Detailed Study and Constitutional Validity of Sections 21(1) and 22(1) of the Canadian Income Tax Act*

Purpose

The purpose of ss. 21(1) and 22(1) of the *Income Tax Act* is to prevent income splitting by transferring income-producing property. It should be noted that a transfer under these sections may also be subject to gift tax.

History

These provisions are as old as federal income tax law. Their history may be set out as follows:

(1) The *Income War Tax Act*, Statutes of Canada, 1917, chapter 28, section 4(4), provided that income from property assigned by one spouse to the other or by parents to children would be taxed to the transferor unless the Minister was satisfied that the assignment was not made to evade tax.

(2) The *Income War Tax Act Amendments*, Statutes of Canada, 1926, chapter 10, section 7, repealed section 4(4) and enacted that income from property transferred to a transferor's children was taxable to the transferor unless the transfer was not made to evade tax. But in transfers by one spouse to another, the income was taxable to transferor.

(3) The *Income War Tax Act Amendments*, Statutes of Canada, 1934, chapter 55, within section 16(a), repealed section 4(4) and made income from property transferred to minors under 18 taxable to the transferor. Such income was taxable after a minor reached 18 if the Minister thought tax evasion motivated the transfer.

The provision kept this form until 1948 when it was altered to its present structure.

It should be noted that these sections were directly tied in with tax evasion. Why the shift was made to the present form is not explained in the House of Commons Debates. It can probably be traced to the desire in 1948 to remove most traces of ministerial discretion from the *Act*.

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* Extract from *Studies of the Royal Commission on Taxation*, number 10, "Taxation of the Family", pp. 7-19, reproduced with permission of the Queen's Printer, Ottawa.

Definitional Problems

These provisions refer to transfers of property by a person to his spouse, or to a minor, and deems the income from such property to be taxable to the transferor. The sections contain no definition of the word "transfers". However, there is case law on the problem.

The guide-lines for the definition of transfer are set out in *The Executors of the Estate of David Fasken* v. *M.N.R.*,[1] where it is stated by Mr. Justice Thorson:

> The word "transfer" is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property as te divest himself of it and vest it in his wife, that is to say, pass the property from himself to her. The means by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer.[2]

In this case a company owed Fasken approximately $1,860,757. The company acknowledged this indebtedness to certain trustees under a trust created by Fasken for his wife and covenanted to pay the sum with interest. It was held that the interest paid by the company to the trustees was income from property transferred to Mrs. Fasken and, therefore, taxable to Fasken. It was contended that the property was transferred with the right to income under the trust and it was from this right that income was derived. The Court disregarded the novation and treated the transaction as a transfer in trust for the wife of Fasken.

It has been suggested that the word "transfer" would not include a sale for adequate consideration. This argument has been rejected by the Tax Appeal Board where it was held that a transfer "embraces any passing of ownership".[3] It should be pointed out that in this case the Board held the transaction to be a "sale in name only".[4] Thus, it may still be open to a taxpayer to argue that a sale is not a transfer within the meaning of the *Act*. This argument receives support from *St. Aubyn* v. *Attorney-General*[5] where it was held that payment in cash of the subscription price of shares was not a "transfer of property".

Notwithstanding the wide definition given in the *Fasken* case to the word "transfer", it has been held that a loan is not a transfer.[6]

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[1] [1948] Ex. C.R. 580; 49 D.T.C. 491.
[2] [1948] Ex. C.R., at p. 592; 49 D.T.C., at p. 497.
[3] *Campbell* v. *M.N.R.*, 63 D.T.C. 493, at p. 495.
[4] *Ibid.*, at p. 494.
[5] [1952] A.C. 15.
[6] *Dunkelman* v. *M.N.R.*, [1960] Ex. C.R. 73; 59 D.T.C. 1242.

This decision of the Exchequer Court is interesting because it is directly contrary to the decision of the Tax Appeal Board in an appeal by the same taxpayer a few years earlier.[7] In this case Board Member Fabio Monet, Q.C., said that the word transfer "is to be interpreted as a word of global meaning including every form of conveyance of property".[8]

The Department is satisfied with the view that a loan is not a transfer. However, this interpretation does open up a very large loophole.

An interesting problem arises in connection with transfers to a husband to allow him to use the property for security. In *Brayley* v. *M.N.R.*,[9] it was held that a wife was liable for tax on the income from a boarding house transferred by her to her husband and used by him as security to finance a business operation. This decision was made even though the husband had retransferred the property to the wife. In this case it could be argued that the wife merely *lent* the property to the husband. It should be noted that this decision came down before the last *Dunkelman* case and might be decided differently today.

A variation on this theme may occur if property is transferred by a husband to his wife to secure a loan from her to him. Is this a "transfer" within the meaning of section 21(1)? The implications of the second *Dunkelman* case are that it would not be.

One other problem connected with section 21(1) concerns the words "to his spouse". Would a transfer of property by A to a corporation controlled by A's wife be a transfer to A's spouse? Although section 21(1) refers to transfers, directly or indirectly, by means of a trust or by any other means whatsoever, it is submitted that a transfer to a corporation controlled by the spouse is not a transfer to the spouse. In *Potts' Executors* v. *C.I.R.*,[10] the House of Lords held, in connection with a provision of the English *Income Tax Act*,[11] that a payment by a trustee to the creditor of A at the direction of A was not a payment to A. Section 40(1) of the *Finance Act*,[12] 1938, provided in part that "any capital sum paid, directly or indirectly, by trustees of a settlement to the settlor is to be treated as income of the settlor to the extent of the available income arising

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[7] *Dunkelman* v. *M.N.R.*, 51 D.T.C. 107.
[8] *Ibid.*, at p. 109.
[9] 51 D.T.C. 4.
[10] [1951] 1 All E.R. 76.
[11] See *infra*, n. 12 as *Income Tax Act* is part of the *Finance Act*.
[12] 1938, 1 & 2 George 6, c. 46.

under the settlement". This section resembles quite closely the wording of section 21(1) so that the decision on it might apply in Canada.

Lord Simonds made an interesting comment on the words "directly and indirectly" when he stated:

> I do not think it matters whether the words 'directly or indirectly' qualify the payment or the receipt. I will assume they qualify both or either.[13]

And he went on to say:

> So far, my Lords, I have not specifically dealt with the word 'indirectly'. It is sufficient to say that it cannot so enlarge the meaning of the words 'paid to the settlor' as to include payment to some other person than the settlor for his own use and benefit. I do not feel called on to determine positively what transactions it might be apt to cover. It may be that it is not apt to cover any that are not already covered by the normal meaning of the words 'paid to the settlor'.[14]

One last comment on the terms of the section refers to the words "or by any other means whatsoever". It has been held that these words do not enlarge the meaning of the word "transfer" but refer only to the means or procedure by which transfers may be accomplished.[15]

Suggested Revision

Both sections 21(1) and 22(1) should be revised by changing the words "to his spouse" or "to a minor" to "to, or for the benefit of his spouse" or "of a minor". This would avoid the *Potts Executors* case problem.

General Criticisms

Both sections apply even though the transfer was made while the transferor was not resident in Canada, if he subsequently becomes resident. Thus, persons coming to Canada may inherit tax liability never contemplated while living outside the country. Possibly the Department would not enforce the section in this manner but it is certainly open to it to do so. On the other hand, if the Department does not enforce the provision strictly, people may avoid the section by giving up Canadian residence for a time, making their transfer, then returning to Canada.

One significant point is that section 22(1) is unlimited in its application. It is not limited to transfers made by a father to a

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[13] [1951] 1 All E.R. 76, at p. 80.

[14] *Ibid.*, at p. 81.

[15] *Dunkelman* v. *M.N.R.*, [1960] Ex. C.R. 73, at p. 82; 59 D.T.C. 1242, at p. 1246.

son but encompasses all transfers of property by any person to a minor under 19 years of age.

Why section 22(1) is so broad is hard to determine. A clause of this nature is surely designed to prevent income splitting in a family unit. If someone outside the family unit wishes to exercise his benevolence, our tax law surely misses the mark in penalizing him. It is suggested that section 22(1) should be limited to transfers between parent and child.

Another problem which applies to both sections 21(1) and 22(1) concerns their constitutional validity. This question will be discussed with reference to section 21(1) but the arguments apply equally to section 22(1).

Constitutional Validity of Section 21(1)

Under the *British North America Act* [16] the provinces are granted jurisdiction to regulate "Property and Civil Rights in the Province".[17] Parliament is given the power, *inter alia*, to "The raising of Money by any Mode or System of Taxation".[18] In the exercise of this power Parliament has enacted the *Income Tax Act*. But clearly, the power to enact tax laws does not give the power to legislate respecting property and civil rights in the provinces. Any tax levied by the Parliament of Canada must be for "The Raising of Money" and cannot legally purport to affect, directly, the property rights of individuals between themselves. It is our contention that section 21(1) contains these basic rules and is therefore *ultra vires*.

The section states in part:

> Where a person has ... transferred property ... to his spouse ... the income for a taxation year from the property ... shall, during the lifetime of the transferor while he is resident in Canada and the transferee is his spouse, be deemed to be income of the transferor and not of the transferee.

If this section is literally interpreted then its effect is to divest one spouse of the ownership of income from property (which is itself property) and invest the other spouse with that ownership. It states clearly that the income from the property *shall be deemed to be income of the transferor and not of the transferee.* Admittedly the ownership is limited in duration "to the lifetime of the transferor while he is resident in Canada and the transferee is his spouse". But this does not change the fact that ownership has been shifted.

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[16] 30 & 31 Vict., 1867, c. 3.
[17] *Ibid.*, s. 92(13).
[18] *Ibid.*, s. 91(3).

Force is added to the argument by *De Romero* v. *Read.*[19] This is an Australian decision which held section 83 of the *Income Tax (Management) Act,* 1928, (N.S.W.), voided transactions for all purposes. The section stated that:

> Every contract, agreement or arrangement made or entered into, in writing or verbally, whether before or after the commencement of this Act, shall, so far as it has or purports to have the purpose or effect of in any way, directly or indirectly — (a) altering the incidence of any income tax; or (b) relieving any person from liability to pay any income tax or make any return; or (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or (d) preventing the operation of this Act in any respect, be absolutely void, but without prejudice to its validity in any other respect or for any other purposes.

In this case the court declared void a covenant in a deed of separation made by the deceased before his death under which he covenanted to pay £10,000 to his wife during her lifetime. The deed has the effect of altering the incidence of tax because the covenantor has also covenanted to pay taxes legally exigible from the covenantee or to reimburse the covenantee for taxes payable by her. This covenant was held absolutely void not only as against the tax authorities but also as between the parties.[20]

The degree of pertinency of the *De Romero* decision to our problem becomes crystal clear when we consider the contrary arguments supporting section 21(1) as *intra vires.*

It may be said that section 21(1) was enacted to prevent tax avoidance. Keeping this purpose in mind, we may then argue that the section must be limited in application to the *Income Tax Act,* or, that implied in the section are the words "for the purposes of this Act". But this is the same argument advanced by the plaintiff in the *De Romero* case which failed to carry the Australian High Court.

Adding to the burden of the contrary argument are two rules of statutory construction. On the one hand is the plain meaning rule admonishing the interpreter to read the words of the statute and if they are clear and unambiguous, to apply them. There is, under this rule, no reason to ask "what is the 'purpose' of this provision." The statutory rule of construction is that:

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[19] (1932-33), 48 C.L.R. 649.

[20] Section 260 of the *Income Tax and Social Services Contribution Assessment Act, 1936-1950,* (CA), Australia 1901-1950 Vol. III, p. 2038, contains the words "as against the Commissioner" in order to avoid the effect of the *De Romero* decision.

> Where by the use of clear and unequivocal language capable of only one meaning, anything is enacted by the legislature, it must be enforced even though it be absurd and mischievous.[21]

It is submitted that this rule of construction applies to section 21(1). The section is clear and unambiguous. On the other hand, is the rule of strict construction related to taxing statutes ? This rule says that to enact a tax or to gain a deduction the words of the *Act* must be clear and certain. Nothing will be implied.

In *Cape Brandy Syndicate* v. *I.R.C.*,[22] Rowlatt, J., stated the rule as follows:

> (I)n a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[23]

Many Canadian decisions have reiterated and followed this rule. Although the argument declaring section 21(1) *ultra vires* is not concerned with whether it levies a tax or grants a deduction, it is concerned with whether anything may be implied in the section. For this reason the rule of strict construction applies.

Now it may be contended with strength that the words of section 21(1) are clear and unambiguous, but in favour of holding the provision *intra vires*. The words "shall ... be deemed to be the income of the transferor and not of the transferee" are used in the section. If the word "deemed" is construed as a "rebuttable presumption" then clearly a spouse could introduce evidence showing he or she, in fact and law, owned the property. The word "deemed" has been interpreted to mean a "rebuttable presumption" but it has also been construed as an "irrebuttable presumption". This latter meaning is now accepted in tax cases.[24]

In addition, it seems clear that section 21(1) did not intend to establish a "rebuttable presumption"; otherwise, it would be open

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[21] *Maxwell on Interpretation of Statutes*, 11th ed., p. 4.

[22] [1921] 1 K.B. 64.

[23] *Ibid.*, at p. 71.

[24] See the following cases: *No. 25* v. *M.N.R.*, 51 D.T.C. 331 in which Mr. Fordham, Q.C., held "deemed" to mean "conclusively considered". (Fabio Monet concurring). Mr. Fisher, Q.C. dissented, holding that "deemed" in section 127(5)(c) (arm's length between brothers) was a rebuttable presumption; *Western Printers Association Ltd.* v. *M.N.R.*, 51 D.T.C. 345. Members Fordham and Monet again interpreted "deemed" as an irrebuttable presumption while Mr. Fisher stuck to his original view. In *Benedet* v. *M.N.R.*, 54 D.T.C. 51, Mr. Fisher stated, at page 52, that: "The majority of this Board has held, in previous judgments that the word "deemed" as used in this Act is to be interpreted as 'conclusively considered'". This phrase demonstrates his final conversion to the majority view.

for a spouse to rebut the presumption and defeat the purpose of the section.

This entire argument revolves around the interpretation of the word "deemed". It has been suggested that where the word "deemed" is used you are entitled to look to the purpose of it. In *Ex parte Walton*[25] it was stated by James, L.J.:

> When a statute enacts that something shall be deemed to have been done, which in fact and truth was not done, the Court is entitled and bound to ascertain for what purposes and between what persons the statutory fiction is to be resorted to.[26]

These words are in favour of implying into section 21(1) the phrase, "for the purpose of this Act".

The problem of section 21(1) has been discussed in the context of English tax law. The *Income Tax Act*[27] provides:

> A married woman ... entitled to any property or profits to her separate use, shall be assessable and chargeable to tax as if she were sole and unmarried: provided that — (1) the profits of a married woman living with her husband shall be deemed the profits of her husband, and shall be assessed and charged in his name, and not in her name or the name of her trustee;

In *Walker* v. *Howard*[28] the words "shall be deemed to be the profits of her husband" in the proviso to Rule 16 were given a literal construction. Rowlatt, J., said:

> I have come to the conclusion that I have not any right to limit the words of this Rule so as to make Rule 2 of Case III have any special effect. There it is. Her profits are to be deemed his profits and there is nothing to limit that in any way and I do not think I can do it. If he and she had profits in the same year they would be simply assessed together. They happen to have acquired them at different times and this problem arises, but I think I must take no notice of that and just give effect to what the words say.[29]

Although these words were uttered in a tax decision on a pure tax question, nothing in the language indicates that they are to be restricted to tax cases. However, in *Leitch* v. *Emmott*[30] the Court of Appeal disapproved of this broad interpretation by Mr. Justice Rowlatt and suggested a much narrower construction. Lord Hanworth, M.R., said:

> It appears to me that the rule is intended to convey the same meaning as in s. 45 of the Act of 1842 and definitely to impose a charge upon the married woman in respect of her profits, although collection is to be made from the

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[25] (1880-81), 17 Ch. D. 746.
[26] *Ibid.*, at p. 756.
[27] 1918, 8-9 George 5, Sch. D., Case III, r. 16, p. 309.
[28] (1927-28), 13 T.C. 313.
[29] *Ibid.*, at pp. 317-318.
[30] [1929] 2 K.B. 236.

> husband and the profits of the wife are in that sense and for that purpose to be deemed the profits of the husband.[31]

and Lawrence, L.J., said:

> This provision does not, in my judgment, operate to convert the income of the wife into income of the husband further than is necessary for the purpose of collecting the tax;[32]

On a superficial view of these statements one could easily conclude that they dismiss the argument for holding section 21(1) *ultra vires;* yet there are significant differences in the wording of section 21(1) and that of the English section being interpreted in *Leitch* v. *Emmott.* This difference is disclosed clearly by Sanky, L.J., in *Leitch* v. *Emmott,* when he says:

> Founding myself upon those words, I turn to the proviso to r. 16, and it is to be observed that in the proviso what is being dealt with are *"the profits of a married woman living with her husband"*. It starts with that assumption and then says that in that case — namely, *when the profits are the profits of a married woman living with her husband,* they shall be deemed to be the profits of the husband and shall be assessed and charged in his name: *but they still remain the profits of the married woman* living with her husband, *because that is the subject with which the proviso is dealing.*[33] (Emphasis added.)

Clearly section 21(1) is much different. There is no assumption that the income from property is the transferee's. It is not based or premised on that situation. All it purports to do is deal with income from property transferred and in so doing declares that the income "shall be deemed to be income of the transferor, and not of the transferee". In other words, section 21(1) never allows the *income* to vest in the transferee. It vests that income in the transferor and for this reason interferes with ownership of property, thereby conflicting with the *exclusive* jurisdiction of the provinces over "property and civil rights".

Moreover, the words "and shall be assessed and charged in his name", found in the proviso to Rule 16 of the English Statute make it easy to read into the section a purpose, namely, to collect tax from the husband. No similar words are found in section 21(1) and if a purpose is to be implied "for a taxation year" in section 21(1) it is not *tax collection* but tax avoidance.

Another argument supporting the proposition that section 21(1) does affect the ownership of income from property transferred to a spouse is found in a reading of section 2(1) of the *Act.* This is the charging provision of the *Act* and it states:

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[31] *Ibid.,* at p. 243.
[32] *Ibid.,* at p. 247.
[33] *Ibid.,* at p. 248.

> An income tax shall be paid as hereinafter required upon the taxable income for each taxation year *of every person* resident in Canada at any time in the year. (Emphasis added.)

The possessory "of" found in the charging section makes it clear that section 21(1) used the words "income of the transferor" deliberately. By so doing the transferor fits squarely within the charge. If section 21(1) were intended merely as a collection rule it could easily have said tax on the income of the transferee shall be paid by the transferor as if that income were included in computing his income. This was the effect of the predecessor to section 21(1) found in section 32(2) of the *Income War Tax Act*[34] which stated:

> Where a husband transfers property to his wife, or vice versa, the husband or the wife, as the case may be, shall nevertheless be liable to be taxed on the income derived from such property or from property substituted therefor as if such transfer had not been made.

One last argument opposed to this contention is the interpretation rule that courts will lean in favour of constitutionality. In *Severn* v. *The Queen*,[35] Mr. Justice Strong stated the rule:

> It is, I consider, our duty to make every possible presumption in favour of such Legislative Acts, and to endeavour to discover a construction of the British North America Act which will enable us to attribute an impeached Statute to a due exercise of constitutional authority, before taking upon ourselves to declare that, in assuming to pass it, the Provincial Legislature usurped powers which did not legally belong to it;[36]

And in *Hewson* v. *Ontario Power Co. of Niagara Falls*,[37] Taschereau, J., said after stating that the appellant had tried to impeach the *Act* as *ultra vires:*

> Now, upon him was the burden of establishing the soundness of that contention; the presumption in law always is that the Dominion Parliament does not exceed its powers.[38]

In other words, if two interpretations are open — one favouring constitutional validity and one opposed — the Court will choose the former and reject the latter. Although this rule makes the argument in favour of *ultra vires* a little more difficult to accept, it would not constitute a permanent block.

The two following examples will serve to illustrate how this whole problem could arise:

1. *Tax Case:* A, the husband, is assessed for tax on income from property transferred to W, his wife. W receives the income

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[34] 1927, R.S.C., c. 97.
[35] (1879), 2 S.C.R. 70.
[36] *Ibid.*, at p. 103.
[37] (1905), 36 S.C.R. 596.
[38] *Ibid.*, at p. 603.

and treats it in all respects as her own. A objects to the assessment on the ground that his wife's income is not his income and that section 21(1) is *ultra vires.*

2. *Non-Tax Case:* A husband transfers property to his wife as a gift. Over a period of years the wife receives the income from the property and accumulates it in a separate bank account. The wife has an auto accident and is found liable. In an action by the judgment creditor attempting to seize the bank account, the husband is joined and he defends on the grounds that section 21(1) transfers ownership of the account to him and, therefore, his wife's debts may not be satisfied out of it. The judgment creditor says that if the section has that effect it is *ultra vires.*

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