The Source Doctrine is the Sauce for Confusion in Tax Law

By

Vern Krishna, CM, QC

When it comes to taxation, Canadians investors can be forgiven for being overwhelmed by the Byzantine maze of tax rules. The source doctrine in income tax law is one of the rules responsible for the intrinsic structural complexity of the tax statute.

The *Income Tax Act* divides income into five named categories or "sources" of income. The sources are income from office, employment, business, property, and capital gains, each of which is taxed at different rates and according to different rules. The important point is that the sources cannot be comingled with each other. A buck is not a buck for tax purposes. Income from each source is determined separately within its own boundaries, and according to the rules that apply to each of the sources.

The complexity does not stop at the five principal sources of income. There are further sub-sources within some of the sources, again each with its own sub-rule structure. For example, in 2015, Ontario's top marginal rate on dividends is 33.82 %, whereas interest income is taxable at 49.53%. Capital gains are taxable at 24.77%, but some capital gains are completely exempt, whilst others are exempt to a maximum of $750,000. Thus, Canadians must decide where they wish to invest, taking into account risk, net after-tax returns, and a myriad of rules for each of the options.

Within capital gains, there are sub-categories, such as, personal property and listed personal property (LPP) gains. A taxpayer can

offset LPP losses, but only against 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". We see this in the example below.

Assume that an individual earns $60,000 in a particular year. In the same year, he has uninsured losses of $100,000 due to theft of his works of art and jewelry. In economic terms, the individual has a net loss of $40,000 for the year. Nevertheless, he must pay tax on his employment income of $60,000, even though he does not really have any net economic gain for the year. Further, it is quite possible that he may never be able to utilize his LPP loss of $40,000 if he does not generate sufficient LPP gains in the future against which he can offset the loss.

Canada inherited its source doctrine from England, which first introduced the concept in *Addington's Act* (1803) to finance the Napoleonic wars. The scheduler system was supposed to counter tax evasion and ensure taxpayer privacy by placing the responsibility for each of the schedules in the hands of different Commissioners of Taxation. To be sure, the tax 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 to Napoleon.

There is, however, an important difference between the English scheduler system and the Canadian source doctrine. Under the English tax system, a receipt is not taxable as income unless it comes within one of the named schedules, which are mutually exclusive. Thus, the schedules mark the outside boundaries of the tax net.

In Canada, however, the language of income tax statutes is more expansive. Under the *Income Tax Act* (Canada), the named sources of income (office, employment, business, property and capital gains) in section 3 are not exhaustive and income can arise from *any* other unnamed source. Income from *any* source inside or outside Canada is taxable.

This is justifiable on the basis of the statutory language, tax principles, and the history of the source doctrine. To the extent that horizontal equity, as measured by the ability to pay, is an important objective of the tax system, all income should be taxable, regardless of its particular source. The touchstone of income in law is realized economic enrichment, regardless of its source.

However, nearly one hundred years after the enactment of the "temporary" income tax in Canada, the scope of the source doctrine, remains unsettled. Canadian courts have excluded many payments as not constituting income from a source, even though the payment enhanced 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. The Court did not, however, address the fundamental underlying question: was the strike pay not taxable because it was not "income" in the sense of realized enrichment or because it did not flow from a named "source" in section 3?

The Supreme Court, which, at the time, was heavily backlogged with reserved decisions, disposed of the appeal in a terse decision excluding strike pay from income because the Act did not *specifically*

provide for its inclusion in the taxable base. Thus, the Supreme Court bypassed the fundamental issue: should section 3 be read expansively or narrowly.

Although Canadians may be forgiven for their mesmerized ignorance of tax law, the Canada Revenue Agency is not nearly as forgiving of taxpayer errors. Indeed, the CRA often adds to taxpayer confusion by giving out inconsistent and erroneous tax information to Canadians who seek its help on their tax lines.

Vern Krishna, CM, QC, FRSC, University of Ottawa Law School
Of Counsel, TaxChambers LLP (Toronto)
Email: vern.krishna@TaxChambers.ca
www.vernkrishna.com