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• COMMENTARY •

The Constitutional Power to Tax

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Democratic societies cherish fundamental principles of the rule of law and accountability for the collection of taxes for public purposes. Under Canadian law, the federal Parliament and provincial legislatures can only impose taxes based on authority pursuant to the Constitution. We can trace the origin of this ancient rule — no taxation without representation — as far back as *Magna Carta* (1215). Under the doctrine of parliamentary supremacy, the Constitution and legislative traditions determine the power to tax and the processes of passage of money bills.

• In This Issue •

No Taxation Without Representation

Section 53 of the *Constitution Act*, 1867 embodies the principle of no taxation without representation as a constitutional imperative[1]:

> Bills for appropriating any Part of the Public Revenue, or for imposing any Tax or Impost, shall originate in the House of Commons.

The provision enshrines the doctrine of control and accountability over taxation by elected representatives.

Division of Powers

The Constitution[2] divides the authority to impose taxes between the federal and provincial governments. The federal Parliament has the power under subs. 91(3) to raise money by *any* mode or system of taxation. Subs. 92(2) allows the provinces to impose income taxes but only through *direct* taxation within the province and only for raising revenue for

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provincial purposes. This division of the taxing power gives the federal government considerable power over the national economy and the distribution of wealth amongst the provinces.

The legislature must clearly express its will to levy a tax in the first instance. Although the legislative body can delegate the details of taxation and its mechanism to another body, it must do so in unambiguous language that clearly expresses its intention.[3] However, neither the Dominion nor a province may delegate to the other its power to legislate on taxation.[4]

The dual authority to levy income taxes results in differential income tax burdens in various regions in the country. The income tax burden for Ontario residents, for example, is substantially higher (46.4 per cent in 2008) than the equivalent tax in Alberta (39 per cent).

Sources of Tax Law

The *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) is the primary source of domestic income tax law. The Act authorizes the enactment of *Income Tax Regulations* ("Regulations"). Parliament can amend the Act but only through a Bill introduced in the House of Commons. In contrast, an Order-in-Council is sufficient to enact a Regulation.

The rationale for limiting provincial legislatures to direct taxation is to contain provincial powers within provincial boundaries. Thus, the provincial taxing power is limited to: (1) direct taxes; (2) imposed within the province; and (3) for provincial purposes. The last of these requirements prevents a province cannot use its taxing power for colorable purposes by concealing its real objectives.

To be sure, in economic terms, we cannot contain provincial taxes within a province. Taxpayers can always pass on direct taxes to persons (for example, consumers) outside the province. As a matter of law, however, there is an important distinction between direct and indirect taxation. In 1848, John Stuart Mill stated the distinction between direct and indirect taxation as follows:[5]

> A direct tax is one which is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another, such as the excise or customs.

The constitutional validity of a tax depends upon its pith and substance.[6] Thus, the crucial inquiry is the object and primary purpose of the scheme and not simply its formal or superficial characteristics.[7] The pith and substance approach contrasts with blanket categorizations whereby courts regard certain categories of taxes — such as property and income taxes — as direct taxes.[8]

The categories approach was appropriate for traditional forms of taxation — such as taxes on land and sales of goods — that existed in 1867. It is not helpful, however, in assessing whether innovative taxation schemes — which could not have been within the reasonable contemplation of the British Legislature when it enacted the *Constitution Act* in 1867 — are direct or indirect taxation. In *Atlantic Smoke Shops Ltd. v. Conlon,* Lord Simonds emphasized the need for analysis of the real nature of the tax:[9]

> Their Lordships are of opinion that Lord Cave's reference in his judgment in the Fairbanks' case to "two separate and distinct categories" of taxes, "namely those that are direct and those which cannot be so described", should not be understood as relieving the courts from the obligation of examining the real nature and effect of the particular tax in the present instance, or as justifying the classification of the tax as indirect merely because it is in some sense associated with the purchase of an article.

Hence, we look at the *legal* incidence of a tax, not its label, to determine its constitutional validity.[10]

The categories approach does not provide an unequivocal answer to the nature of a tax. For example, a land tax would usually be a direct tax; it may, however, also be an indirect tax under the legal incidence test. As Justice Iacobucci said in *Ontario Home Builders' Association*:[11]

> The hallmarks of a land tax are that the tax is, of course, imposed on land against the owner of the land, and that the tax is assessed as a percentage of the value of the land, or a fixed charge per acre. The tax may be an annual, recurring assessment, or a one-time charge ... Although landowners, like everyone, may wish to pass on their tax burden to someone else or otherwise avoid taxation, this desire or ability does not transform the direct nature of the tax into an indirect one ... the case law reveals that land taxes are generally direct taxes; but I do not believe the case law

> prevents a tax on land by itself from being treated as an indirect tax.

Most economists consider Mills' definition of direct and indirect taxes to be narrow and rigid. Indeed, the question as to who actually bears the burden of any tax ("incidence of taxation") is an unsettled economic issue that engenders considerable debate.

Nevertheless, in constitutional law, Mills' distinction between the two forms of taxes is the legal yardstick.[12] The courts regularly use the test.[13] Given the uncertainty of the ultimate incidence of a tax, for the purposes of constitutional law, Mill's definition is a useful demarcation between direct and indirect taxes.[14]

Restraint on Powers

Section 125 of the *Constitution Act, 1867* provides that no lands or property belonging to Canada or any province shall be liable to taxation. Section 125 provides inter-governmental immunity from taxation in respect of any "lands or property" that the federal or provincial Crown may own. The provision also extends to Crown agents such as Crown corporations.[15]

What is the extent of inter-governmental immunity? The first question we must determine is whether a particular statutory measure is a "taxation" measure or the exercise of regulatory power under some other legislative head - for example, the commerce clause.

On its surface, it appears as though s. 125 exempts only provincial "lands or property" from federal taxation. In fact, the restraint on the federal government is broader: the section applies not only to provincial lands or property but also to taxes levied on persons and transactions in respect of Crown property.

Thus, s. 125 overrides the express powers of taxation contained in subs. 91(3) (the federal power) and 92(2) (the provincial power) of the *Constitution Act, 1867* and provides a constitutional guarantee of immunity from federal taxation of provincial property.[16]As the Supreme Court of Canada said in *Re Exported Natural Gas Tax*:[17]

> This immunity would be illusory if it applied to taxes "on property" but not to a tax on the Crown in respect of a transaction affecting its property or on the transaction itself. The immunity would be illusory since, by the simple device of framing a tax as "*in personam*" rather than "*in rem*" one level of government could with impunity tax away the fruits of property owned by the other. The fundamental constitutional protection framed by section 125 cannot depend on subtle nuances of form.

Hence, once we determine that the "pith and substance" of a measure are "taxation", s. 125 restrains the federal government from imposing the tax on provincial lands, property, Crown agents, and transactions directly involving provincial property. This appears to be the case whether or not the province is involved in commercial activity. In Professor Hogg's words:[18]

> Section 125 probably covers taxation of all property belonging to Canada or a province, regardless of whether the property is acquired for or employed in a commercial activity or a governmental activity. The section is not limited to non-commercial property.

The determination of whether the substance of legislation constitutes taxation or the exercise of a regulatory power can be a difficult question and, in some cases, produces dubious results.[19]

Administrative Responsibility

The Department of Finance determines the policy of financial affairs that fall within the authority of the federal power.[20] The Minister of National Revenue is responsible for administering the *Income Tax Act*.[21] Thus, unlike most other countries, Canada places the responsibility for enacting fiscal legislation and its administration in different ministries.

Federal-Provincial Agreements

The *Federal-Provincial Fiscal Arrangements Act* governs federal-provincial income tax arrangements.[22]

Prior to 1962, the federal government dominated the field of income taxation. Except for Ontario and Quebec, the federal government occupied the entire field of individual and corporate income taxation in exchange for agreed-upon "rental" payments to the provinces. The "rental" payments were compensation to the provinces in exchange for giving up their constitutional rights to levy direct taxes.

The *Federal-Provincial Fiscal Arrangements Act (1961)* altered the revenue sharing structure. The federal Parliament unilaterally vacated a portion of the income tax field to the provinces, which allowed the provinces to re-enter the income tax field and impose their own taxes.

The federal government has tax collection agreements ("TCAs") with all the provinces and territories — except Quebec — for the collection of personal income taxes. It also has TCAs with all the provinces and territories — except Quebec, Ontario and Alberta — for the collection of corporate income taxes. Thus, Quebec is the only province that administers both its corporate and individual income taxes.

To facilitate collection and assessment, the agreements require the provinces to levy their tax by reference to a taxable base that is identical to that used for federal income tax purposes.

Prior to 2000, the federal government used the "tax on tax" method of income tax collection. Under this method, individuals calculated their provincial income tax payable as a percentage of their federal tax payable. For example, if the federal tax was $100 and the provincial rate was 45 per cent, the provincial tax was automatically $45. The disadvantage of this method is that it restricts the provinces' ability to raise revenues and to create tax policies based on their own evolving social and economic priorities.

In response to the provinces' desire for increased control and flexibility in setting tax policy, the federal government agreed to amend the TCAs to permit a new change the basis on which the provinces levy provincial income taxes.[23] Participating provinces can continue to use the old "tax on tax" method of calculating provincial income taxes or elect to use the new "tax on income" method. The new method calculates provincial income tax payable by individuals as a percentage of their *taxable income* rather than of their federal tax payable.

The new method allows the provinces to determine their own unique income tax brackets and rates and to create their own distinct block of non-refundable tax credits,[24] which gives the provinces greater flexibility in setting tax policy. However, the provinces must still use the federal definition of "taxable income" in order to ensure a common tax base.

Ensuring a common tax base not only facilitates tax collection and assessment, but also mitigates the problems that can arise where there are significant discrepancies in tax policy from one province to the next. For example, a province may wish to establish a very low tax rate on capital income, compared with other sources of income, in order to attract the highly mobile capital from other provinces. If this was permitted, it could negatively impact the national economy.

Residents of Quebec receive an abatement of 16.5 per cent from their basic federal tax, but must pay Quebec income tax according to a special scale of rates.

The Executive Process

The responsibility for fiscal policy and legislation rests with the Minister of Finance. The Department of Finance advises the Minister on changes to income tax legislation. The Department also prepares substantive tax policy papers and drafts most income tax legislation.

The Tax Policy and Legislation Division of the Department studies tax policy issues and reports to the Deputy Minister of Finance through an Assistant Deputy Minister.

The Department of National Revenue administers the *Income Tax Act*. In practice, the Department of Finance and the Canada Revenue Agency (the "CRA")[25] liaise closely on income tax legislation.

The Legislative Process

Legislation in respect of income tax originates in the House of Commons on the recommendation of the Governor General.[26] The government cannot introduce income tax legislation in the Senate, which is unelected. Nor is it possible for a private member to introduce a tax Bill in the House of Commons.

The Budget Process

As a matter of parliamentary tradition, the Minister of Finance presents a Budget[27] to the House of Commons, following which he tables a Notice of Ways and Means Motions to introduce amendments to the *Income Tax Act*. The Budget allows the government of the day an opportunity to review the state of the economy and to announce policies in respect of economic and fiscal programs.

Following the Budget, there is a debate in the House. The debate cannot exceed six sitting days of the House of Commons.

The parliamentary tradition that the Minister of Finance should announce tax changes only in the House of Commons has softened somewhat and some Ministers of Finance now simply announce proposed tax changes by press release.

Some time after the Budget debate, the Minister of Finance introduces amending legislation in the form of a Bill to implement the proposals set out in the Notice of Ways and Means Motions. The Bill is given a first reading in the House to make it a public document.

The House of Commons then debates the Bill in principle during second reading.

Following second reading, the Committee of Ways and Means — a committee of the whole House — debates the Bill.[28] Specialized committees — such as the Committee on Finance, Trade and Economic Affairs — may also consider the Bill. Following detailed examination of the Bill by the Committee of the Whole House, it is given third reading and sent to the Senate.

The Senate does not have the power to initiate income tax legislation; it does, however, have the constitutional authority to debate tax Bills that the House of Commons refers to it. The Senate Committee on Banking, Trade and Commerce is a particularly influential committee whose deliberations may have a substantial impact on such a Bill. As a practical matter, with the exception of purely technical changes, the Senate does not amend income tax legislation without the approval of the Cabinet.

The Bill is then sent for Royal Assent and becomes law the day that it receives Assent and comes into force. With some exceptions, the law proposed in the Bill is usually stated to be effective as of the date of the Budget. Absent Charter protection of property rights, there is no constitutional protection against retroactivity of fiscal legislation.

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1 See, for example, *Confédération des syndicats nationaux v. Canada* (Attorney General), [2008] S.C.J. No. 69, 2008 SCC 68, December 11, 2008; Docket: 31809, 31810 for modern application of the principle.

2 *Constitution Act, 1867* (U.K.), 30 & 31 Vict., c. 3.

3 *Ontario English Catholic Teachers' Assn. v. Ontario (Attorney General)*, [2001] S.C.J. No. 14, 2001 SCC 15 (CanLII), [2001] 1 S.C.R. 470, 2001 SCC 15. (Provincial legislation authorizing the Minister of Finance to prescribe tax rates for school purposes was constitutional. The legislation set out the structure of the tax, the tax base, and the principles for imposing the tax.)

4 *A.G. N.S. v. A.G. Can.* (1950), [1950] S.C.J. No. 32, [1951] S.C.R. 31, 50 D.T.C. 838 (S.C.C.).

5 See: *Cotton v. The King*, [1913] J.C.J. No. 3, [1914] A.C. 176 at 193 (P.C.); see also *Atlantic Smoke Shops Ltd. v. Conlon*, [1943] J.C.J. No. 1, [1943] C.T.C. 294 (P.C.); see generally La Forest J., "The Allocation of Taxing Power under the Canadian Constitution", *Can. Tax Paper No. 45* (Can. Tax. Foundation, 1967) at 81.

6 See, for example, the majority of the Supreme Court in *Reference re Questions set out in O.C. 1079/80, Concerning Tax Proposed by Parliament of Canada on Exported Natural Gas* (1982), 136 D.L.R. (3d) 385 (S.C.C.) at 438: "The essential question here is no different than in any other constitutional case: what is the 'pith and substance' of the relevant legislation?"

7 *Ontario Home Builders' Assn. v. York (Region) Board of Education (1996)*, 137 D.L.R. (4th) 449 (S.C.C.).

8 See *Halifax (City) v. Fairbanks Estate*, [1927] J.C.J. No. 1, [1927] 4 D.L.R. 945 (Nova Scotia P.C.).

9 [1943] J.C.J. No. 1, [1943] A.C. 550 (Canada P.C.) at 565, quoted with approval by Justice Iacobucci at 492 of *Ontario Home Builders' Assn.*

10 *Ontario Home Builders' Assn.* at 476:

> Of course, it is the general tendency of the tax that is of concern, rather than the ultimate incidence of the tax in the circumstances of a particular case ... the test of incidence is based on a legal, rather than an economic distinction ... When determining the incidence of a tax, it is important to bear in mind the context within which the tax operates as well as the purpose of the tax.

See John Stuart Mill "Principles of Political Economy, Book V", (London: John W. Parker & Son, 1852).

11 At 478-479.

12 See *Lambe v. North British Mercantile Fire & Life Insurance Co.* (1887), (sub nom. *Bank of Toronto v. Lambe)*, [1887] J.C.J. No. 1, L.R. 12 App. Cas. 575, [1917-27] C.T.C. 82 (Quebec P.C.) at 582 per Lord Hobhouse:

> Taxes are either direct or indirect. A direct tax is one which is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation

and intention that he shall indemnify himself at the expense of another; such are the excise or customs.

The producer or importer of a commodity is called upon to pay a tax on it, not with the intention to levy a peculiar contribution upon him, but to tax through him the consumers of the commodity, from whom it is supposed that he will recover the amount by means of an advance in price.

13 *Eurig Estate, Re.* (taxpayer challenged Ontario's estate probate fees as being an indirect tax beyond the power of the provincial government. Applying Mills' definition, the tax would be indirect if the executor was personally liable for payment of probate fees, as the intention would clearly be that the executor would recover payment from the beneficiaries of the estate. However, the legislation did not make the executor personally liable for the fees. The executor would pay only in his or her representative capacity. The majority of the Supreme Court held that amounts collected in respect of grants of letters probate constituted a tax rather than a regulatory fee. The probate fee was a direct tax and, therefore, *intra vires* the Province of Ontario.)

See also, *Hudson's Bay Co. v. Ontario*, [2000] O.J. No. 2203, 49 O.R. (3d) 455 (Ont. S.C.J.).

14 *Bank of Toronto v. Lambe* [1887] J.C.J. No. 1, L.R. 12 App. Cas. 575 (P.C.).

15 See, *e.g.*, *Nova Scotia Power Inc. v. R.*, [2004] S.C.J. No. 36, 2004 SCC 51 (S.C.C.) (NSPC acting within its purposes as a Crown agent and thus entitled to immunity from legislation, including the *Income Tax Act*, as provided by s. 17 of the *Interpretation Act*, R.S.C. 1985, c. I-21).

16 *Re Exported Natural Gas Tax*, [1982] S.C.J. No. 52, [1982] 1 S.C.R. 1004 (S.C.C.).

17 *Ibid.*, at 1078.

18 Hogg, *Constitutional Law of Canada*, loose-leaf (Toronto: Carswell, 1997) at 30-32.

19 See *British Columbia (A.G.) v. Canada (A.G.)*, [1923] J.C.J. No. 5, [1924] A.C. 222 (P.C.).

20 *Financial Administration Act*, R.S.C. 1985, c. F-11.

21 *Canada Customs and Revenue Agency Act*, S.C. 1999, c. 17.

22 *Federal-Provincial Fiscal Arrangements Act*, R.S.C. 1985, c. F-8.

23 See generally the Department of Finance's *Federal Administration of Provincial Taxes*, October 1998, Report prepared by the Federal-Provincial Committee on Taxation for Presentation to Ministers of Finance, online: <*http://www.fin.gc.ca/fapt/fapt3e.html*>.

24 Subject to restrictions on minimums; see *Ibid.* at Design and Operation.

25 In December 2003, the Canada Customs and Revenue Agency became the Canada Revenue Agency. The Customs program is now part of the new Canada Border Services Agency.

26 *Constitution Act, 1867* (U.K.), c. 3, ss. 53, 54.

27 “Budget” (contrary to the understanding of the term by accountants who view it as a financial statement) is a derivation from the old French “bougette”, meaning “a little bag”. In British parliamentary tradition, the “little bag” was replaced by a “little box” (14 1/2" by 10") made for Gladstone in about 1860. The box was replaced by a new one in 1996.

28 Unlike bills dealing with non-tax matters, it is the entire House which constitutes the Committee. The public may not make representations directly to the Committee of the Whole House.

• COMMENTARY •

Profiling for Tax Audits

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Governments use probability theory to justify profiling in fighting crime, terrorism and tax avoidance. Unlike racial profiling — which, despite some scientific validity, is always politically incorrect — profiling for income tax audits is legal and even socially acceptable. There is no Charter protection for Canada Revenue Agency (“CRA”) audit profiling. As you prepare to file your 2008 income tax returns, you may be wondering when and if the CRA will audit you. It all depends upon your profile and luck at having your tax return drawn for scrutiny.

An audit is an investigation and verification of reported events to determine whether there is “under-reporting" of taxes by omitting income or inflating deductions. Most employees have a low risk profile because the "pay-as-you-earn" withholding tax system requires employers to deduct income taxes at source from employment income. In the majority of cases, the tax withheld is close to the employee's ultimate tax liability. In terms of statistical profiling, it does not pay the government to expend substantial resources in auditing employee tax returns.

In contrast, self-employed individuals — for example, professionals and cash oriented businesses — are high risk and, therefore, picked upon more frequently for audits. Within the self-employed group the risk of under-reporting increases as earnings rise. Thus, the CRA is much more likely to audit a person earning more than $100,000 — about two and a half per cent of the population — than a person earning less than that amount. The incentive to under-report income varies directly with earnings.

From the taxpayer's vantage, there are two distinct categories of audits: regulatory and criminal. In a regulatory audit, the CRA can demand that the taxpayer immediately produce all of his or her documents for examination. The taxpayer has no *Charter*, and only minimal legal, rights to protect him in a regulatory audit. Indeed, quite the contrary: the law *deems* the Minister's assessment correct unless the taxpayer can prove otherwise in a court of law.

In contrast, the law steps in quickly to protect an individual if the CRA conducts an audit for the purposes of laying potential criminal charges against the taxpayer. The law considers criminalcharges as serious intrusions into the individual's liberty and protects taxpayers from unnecessary and over-extensive intrusions into their financial affairs.

In life, however, the line between routine regulatory audits and criminal investigations is blurred. After all, the only real difference between a regulatory and a criminal audit is the mind of the auditor who must determine whether the evidence that she is accumulating will lead to civil or criminal sanctions at the end of the audit process. The auditor cannot know with any certainty the fork in the road that she will take until he has an opportunity to assess the evidence *after* he gathers and examines it. Thus, invoking taxpayer *Charter* rights is often an ex-post analysis after the government lays criminal charges.

In theory, individuals should always ask at various stages of an income tax audit whether the auditor is conducting a routine regulatory examination or has any other purpose in mind. If the latter, the individual should immediately engage legal counsel and trigger all of her *Charter* rights. Of course, asking the question may well raise the tax auditor's antenna as to the cause of the taxpayer's anxiety.

Tax avoidance is not going away. As governments collect ever-increasing amounts of revenue through taxes, the temptation for under-reporting increases because taxpayers view the tax burden — about ten per cent of Canadians pay 50 per cent of all income taxes — as unfair. Thus, governments use increasingly more sophisticated statistical tests and computerized data to profile high-risk taxpayers who are likely to engage in tax avoidance and evasion. Ultimately, your chance of audit depends upon your profile.

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• COMMENTARY •

Stock Dividents

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Even simple corporate transactions can have hidden tax traps for shareholders. Directors are responsible for understanding the financial consequences of their corporate resolutions and rely upon their legal counsel for appropriate advice on all aspects of their legal decisions. Dividends and share redemptions are two routine corporate transactions with significant legal consequences.

Corporations can pay dividends in various ways. The corporate, accounting and tax considerations of dividends vary according to their purpose and mode of payment.

The most common form of dividend is the cash dividend. Where a corporation declares a cash dividend, it will announce the "record date" — the date when the list of registered shareholders is prepared. The corporation pays the dividend to shareholders on the list as of the record date. The shareholder receives cash that he or she can actually spend.

Modern corporate statutes — such as the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 — contain restrictions on the payment of cash dividends, share redemptions and purchases. For example, the *CBCA* prohibits the payment of a dividend if there are reasonable grounds for believing that the payment would:

(1) render the corporation unable to pay its liabilities as they become due [the liquidity test]; or
(2) cause the realizable value of the corporation's assets to be less than the sum of its liabilities and stated capital.

Thus, there are two prongs: a cash flow test that measures the ability of a corporation to meet its obligations — including interest on debt — as they come due; and an asset test that measures whether the corporation will be able to fulfill its obligations and pay off its liabilities if it sold its assets for their net realizable value. Both corporate tests are fluid and the corporation must satisfy them as of the relevant statutory or contractual date.

Corporate directors who vote for or consent to a resolution that authorizes the payment of an "improper dividend" are jointly and severally liable to restore to the corporation any amounts that contravene the statutory rules.

The power to declare dividends is within the discretion of the board of directors. Directors must use their business judgment to determine the amount of the dividend but cannot cause the corporation to become illiquid or insolvent in the process. Directors cannot delegate the power to pay a dividend to other persons.

A declared dividend is a liability and ranks as corporate debt. The shareholders of the corporation as of the record date can sue the corporation on the debt if the corporation fails to pay the dividend.

A shareholder who receives an "improper dividend" may be liable to repay the improper amount to the directors who are jointly and severally liable for the dividend. Thus, although personally liable for improper dividends, the directors can claim restitution through a judicial order. The remedy is subject to the rules of equitable restitution.

Corporations can also pay stock dividends. A stock dividend is a dividend payable in additional corporate shares. For example, XYZ Inc. has one million shares outstanding. It may declare a ten per cent stock dividend and issue an additional 100,000 shares to existing shareholders. After the stock dividend, the corporation will have a total stated capital of 1.1 million shares outstanding.

A stock dividend is nothing more than an additional proportional distribution of shares to existing shareholders without fresh consideration. It does not require the corporation to distribute either cash or assets to the shareholders. Thus, a stock dividend is not technically a "distribution".

Stock dividends are entirely cosmetic. The stockholder owns exactly the same proportional percentage of the total shares of the corporation after the dividend as he or she did before the dividend. In the above example, a shareholder of XYZ

Inc. who owned 5000 of the million shares — one-half per cent of the outstanding shares — before the dividend, would own 5500 of the 1.1 million shares — one-half per cent of the corporation — after the dividend.

A stock dividend is really a "feel good" dividend without any meaningful financial value. The shareholder receives more shares without any change in proportional ownership. The corporation does not receive any additional assets and is in the same position after the dividend.

There are, however, important accounting and tax consequences of stock dividends. Under generally accepted accounting principles, a corporation must "capitalize" the fair market value of the dividend from its retained earnings account to its capital account. Thus, the retained earnings of the corporation drop by the value of the stock dividend and the stated capital account increases by exactly the same amount. To be sure, the total equity of the corporation remains exactly the same, but it is classified differently on the balance sheet.

Assume that XYZ Inc.'s shares trade on the stock exchange at $20 per share on the day it declares the stock dividend. The value of a ten per cent stock dividend — equal to 100,000 shares — would be $2 million. Generally Accepted Accounting Principles ("GAAP") requires that XYZ Inc. transfer $2 million from its retained earnings account to its capital account.

The cosmetic advantage of a stock dividend is that it reduces retained earnings and, therefore, gives the appearance that there is less cash available for corporate distributions. Shareholders who look only at the retained earnings account are less likely to pressure for cash dividends if they see that the amount in the account is comparatively small. Of course, sophisticated investors know that the place to look for cash to determine the viability of paying a real dividend is in the cash and investment accounts.

However, although essentially cosmetic, stock dividends are not entirely without merit. For irrational reasons, the market does not always respond exactly as the underlying mathematics might suggest. In the above example, the theoretical value of the stock market price of XYZ Inc. should drop from $20 to $18.18 per share after the dividend. If it does, the total market value of the corporation remains $20 million. One cannot create wealth simply by issuing more paper — a principle that governments steadfastly refuse to accept.

There is some evidence that suggests that the market does not always react rationally, particularly if the size of the stock dividend is small — in a range of five to ten per cent. Stock prices do not always fall exactly proportionately to the dilutive effect of a stock dividend. Thus, a shareholder of XYZ Inc. will improve his overall financial position to the extent that the per share market value is above $18.18 immediately after the stock dividend.

Although an investor who receives a stock dividend may not actually enhance his or her wealth, the law taxes him or her as if he or she actually receives an asset of economic value. Tax law requires the investor to recognize the capitalized value — generally the increase in the paid-up capital of the shares — of the stock dividend as income in the year that he receives it. The amount capitalized is then added to the cost of the taxpayer's shares so that it is not taxed again when he sells the shares. Thus, in the above example, the shareholder would be taxable on a dividend of $10,000 — 500 x $20 — and would add the value of the dividend to the cost of his shares.

The immediate inclusion of stock dividends in income violates two fundamental premises of income tax law:

(1) income is the *net increment* of taxpayer wealth in the year; and
(2) income should be taxable only when the taxpayer realizes it.

For tax purposes, there is no difference between a stock dividend and a cash dividend. Both are taxable and taxable in the year of receipt. The investor must raise the cash to pay for his or her non-cash stock dividend.

The purported rationale of the tax rule is to prevent tax avoidance. In the absence of such a rule, a corporation could distribute its retained earnings indirectly — first by converting it into paid-up capital through a stock dividend and then returning the PUC tax-free to shareholders. The rule protects the treasury and prevents tax leakage. Of course, a rule that prevented any increase in PUC for a stock dividend — essentially a non-economic transaction — might address the same concern and be fairer for taxpayers.

Lawyers should be aware of the tax consequences of accounting and market transactions in advising their clients and rendering legal opinions on the viability, legality and financial consequence of corporate dividends. Directors are entitled to rely upon their corporate counsel for advice on all aspects of corporate transactions.

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• COMMENTARY •

The Nature of Tax Law

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Tax law is an unpleasant subject. Income tax is the involuntary expropriation of property without direct compensation — compulsory contributions that the government levies on transactions in goods, services and intellectual property to finance public expenditures that society considers to be for the public good.

Income tax law has a reputation of being a difficult and dry subject. To be sure, tax law is difficult, but it is neither dry nor unpleasant. Yes, tax law is replete with technical detail, difficult — often incomprehensible — sometimes circular, and usually uses obtuse language. Nevertheless, taxpayers must live with the statute as it is and not with the one that they wish to have written. We must comply with tax laws or face severe sanctions. Advisors must advise on uncertain, complex and poorly drafted provisions. Courts must interpret tax legislation in lengthy court battles.

All economic laws are behavioural. Tax laws invite behavioural reponses from taxpayers. At the top end of the rate scale, governments take approximately one-half of earned income. Therefore, it is understandable that taxpayers expend considerable energy and resources trying to minimize the government's tax bite. At the same time, legislators respond to taxpayer planning by drafting provisions that are ever more complex to reduce tax leakage and revenue loss. The *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) and related law takes up 2500 printed pages and grows every year.

To be sure, the raising of revenue is an important, if not imperative, justification of tax law. But governments also use tax law for the purposes of implementing social policies and redistributing income. We see this in the title of the individual tax return form — "Income Tax and Benefit Return". Nearly one-third of Canadians who file tax returns do so primarily to receive benefits from the government and do not pay any income tax at all.

Hence, tax law balances different objectives: for example, funding of public expenditures, economic policies, regional incentives, fair redistribution of income and procedural fairness in administration. Any statute that serves so many diverse — and, often, conflicting — purposes is necessarily going to be more complex than a limited single purpose statute. The tax system should also ensure reasonable access to the courts to resolve disputes.

The *Income Tax Act* is badly drafted. The statute violates almost every principle of grammatical construction. For example, Canadian drafting tradition requires that each section of the Act — no matter its length — should be in a single self-contained sentence. Single sentence drafting of complex provisions makes the statute susceptible to interpretational error.

The comments of a member of the British Parliament speaking about the Irish Home Rule bill in 1889 would fairly describe the Canadian *Income Tax Act* today:

> ... it sweats difficulties at every paragraph; every provision breeds a dilemma; every clause ends in a cul-de-sac; dangers lurk in every line; mischiefs abound in every sentence and an air of evil hangs over it all.

Judge Mogan of the Tax Court of Canada described the definition of "term preferred share" in *Citibank Canada* as follows:[1]

> The definition of "term preferred share" is prolix in the extreme. The persons who drafted that definition did not practise any economy of words or language. One may well ask how many members of parliament understood the definition when it was made law by amendment to the Act.
> ...
> It is so detailed, so particularized; so long [the definition extends over 2580 words in a single sentence] and tedious and excessive in its use of language.

The income tax statute is more than a mere laundry list of provisions Shorn of its technical language, the statute is a policy document that reflects the social, political, economic, and moral values of society at any particular time. A reason underlies each provision. Ultimately, a policy underlies every statutory provision.

Although the policy of provisions may not be obvious on first reading, the rationale is there for those who search for it. As Justice Frankfurter said:[2]

> Legislation has an aim: it seeks to obviate some mischief, to supply an inadequacy, to effect a change in policy, to formulate a plan of Government. That aim, that policy is not drawn, like nitrogen, out of the air; it is evinced in the language of the statute as read in the light of other external manifestations of purpose.

The focus of tax interpretation should be to reconcile the language of the statute with the purpose of the provisions. This creates tensions in statutory construction. For example, should we apply the plain meaning of words — assuming we can discern plain meaning — or the purpose of the underlying provision? The Supreme Court says that it will apply the plain meaning of words where the language is "clear and unambiguous" and look to the purpose of the provision where the language is not so clear but the purpose is.

As we shall see, there are not that many provisions in the *Income Tax Act* that are unambiguous and it is not always clear as to the purpose of provisions. In *Bailey v. R.*,[3] for example, the taxpayer claimed private elementary school fees as "child care" expenses — which are deductible — and not as education expenses — which are not. The Tax Court in an informal decision looked at the so-called "object and spirit" of the childcare provisions and allowed the deduction saying that any education from the school was merely an *incidental* benefit.

Ultimately, all judges are lawmakers. To be sure, they endeavour to remain inconspicuous in tax law. In important ways, however, judges act as policymakers and determine meaning of the law. The meaning of words in tax law is rarely as plain as its authors anticipate when they draft the legislation. Thus, judges must look at legislative history and engage in purposive analysis when the words of the statute are capable of different meanings.

Courts must also cope with the technical detail of tax law and for the purpose of the legislation. In *Hewlett-Packard (Canada) Co. v. R.*,[4] for example, the Tax Court had to wrestle with whether the word "lodge" included "luxury hotels". If it did, the taxpayer could not deduct expenses to entertain its employees in the particular hotels. The purpose of the rule prohibiting deduction of lodge expenses is to prevent expense account living on the public purse. Although dictionaries sometimes use the word "hotel" to describe "lodge", the Tax Court did not think that most Canadians would describe large resort hotels with a range of modern amenities as "lodges". Hence, the court allowed the taxpayer to deduct its substantial expenses. The interpretation sideswiped the underlying policy of the provision against the deduction of such expenses.

Purposive analysis requires an understanding of the underlying principles of tax law, which allows judges to inject their own policy perspective in interpreting the statute. Thus, judges often apply their own normative beliefs of the appropriate policy. Hence, in tax litigation, it is helpful if you "know" your judge.

Thus, many of the important principles of Canadian tax law come in the form of judge-made common law. Of course, the selection of one method of interpretation over another becomes clear only retrospectively. Bureaucrats write complex laws. Taxpayers must live with the complexity of the statute and pay for professional advisors to comply with it. Ultimately, tax advisors must anticipate whether a court will interpret the "unambiguous words" in the same manner as the advisor. Resolving tax disputes, however, is a slow, arduous and expensive process. Hence, we speak of the unpleasant subject of taxes.

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1 *Citibank of Canada v. R.*, [2001] T.C.J. No. 14, [2001] 2 C.T.C. 2260 (T.C.C. [General Procedure]); aff'd. [2002] F.C.J. No. 496, [2002] 2 C.T.C. 171 (Fed. C.A.).

2 Felix Frankfurter, "Some Reflections on the Reading of Statutes" (1947) 47 Colum. L. Rev. No. 4, 527 at 538-39.

3 [2005] T.C.J. No. 203, 2005 TCC 305, [2005] 3 C.T.C. 2170 (T.C.C. [Informal Procedure]).

4 [2005] T.C.J. No. 280, 2005 CarswellNat 1765, 2005 TCC 398, 2005 D.T.C. 976, [2005] 4 C.T.C. 2274 (T.C.C. [General Procedure]).

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