FINANCIAL POST

Canada’s complicated tax rules fail to recognize that a ‘buck is a buck’

Vern Krishna
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In 1966, the Carter Commission said Canadian tax law should recognize that 'a buck is a buck' when it comes to income. Nearly 50 years later, we still treat income in several complicated ways. Jonathan Hayward/The Canadian Press

Having just gone through tax filing season, Canadians can breathe a sigh of relief, at least temporarily, as they wait for the Canada Revenue Agency to determine whether it accepts their returns as filed. Those whose returns are not accepted will learn the meaning of living hell in tax litigation. The CRA does not forgive individuals for being overwhelmed by the Byzantine maze of tax rules. Taxpayers are presumed to know and understand almost 2,700 pages of tax law. The source doctrine is the rule most responsible for the intrinsic structural complexity of the tax statute.

The Income Tax Act divides income into categories known as “sources” of income: office, employment, business, property, and capital gains. Each is taxed at different rates and according to different rules. The sources are silos and cannot be co-mingled. Each source is determined separately according to complex rules that apply only to that source. For example, a capital loss cannot be applied against employment income, but a capital gain is added to income and taxable. All of which baffles taxpayers, and leads to expensive disputes with the CRA.

We inherited our source doctrine from the United Kingdom, which introduced the concept of a scheduler system in Addington’s Act (1803), which was used to finance the Napoleonic wars.

The purpose of the scheduler system was to ensure taxpayer privacy by placing the responsibility for each of the schedules in the hands of different commissioners of taxation, so that no one Commissioner would have a global picture of an individual's financial affairs. The system was not popular, but it eventually gained patriotic support. Some said that it was wiser to declare part of one's profits to the income tax commissioners, rather than give up all it to Napoleon.

The complexity does not stop at the five named sources of income. There are sub-sources within some of the sources, each with its own sub-rule structure. For example, within capital gains, there are sub-categories, such as, personal use property, and listed personal property (LPP) gains. An individual can offset her LPP losses, but only against her LPP gains, and not against any other capital gains. This form of segregation of income can result in a taxpayer actually paying taxes on "negative income."

For example, assume that Jennifer is a partner in a law firm and earns $200,000 in 2015. Her investment adviser puts her into a $125,000 option contract in a speculative oil stock. The stock turns out to be a disaster when oil prices collapse, and Jennifer loses her entire investment. In the same year, as a result of a home invasion, she has uninsured losses of $100,000 on her entire inherited jewelry collection.

In economic terms, Jennifer has negative income (losses) of $25,000 in the year. Nevertheless, she must pay tax on her business income of $200,000, even though she does not really have any net economic gain. She cannot claim her investment loss of $125,000, if it is considered a capital loss, but she can claim it if it is a business loss. Characterizing the loss as a business loss will lead to litigation with the CRA, who will claim it is a capital loss. Further, she will likely never be able to utilize her LPP loss of $100,000 on her jewelry unless she generates sufficient LPP gains in the future against which she can offset the loss.

Similarly, there are various sources of investment income. For example, in 2015, Ontario's top marginal rate on dividends is 33.82 per cent, whereas interest income is taxable at 49.53 per cent. Capital gains are taxable at 24.77 per cent, but some capital gains are completely exempt, whilst others are exempt to a maximum of $813,600. Thus, Canadians must invest, taking into account risk, returns, and the source of their investment income.

Horizontal equity, as measured by the ability to pay, is an important objective of the tax system. Income should be taxable, and losses deductible, regardless of their particular source. The touchstone of income should be realized economic enrichment or loss. The Carter Commission recognized this fundamental principle in its report in 1966, where it recommended that Canada consider a "buck is a buck," and tax it, regardless of its source.

However, nearly 100 years after the enactment of the "temporary" income tax in Canada, we continue to tax income according to its source, and enact restrictive and complex rules to ensure that each source remains in its own silo. To add to the complexity of the source doctrine, Canadian courts exclude some payments, such as windfall gains, as not constituting income from a source at all, even though the payment enhances the taxpayer's wealth. Thus, understandably, taxpayers make every effort to have their receipts classified as something other than income from a source.

In Fries, for example, the Supreme Court held that strike pay is not taxable as income, even if the income replaces the employee's regular wages. The Court did not address the fundamental underlying question: was the strike pay not taxable because it was not "income" in the sense of realized economic enrichment, or because it did not flow from one of the five named "sources"?

Although Canadians may be forgiven for their ignorance of tax law, the CRA is not nearly as forgiving of taxpayer errors. Indeed, the CRA often adds to taxpayer confusion by giving out inconsistent and erroneous tax information on sources of income to Canadians who seek help on their tax lines. The CRA is not bound by its erroneous legal advice, and taxpayers are presumed to know all of the tax law.

vern.krishna@TaxChambers.ca">*vern.krishna@TaxChambers.ca*

Vern Krishna is counsel with TaxChambers LLP in Toronto and professor at the University of Ottawa Law School.