in the Act even now are essentially gap-plugging sections directed at the most tempting holes in the fence. That is, of course, no solution; it gives the green light to the tax experts and their clients. Or, to go to the other extreme, they could, as was actually suggested in the House of Commons,<sup>10</sup> make tax avoidance a crime. But why try to stamp as a criminal a person whom you will find it extremely difficult in practice to convict, when what you

5. *David Fasken Estate v. Minister of National Revenue*, 1948, Ex. C. R. 580, 589.

6. *Inland Revenue Commissioners v. Westminster (Duke)*, (1936), A.C. 1, 19-20, per Lord Tomlin.

7. Quoted in Paul, *Taxation for Prosperity*, (Bobbs-Merrill, 1947), p. 277.

8. *Debates*, 1943, p. 2255.

9. *Latilla v. Inland Revenue Commissioners*, (1943), A.C. 377, 381.

10. *Debates*, 1943, p. 2232, Mr. M. J. Coldwell.

really want from him are the taxes which he ought to have paid? Or, to take a more moderate proposal, they could draft the Act in terms rather wider than they expected to enforce in practice. The difficulty here is that the tax law in action becomes not the tax law prescribed by the openly arrived at decisions of Parliament and the Courts, but the tax law lurking in the secret recesses of the minds of the income tax officials.

### When Is Avoidance "Improper"?

Section 126, under which a committee of the Cabinet may counteract the income tax avoidance resulting from any transaction one of whose main purposes was the improper avoidance of tax, is an attempt to get the best of both worlds. The citizen is liable only to the tax imposed by the Income Tax Act as interpreted by the Courts but the government holds in reserve the power to deal effectively with tax avoidance carried out by devices it cannot at present foresee. A number of objections to the section have been raised, of course, by those who rather optimistically hoped that the power would not be carried over into the permanent peace-time legislation: "it casts a continuing cloud on legitimate transactions and prevents finality"<sup>11</sup>; "put in the hands of a vindictive administration . . . it could be used vindictively"<sup>12</sup>; it is "pure autoeracy" to make a man pay taxes when he is not within the law.<sup>13</sup> The history of the section's wartime predecessors and the narrow wording of the section itself, however, suggest that it will in practice be used only in the most flagrant cases.

The position taken by Mr. Abbott on both these points is significant. He has assured the objectors that the power has only been used four times in the five years which have elapsed since its inception in 1943 and has emphasized the large sums of money and the bare-faced type of avoidance involved in those cases.<sup>14</sup> He has, as pointed out above, emphasized the fact that the power does not extend to any transaction unless one of its "main" purposes is the avoidance of tax and has indicated that it does not in particular extend to the bare-faced tax dodging scheme of reducing tax on the incorporation of a small business by issuing a small number of shares and a large number of bonds. And he consented to an amendment of the section as originally drafted whereby that main purpose must be not merely avoidance of tax but "improper"; there are, it seems, two sorts of tax avoidance, "proper" and "improper" avoidance.

The future of tax avoidance and the tax experts in Canada still looks bright. That should not be. It is fundamental to the successful operation of any system of taxation which, like the income tax, presupposes the honesty and co-operation of the taxpayer that each taxpayer should feel that the law which applies to him applies to all. He cannot feel that so long as there is one law for him and another law for those who are rich enough or tax-conscious enough to employ tax experts. Re-assured on this point, he might even tolerate another more sophisticated type of current tax avoidance—special legislative concessions obtained by unceasing pressure of organized lobbies. But that is another story altogether.

11. Standing Committee, Banking and Commerce House of Commons, 1948, p. 690.

12. Same, p. 708.

13. Same, p. 696.

14. Same, pp. 697-698.